Baird Market & Investment Strategy

2014 Economic & Stock Market Outlook

December 4, 2013

Please refer to Appendix – Important Disclosures.

Signs of Secular Progress?

Outlook Summary

Economy poised to show modest acceleration (GDP growth up from sub-2.0% to 2.5%).

Stock prices have gotten ahead of fundamental improvement – correction risk high by mid-2014.

Fed tapering could shock interest rates higher, but modestly rising bond yields do not necessarily forestall an equity market rally.

Still-low inflation and historically depressed growth could keep a lid on bond yields. 10-year T-Note yield above 3.25% appears unsustainable in 2014.

Cyclical bear in 2014 could provide a test of the secular bull thesis – if we have transitioned, weakness should be contained in degree and duration.

2014 poised as year of transition, with little overall upside for stocks. S&P 500 year-ending 2014 target at 1900.

Highlights:

- **Secular Transition Still Marked By Uncertainty**
- **Fed Poised To Taper, But Zero-Percent Interest Rates Remain**
- **Economy Making Slow Progress, But Growth Accelerating**
- **Valuations Are Stretched; Need To See Price Retrenchment & Earnings Acceleration**
- **Main Street Gloominess Offsetting Investor Optimism**
- **Seasonal Patterns Favorable To Start & End 2014 – In The Middle They Are Challenging**
- **Breadth Still Robust; Watching For Potential Divergences**

Often times, secular shifts are obvious only in hindsight. In real time, identifying changing environments is much trickier. To a large extent, proper identification relies on an accurate assessment of realities and uncertainties. The goal is to have proper knowledge of reality – to know what is knowable and to not think we know that which is not knowable. For instance, *we* ***can*** *know* that stocks enjoyed a robust rally in 2013, featuring broad participation both domestically and internationally. *We* ***can*** *know* that the pattern of corrections over the past few years is more consistent with secular bulls than secular bears. *We* ***cannot*** *know* how the current policy mix of fiscal passivism and monetary activism will affect the growth and profitability of corporate America in coming years.

