Market Strategy
by STRATEGAS A BAIRD COMPANY

BAIRD
Private Wealth Management

Strategegas Base Case for Economy and Markets

November 8, 2022

BULLET POINT BASE CASE

- Recession odds are ~50% in each of the next two years. Combined, odds of a recession within two years are ~75%.
- Inflation may be "sticky" due to wages, rents, and energy. Roughly 60% of government spending is indexed to inflation.
- No "Fed put" for the foreseeable future. Talk of Fed "pivot" is premature. **Greatest risk to markets and the economy might be the Fed's need to tighten more than anticipated.** There are still too many signs of financial excess.
- Earnings estimates likely too high for 2023. In a typical recession, earnings fall ~30%.
- Favor Value over Growth, Domestic over International, and High Quality Small cap over Large. Preference for short duration stocks that generate large cash flow. Overweight Energy, Staples, and Healthcare.
- Market bottoms are usually associated with lower earnings multiples, a higher VIX, and a blowout in high yield spreads. Haven't seen that yet.
- Major themes are deglobalization, Fed tightening (and QT), "sticky" inflation, and economic slowdown.

Strategas Earnings and Economic Forecasts

	2022				2023			
	Q1	Q2	Q3*	Q4*	Q1*	Q2*	Q3*	Q4*
Real GDP**	-1.6%	-0.6%	2.6%	0.0%	-0.5%	0.0%	1.5%	0.5%
Core CPI**	6.5%	6.6%	6.4%	5.0%	3.5%	2.8%	3.5%	2.5%
Fed Funds Rate	0.5%	1.8%	3.3%	4.5%	5.0%	5.3%	5.3%	5.3%
10-year Treasury	2.35%	3.03%	3.85%	3.45%	3.05%	2.90%	3.00%	3.45%

	2022					2023				
S&P 500 Earnings Estimate	Q1	Q2	Q3*	Q4*	Full year*	Q1*	Q2*	Q3*	Q4*	Full year*
Strategas	$54.8	$57.6	$52.3	$55.8	$220.5	$44.5	$46.5	$52.3	$56.3	$ 199.5
Consensus	$54.8	$57.6	$55.2	$56.2	$221.1	$55.7	$57.6	$59.2	$61.2	$ 234.9

* Forecast
** Q/Q% at an annual rate

BULL VERSUS BEAR CASE

The Bull Case

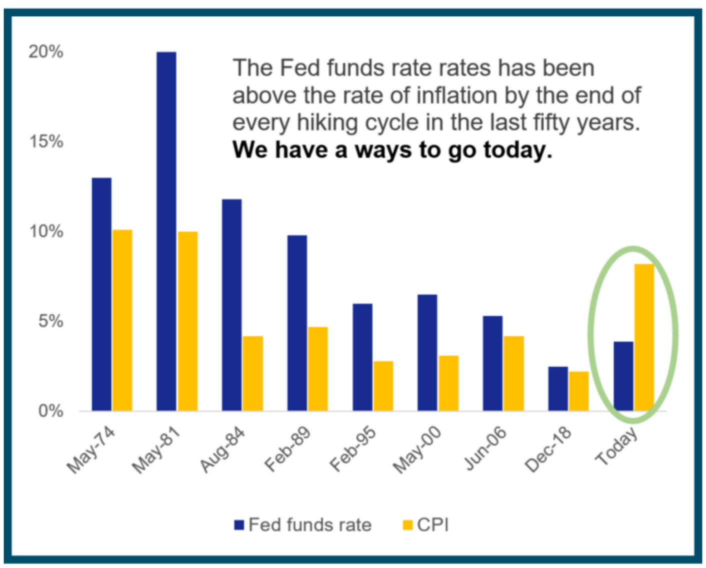
- Since early 2020, the money supply (M2) has grown by roughly 40% and the assets on the Federal Reserve's balance sheet have more than doubled. Money growth works with a lag and more liquidity is supportive of risk assets.
- Meaningful price declines in growth stocks have already occurred.
- **Consumer balance sheets are strong.** The personal savings rate (as a percent of disposable income) is 3.1%.
- Companies have high levels of cash on their balance sheets.
- Though narrowing, the earnings yield on US stocks still looks attractive versus yields on fixed income.

The Bear Case

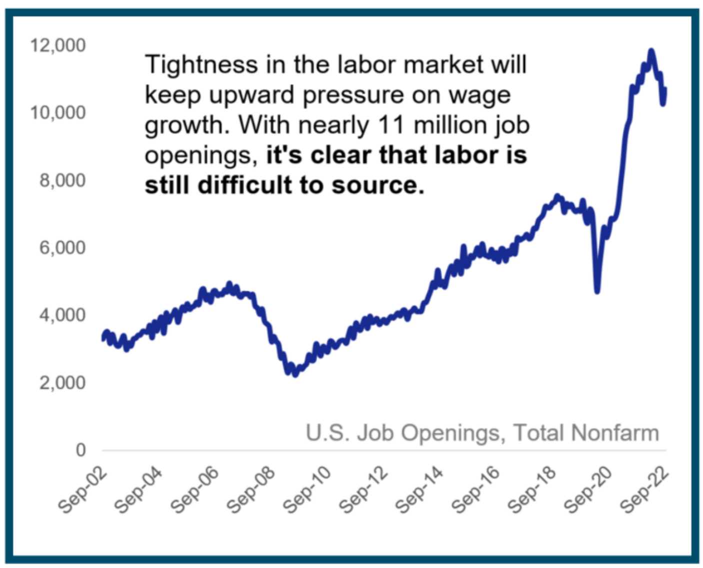
- The Fed is behind the curve on inflation and may need to tighten policy more than anticipated.
- Money supply (M2) growth is slowing rapidly.
- The Treasury yield curve (2-yr vs. 10-yr) is inverted.
- **Rising food and energy prices are likely to put Europe into recession.**
- High inflation puts pressure on earnings multiples.
- High input costs for items like labor and commodities may negatively impact margins and earnings growth.
- Administration unlikely to back off aggressive regulation of Financials, Energy, and Healthcare.
- Venture capital and crypto activity suggest too much investment in speculative assets.

