Several Factors Argue for Caution… But They May Not Be the Ones You Think

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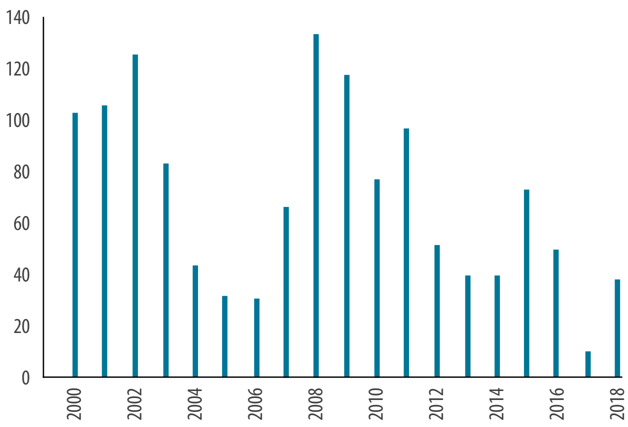
As investment strategists, we don't try to predict specific market behavior even in uneventful environments. Currently the nation is gearing up for a potentially contentious mid-term election amid rumblings about trade wars and likely interest rate increases. But those aren't the reasons we recommend a cautious approach to the balance of 2018.

> "There's enough going on that we can see and know to make the argument for a more cautious investment approach to the back half of the year. So we see no need to get caught up in speculation over the unknowable."

NEWS VS. NOISE Considering what could happen is an important part of good investment strategy. But without the context of knowing what is happening – and how that compares to historical norms – it can easily become counterproductive. Take for example recent headlines about new tariffs on imports and a possible multi-front trade war. While speculation and projections paint a pretty scary picture for the consumer and certain industry sectors, the impact on the U.S. economy and jobs market is something we can't reliably predict at this point. We do know economic fundamentals finished the first half of the year strong and unemployment was at an 18-year low. The macroeconomic factors we pay attention to haven't changed direction. In a historical context, there is room for the economy to continue growing and current trends seem to indicate it can. So we rate economic fundamentals as a positive factor in our outlook.

DON'T FEAR THE FED Federal Reserve policy as it impacts interest rates has been another recent source of media fodder as the Fed announced its second rate increase of 2018 in June. Such news usually tends to rattle bond investors, and stocks have definitely benefitted from the historically low rates of the past decade. But it's important to keep in mind that even with two more increases planned for the

NUMBER OF +/- 1% DAILY MOVES ON S&P 500
2018 data through 6/30



Data source: Wall Street Journal

year (if economic strength holds up), from a historical perspective the Fed is still normalizing rates, not targeting new highs. For that reason we continue to rate monetary policy as neutral.

WHAT THE MARKET IS TELLING US If you're worried about the volatility we've seen in the markets this year, you're probably thinking about it in terms of last year. As the chart to the left shows, you really shouldn't. Last year was unusually quiet from a historical standpoint.

Despite the return of more historically normal volatility, stock prices overall are still fairly high relative to corporate earnings. Those earnings were generally stronger than expected in the first half of the year, but not enough to make us comfortable with where stocks are priced now. Ironically, more volatility in the second half of the year might help bring prices into a more reasonable range.

We often measure the strength of a bull market by the number

Weight of the Evidence : EVIDENCE ARGUES FOR CAUTION

Below are the six factors we evaluate in determining our investment strategy and arriving at our overall stance on the market. You can always find the latest version of this chart at **rwbaird.com/news-insights/markets-and-the-economy**

FED POLICY
Fed continues to normalize policy by raising rates and paring back balance sheet – next hike likely in September

NEUTRAL

ECONOMIC FUNDAMENTALS
Domestic growth remains robust but there are hints of slowing growth overseas

BULLISH

VALUATIONS
Second-quarter earnings are meeting elevated expectations, but overall valuations remain elevated

BEARISH

SENTIMENT
Optimism is building but remains generally shy of excessive levels

NEUTRAL

SEASONAL PATTERNS AND TRENDS
The months leading up to midterm elections tend to be volatile for stocks

BEARISH

BREADTH
Broad market indicators suggest rally participation has been less than robust

NEUTRAL

and variety of companies we see rallying (commonly referred to as breadth). But some consolidation of market "winners" isn't unusual in a bull market. So, even though we're changing our market breadth rating from bullish to neutral, we aren't concerned that recent activity could spell the beginning of a bear market.

OPTIMISM CAN BE PROBLEMATIC While it may seem counterintuitive, historically the market tends to perform better when investor sentiment is pessimistic. Ignoring for a minute the reams of data analyzed to draw this conclusion and the various behavioral theories that try to explain it, let's agree that when expectations are generally low there's more room for pleasant surprises. Investors have been on an emotional roller coaster so far this year, swinging from record optimism in Q1 to deep pessimism in Q2. Lately bullish sentiment seems to be on the upswing (as reflected by weekly sentiment surveys and inflows to stock mutual funds). If historical patterns hold, this increases the risk to market performance in the second half of the year, leading us to rate current investor sentiment as a neutral factor in our outlook.

ABOUT THAT ELECTION We say it every election year, but it bears repeating: The market doesn't like uncertainty. And the general sense of uncertainty in the United States tends to peak in presidential and congressional election years. Election years are often volatile for stocks and pullbacks in the fall aren't uncommon. We currently rate seasonal trends as a negative factor but, if history is any indication, we would expect them to turn more favorable after the elections. Even with the potential electoral headwinds, we're seeing relative strength and leadership in U.S. markets compared to the rest of the world.

THE BOTTOM LINE There's enough going on that we can see and know to make the argument for a more cautious investment approach to the back half of the year. So we see no need to get caught up in speculation over the unknowable. Your Baird Financial Advisor can help you develop an investment strategy and related plans to ensure you stay focused on your financial goals through the market's unpredictable ups and downs.

Planning Calendar

OCTOBER

Most employers hold benefit open enrollment in the fall. Review how your needs may have changed since last year.

OCTOBER 1

First date to file the Free Application for Federal Student Aid (FAFSA) for the 2019–2020 school year.

Deadline for self-employed persons or small employers to establish a SIMPLE IRA for 2018.

OCTOBER 15 – DECEMBER 7

Annual election period for making changes to Medicare or Medicare Advantage coverage.

OCTOBER 15

Final extended due date for filing 2017 income tax returns.

Last day to recharacterize a Roth IRA conversion done in 2017.

NOVEMBER 30

Last day to buy a security and recognize a loss on the sale of a substantially identical security by the end of the year. (Sale must occur December 31.)

DECEMBER 31

Deadline for taking Required Minimum Distributions from retirement plans for 2018 (extended to April 1, 2019, if 2018 is your first year taking RMDs).

Deadline for establishing most employee retirement and profit-sharing plans.