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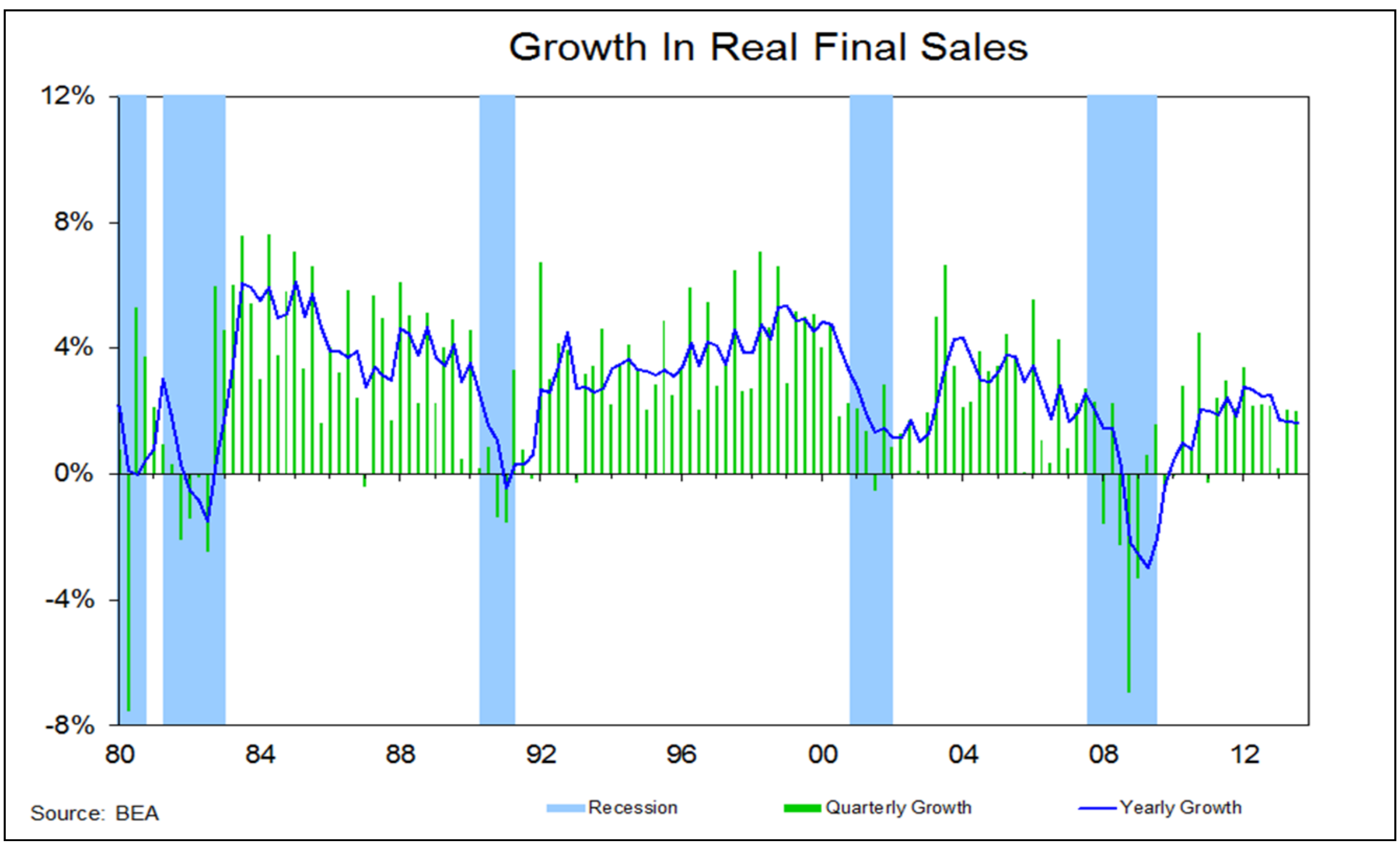
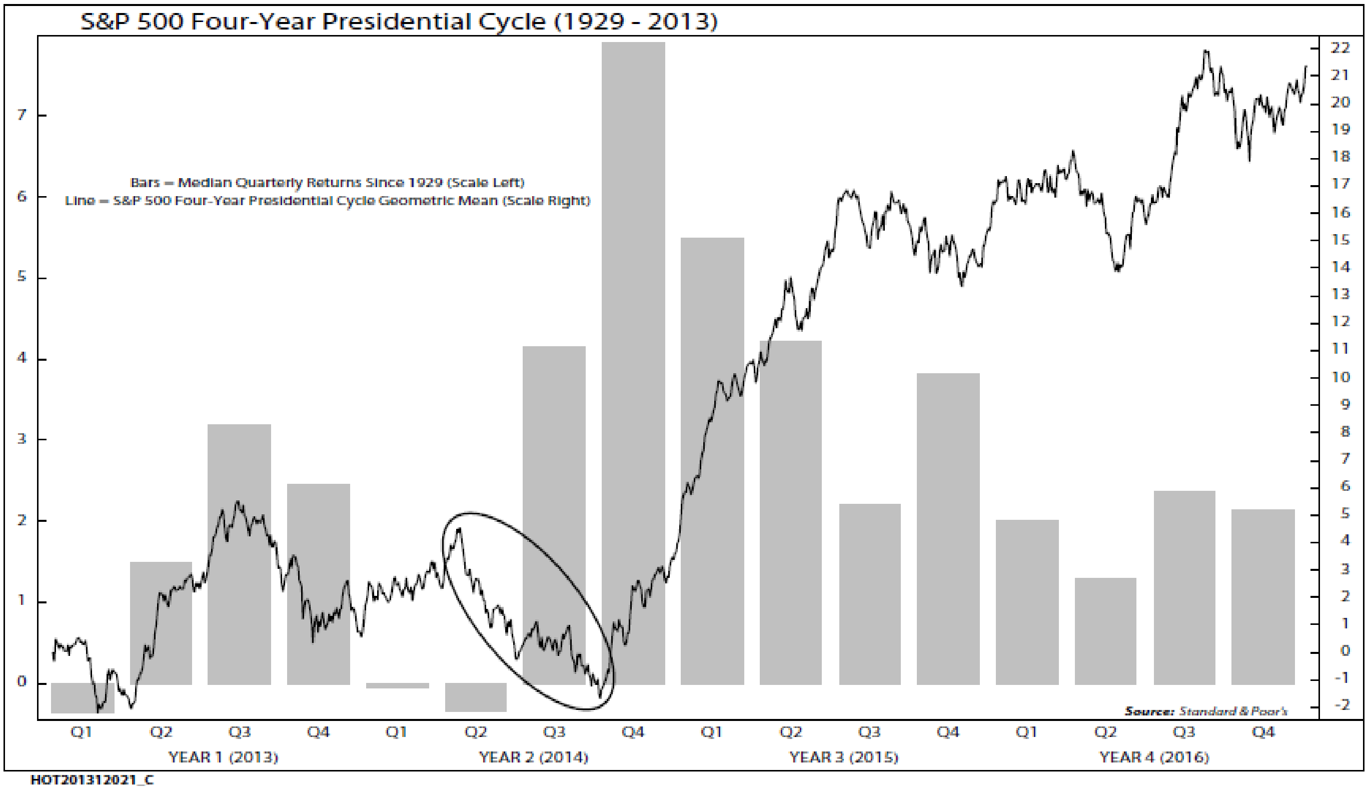
We ***cannot*** *know* how an increasingly bifurcated society or the mix of still-high overall debt levels and generationally low debt servicing costs will impact consumer activity going forward. *We* ***can*** *know* that the cyclical bull market that we have enjoyed since late 2011 is exhibiting evidence of being in its late stages – valuations are extended based on historical comparisons. *We* ***cannot*** *yet know* whether this is an early move within a new secular bull market or if the old secular bear remains intact.

