Baird Market and Investment Strategy

Macro Update

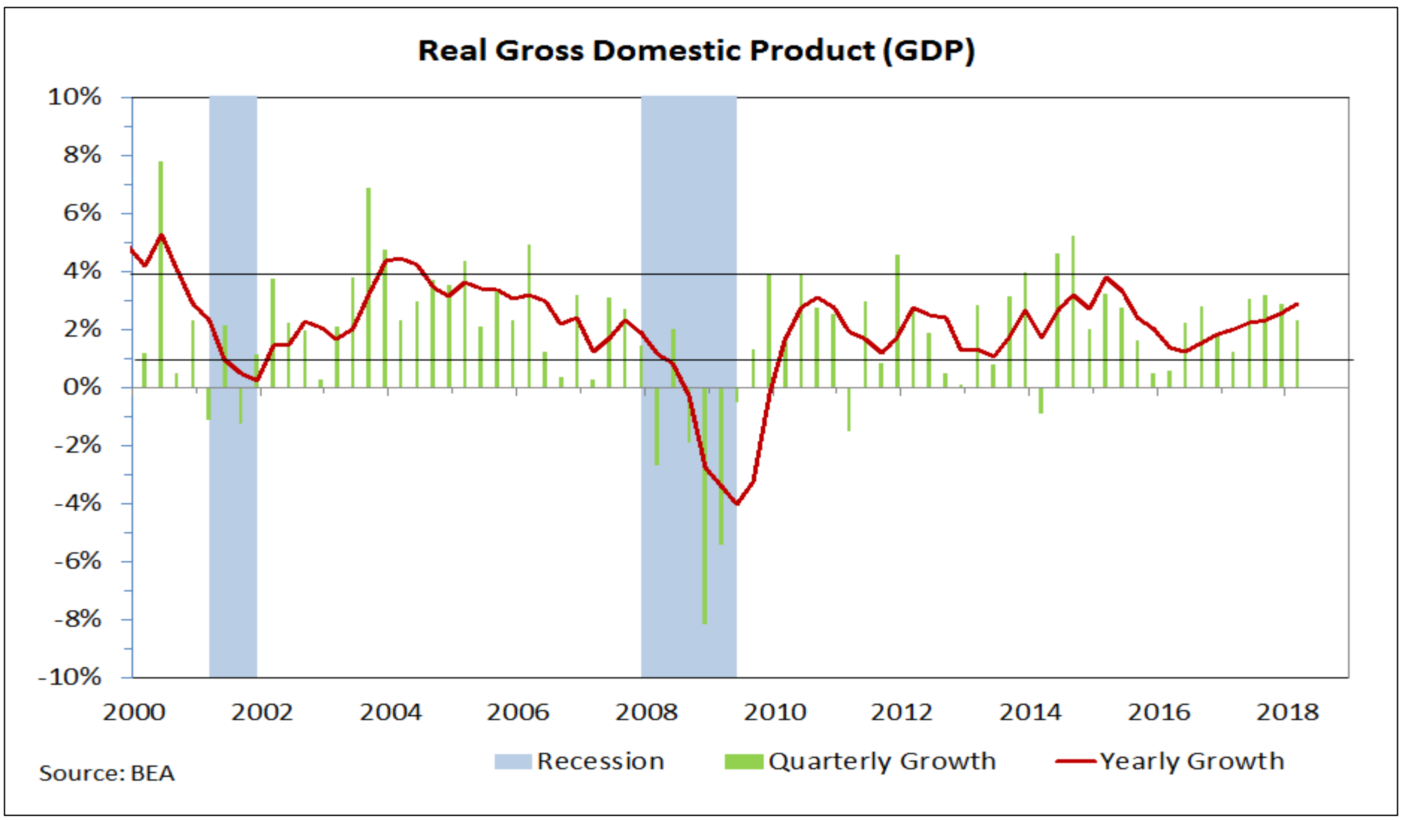
May 1, 2018

Please refer to Appendix – Important Disclosures.

