Market Strategy
by STRATEGAS A BAIRD COMPANY

BAIRD
Private Wealth Management

Quarterly Market Update

Second Quarter, 2024

A MARKET AND ECONOMY AT A CROSSROADS

A change brewing. On the surface, the growth in the U.S. economy and in risk assets (e.g., stocks) looks like it has been inexorable and without drama. But we believe there are slight changes in both the economy and the stock market that will lead to greater economic volatility and a dispersion in returns from risk assets over time.

Bullish for now. Let us be clear, we would be loath to fade the upward trend in the economy and stock market, especially with just 4 months before the presidential election. The Biden administration's made no secret about its willingness to stimulate consumer spending (the Strategic Petroleum Reserve, student loan forgiveness, the Employee Retention Tax Credit, granting statutory authority for Freddie Mac to buy home equity loans, etc.) and to keep long-term rates in check (an interplay between the Overnight Reverse Repo Facility, the Treasury General Account, and the Treasury's refunding schedule). For this reason, election years are often good to markets.

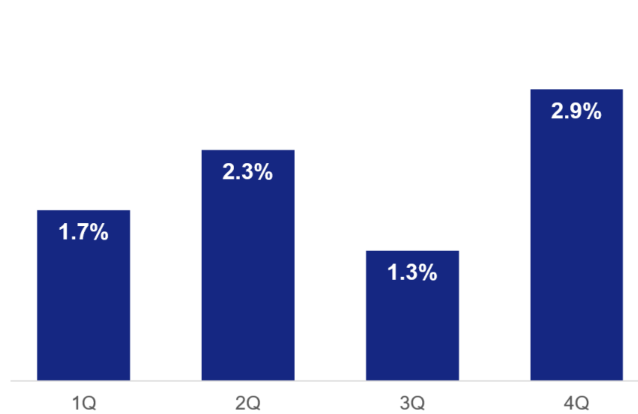
Pressure builds. Still, there seems to be a widening gap between the volatility and performance of the average stock and the stock market as a whole. Higher long-term interest rates are putting pressure on the earnings power and market performance of highly levered companies dependent upon outside sources of capital. Higher prices also seem to be having an effect on consumer preferences and the performance of certain Consumer Discretionary stocks. We have been able to see the cumulative effect of inflation on consumer spending, especially among low earners. Perhaps as a result, high quality growth stocks that possess organic sources of growth (AI spending) continued to dominate performance in the quarter.

Inflation is key. It is difficult to deny that progress has been made by the Federal Reserve in its fight against inflation and we suspect that the Fed will follow the lead of other global central banks and cut rates between now and the end of year. At the same time, progress has been slower than anticipated and has no doubt been hampered by ongoing federal spending. Running budget deficits of nearly 7% of GDP is unheard of at a time when the country is near full employment, as it is now.

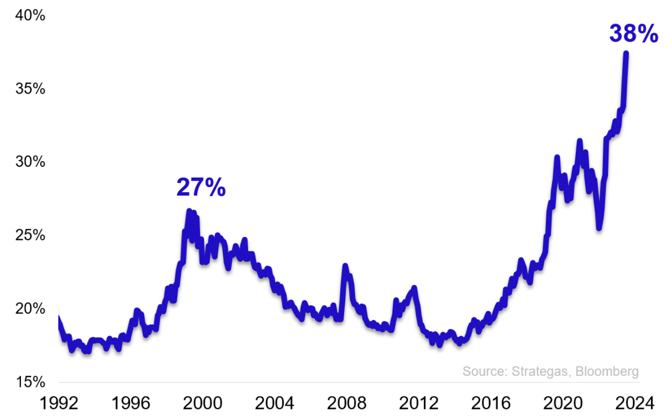
A bill comes due. There is a growing chorus among investors that deficits and valuations don't really matter in the end. Solid earnings growth, relatively low long-term interest rates, tight credit spreads, and the continued outperformance of Growth over Value seem to strengthen that view. Still, we believe those assumptions will be stress-tested later this year and next.

Asset Class	Representative Benchmark	Q2 Return
US Large Cap	S&P 500	4.3%
US Small Cap	Russell 2000	-3.3%
International	MSCI AC World ex-USA (USD)	1.2%
Commodities	Bloomberg Commodity	2.9%
Gold	LBMA Gold PM ($/oz)	5.3%
Municipal Bonds	Bloomberg Municipal Bond	0.0%
Taxable Bonds	Bloomberg US Aggregate	0.1%
Cash	Bloomberg 3-Month T-Bill	1.3%

S&P 500 Average Quarterly Return (since 1928)

