Baird Market & Investment Strategy

Investment Strategy Outlook

February 21, 2020

BAIRD

Please refer to Appendix – Important Disclosures.

Evidence Bullish Despite Volatility & Uncertainty

Highlights:

- **Fed Trying to Stay on the Sidelines**
- **Economic Confidence Supporting Growth**
- **Valuations Pricing in Earnings Rebound**
- **Equity Fund Flows Confirm Excessive Optimism**
- **Stocks Could Follow Path of Incumbent Victory**
- **Rally Garnering Broad Participation**

Outlook Summary

Weight of the Evidence remains bullish

Excessive optimism and widespread complacency turns sentiment bearish

Seasonal patterns bullish with economic confidence consistent with incumbent re-election

Declining bond yields fueling strength in Gold

While the mid-January news of the coronavirus in China briefly derailed early year stock market gains, 2020 has been marked by more strength than weakness for both stocks and bonds. Stocks around the world have moved to new highs and bond yields have moved lower. While the exact economic impact of the coronavirus remains to be determined, historical experience suggests it may be limited. Stocks have looked past this uncertainty, with gains being fueled by favorable Fed policy and broad rally participation. Economic conditions appear poised for improvement though valuations have already priced in a better earnings backdrop.

Widespread optimism in the stock market is being echoed when it comes to the economy. While market optimism can be a headwind for stocks, economic confidence can be a tailwind for growth. Moreover, in this election year satisfaction with the direction of the US economy can be a tailwind for the stock market as it increases the likelihood that the incumbent will be returned to office. While the weight of the evidence remains bullish and the cyclical rally that emerged over the course of 2019 remains intact, the volatility seen already in 2020 is not likely to meaningfully ebb as the year progresses.

Indicator Review

Macro Factors (What Could Happen)		
• Federal Reserve Policy	Bullish	+1
• Economic Fundamentals	Neutral	0
• Valuations	Bearish	-1
Market Factors (What Is Happening)		
• Investor Sentiment	Bearish	-1
• Seasonal Patterns/Trends	Bullish	+1
• Tape (Breadth)	Bullish	+1
Weight of the Evidence =	Bullish	+1

