Baird Market & Investment Strategy

Investment Strategy Outlook

September 26, 2019

Please refer to Appendix – Important Disclosures.

Outlook Summary

Despite hints of improvement, Weight of evidence remains neutral.

Political uncertainties could weigh on consumer confidence and impact growth outlook.

As growth concerns fade, globally-based, broadly supported cyclical bull market could emerge.

November/December could provide improving backdrop for stocks.

Weight of Evidence Neutral Heading Into Q4

Highlights:

- **After Two Rate Cuts, Fed Appears Data Dependent**
- **Outside of Manufacturing, Economy Still Chugging Along**
- **Margin Contraction Could Pressure Valuations**
- **Equity Funds Seeing Inflows**
- **Political Noise Could Elongate Pre-Election Volatility**
- **Breadth Improving, but Not Yet Bullish**

Perspective. How you feel about the stock market right now can depend on your perspective – what you are looking at and over what time frame. Considering only the performance of the S&P 500 over the course of 2019 (up nearly 20% for the year and just a couple percent below all-time highs) might lead to a discussion of persistent strength and cyclical uptrends. Looking only at the Value Line Geometric Index (a broader albeit more obscure index that provides a sense of how the median stock is faring) since early 2018 might lead to a discussion of down trends and stock market weakness. Incoming economic data can be seen as pointing to impending weakness (the manufacturing and overseas-related data) or remarkable resilience (building permits & housing starts at new recovery highs) as the economic expansion enters its second decade.

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	Neutral	0
• Seasonal Patterns/Trends	Neutral	0
• Tape (Breadth)	Neutral	0
Weight of the Evidence =	Neutral	0

Maintaining perspective in the face of mixed stock market and economic data is a challenge even without rising political tensions in advance of next year's Presidential election. Distinguishing between news and noise will be as difficult as ever. We strive to help investors navigate this environment by relying not on feelings, but on the weight of the evidence. While we expect that conditions might improve going forward, we do not yet have that evidence in hand and so maintain a neutral view on stocks for now.