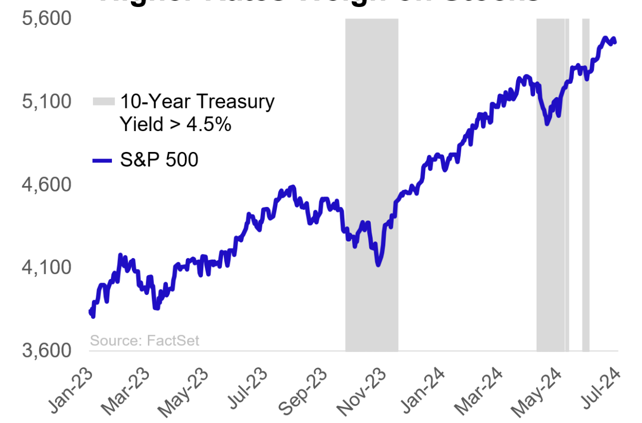


Top 10 Stocks as a Percent of S&P 500



The 10 largest stocks in the S&P 500 now account for 38% of the market's total capitalization. This understandably makes people nervous, especially given how far we are past the prior peak of 27% in 1999. But it is important to note that the 10 largest stocks today also account for 31% of the S&P's total net income, with an average trailing profit margin of 26% and average trailing annual earnings growth of 264%. In short, the top 10 are the top 10 for a reason. This does not mean that *any* valuation is justified, but with the 10-year Treasury yield currently at 4.25% as opposed to rates around 6.8% in the early part of 2000, the party could continue indefinitely.

Higher Rates Weigh on Stocks



In 2024, our market forecast has generally been risk-on with long-term interest rates below 5% and more cautious at levels approaching 5%. Refining the concept, a 10-year Treasury yield above 4.5% seems to be the level at which added caution is needed. Long-term interest rates are critical in determining the current present value of future earnings (i.e., higher rates lower the present value of future cash flows). Better inflation data are likely to relieve pressure at the long end of the Treasury curve in the short term, but we remain worried that the large volume of Treasury issuance could put structural upward pressure on rates going forward.

Global Trends in Digital and Energy Indicators

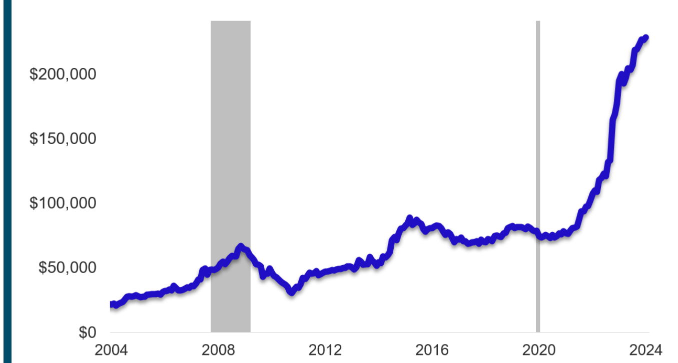
	2015	2022	Change
Internet Users	3 billion	5.3 billion	**+78%**
Internet Traffic	0.6 ZB*	4.4 ZB	**+600%**
Data Center Workloads	180 million	800 million	**+340%**
Data Center Energy Use (excl. crypto)	200 TWh**	240 – 340 TWh	**+20 – 70%**
Crypto Mining Energy Use	4 TWh	100 – 150 TWh	**+2,300 – 3,500%**
Data Transmission Network Energy Use	220 TWh	260 – 360 TWh	**+18 – 64%**

Source: IEA, *ZB = zettabyte, **TWh = Terawatt-hour

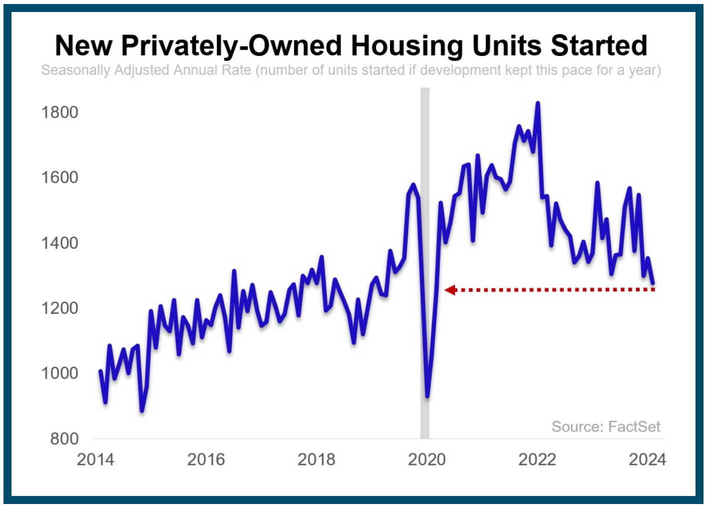
What is often lost in AI excitement is how much power it requires to perform its growing list of functionalities. For example, the Gartner Group estimates that AI will make up as much as 3.5% of global electricity demand by 2030 (roughly twice the energy consumption of France). And despite a desire to wean the global economy off "dirty" forms of energy, the ability to do so is likely to take much longer than the goals that have been set out. Natural gas provides 10x the amount of electricity to the American power grid than does solar, while coal still provides 16% of America's electricity generation (per the EIA). Utilities outperformed the S&P in the second quarter.

Total Construction Spending: Manufacturing in the U.S.