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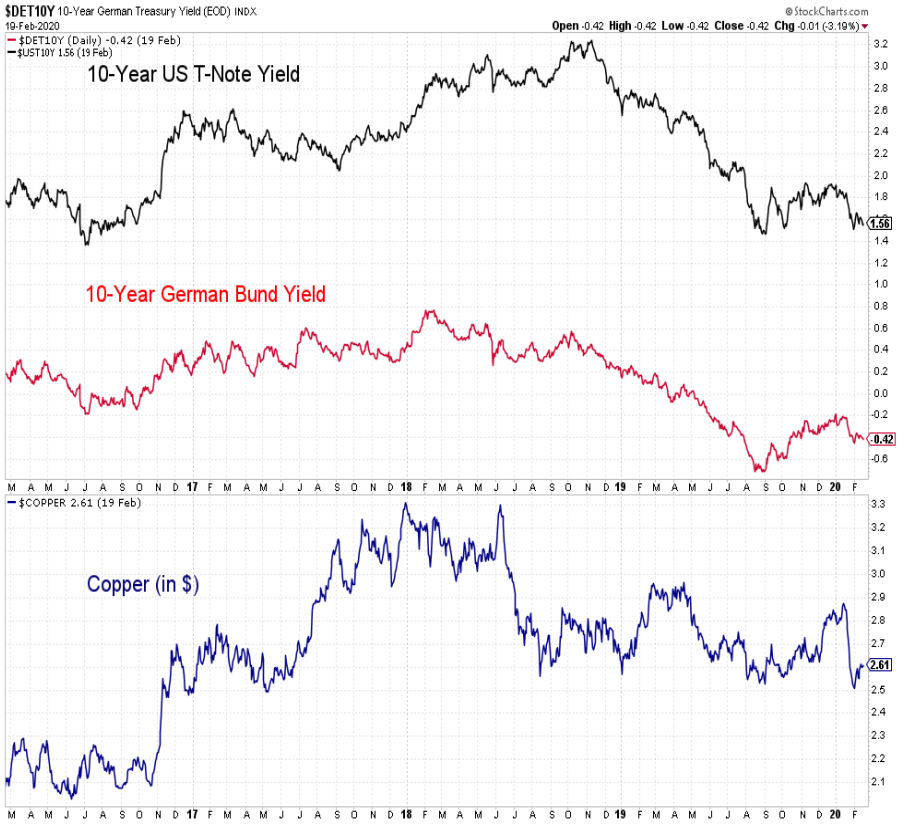
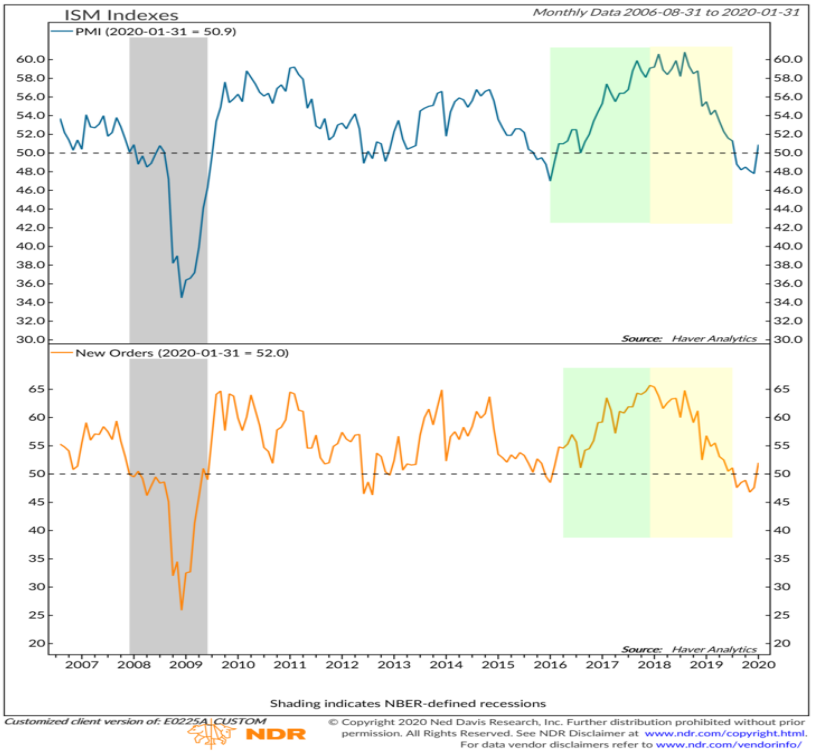
Federal Reserve policy is bullish. After cutting rates three times in 2019, the Fed has signaled a desire to move to the sidelines in 2020. Whether they are able to remains to be seen. Declining bond yields and weakness in copper prices may be pointing to concern about the global economy, especially given that bond yields began dropping prior to news about the coronavirus outbreak in China. Fed funds futures are currently pricing in a better than 80% chance of at least one additional rate cut this year. The Fed has made clear that the threshold for raising rates is high and while they might prefer not to cut rates any further, 2019 demonstrated their willingness to respond to data rather than stick with their preferences. We do have some concern that at some point additional easing from the Fed will be seen as reflecting weakness rather than taking out insurance.