The reality of secular progress remains filled with uncertainty. The behavior of the economy and the stock market in 2014 should go a long way toward providing more definitive answers. *If we have indeed moved into a new secular bull market, rallies will persist and declines will be relatively shallow and short-lived. If we have indeed moved into a new secular bull market, a modest rise in interest rates will not forestall a rally in stocks* – short-term interest rate spikes will pretty consistently be headwinds for stocks. A slow rise in rates associated with improving economic fundamentals, less active involvement from the Fed and asset re-allocation from bonds to stocks is not.

If we have indeed moved into a new secular bull market, fiscal policy will start to address the long-term secular challenges that we are facing as a country (Simpson-Bowles could get resurrected) and the economy will respond accordingly. **In other words, if we have indeed moved into a new bull market, macro-related uncertainties will subside, the economy will generate some momentum of its own, and stocks will continue to enjoy the benefit of the doubt.** *For now, we can know that stocks are in a cyclical bull market and the weight of evidence argues for further upside into early 2014.*

So then, 2014 is shaping up as a year of transition. *The overriding question for 2014 as we see it is whether this is the year we finally see a meaningful acceleration in economic growth?* After three years of growth near 2.0%, 2014 could represent something of a breakout with growth perhaps accelerating towards 2.5%. This is still low by historical standards, but positive momentum nonetheless. **Secular imbalances have the potential of being alleviated if we can generate positive forward momentum for the economy.** Guiding the economy is like steering a





Source: Ned Davis Research

sailboat that is dead in the water. The first action needs to be generating forward momentum; only then can course corrections be made.

An economy that is getting back in gear may provide the Fed with the cover it needs to pare back on QE. **The perception of a less-friendly Fed, seasonal patterns and historical tendencies arguing for correction, and valuation models primed for multiple-retrenchment could put pressure on stocks just as the economic fundamentals improve.** This would provide a test of the thesis that a new secular bull market in stocks is at hand. *If the fundamental economic progress that is being made can continue, the risk of recession will be negligible and downside for stocks could be limited to 20% over the course of Q2 and Q3.* A cyclical bear within the context of a secular bull would not be an altogether unwelcome event. Coming after the gains in stocks seen since late-2011 this could be a pause that refreshes. **Providing more attractive entry points for stocks could set the stage for the next leg of a secular expansion, one built in improvements in the real economy and not so heavily dependent on balance sheet expansion by the Fed**. *At this stage in the rally, we would continue to focus on quality and resist the urge to reach for yield by increasing risk. Investors should adhere to current asset allocation plans. If we get the expected correction, that would be the time to increase risk exposure from a strategic perspective.*

