Market Strategy
by STRATEGAS A BAIRD COMPANY

BAIRD
Private Wealth Management

Quarterly Market Update
Second Quarter, 2023

ASSESSING THE MARKET'S CONTINUED STRENGTH

Much like Q1, the second quarter confounded bears on both the economy and the markets. The rally in risk assets continued with Technology, Discretionary, and Communications outperforming the S&P 500 by a wide margin, and the 10-year Treasury yield rising almost 30 basis points. To the extent to which investors added concerns about the health of banking system as a brick in the wall of worry, there seems to be little to stop the current bull market off its October 2022 low.

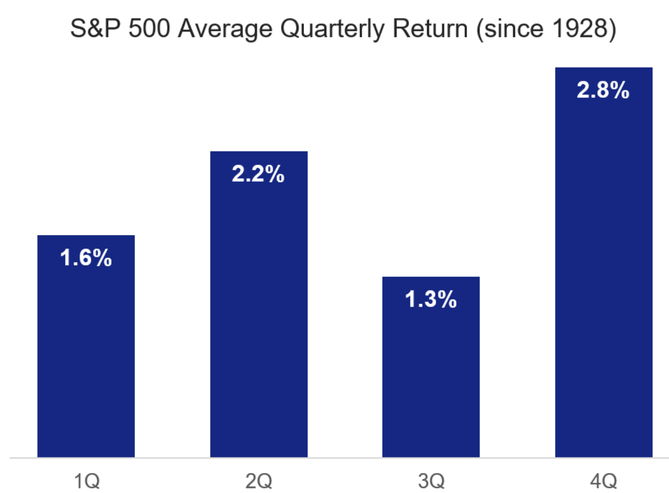
Still, we remain cautious for many of the same reasons that we held last quarter: the yield curve is deeply inverted, the money supply (i.e., M2) is shrinking, corporate profits peaked in 2022, bank lending standards are tightening (a change usually associated with job loss), the impact of Fed tightening is likely not yet fully felt, and a policy-driven liquidity drain is potentially still to come (more below).

There are two leading explanations as to why these items have not had an impact on risk assets thus far. The optimistic case is that investors are discounting a revolutionary change in the economy that renders the old rules useless. Artificial intelligence could indeed be a long-term catalyst for the economy that will usher in a productivity boom. A more cynical view is that amid the U.S. hitting its debt ceiling and several regional bank failures, there was a meaningful liquidity injection into the financial system. Naturally, neither scenario is mutually exclusive – both could be true at once. However, a double dose of liquidity from monetary and fiscal stimulus is not consistent with the goal of fighting inflation. We expect a significant liquidity drain for both the economy and the market in the second half of the year.

In the end, we believe the costs of achieving the Fed's 2% inflation target will be too costly for the central bank as we head into an election year. While the Fed's preferred inflation measure (core PCE) has fallen from 5.4% to 4.6%, recent commentary would suggest that sustained monetary easing is still a long way off. It is likely that there will be at least one additional rate hike this year. We also believe, given the Fed's commitment to the Phillip's curve, that the labor market will continue to be critical in assessing the future of policy. And, although there are some signs of cracks in the employment picture, the labor market remains tight by almost any measure.

A final word on market concentration. While a small group of firms has made up the majority of the gains in the market this year, it is important to note that they are largely awash in cash and can therefore have the potential to be the ultimate short-duration assets, making their own luck in the form of dividends or share repurchases. An increase in long-term rates will affect the present value of all assets, but none more than those without any profits. Shockingly, this cohort still makes up more than ~40% of the Russell 2000. Caveat emptor.

