Market Strategy
by STRATEGAS A BAIRD COMPANY

BAIRD
Private Wealth Management

Market Strategy Weekly

December 2, 2022

Strategas President and Head of Portfolio Strategy Nicholas Bohnsack breaks down the market heading into year-end. He shares a very useful framework for evaluating how to think about the stock market, and examines a few key items on that list.

Nicholas Bohnsack, Strategas
President, Head of Portfolio Strategy

Ross Mayfield, Baird
Investment Strategy Analyst

SKEPTICAL OF RALLIES | INFLATION AND THE FED | EARNINGS EXPECTATIONS TOO HIGH

ROSS MAYFIELD: As we find ourselves in the midst of another rally, how are you evaluating the state of the market today?

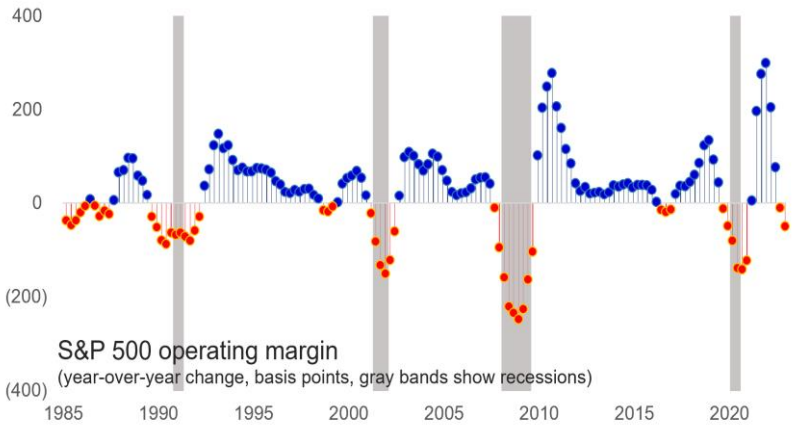
NICHOLAS BOHNSACK: To begin, we've been suspicious about the durability of "countertrend" rallies in this market. **This summer's rally ultimately proved to be a head fake, and even in light of some bullish economic data, we remain skeptical of the current move.** We default back to a three-part framework that has been very helpful for us in understanding the strength underpinning this market: 1) Where are we on inflation? Has the rate of inflation started to roll over and how quickly might it get to a place where the Fed feels comfortable getting less aggressive? 2) Do valuations accurately reflect expectations for corporate earnings, revenues, and profitability? We haven't really seen a big pullback in expectations for profits despite the fact that most economists believe we'll be in a recession next year. 3) What are the organic drivers of growth that would call private capital to be invested in the economy, whether it's free cash flow from businesses or capital from private investors?

ROSS: Could you expand on where you think we are now with regards to the first two pieces of that framework?

NICHOLAS: On inflation, I think there's a case that the rate of change has peaked (from 9%+ in June). But even when prices are increasing, say, 6%, that comes at a real expense to consumers and businesses. So, the Fed will want that much lower. At this point, it seems fair to say the Fed would view the bigger policy mistake as pausing too early and allowing inflation to come roaring back rather than causing a recession. This was the error of the "stop-and-go" policy of the 1970s, when inflation took a decade to beat. Then the subsequent question should be "what is that level at which the Fed would be willing to declare victory?" Is it their 2% stated target, or is it somewhere a bit higher? **One of the things we're concerned about is that even if inflation heads lower from here, the cost of getting from, say, a 4% rate of inflation to 2% becomes increasingly high.** It would likely come with some significant shakeout amongst businesses and the labor market. Ultimately, we think they'll slow the pace at which they're raising rates and then take a long time to observe the landscape and the impact that may have.

On earnings, there seems to be some conflict between the idea that we'll be in a recession next year and the consensus expectation that earnings will grow. Now, there's something to be said for the idea that inflation creates this money illusion, where the level of sales and profits remain elevated simply because prices are higher, especially relative to what might be considered a normal-sized drop in earnings associated with recession. When you incorporate that, it looks like the economy's not being damaged as much. So, what we're very focused on is corporate profit margins and the level of profitability. And there we have started to see some real acute pain across the landscape. **We'd anticipate that earnings estimates keep moving lower as corporate guidance softens and costs continue to increase.**

Significant drops in profit margins often occur around recessions.



IMPORTANT DISCLOSURES

Past performance is not indicative of future results and diversification does not ensure a profit or protect against loss. All investments carry some level of risk, including loss of principal. An investment cannot be made directly in an index.

This communication was prepared by Strategas Securities, LLC ("we" or "us"). Recipients of this communication may not distribute it to others without our express prior consent. This communication is provided for informational purposes only and is not an offer, recommendation or solicitation to buy or sell any security. This communication does not constitute, nor should it be regarded as, investment research or a research report or securities recommendation and it does not provide information reasonably sufficient upon which to base an investment decision. This is not a complete analysis of every material fact regarding any company, industry or security. Additional analysis would be required to make an investment decision. This communication is not based on the investment objectives, strategies, goals, financial circumstances, needs or risk tolerance of any particular client and is not presented as suitable to any other particular client; therefore, this communication should be treated as impersonal investment advice. The intended recipients of this communication are presumed to be capable of conducting their own analysis, risk evaluation, and decision-making regarding their investments.

For investors subject to MiFID II (European Directive 2014/65/EU and related Delegated Directives): We classify the intended recipients of this communication as "professional clients" or "eligible counterparties" with the meaning of MiFID II and the rules of the UK Financial Conduct Authority. The contents of this report are not provided on an independent basis and are not "investment advice" or "personal recommendations" within the meaning of MiFID II and the rules of the UK Financial Conduct Authority.

The information in this communication has been obtained from sources we consider to be reliable, but we cannot guarantee its accuracy. The information is current only as of the date of this communication and we do not undertake to update or revise such information following such date. To the extent that any securities or their issuers are included in this communication, we do not undertake to provide any information about such securities or their issuers in the future. We do not follow, cover or provide any fundamental or technical analyses, investment ratings, price targets, financial models or other guidance on any particular securities or companies. Further, to the extent that any securities or their issuers are included in this communication, each person responsible for the content included in this communication certifies that any views expressed with respect to such securities or their issuers accurately reflect his or her personal views about the same and that no part of his or her compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in this communication. This communication is provided on a "where is, as is" basis, and we expressly disclaim any liability for any losses or other consequences of any person's use of or reliance on the information contained in this communication.

Strategas Securities, LLC is a registered broker-dealer and FINRA member firm, as well as an SEC-registered investment adviser. It is affiliated with Strategas Asset Management, LLC, an SEC-registered investment adviser. Strategas Securities, LLC is also affiliated with and wholly owned by Robert W. Baird & Co. Incorporated ("Baird"), a broker-dealer and FINRA member firm, although the two firms conduct separate and distinct businesses.

A complete listing of all applicable disclosures pertaining to Baird with respect to any individual companies mentioned in this communication can be accessed at http://www.rwbaird.com/research-insights/research/coverage/thirdpartyresearch-disclosures.aspx.

You can also call 1-800-792-2473 or write: Robert W. Baird & Co., PWM Research & Analytics, 777 E. Wisconsin Avenue, Milwaukee, WI 53202.