Weight of the Evidence

We use a weight of the evidence approach to evaluate risk and reward in the stock market. We do not view this as a timing or forecasting tool, but as a risk management device. The construction of the weight of the evidence categories provides a necessary balance between macro-fundamentals and technicals, balancing what could (or should) be against what is being observed. Following are our current observations and expectations. These could change over the course of the year. Follow us on Twitter (@WillieDelwiche) and/or watch for our ongoing weekly/monthly commentary for our latest views.

Federal Reserve Policy is currently bullish. While the Fed has signaled its desire to back away from QE, it has not yet had the opportunity to do so. Our best guess at this point is that the taper emerges in the second quarter of 2014 or later, which could make our scoring of Federal Reserve Policy neutral by mid-year. Zero-percent interest rates from the Fed are likely to be intact into 2015.

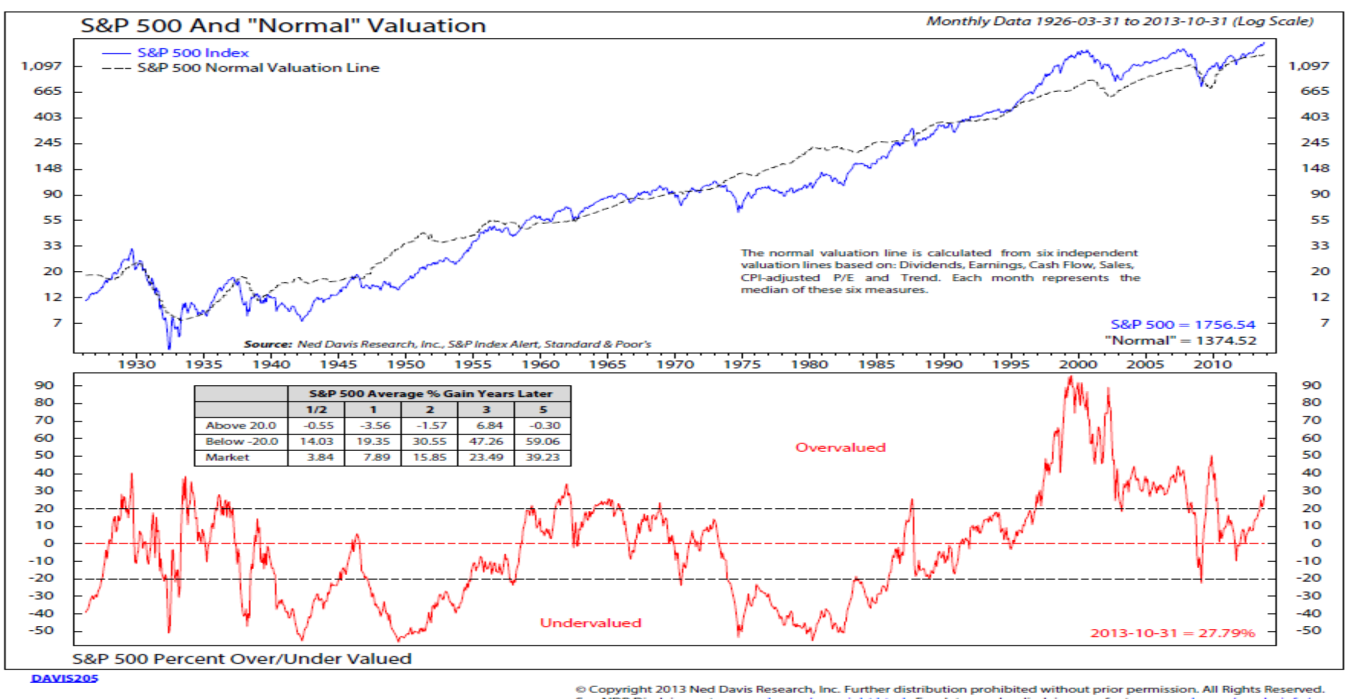
Adding to the uncertainty surrounding Federal Reserve Policy will be the early-2014 transition in leadership. Stocks typically celebrate a new chairman, but then quickly test him. The average maximum drawdown in stocks during the first six months of a new Fed Chairman has been 16%. This is consistent with other indicators that suggest an elevated risk of correction as we move through 2014.