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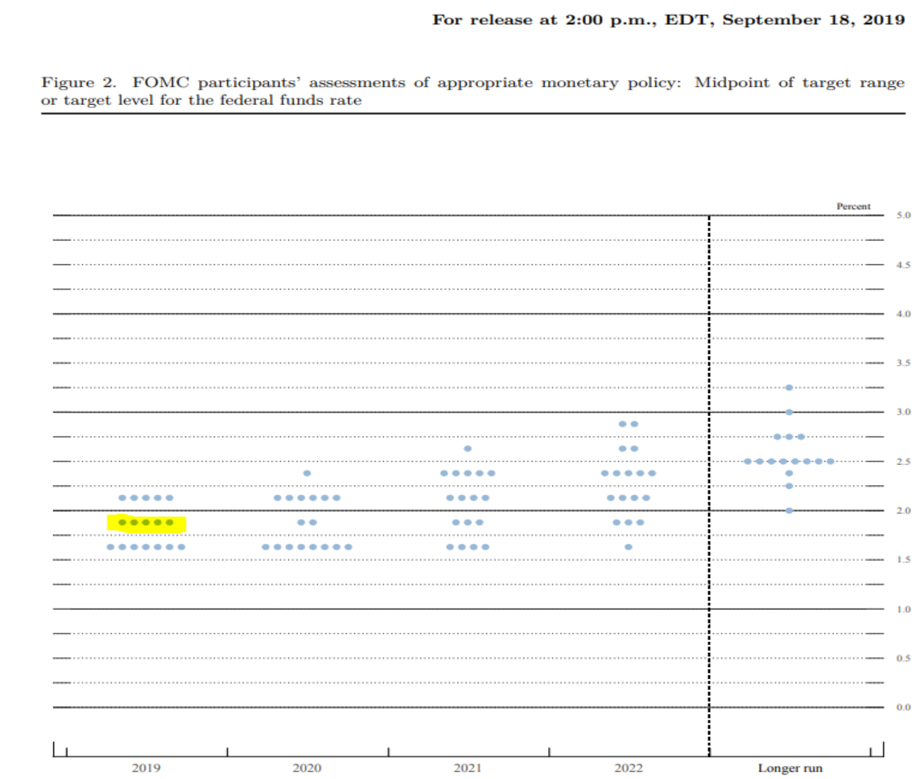
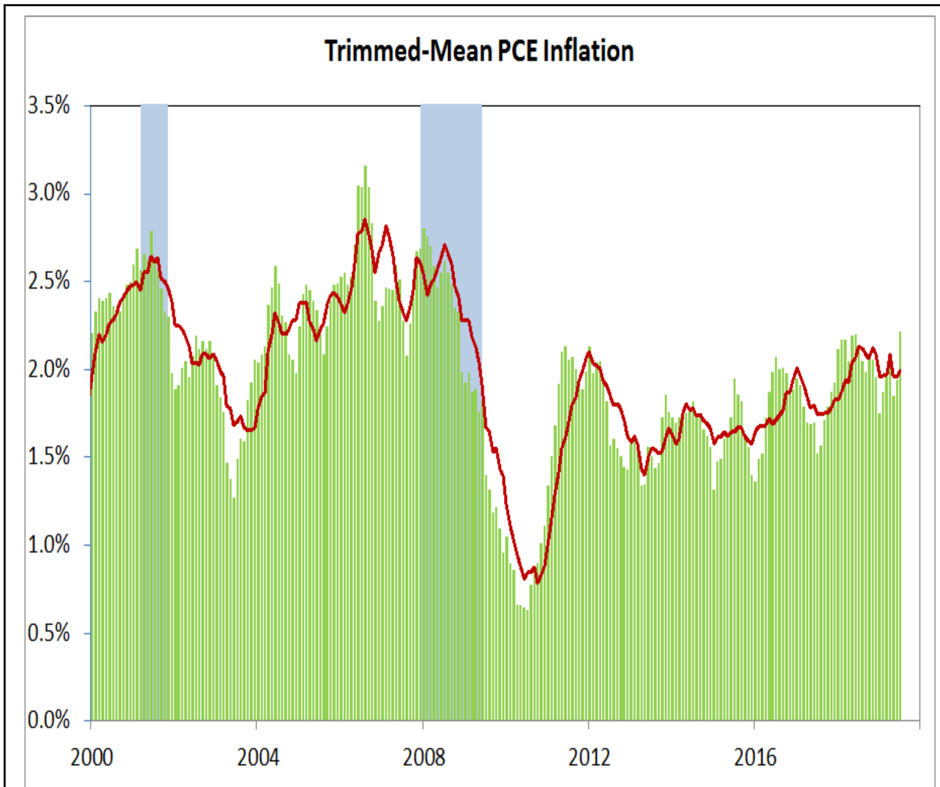
The Federal Reserve, and with them most central banks around the world, are lowering interest rates. The Fed lowered the fed funds rate at both the July and September FOMC meetings. **The dot plot published after the September meeting shows that at this point there is not a clear majority of FOMC participants that view further easing in 2019 as appropriate**. The futures market expects another cut this year – if not in October then in December. Whether the Fed meets those expectations will depend on the tone of the incoming economic data, which has recently has been exceeding expectations.