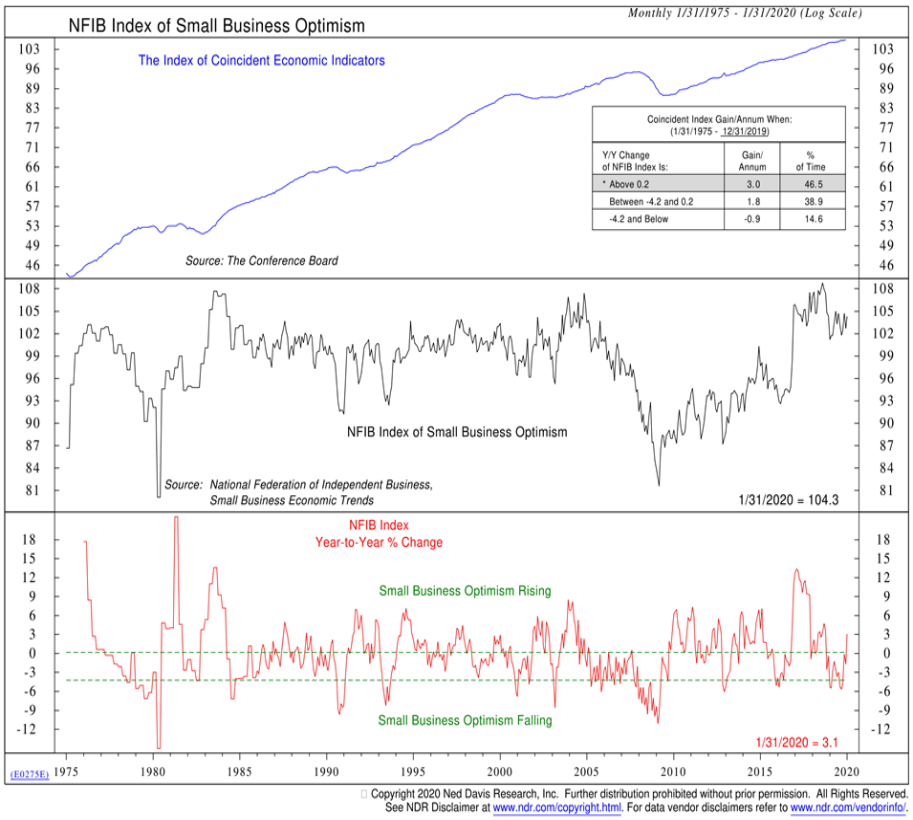
Source: StockCharts



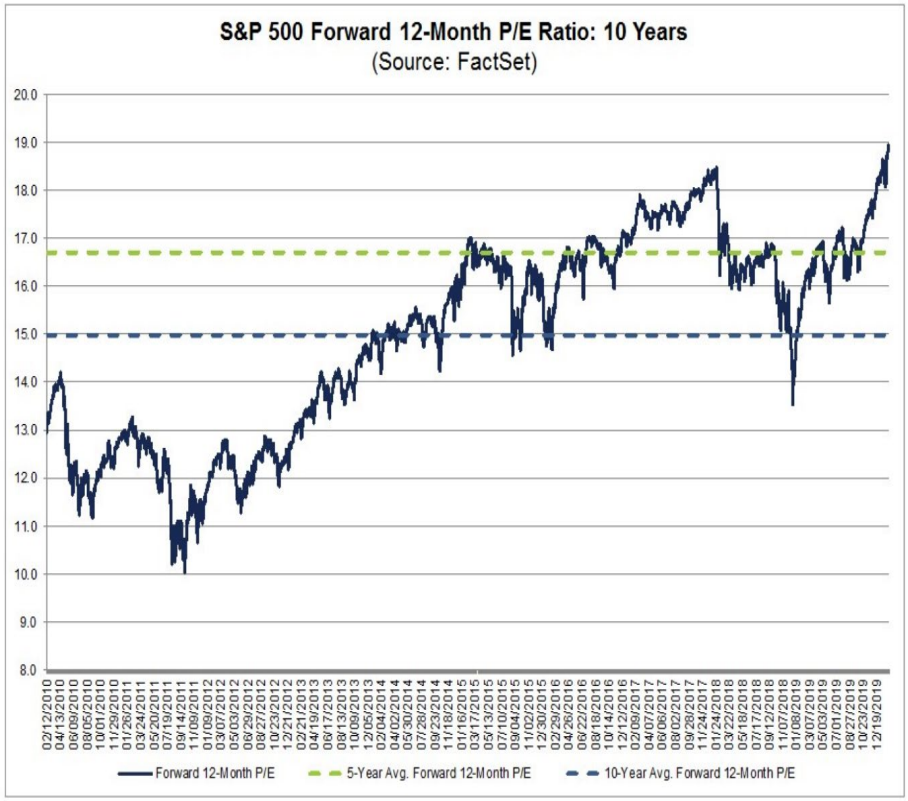
Source: Ned Davis Research

Economic Fundamentals are neutral. While bond and commodity markets may be expressing some caution, incoming data has been more positive. ISM manufacturing data has turned positive in January after deteriorating for the better part of two years. Strength continued in February, with the Philadelphia Fed current conditions index showing unexpected strength and jumping to its second highest since 1993. Building permits, which are an important leading indicator of economic activity have climbed to their highest level since 2007. Overall the only time in the past six years that US economic data has provided more of an upside surprise than is currently being seen was late 2017.

We are watching for economic resiliency in the face of uncertainty surrounding the effects of the virus outbreak in China. If that becomes evident, then we could be in a position to upgrade our view on the economy. At this point, the potential fallout remains unknown. While history suggests little meaningful economic impact from such events, China's influence on the global economy has never been larger. At the time of the SARS outbreak in 2003, China represented 4% of global GDP - now it is between 15% and 20%. Two positive factors that could limit the impact in the current situation: China is injecting liquidity into its economy, and economic confidence (e.g., NFIB Small Business Optimism) in the US suggests animal spirits are returning and their persistence could fuel economic gains.