Economic Fundamentals are currently considered Neutral, although if we see the improvement we expect in 2014, we may soon upgrade the economy to Bullish. There is no doubt that the economic recovery has been sluggish and the improvement in the labor market has been disappointingly slow. We are now seeing indications that employment growth may soon accelerate, and the last few months of 2013 have witnessed a cyclical upswing in business activity that could provide a tailwind into 2014.

Valuations are currently bearish. The rally in stocks in 2013 leaves stocks overpriced on a variety of metrics. Earnings growth in recent years has been driven more by the effects of lowered interest expenses and productivity enhancements that have moved profit margins higher. The outcome has been increased leverage that could negatively impact earnings if sales decline.

On the other hand, if the economy is gaining momentum, an even modest improvement in sales growth could lead to considerable upside for earnings, which would help valuations become more neutral. The potential for improved earnings growth and a mid-year retrenchment in price could put valuations in a more comfortable zone later in 2014.

Investor Sentiment heading into 2014 is bearish, as optimism has become widespread and funds have flowed from the sidelines into equities. Sentiment is best used as a contrarian indicator – market peaks tend to occur at the point of maximum optimism, and troughs emerge when pessimism is rampant. Investor sentiment surveys show widespread optimism among advisory services and active investment managers. This reflects strong gains in 2013 and a normal seasonal swell in optimism.



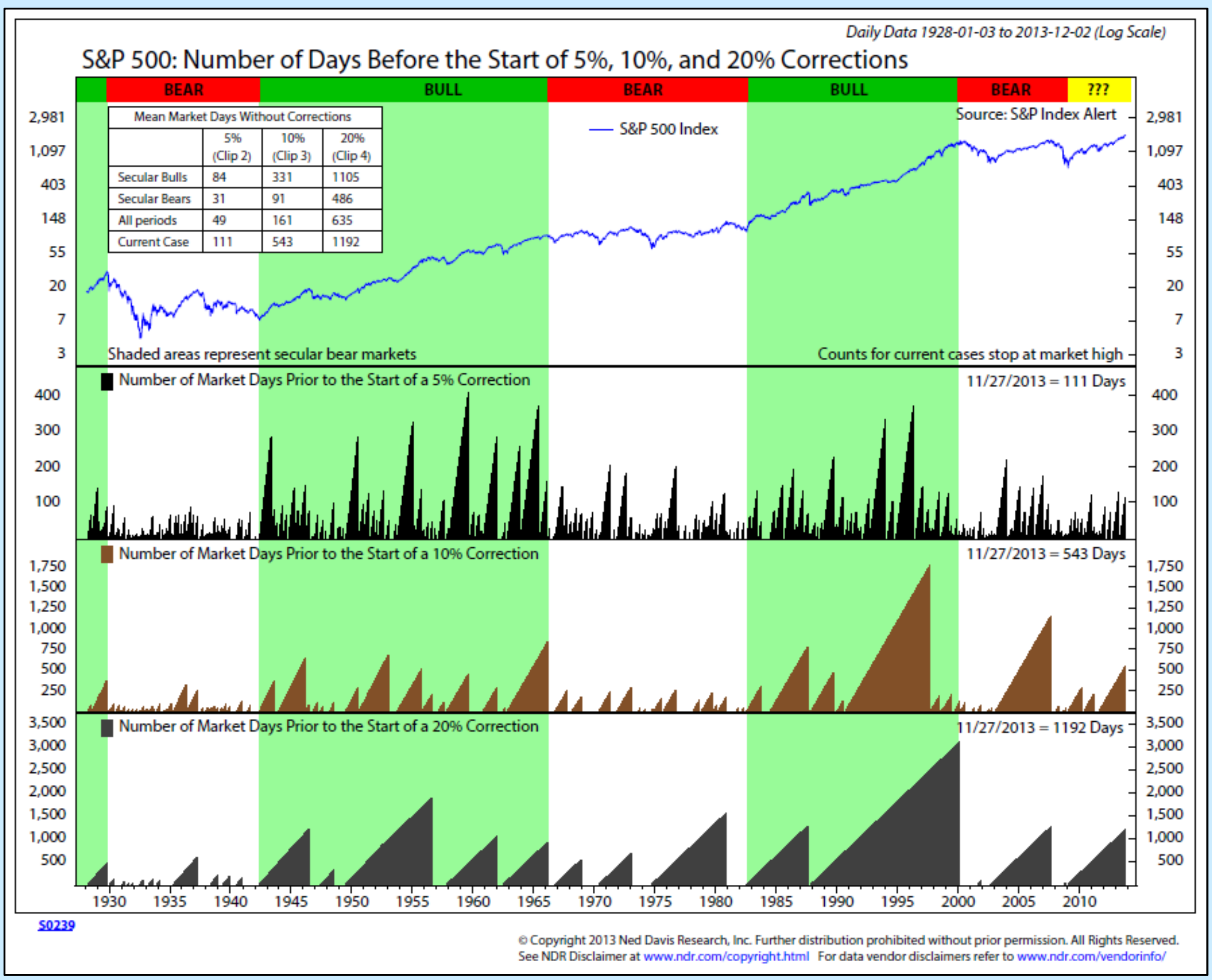
	S&P 500 Average % Gain Years Later				
	1/2	1	2	3	5
Above 20.0	-0.55	-3.56	-1.57	6.84	-0.30
Below -20.0	14.03	19.35	30.55	47.26	59.06
Market	3.84	7.89	15.85	23.49	39.23