Asset Class	Representative Benchmark	Q2 Return
US Large Cap	S&P 500	8.7%
US Small Cap	Russell 2000	5.2%
International	MSCI AC World ex-USA (USD)	2.7%
Commodities	Bloomberg Commodity	-2.6%
Municipal Bonds	Bloomberg Municipal Bond	-0.1%
Taxable Bonds	Bloomberg US Aggregate	-0.8%
Cash	Bloomberg 3-Month T-Bill	1.2%

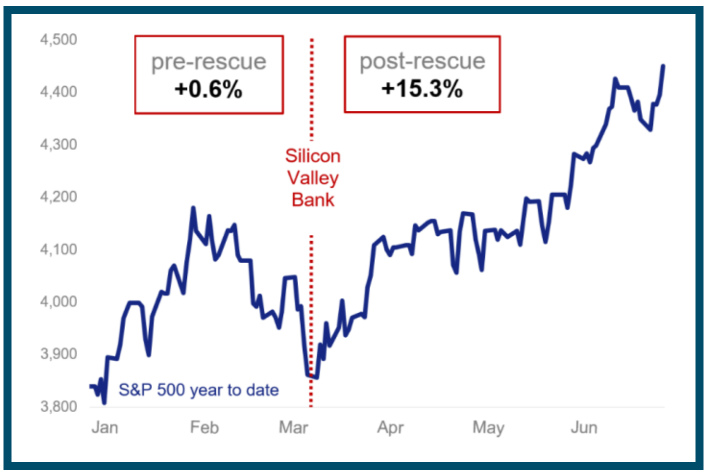


Market concentration has been one of the big stories in 2023, **with the top 10 stocks in the S&P 500 contributing ~77% of the index's gains YTD** (Apple alone is worth more than the entire Russell 2000). In fact, the gap between the S&P 500 cap-weighted and the S&P equal-weighted is the 4th widest since 1990 (this phenomenon is especially true in Growth sectors, like Tech). While equal-weighted underperformance doesn't necessarily portend weaker near-term returns (and, in fact, occurs quite often), the increasingly narrow nature of market leadership is problematic for active management, and particularly those beholden to SEC diversification rules**.**

Rate Cuts With Unemployment Below 5% (Much Less 4%) Are Historically Rare

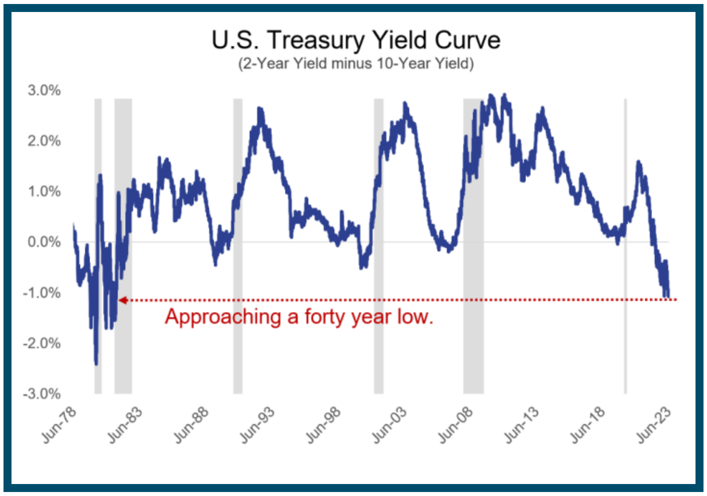
Date	Fed Funds Rate (%)	Size of Cut (bps)	Unemployment Rate (%, sorted)	Inflation Rate (%)
Oct-19	1.75	-25	3.5	1.7
Mar-20	1.25	-50	3.5	2.3
Mar-20	0.25	-100	3.5	2.3
Jul-19	2.25	-25	3.7	1.8
Sep-19	2.00	-25	3.7	1.7
Jan-01	6.00	-50	3.9	3.4
Jan-01	5.50	-50	4.2	3.7
Mar-01	5.00	-50	4.2	3.5
Apr-01	4.50	-50	4.3	2.9
Jun-01	3.75	-25	4.3	3.6
May-01	4.00	-50	4.4	3.3
Sep-98	5.25	-25	4.5	1.6
Nov-98	4.74	-25	4.5	1.5
Oct-98	5.00	-25	4.6	1.5
Aug-01	3.50	-25	4.6	2.7
Sep-07	4.75	-50	4.6	2.0
Oct-07	4.50	-25	4.7	3.5
Dec-07	4.25	-25	4.7	4.3
Sep-73	9.00	-200	4.8	7.4
Sep-01	3.00	-50	4.9	2.7
Mar-08	2.25	-75	4.9	4.0

Since 1971, there have been 124 instances where the fed funds rate has been lowered, **and only six of those cuts have occurred with an unemployment rate less than 4%.** The Fed's laser focus on core services inflation – and wage growth as its key driver – will likely keep the central bank hawkish until the labor market weakens. While the narrative around rate cuts is that they will be bullish for equities, historically, rate cuts with low unemployment levels have not resulted in near-term outperformance (likely because the cut is in response to a weakening economic and market environment – ala 2001 or 2020).