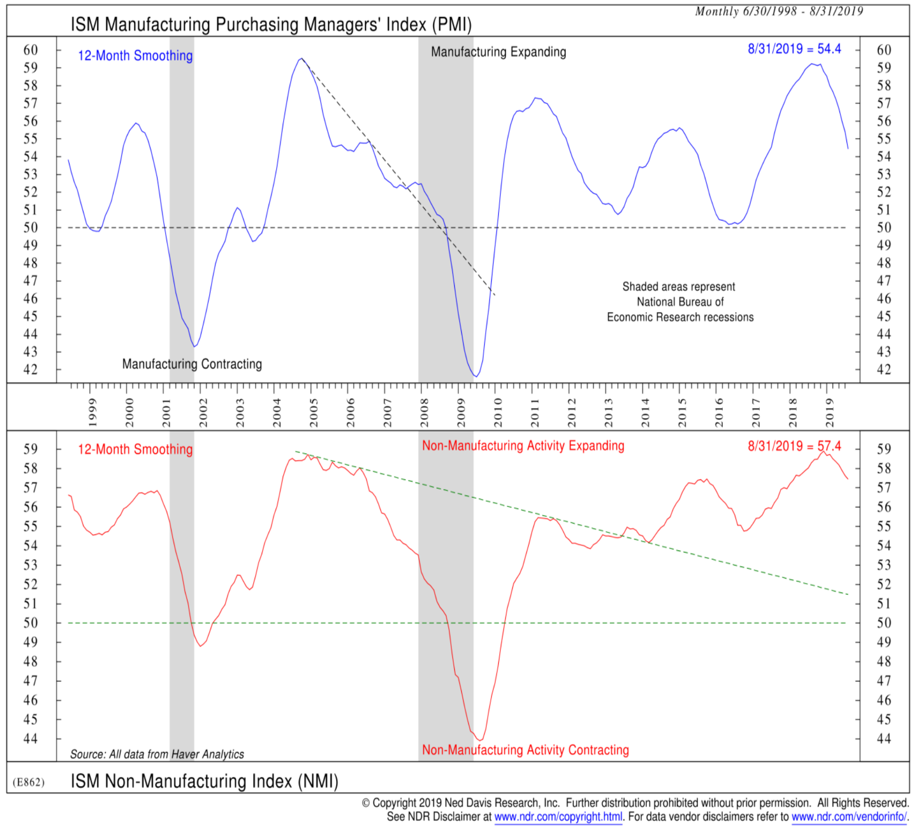


Source: Federal Reserve



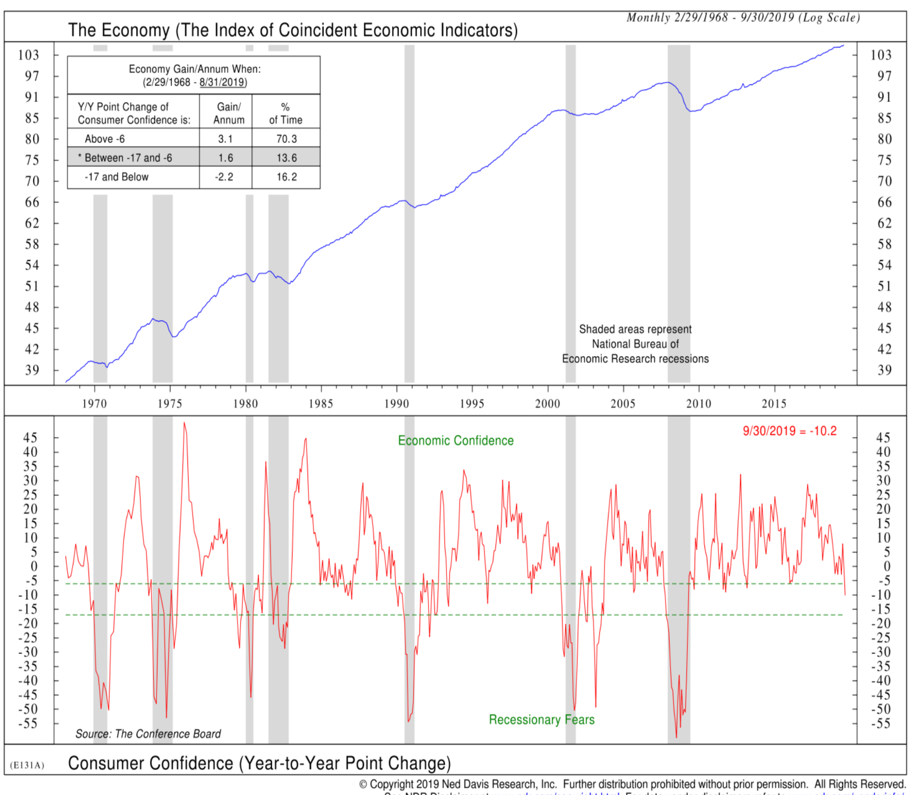
Source: Dallas Federal Reserve

While the data on economic growth (more on that in a moment) gets the bulk of the attention, there is reason not to overlook the inflation data. The inflation picture is not totally benign. **The six-month change in the trimmed-mean PCE inflation indicator has risen to its highest level in a decade.** This measure (published by the Dallas Fed) is moving in the direction of the median CPI (published by the Cleveland Fed). These academically-rigorous inflation measures show more price pressure than the politically expedient core inflation measures that exclude food and energy prices. This could complicate the market's expectation of additional easing by the Fed.