Source: Ned Davis Research

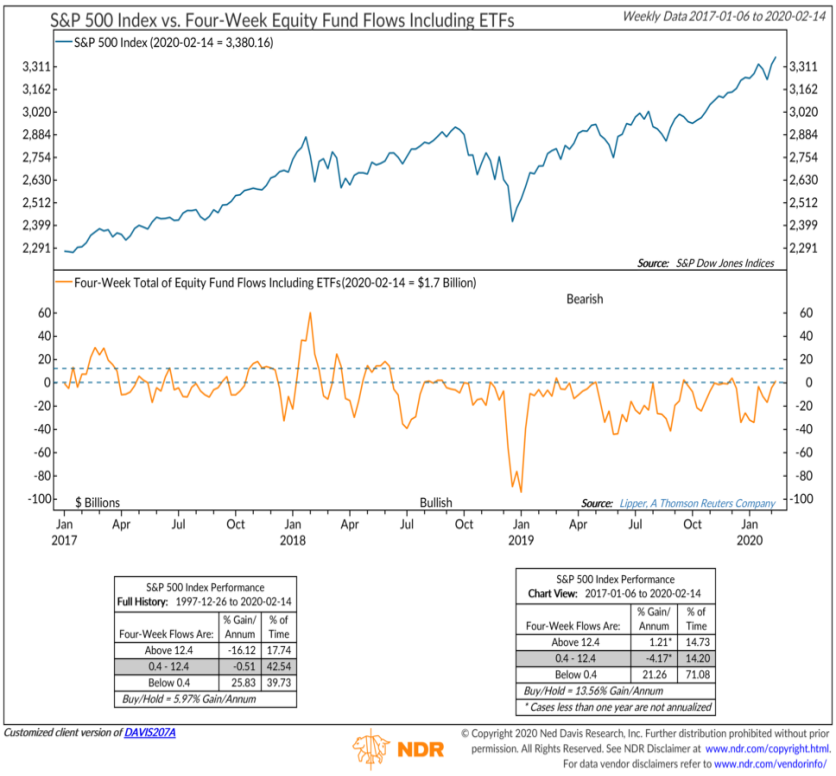


Source: FactSet

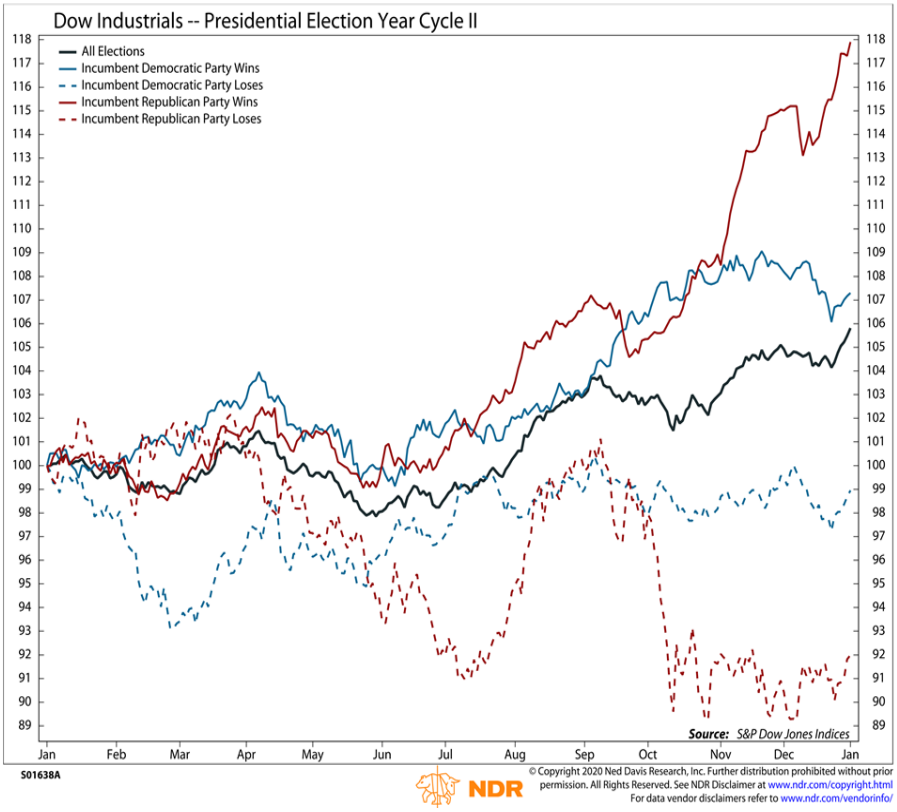
Valuations remain bearish. History suggests that a sanguine view on valuations right here might be a foolhardy strategy. Elevated valuations have tended to be followed by sub-par returns and according to FactSet the forward P/E on the S&P 500 is at its highest level in over a decade.

Q4 2019 earnings results have a veneer of success, but this is more due to reduced expectations over the course of the quarter than meaningful earnings gains. Three-quarters of the way through earnings season, earnings for the S&P 500 are expected to have risen 0.9% in the quarter. This is better than the 1.7% decline expected as the quarter ended, but shy of the 2.5% growth expected as the quarter began. Both the breadth and intensity of earnings beats in the quarter were shy of their 5-year averages. Earnings are expected to re-accelerate in 2020, but those estimates are already facing downward pressure.

Investor sentiment has turned bearish. Initial news of the coronavirus outbreak took the edge off of the optimism that emerged in late 2019, but also knocked out the upside momentum that had helped offset the negative implications of that optimism. As stocks have returned to new highs, optimism has returned but momentum has been slower to re-emerge. Various sentiment surveys show elevated or excessive optimism, including our favorite composites from Ned Davis Research: the Daily Trading Sentiment Composite and the Crowd Sentiment Poll. In addition, equity funds are seeing inflows. Over the past three years and 20+ years, all of the net gains in the S&P 500 have come when equity funds have seen outflows on a four-week basis.