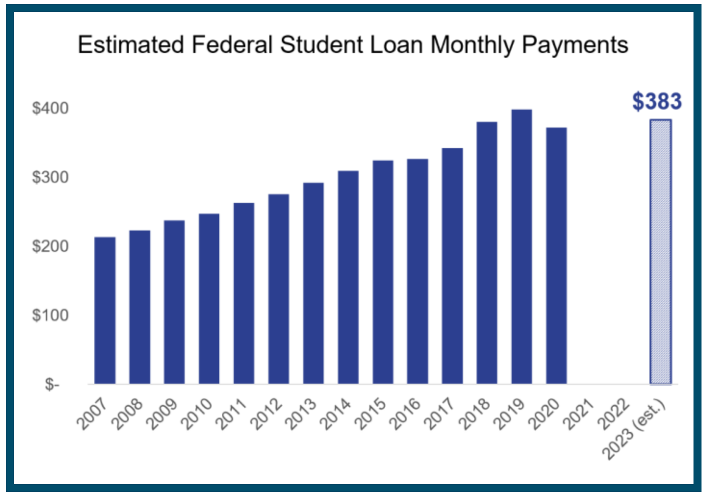


While the first half rally was impressive, we think it is important to remember that the market was basically flat heading into March's regional banking crisis. **Therefore, almost all of the market's outperformance has come on the heels of that event** – particularly when it became clear that policymakers were willing to step into the void to prevent another systemic crisis (i.e., by providing liquidity via lending facilities). This double barreled dose of stimulus – from the Fed post-SVB and from the Treasury spending down its general account after the U.S. hit its debt ceiling – provided a liquidity injection to the economy and markets, and was likely a tailwind for risk assets.

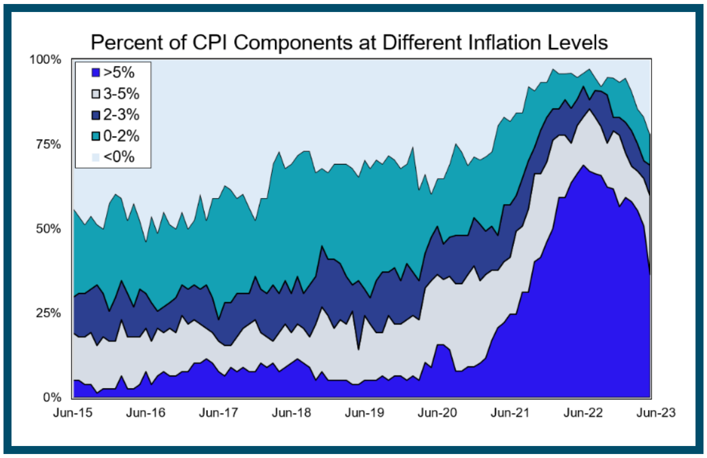
After initially being driven by pandemic-related goods inflation and soaring commodity prices, **CPI is now primarily being sustained at an above-target level by core services inflation (i.e., wages and housing).** And while wage growth has come down meaningfully from its post-Covid highs, it remains historically elevated. This is a problem for both the Fed (which wants to drive core inflation back to 2%) and for corporate operators (who are seeing cost pressure vis-à-vis higher labor expenses). While higher wages are a boon to the consumer, they could prove a difficulty for central bankers and CFOs alike if they remain sticky above long-term levels.