Recession Checklist Shows Mounting Risk

Indicator	Movement	Signalling recession?	Explanation
Single Unit Housing Permits	Decline	Yes	Single unit permits peaked in 2022 and have been trending lower. This implies a softening in the housing market.
Non-defense Capital Good (ex-aircraft) Orders	Decline	No	This has been choppy m/m, but is up roughly 8% from last year. Business confidence is down, but this indicates companies are still investing and spending.
University of Michigan Consumer Expectations	Decline	Yes	Consumer expectations for future economic conditions have deteriorated, and could indicate a looming pullback in spending.
Weekly Initial Jobless Claims	Rising	No	Claims have been choppy over the last month, but we probably haven't seen enough weakness to remove the threat of a wage-price spiral. The Fed remains on high alert.
ISM New Orders	Decline (below 50)	Yes	The ISM and other regional surveys are showing weakness. New orders are a leading indicator of economy health; a reading below 50 indicates contraction.
2-year vs. 10-year Treasury Yield Spread	Decline (below zero)	Yes	The U.S. yield curve remains inverted and is a leading indicator of recession.
Lower-rated, Investment-grade Credit Spreads	Rising	Yes	Rising credit spreads on Baa-rated bonds indicate higher potential for economic weakness and default on the bonds.
Financial Conditions	Tightening	Yes	Not all measured are strained, but a number of global stress indicators are rising, including stock market volatility.



Historically, tightening cycles don't end until the Fed funds rate is above the inflation rate. Demand falling as the economy slows should cause inflation to ease, but it will not come all the way to the 2% target quickly. The CPI includes several sticky components (e.g., rents) that will take time to rein in. Putting this together, we expect a terminal fed funds rate of 5-5.25% and we think the Fed will keep rates there until it has solid evidence that its policies are working. At this juncture, we think the Fed believes easing too soon (like the unsuccessful "stop and go" monetary policy of the 1970s) would be a bigger policy error than a recession.



The biggest issue the Fed (and investors) face is the stickiness of this inflation. We believe the current bout of inflation is likely to be more structural for several key reasons:

- Globalization – a key source of disinflation – is waning in effect.
- Money supply (M2) is up 40% since February 2020.
- Over 10.7 million job openings will put pressure on wages.
- 60% of the Federal Budget is indexed to inflation.
- Home prices are +13% (y/y) and shelter is a big percent of CPI.
- Environmental policies increase energy prices and the cost of doing business.

IMPORTANT DISCLOSURES

This communication was prepared by Strategas Securities, LLC ("we" or "us"). Recipients of this communication may not distribute it to others without our express prior consent. This communication is provided for informational purposes only and is not an offer, recommendation or solicitation to buy or sell any security. This communication does not constitute, nor should it be regarded as, investment research or a research report or securities recommendation and it does not provide information reasonably sufficient upon which to base an investment decision. This is not a complete analysis of every material fact regarding any company, industry or security. Additional analysis would be required to make an investment decision. This communication is not based on the investment objectives, strategies, goals, financial circumstances, needs or risk tolerance of any particular client and is not presented as suitable to any other particular client; therefore, this communication should be treated as impersonal investment advice. The intended recipients of this communication are presumed to be capable of conducting their own analysis, risk evaluation, and decision-making regarding their investments.

For investors subject to MiFID II (European Directive 2014/65/EU and related Delegated Directives): We classify the intended recipients of this communication as "professional clients" or "eligible counterparties" with the meaning of MiFID II and the rules of the UK Financial Conduct Authority. The contents of this report are not provided on an independent basis and are not "investment advice" or "personal recommendations" within the meaning of MiFID II and the rules of the UK Financial Conduct Authority.

The information in this communication has been obtained from sources we consider to be reliable, but we cannot guarantee its accuracy. The information is current only as of the date of this communication and we do not undertake to update or revise such information following such date. To the extent that any securities or their issuers are included in this communication, we do not undertake to provide any information about such securities or their issuers in the future. We do not follow, cover or provide any fundamental or technical analyses, investment ratings, price targets, financial models or other guidance on any particular securities or companies. Further, to the extent that any securities or their issuers are included in this communication, each person responsible for the content included in this communication certifies that any views expressed with respect to such securities or their issuers accurately reflect his or her personal views about the same and that no part of his or her compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in this communication. This communication is provided on a "where is, as is" basis, and we expressly disclaim any liability for any losses or other consequences of any person's use of or reliance on the information contained in this communication.

Strategas Securities, LLC is a registered broker-dealer and FINRA member firm, as well as an SEC-registered investment adviser. It is affiliated with Strategas Asset Management, LLC, an SEC-registered investment adviser. Strategas Securities, LLC is also affiliated with and wholly owned by Robert W. Baird & Co. Incorporated ("Baird"), a broker-dealer and FINRA member firm, although the two firms conduct separate and distinct businesses.

A complete listing of all applicable disclosures pertaining to Baird with respect to any individual companies mentioned in this communication can be accessed at http://www.rwbaird.com/research-insights/research/coverage/thirdpartyresearch-disclosures.aspx.

You can also call 1-800-792-2473 or write: Robert W. Baird & Co., PWM Research & Analytics, 777 E. Wisconsin Avenue, Milwaukee, WI 53202.