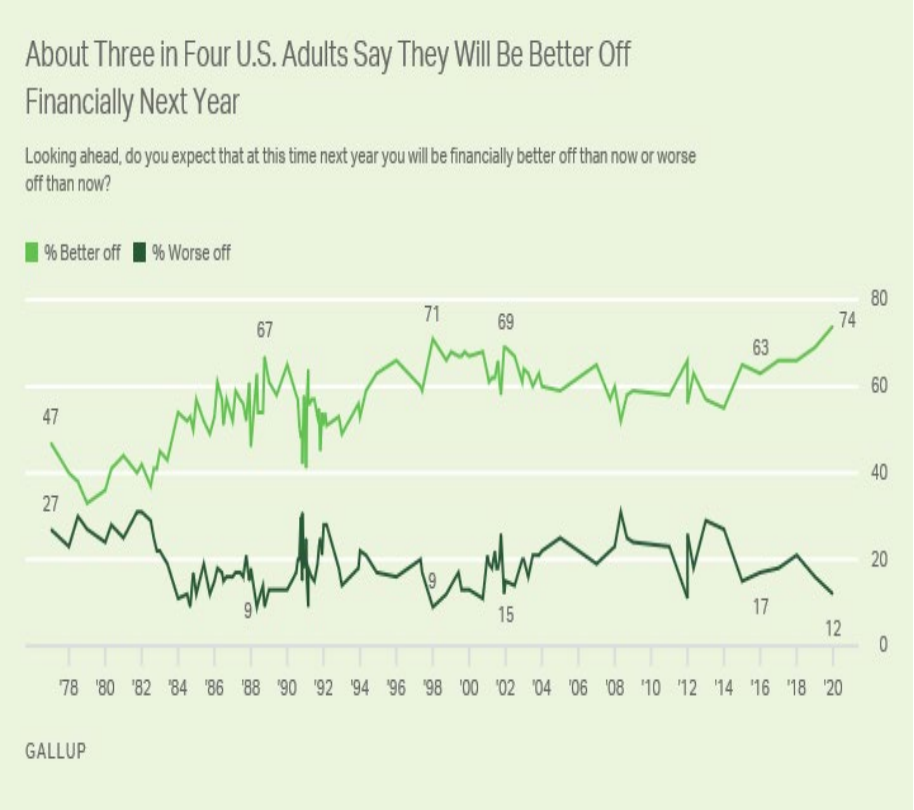
Source: Ned Davis Research



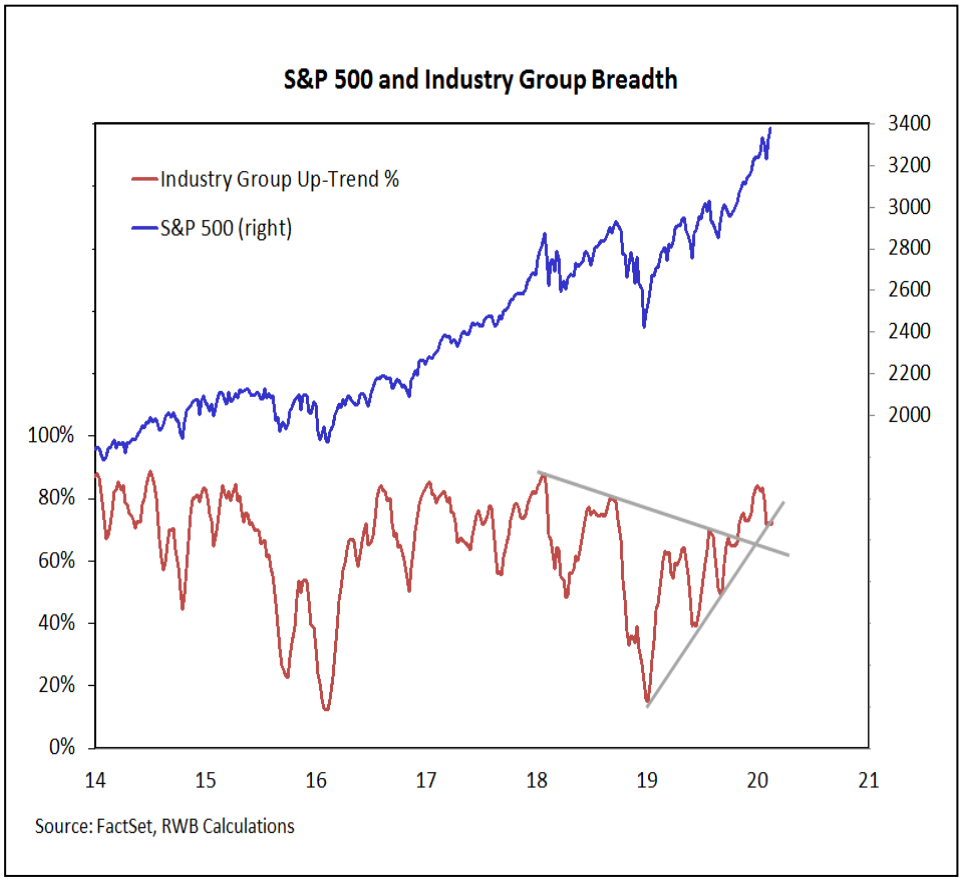
Source: Ned Davis Research

Offsetting the view that sentiment has become a headwind for stocks is evidence that seasonal patterns can be seen as a tailwind for stocks. The overall pattern in presidential election years is one of middling performance in the first half followed by strength in the second half. That average, however, aggregates distinct and divergent paths (which come down to whether the incumbent party wins or loses). For 2020, the relevant paths are whether the incumbent Republican party wins or losses. While a lot of election-related commentary is focused on the market reactions to the election outcome, the more appropriate focus may be on the stock market's tendency to anticipate election outcomes. This should not be seen as an expression of preference for one candidate or party over another, but a reflection that stock market weakness tends to reflect economic challenges and it is in those periods when incumbents tend to lose.

Recent polling data from Gallup suggest voters are feeling financially secure, and in such environments incumbents tend to get re-elected. Six in 10 Americans feel better off financially now than a year ago (the most since 1999) and nearly three-quarters