Source: Ned Davis Research

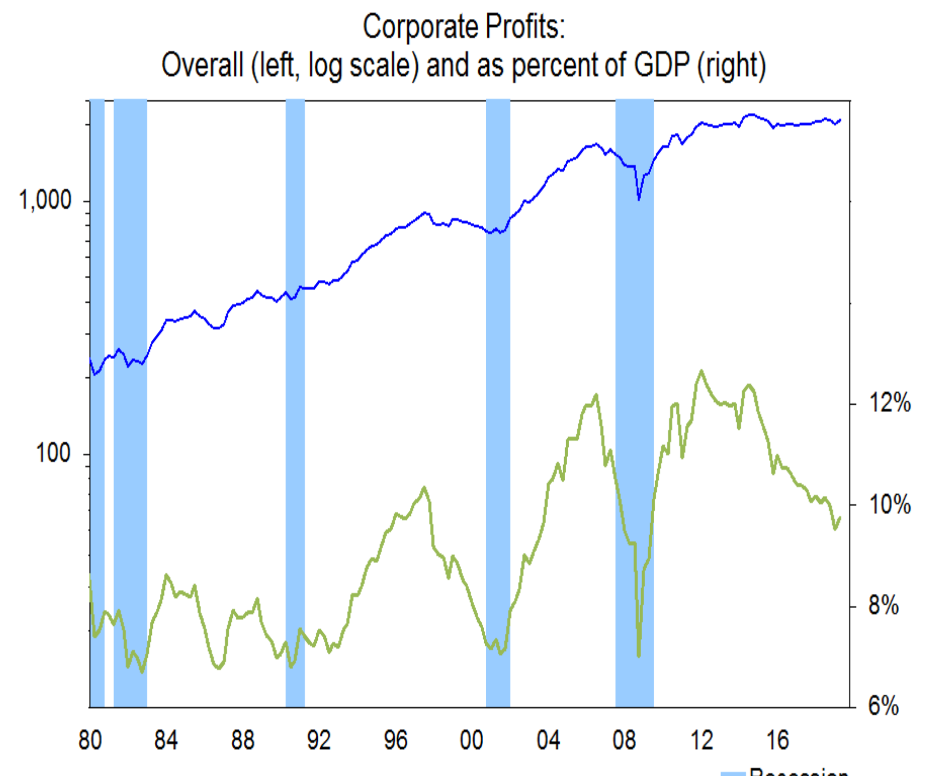
Growth has generally slowed across the economy, though the latest data on new home sales and housing starts/building permits shows activity moving to new cycle highs. **The 12-month trends for both manufacturing and non-manufacturing activity have rolled over.** Weakness in manufacturing has been more acute. While this represents a smaller share of overall economic activity than it has in the past, manufacturing data is still seen as being a leading indicator for the economy. We are keeping a close eye on manufacturing new orders – persistent weakness there would have negative implications for growth going forward and could coincide with a shift in investor appetite from the "risk off" pattern of the past two years to one of "risk aversion."