Source: Ned Davis Research

In Focus: Secular Bull vs. Secular Bear

Listening to the message of the market

On top of the seasonal patterns that call for mid-year weakness, stocks move into 2014 overdue for a correction. As can be seen in the chart below (courtesy of Ned Davis Research), the current rally in stocks has surpassed the historical norms between 5%, 10%, and 20% corrections. But we want to use this chart to make a larger point: one of the distinctions between secular bulls and secular bears is the frequency and intensity of corrections. For example, within secular bull markets, 10% corrections tend to emerge once every 331 trading days (about 1 ½ years), while within secular bear markets, 10% declines occur every 91 days (or about every 4 ½ months). It has now been more than two years since the last 10% correction on the S&P 500. Given typical weakness ahead of mid-term elections, the pattern that we are watching most closely for 2014 is the frequency with which 20% corrections emerge. Across all periods, 20% corrections emerge once every 2.5 years. In secular bull periods, 20% corrections are seen only once every 4.4 years. That the last 20% correction was 1200 days ago (nearly five years) suggests that we may be due for a cyclical bear market (20% peak-to-trough decline) in 2014. Importantly, this would likely be in the context of a secular bull market – meaning downside would ultimately be limited and it could provide an attractive strategic entry point. Secular bull and bears are ultimately identified by the behavior of stocks, and based on the pattern of corrections seen (or better, not seen) recently, stocks are behaving as if they have entered a new secular expansion.



If it persists beyond early 2014, it could become more problematic.

The other side of the sentiment coin is that the sluggish economic recovery, bruising political battles, and geo-political uncertainty have led to depressed readings of consumer and CEO confidence and low Gallup presidential approval polls*. As long as broader confidence measures remain depressed, the surface-level bullishness shown in the investor surveys is likely to dissipate at the first sign of trouble (this was the pattern in 2013).* Higher confidence scores would make the excessive optimism in the sentiment surveys more troubling.

Trends & Seasonal Patterns are currently bullish, but this tailwind expires in the first quarter of 2014, and seasonal headwinds will intensify as we move into the second and third quarters. The strength seen in September/October 2013 strongly supports a continuation of the rally into Q1 2014. The cycle composite, which aggregates the annual cycle, four-year presidential cycle and 10-year cycle turns lower in the second and third quarters before turning higher again in the final quarter of 2014. The typical presidential election cycle sees a mid-term election peak to trough decline of ~20%, so a correction of that magnitude would not be out of the ordinary from a historical perspective.