expect to be better off a year from now (a 40-year high). President Trump's approval rating has been climbing recently and is now at its highest level of his presidency (and for the first time his approval rating is higher than the disapproval rating). All politics aside, these are not the type of numbers typically associated with an incumbent that is going to be thrown out of office. As such, the relevant seasonal pattern for 2020 maybe the course that points to re-election. With that being the case, seasonal patterns are seen as bullish.



Source: Gallup



Source: FactSet, RWB Calculations

Breadth is bullish. While a handful of large-cap stocks may be leading the rally, participation remains broad. New highs on the S&P 500 have been followed by new highs on the equal-weight version of the index, as well as new highs by mid-caps, broker/dealers and indexes across Europe. Eight of the 11 S&P sectors have moved to new highs as well.

Neither the daily or weekly new high lists of individual stocks nor our industry group trend indicator have yet confirmed this index-level strength, but clear evidence of divergences is lacking. We are still watching for strength in the form of new highs from small-caps and the Value Line Geometric Index.

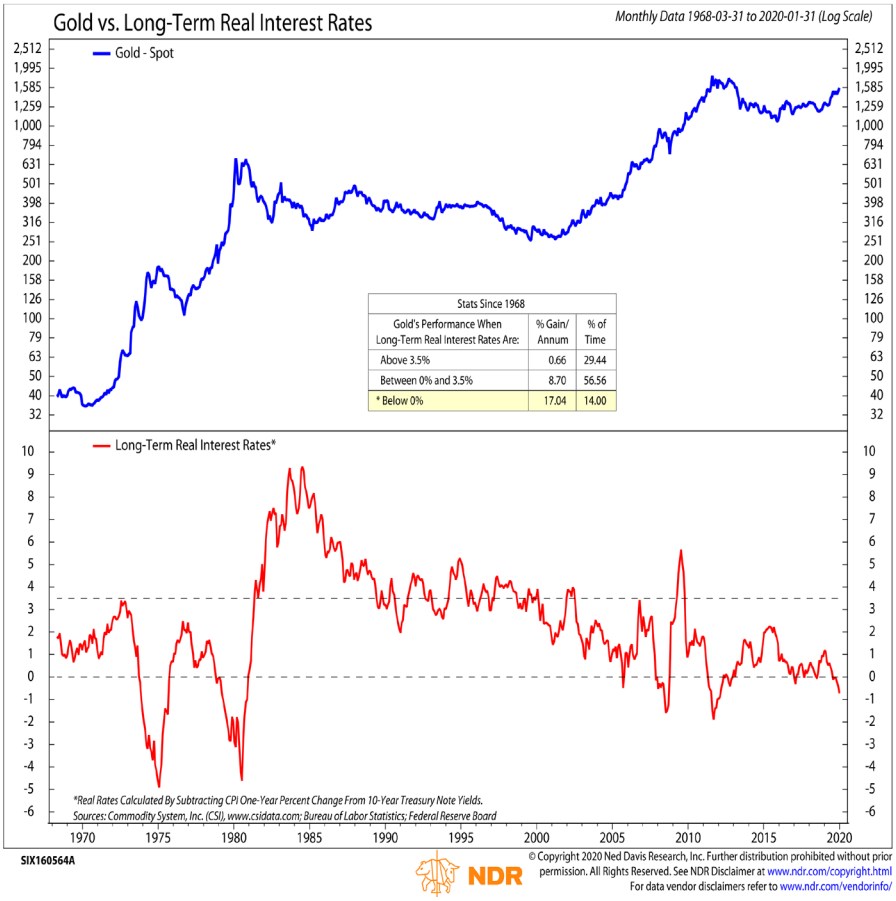
Asset Allocation Implications:

While the weight of the evidence remains tilted toward bullish outcomes, we don't want to look past risk. Elevated stock market valuations and depressed bond yields suggest that forward returns for both stocks and bonds may be lower than those seen in the recent past.

As such a buy-and-hold passive approach may not meet investor expectations, especially when accounting for potential volatility.

A more tactical approach to asset allocation may help smooth out some of the volatility. While both stocks and bonds appear to be loved, cash remains an unloved asset class.

Source: StockCharts



Source: Ned Davis Research

In the near term, investors may want to increase exposure to gold. Gold has broken out to its highest level since early 2013 and is outperforming the S&P 500 so far in 2020. Gold has made a series of higher lows versus the S&P 500 since October 2018, though higher highs remain lacking.

The case for gold is bolstered by the ongoing decline in bond yields. Gold tends to do well when real rates are negative. While bond yields have fallen, inflation has remained near a 10-year high. Global economic uncertainty (as well as potential political concerns) could add to gold's near-term attractiveness.

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Model Portfolio	Mix: Stocks / (Bonds + Cash)	Risk Tolerance	Strategic Asset Allocation Model Summary
All Growth	100 / 0	Well above average	Emphasis on providing aggressive growth of capital with high fluctuations in the annual returns and overall market value of the portfolio.
Capital Growth	80 / 20	Above average	Emphasis on providing growth of capital with moderately high fluctuations in the annual returns and overall market value of the portfolio.
Growth with Income	60 / 40	Average	Emphasis on providing moderate growth of capital and some current income with moderate fluctuations in annual returns and overall market value of the portfolio.
Income with Growth	40 / 60	Below average	Emphasis on providing high current income and some growth of capital with moderate fluctuations in the annual returns and overall market value of the portfolio.
Conservative Income	20 / 80	Well below average	Emphasis on providing high current income with relatively small fluctuations in the annual returns and overall market value of the portfolio.
Capital Preservation	0 / 100	Well below average	Emphasis on preserving capital while generating current income with relatively small fluctuations in the annual returns and overall market value of the portfolio.

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Asset Class / Model Portfolio	All Growth	Capital Growth	Growth with Income	Income with Growth	Conservative Income	Capital Preservation
Equities:						
Suggested allocation	95%	75%	55%	35%	15%	0%
Normal range	90 – 100%	70 - 90%	50 - 70%	30 - 50%	10 - 30%	0%
Fixed Income:						
Suggested allocation	0%	15%	35%	45%	50%	60%
Normal range	0 - 0%	10 - 30%	30 - 50%	40 - 60%	45 - 65%	55 – 85%
Cash:						
Suggested allocation	5%	10%	10%	20%	35%	40%
Normal range	0 - 10%	0 - 20%	0 - 20%	10 - 30%	25 - 45%	15 - 45%

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