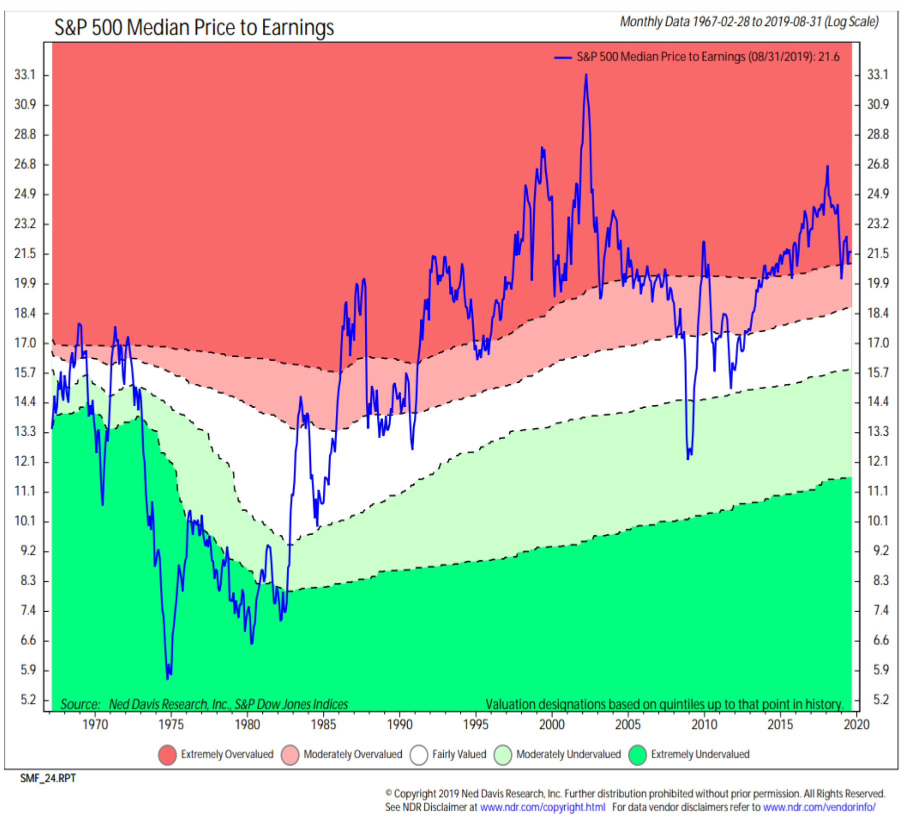
Source: Ned Davis Research

Too much can be made of political headlines but they are a reality that many deal with. If rising uncertainty (whether because of news on tariffs or congressional investigations) leads to a sustained decline in consumer confidence, downside risks in the economy would likely grow. **Already, consumer confidence is lower than where it was a year ago, a decline consistent with deteriorating growth prospects.** If the consumer shakes off these concerns, any market volatility associated with investigations is likely to be short-lived. If confidence (and the President's approval rating) slips from here, than consumer spending could weaken and the economic expansion could face a test heading into next year's election.

Economic uncertainties are coming at a time when corporate profitability has already become more challenging. Rising wages, while good for the consumer, mean that labor costs are going up and that has negative impact on profit margins. **Corporate profits (as reported in the GDP data) peaked five years ago and as a percent of GDP, profits are at their lowest level in a decade.** With profit margins contracting, a higher level of revenue growth will be needed to fuel earnings growth.