Millions of Dollars, Seasonally Adjusted Annual Rate, Source: Census Bureau

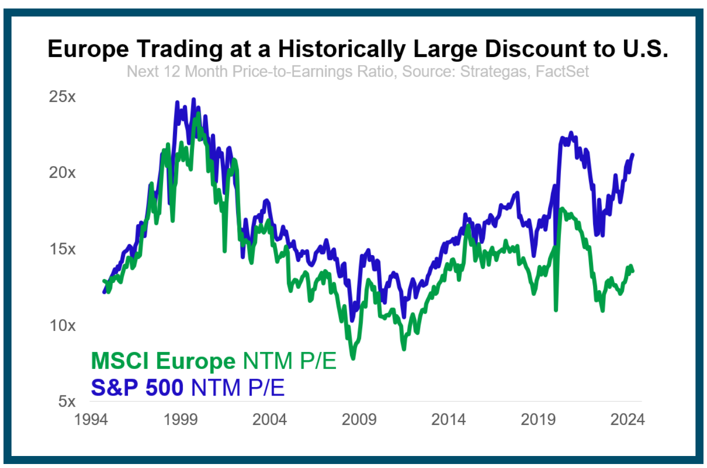


There are signs of a U.S. manufacturing rebound in the works, including a recent surge in the construction of manufacturing facilities. Yet industrial production has been range bound over the past decade, and local manufacturing employment has increased only slightly. Politicians from both political parties have shown a desire to reshore manufacturing production, as robustness and national security have taken precedence over sheer efficiency. This approach is strategic and political vs. economics-driven, however, and, as such, reshoring has been slow. But federal funding is just starting to hit, and this theme should become structural in the coming years.

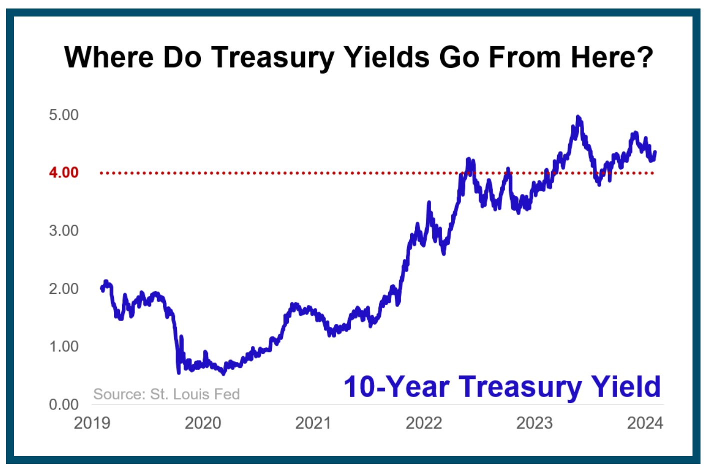


U.S. new home sales plunged -11.3% from April to May, while housing starts fell to their slowest pace since June 2020. With mortgage rates remaining elevated, both supply and demand for U.S. housing appear to have ebbed (individuals with lower fixed-rate mortgages are reluctant to move). New construction had helped relieve some pressure, but hasn't been enough and is weakening again. The U.S. is left with frozen activity and high prices at the same time. It's tough to call that a healthy housing market, and it's hard to see reprieve on the horizon with the Fed's concern about sticky inflation limiting the number of rate cuts possible in 2024.

U.S. job openings continue their descent toward pre-Covid levels (with the job opening rate and quits rate already back to 2019 levels). This is important because a key portion of the soft landing argument relied on the Fed's higher rate policy killing job openings rather than eliminating actual jobs. Until employment weakens significantly, there remains a fundamental support for the U.S. economy, but there is some evidence of slowing. Bottom line: the Fed has a dual mandate (inflation and employment), and a cooling U.S. labor market could tip the scale to rate cuts quite quickly. We continue to look for the first Fed rate cut in September.



In June, we increased exposure to Developed Markets from Neutral to Overweight as the cyclical tailwinds appear a touch stronger across developed economies. Though history suggests rate cuts are "better feared than hoped for," the market appears to have disregarded this adage and continues to lean into whichever market seems intent on (relative) policy accommodation. The European Central Bank has already cut and appears poised to be somewhat aggressive. The Fed is likely to join in September, but with uncertain timing and scale. Europe is also trading historically cheaply relative to the U.S. on a forward P/E basis.



Entering Q3, we maintain the view that a recession is growing less likely for 2024 (and even 2025), though it can't be entirely ruled out either. We put the odds of a soft landing over the next 12 months at about 80%. We believe that in a soft landing, Treasury yields across the curve have room to dip over the next 2 quarters, driven in large part by the much-anticipated start of rate cuts and the slowing of quantitative tightening. But this yield reprieve should prove short-lived, as Treasury supply should become problematic again by early 2025, with inflation likely to emerge in a second wave by late 2025. We see 10-year yields ending 2024 just north of 4.00%.

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 equities 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 and 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):** Composed 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.

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