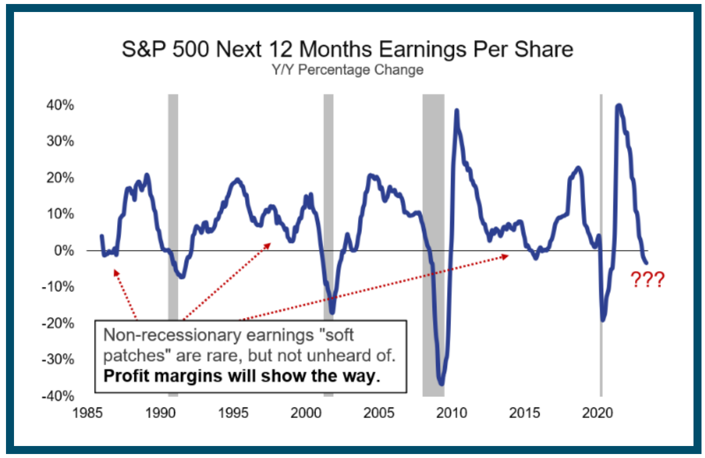
Yield curve inversion (i.e., when short-term Treasurys yield more than long-term Treasurys) is one of the more widely followed recession predictors. **Overall, a recession has followed 7 of the last 9 tightening campaigns**, and since 1978, recessions have started 14 months after the first inversion on average. Today, the yield curve is more inverted than any time in the last forty years, and in fact, only the 2005 cycle had a longer time from initial inversion to first rate cut. From here, we're watching Fed activity and short-term rates, as, historically (and perhaps surprisingly), the market is actually most at risk once the curve starts to re-steepen.



On June 30, the Supreme Court ruled that President Biden's student loan forgiveness program cannot move forward. It's a big decision, as student loan payments are now set to resume this fall after being on hold for several years; **this is likely to weigh on growth as households are forced to reallocate spending power in an already-slowing economy.** The White House is now looking to begin a new income driven repayment plan that could provide a partial offset over time, but the program is complex and may take time to implement. Still, any relief is welcome given how reliant the U.S. economy has been on consumer spending for the last 18 months.



The Federal Reserve wants to force a landing in economic activity to control inflation, but the U.S. economy is proving resilient and inflation is proving sticky. So, while improving rapidly, **over a third of CPI components are still above 5% y/y** – a level too broad for comfort. From here, the Fed seems to want insurance that the anchor on inflation will hold, so rates are set to rise further. We expect another +25bp fed funds hike in July, and we think it makes sense to take the Fed's forecast of another hike after that as the base case, especially with the main drivers of inflation being domestic and sticky (wages, housing) vs. global and volatile (energy).



With earnings having peaked in 2022, the question now is "how far do they fall?" Over the past 40 years, there've been a handful of steep declines associated with recession and a few "soft patches" where the economy stayed afloat. These soft patches are rare and not usually paired with significant profit margin strain. We've seen a flattening out of aggregate margins since last fall, and it's expected that they will continue to come under pressure as we move towards 2024. **The consensus is a little bit more optimistic on the earnings outlook than we are**, but if recession is the base case, we'd anticipate a greater drawdown than the market has baked in.

S&P 500 Index (Large Cap / U.S. Stocks): A representative sample of 500 leading companies in leading industries of the U.S. economy. These are equity securities of large capitalization (generally $7 billion plus market cap) companies having growth and value characteristics. ● **Russell 2000® Index (Small Cap / Small Core):** Measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represent approximately 10% of the total market capitalization of the Russell 3000® Index. These are equity of small capitalization.● **MSCI EAFE Index Net (International / Developed Markets):** A free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. As of May 27, 2010 the MSCI EAFE Index consisted of the following 22 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom. ● **BBgBarc Aggregate Bond Index (Taxable Bonds / Bonds):** Comprised of approximately 6,000 publicly traded bonds, including U.S. Government, mortgage-backed, corporate, and Yankee bonds with an average maturity of approximately 10 years. ● **BBgBarc Muni Bond Index (Municipal Bonds):** Bonds must have a minimum credit rating of at least Baa, an outstanding par value of at least $3 million, part of a transaction of at least $50 million, issued after December 31, 1990 and have a year or longer remaining maturity ● **FTSE 3-month T-bill Index (Cash):** This index measures monthly return equivalents of yield averages that are not marked to market. It consists of the last one-month and three-month Treasury bill issues, respectively. ● **Bloomberg Commodity Index (Commodities):** Composed of commodities traded on U.S. exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME). Subindices include Petroleum, Grains, Industrial Metals, Livestock, Precious Metals, and Softs.

IMPORTANT DISCLOSURES