Breadth is bullish, indicative of most areas participating in the rally and supportive of further gains in the popular averages. We will be watching the breadth indicators closely as we move into 2014, as they usually act as an early warning system to provide an alert that the rally is seeing decreasing participation, a sign the index-level gains may be unsustainable. This was true at the market peaks in 2000 and 2007 – breadth measures had already peaked and were moving lower when the popular averages reached their highs. *Right now, there is little evidence from the broad market to indicate that the rally seen on the S&P 500 has reached unsustainable levels.*

Things to Watch – Four for '14

1. The strength of a trend is hard to determine when it is moving in only one direction. A cyclical correction/bear market in 2014 would be a chance for the longer-term trend to prove itself, and help answer the question of secular bull vs. bear.

2. The rally in stocks in recent years has been fueled in part by the Fed, with cost-cutting and credit expansion coming at the expense of real investment. Getting real sustained investment growth, particularly in an environment where the Fed is marginally less friendly, would signal secular improvement in the economy.

3. While there is a small window for progress on the fiscal policy front, 2014 is a mid-term election year. The hope of gaining political advantage may lead to policy posturing early in the year. Despite the aspirations of political operatives on either side, control of the House and Senate is unlikely to change hands in 2014. Getting beyond that headwind could provide a window for policy progress later in the year.

4. Cheap and ample supplies of domestic energy, the opportunity for increased infrastructure investment and a resurgent manufacturing sector could make the United States the hot emerging market in 2014. As these trends play out, the economy will be building a strong foundation from which a secular expansion will be able to emerge.

While the answer about secular progress overall remains unanswerable at present, we can nonetheless look at certain secular developments that are heading in the right direction, and those that are not seeing any improvement. While not necessarily actionable in a specific sense, our hope is that this discussion will provide some context as we see development emerge over the course of 2014.

Going Well

Domestic Energy Revolution – In October 2013, the U.S. produced more oil than it imported for the first time since 1995 and production is currently at a 25-year high. According to the International Energy Agency (IEA), the U.S. is on track to be the largest global producer of oil by 2015. Add in natural gas production, and the ongoing energy revolution continues to gain traction and could be an increasingly important driver of economic growth going forward.

Budget Deficit Improvement – One effect of the higher taxes and lower government spending in 2013 was that the Federal budget deficit has fallen from a peak of more than 10% down to 3% of GDP. This provides policymakers with more flexibility to make the necessary reforms that could help promote a sustainable acceleration in growth. The caveat is that the deficit is projected to worsen in future years, so the time for action is now.

Inflation Remains Low - Inflation is a key long-term driver for stocks. Low inflation is good for stocks, while high inflation, and the distortions and uncertainty that come with it, are bad for stocks (and the economy).

Heading In Wrong Direction

Fiscal Policy Process – This remains a mess. 2013 showed us that Washington, D.C. remains broken. Policy that emerges lacks coherence and tends to distort preferences and behaviors in unwelcome ways. Until decisions are driven by policy and not politics, the situation is unlikely to significantly improve.

The Middle Class – Despite the rhetoric, the middle class remains under pressure. This is a direct effect of monetary and fiscal policy over the past decade-plus that has rewarded investors at the expense of workers. Income statistics show a general decline in household income over the past dozen years and a rise in deep poverty. Rather than seeing the re-emergence of a robust middle-class, society is increasingly bifurcated. The gulf between the well-off and struggling has widened and there is an emerging tension here that will need to be relieved.

Student Loan Debts – Not only are debt levels increasing (the aggregate statistics can hardly keep up, but the last number we saw had student loan debts outstanding exceeding $1.2 trillion), but delinquency rates are also on the rise. Those leaving college are increasingly saddled with debt and facing poor job prospects. College costs will not be controlled by making more loans available to potential students, and we are doing an entire generation a disservice by allowing/encouraging such borrowing behavior.

Appendix – Important Disclosures

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