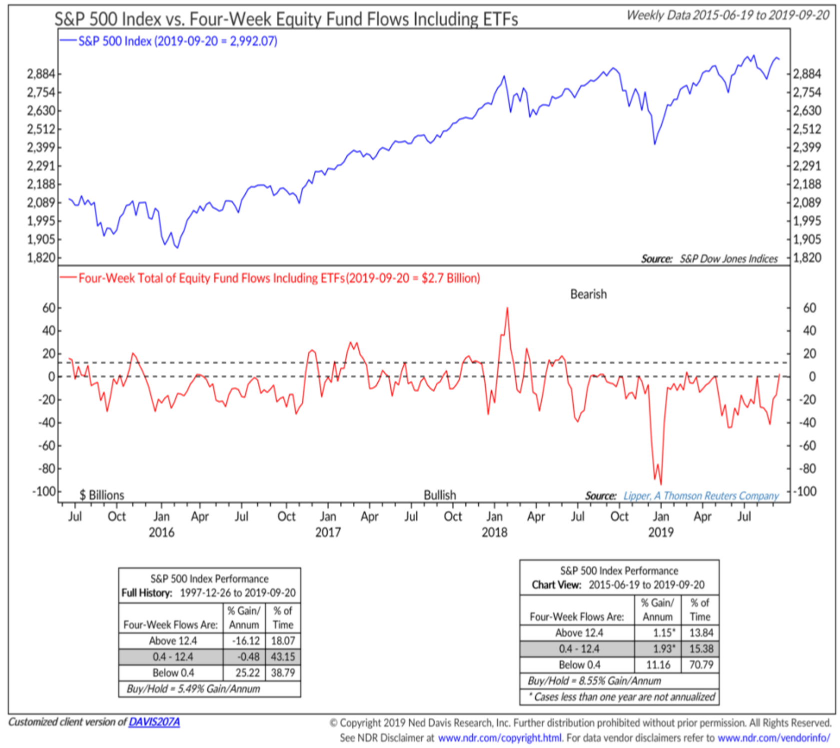
Source: BEA



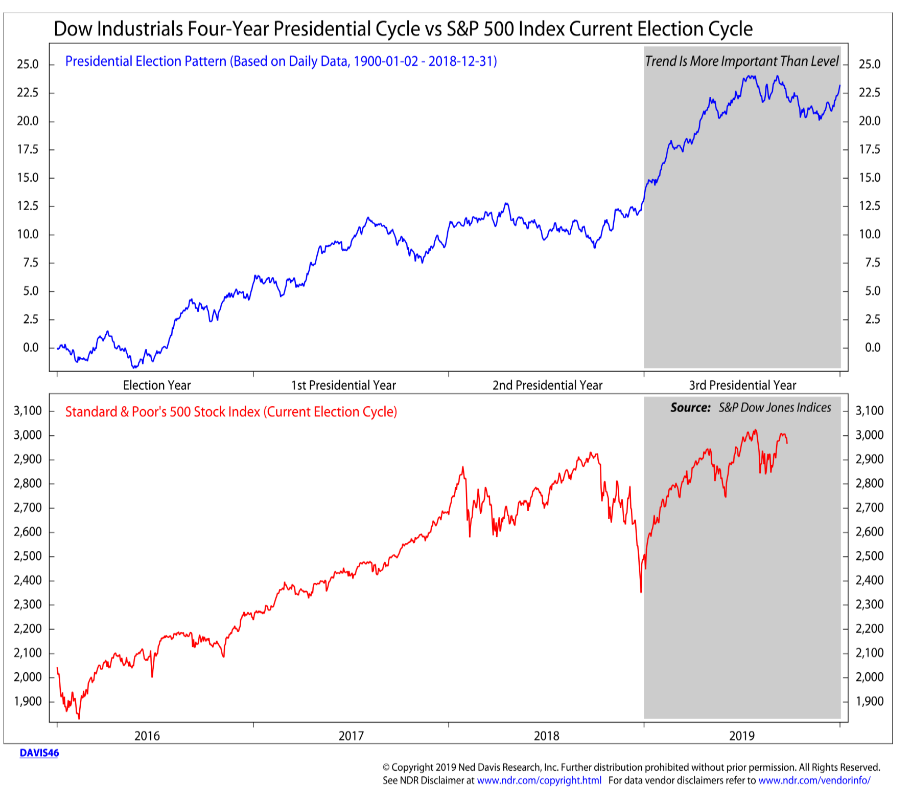
Source: Ned Davis Research

This increasingly challenging earnings growth backdrop comes at a time when stock market valuations are already stretched. **While not at the highest level on record, valuations are at a level where forward returns for stocks have been muted.** Valuations are elevated in the US but international stocks are more attractively priced. For more on this please see our July [Portfolio Perspectives] piece that discusses the prospect of international leadership going forward.

Investor sentiment is as mixed as ever and seems to swing widely from week to week. Discerning the underlying view of market participants is as challenging as ever. The latest Investors Intelligence data shows more than 55% bulls and less than 17% bears, while the AAII survey of individual investors shows more bears than bulls. **One notable sentiment development in September has been flows moving toward equities.** Equity fund outflows have been the norm of late (though even with this, household equity exposure remains elevated) but the first few weeks of September have seen a pronounced shift. Beneath the noise of weekly surveys, investors may be turning more complacent.



