2016 Already Offering a Rocky Ride

Highlights:
- Fed Policy, Election Season Fueling Volatility
- Economic Fundamentals Stable
- Investors Turn Pessimistic
- Broad Market Behavior Suggests Risks Still High

After several years of muted volatility, the January roller coaster in the stock market caught many investors off guard. Coming into the year, we thought 2016 held the potential to see an uptick in volatility, but had expected the usually strong seasonal tailwinds to delay significant weakness until after the first quarter. The S&P 500 was able to recover roughly half of the decline seen at its worst levels but still posted a 5% decline for the month.

We have pointed to four things to look for as evidence that a sustainable low for stocks is in place. From a longer-term perspective we would expect excessive valuations to be meaningfully relieved. Additionally, investor sentiment should show excessive pessimism, up-side momentum should replace down-side momentum, and breadth trends should show a meaningful expansion in rally participation. Of these, we do have investors turning fearful and downside momentum has been broken (although it is hard to say that upside momentum has emerged in its wake). Absent at present are significant improvements in valuation or breadth. As such, a cautious approach (echoed by a turn to neutral by the weight of the evidence) remains appropriate.

While stock market volatility has increased, there is little evidence that recession risks have significantly increased. This decreases the risk of a 2008-style melt down in the financial markets. Not over-correcting in response to near-term developments, but maintaining (or returning to) a disciplined approach to asset allocation remains the best strategy for most investors.

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**Outlook Summary**

- Weight of the Evidence Neutral
- Valuation Excesses Have Not Been Relieved
- U.S. Large-Caps Showing Leadership
- Defensive Sectors Gaining Relative Strength
- Evidence of a Sustainable Low Still Lacking

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**Indicator Review**

<table>
<thead>
<tr>
<th>Fundamental Factors</th>
<th></th>
<th>Technical Factors</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Federal Reserve Policy</td>
<td>Neutral</td>
<td>• Investor Sentiment</td>
</tr>
<tr>
<td>• Economic Fundamentals</td>
<td>Bullish</td>
<td>+1</td>
</tr>
<tr>
<td>• Valuations</td>
<td>Bearish</td>
<td>• Seasonal Patterns/Trends</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Tape</td>
</tr>
<tr>
<td>Weight of the Evidence =</td>
<td>Neutral</td>
<td></td>
</tr>
</tbody>
</table>

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Bruce Bittles
Chief Investment Strategist
bbittles@rwbaired.com
941-906-2830

William Delwiche, CMT, CFA
Investment Strategist
wdelwiche@rwbaired.com
414-298-7802
Outside of the August swoon and October surge, 2015 as a whole was a relatively quiet year. From the perspective of the range between the maximum year-to-date gain and maximum year-to-date loss, 2015 saw the narrowest spread since 2005. This range that was about half the long-term average. Despite this, investors had a sense that volatility was at extremely high levels. **Given this reaction, and indications that stocks remain overvalued, breadth failed to follow through to the upside and investors remained fully allocated to stocks, it seemed a real return to volatility was more likely than not in 2016.** So far, that has been the case. Volatility is not necessarily entirely negative for stocks, as high levels of volatility are usually seen as stocks make important lows.

**Federal Reserve Policy is neutral.** Another source of potential volatility is a less friendly Fed. The 25 basis point rate hike enacted in December is unlikely to represent a meaningful drag for the economy or for stocks. **But by embarking on a path of normalizing interest rates, the perceived protection the Fed was supplying to the financial markets has been taken away.** Further, while the collapse in oil prices has depressed headline inflation, **core measures of inflation, as well as wages, are starting to accelerate.** While we do not expect inflation to get out of control, there is room for some upside surprises in inflation and that could add to the noise that stocks must navigate.
Economic Fundamentals remain bullish. The U.S. manufacturing sector continues to have pockets of weakness, but overall the economy remains on stable, if not spectacular footing. The decline in the price of oil has captivated headlines and is leading to increased concern about the health of the global economy. Just as parts of the U.S. economy are negatively impacted by weakness in the energy sector, so too are parts of the global economy (especially emerging markets). The driver behind lower oil prices, however, is not a collapse in demand, but surge in production, especially here in the U.S. We have doubled our annual production of oil over the past decade, while demand has held relatively stable.

Another global economic concern has to do with slowing growth in China. To whitewash the imbalances that have emerged in the Chinese economy would be naïve, and whatever the actual growth rate is (the official numbers are viewed by many as somewhat suspicious), it represents a marked deceleration over the pace of growth seen in recent years. Some slowdown is to be expected, however, as the Chinese economy is now four times as large as it was 15 years ago. China’s contribution to global growth is as large as in recent years even though its growth rate is slower. Despite its increased size, exports to China still represent only a tiny portion of U.S. economic activity.
Valuations remain bearish. When considering valuations, we look at reported earnings on a trailing basis. Valuations based off of forward earnings or operating earnings can give a distorted view of the valuation picture. Operating earnings can be massaged and forward earnings have tended to be overly optimistic. Valuations have been building over the past few years as stock market gains have gotten ahead of fundamental improvements. A meaningful low in stocks is not likely to be reached when stocks are overvalued relative to their historical average. Importantly, valuation improvement can come through price correction, better earnings growth or, as may be the case in 2016, both.