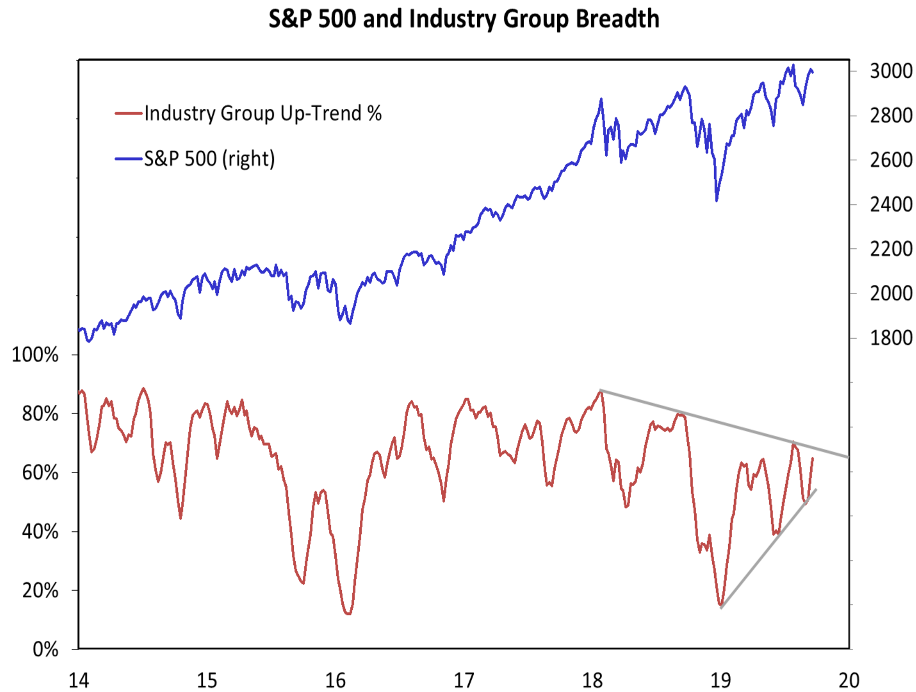
Source: Ned Davis Research



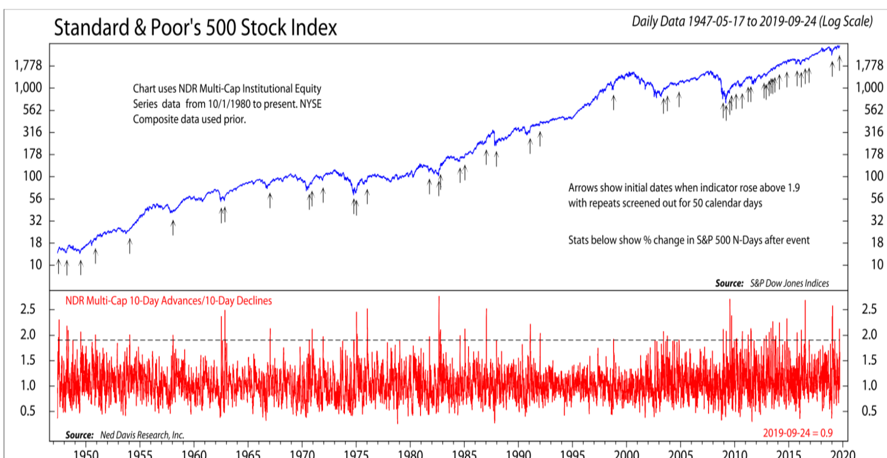
Source: Ned Davis Research

The typical seasonal pattern is for stocks to bottom late in September or October and then finish the year on an up note. Last year's Q4 weakness was a notable exception to that pattern. Looking beyond annual patterns, Election cycle patterns suggest stocks could work higher into mid-2020 before experiencing pre-election volatility. **With political noise on the rise, there is a distinct possibility that election-related volatility will not wait until the middle of next year to emerge.** While this could hinge on how consumer confidence responds, we may be facing an elongated cycle of noise and volatility.

Expectations of better stock market conditions going forward are dependent on an improving view on the economy (consumer confidence will be the key there) and the health of the broad market. Stock market breadth has been improving in 2019. **Our industry group trend indicator has made a series of higher lows which is an encouraging shift from last year.** However, the dominant pattern of lower highs that emerged in 2018 has not been broken. Moreover, the Value Line Geometric Index has recently made a series of lower highs and lower lows and is still 10% below its 2018 peak.



Source: FactSet, RWB Calculations



Event Date	10-Day A/D	5 Days	10 Days	22 Days	63 Days	126 Days	252 Days
1947-06-23	1.96	-0.2	2.8	5.8	-0.4	-2.6	4.2
1948-03-29	2.05	3.1	4.0	7.3	16.1	7.6	0.6
1949-07-13	2.06	1.3	1.9	3.7	7.3	12.7	26.7
1950-11-20	2.01	1.3	-2.0	-1.5	11.0	10.2	19.4
1954-01-25	2.00	0.2	1.2	-0.1	7.5	17.0	37.0
1958-01-24	2.00	-0.0	0.0	-2.6	3.4	11.8	33.7
1962-07-10	1.98	-0.7	-1.5	0.5	-0.2	12.9	22.2
1962-11-07	1.91	2.5	3.6	6.1	12.7	19.8	24.4
1967-01-13	1.94	1.8	1.9	4.3	7.0	9.7	14.1
1970-08-31	1.91	1.9	-0.2	3.4	7.0	19.0	22.1
1970-12-03	1.95	1.1	1.3	3.9	11.3	13.9	7.8
1971-12-08	1.98	1.7	4.4	6.6	12.4	11.1	21.8
1974-10-14	1.91	1.0	-3.6	0.8	-1.5	18.6	23.0
1975-01-08	1.98	3.0	2.4	12.3	18.3	35.4	34.1
1976-01-06	2.05	2.2	5.7	7.3	10.7	10.7	13.0
1981-10-09	1.97	-1.9	-2.3	1.0	-3.8	-4.5	7.9
1982-08-24	1.96	3.6	5.9	6.9	16.4	26.1	42.5
1982-10-18	2.11	-2.5	-0.9	0.9	7.3	16.8	24.2
1984-08-07	1.95	1.1	3.1	1.0	3.6	11.0	15.5