Source: Ned Davis Research

Sentiment is bullish, but this view comes with a caveat. Based on the experience of the past several years, pessimism is at a level from which stocks have tended to rebound. Investors have responded to the December/January stock market weakness by raising cash and tilting away from equities. The caveat is that this may be the beginning of needed longer-term asset allocation shift from equities to cash. When completed, that shift would have bullish implications, but as it is underway it may mean that more evidence of excessive pessimism is needed to fuel stock market gains.

Source: Ned Davis Research
Seasonal patterns and trends are now neutral. While there is modest bias higher in the first quarter of presidential election years, the overall pattern over the first three quarters of the year tends to be trendless volatility. Stocks tend to rise in the fourth quarter as the outcome of the election comes into focus. Early year volatility could be more exaggerated this year given the seemingly wide-open primary battles and the lack of a prevailing trend higher in stock prices. While the January pullback found support near last year’s lows, this chart of the S&P 500 shows that stocks have gone basically nowhere since the second half of 2014.

Breadth is bearish. The rally that emerged in October last year initially featured a turn higher in our industry-group trend indicator. The pace of this improvement suggested broad rally participation, which was a change in tone over the deterioration that had been seen over the first half of 2015. This initial thrust higher stalled, however, and breadth has deteriorated in 2016. New lows have expanded and the percentage of industry groups in up-trends has contracted. Given the weakness in the broad market, we would view any price rallies seen in the popular averages with some skepticism. Breadth tends to bottom before price and there is not yet evidence that the broad market has made a good low.
Given the neutral assessment of the current environment from our weight of the evidence and the prospects for continued volatility, investors should consider using near-term rallies to trim exposure to equities to levels that are slightly below their longer-term target levels. Holding levels of cash can help mitigate the effects of higher volatility. Small-caps were unable to rally with seasonal tailwinds at their back, and it now looks like a longer-term trend in large-cap leadership is emerging. From a regional perspective, equity exposure should be tilted toward the U.S. and away from international stocks.

<table>
<thead>
<tr>
<th>Sector</th>
<th>Relative Strength Ranking</th>
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<tbody>
<tr>
<td></td>
<td>Current</td>
</tr>
<tr>
<td>Energy</td>
<td>8</td>
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<tr>
<td>Materials</td>
<td>10</td>
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<tr>
<td>Industrials</td>
<td>7</td>
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<tr>
<td>Consumer Discretionary</td>
<td>4</td>
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<tr>
<td>Consumer Staples</td>
<td>2</td>
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<tr>
<td>Health Care</td>
<td>5</td>
</tr>
<tr>
<td>Financials</td>
<td>9</td>
</tr>
<tr>
<td>Information Technology</td>
<td>6</td>
</tr>
<tr>
<td>Telecom Services</td>
<td>1</td>
</tr>
<tr>
<td>Utilities</td>
<td>3</td>
</tr>
</tbody>
</table>

Source: Baird

Our relative strength rankings have shown a pronounced shift toward defensive leadership. Information Technology, Consumer Discretionary and Financials have ranking trends that are moving lower, while Utilities and Telecom have trends that are rising. Consumer Staples and Health Care are relative stable near the top of the rankings (although weakness within the Biotech space is weighing on the Health Care sector overall). Energy, Materials and Industrials are relatively stable near the bottom of the rankings. Industrials have not made a relative price low versus the S&P 500 since August and could be a contrarian way to benefit from better economic growth going forward given the overwhelmingly negative sentiment in that space.

Source: Stock Charts
BAIRD STRATEGIC ASSET ALLOCATION MODEL PORTFOLIOS

Baird offers six strategic asset allocation model portfolios for consideration (see table below), four of which have a mix of equity and fixed income. An individual’s personal situation, preferences and objectives may suggest an allocation more suitable than those shown below. Please consult a Baird Financial Advisor in determining an asset allocation that will meet your needs.

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

Baird’s Investment Policy Committee offers a view of potential tactical allocations among equity, fixed income and cash, based upon a consideration of U.S. Federal Reserve policy, underlying U.S. economic fundamentals, investor sentiment, valuations, seasonal trends, and broad market trends. As conditions change, the Investment Policy Committee adjusts the weightings. The table below shows both the normal range and current recommended allocation to stocks, bonds and cash. Please consult a Baird Financial Advisor in determining if an adjustment to your strategic asset allocation is appropriate in your situation.

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