Event Date	10-Day A/D	5 Days	10 Days	22 Days	63 Days	126 Days	252 Days
1985-01-21	2.00	1.2	2.9	2.8	3.1	10.9	17.4
1987-01-13	2.02	3.5	5.3	6.0	9.9	19.5	-5.6
1987-12-18	1.90	-1.4	3.8	-2.4	7.9	7.9	10.9
1991-02-04	1.95	5.8	6.0	7.9	9.1	10.5	17.6
1992-01-03	1.92	-1.0	-0.1	-1.3	-4.5	-1.8	3.9
1998-10-22	1.93	0.7	5.1	10.2	14.4	26.1	20.7
2003-06-04	2.06	1.1	2.4	1.8	4.1	8.2	13.2
2003-10-14	1.99	-0.3	-0.3	0.9	7.7	7.6	5.1
2004-11-05	1.91	1.5	0.4	1.4	3.0	1.1	4.6
2008-12-05	2.12	0.4	1.3	3.8	-17.9	7.6	25.9
2009-03-23	2.08	-4.3	1.5	3.5	8.5	29.4	42.7
2009-07-21	1.91	2.6	5.3	5.5	15.0	19.2	12.0
2009-09-16	2.35	-0.7	-1.1	1.8	3.7	9.1	5.2
2010-02-19	1.92	-0.4	2.7	5.9	-3.4	-3.0	20.8
2010-09-14	1.97	1.7	2.4	4.7	10.6	14.3	4.6
2011-03-30	2.01	0.5	-1.0	2.5	-1.6	-13.3	5.6
2011-07-01	2.14	-1.5	-2.6	-5.9	-15.5	-6.1	1.9
2012-09-14	1.93	-0.4	-1.7	-0.7	-2.4	6.3	17.7
2012-11-30	2.00	0.1	-0.2	3.0	8.7	15.2	27.2

Event Date	10-Day A/D	5 Days	10 Days	22 Days	63 Days	126 Days	252 Days
2013-03-11	2.06	-0.3	-0.3	2.4	5.6	7.4	20.0
2013-05-15	2.14	-0.2	-0.3	-1.2	1.6	6.6	12.8
2013-07-09	2.27	1.4	2.4	2.7	1.4	11.2	19.4
2013-09-17	1.92	-0.4	-0.6	1.7	4.8	9.2	17.4
2014-02-18	2.25	0.2	1.8	1.7	2.4	7.1	14.1
2014-10-27	2.05	2.9	3.9	5.7	2.1	7.4	5.3
2015-10-12	2.05	0.8	2.7	2.9	-3.9	3.2	5.9
2016-02-26	2.11	2.7	3.8	5.9	7.3	11.5	21.6
2016-07-11	2.01	1.4	1.5	1.8	0.8	6.2	13.5
2016-11-17	1.91	1.2	0.2	3.8	8.2	9.5	17.9
2019-01-09	2.38	1.2	2.2	4.8	11.7	16.1	
2019-09-11	2.13	0.2					

Summary Item	5 Days	10 Days	22 Days	63 Days	126 Days	252 Days
Mean	0.81	1.58	3.09	5.07	10.64	16.54
Median	1.05	1.80	2.85	6.97	10.54	17.43
Number Up	34	33	41	38	43	47
Number Down	16	16	8	11	6	1
All Periods Mean	0.17	0.34	0.74	2.09	4.26	8.74

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Source: Ned Davis Research

We do have evidence that would suggest this improving breadth backdrop is likely to come. We saw an early-year round of breadth thrusts as stocks rallied off their December lows and those have been followed with further breadth thrusts in September. **These argue for stock market strength in 2020 and the possible emergence of a new cyclical up-trend.** While the January breadth thrusts helped us move breadth from bearish to neutral in our weight of the evidence framework, we are waiting for the confirmation mentioned above to move breadth to bullish.

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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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