Economic Growth Accelerates, but Escape Velocity Remains Elusive

Key Takeaways: GDP growth continues to move higher, but has not (yet) surpassed a decade-long ceiling. The economy has the wind at its back but a lack of fixed investment spending is restraining growth in final sales (as well as productivity). Confidence that growth is continuing to accelerate may be reflected in rising earnings estimates. With valuations still elevated, improvements in the economy may not translate into stock market gains.

GDP growth of 2.3% in the first quarter fell shy of some early quarter projections (the Atlanta Fed's GDP Now model at one point suggested we could see growth in excess of 5.0% in the quarter) but was still above what was recorded in the first quarter of 2016 (1.2%). This was enough to push the yearly growth in GDP higher for the seventh quarter in a row and closer to 3.0% (a level that has been exceeded in only four quarters over the past 12 years). While headed in a positive direction, it is too early to draw the conclusion that the economy has shifted away from the low-growth mode of the past decade and the charts on the next page seem to hint that perhaps we have not. Further acceleration at this point (which would include surpassing the 3.1% growth seen in Q2 of 2017) would be evidence that we have. With the tax cuts in place, regulatory burdens being lifted and business confidence still high, the economy still has the wind at its back.



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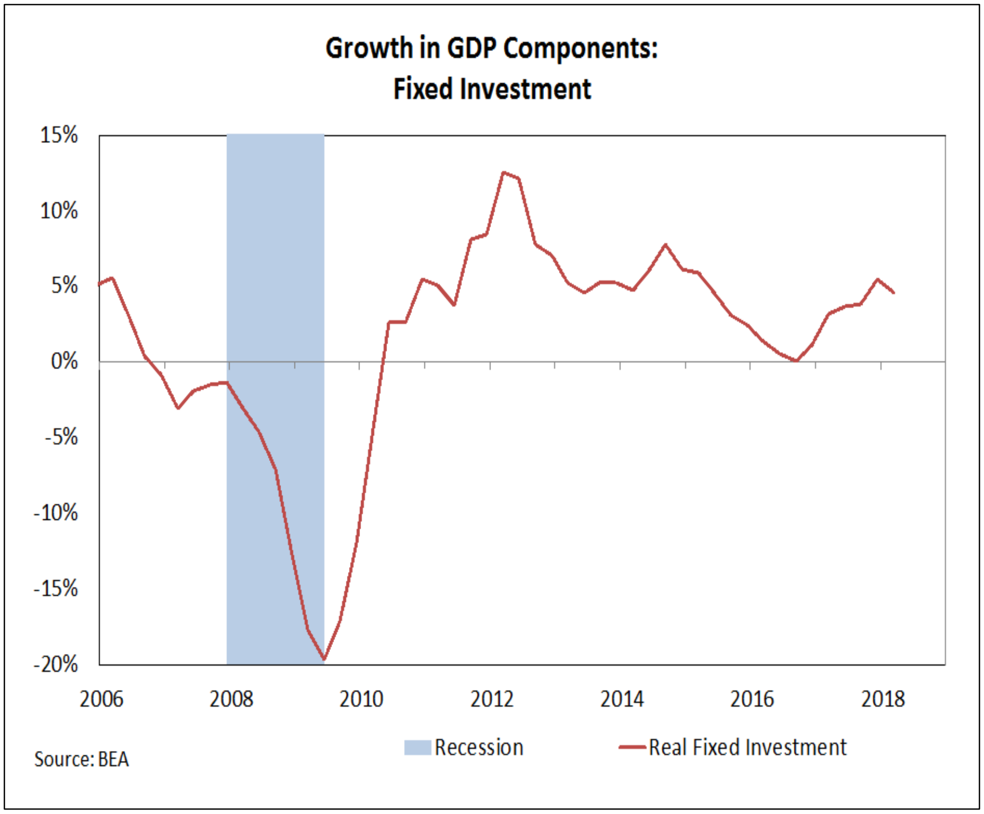
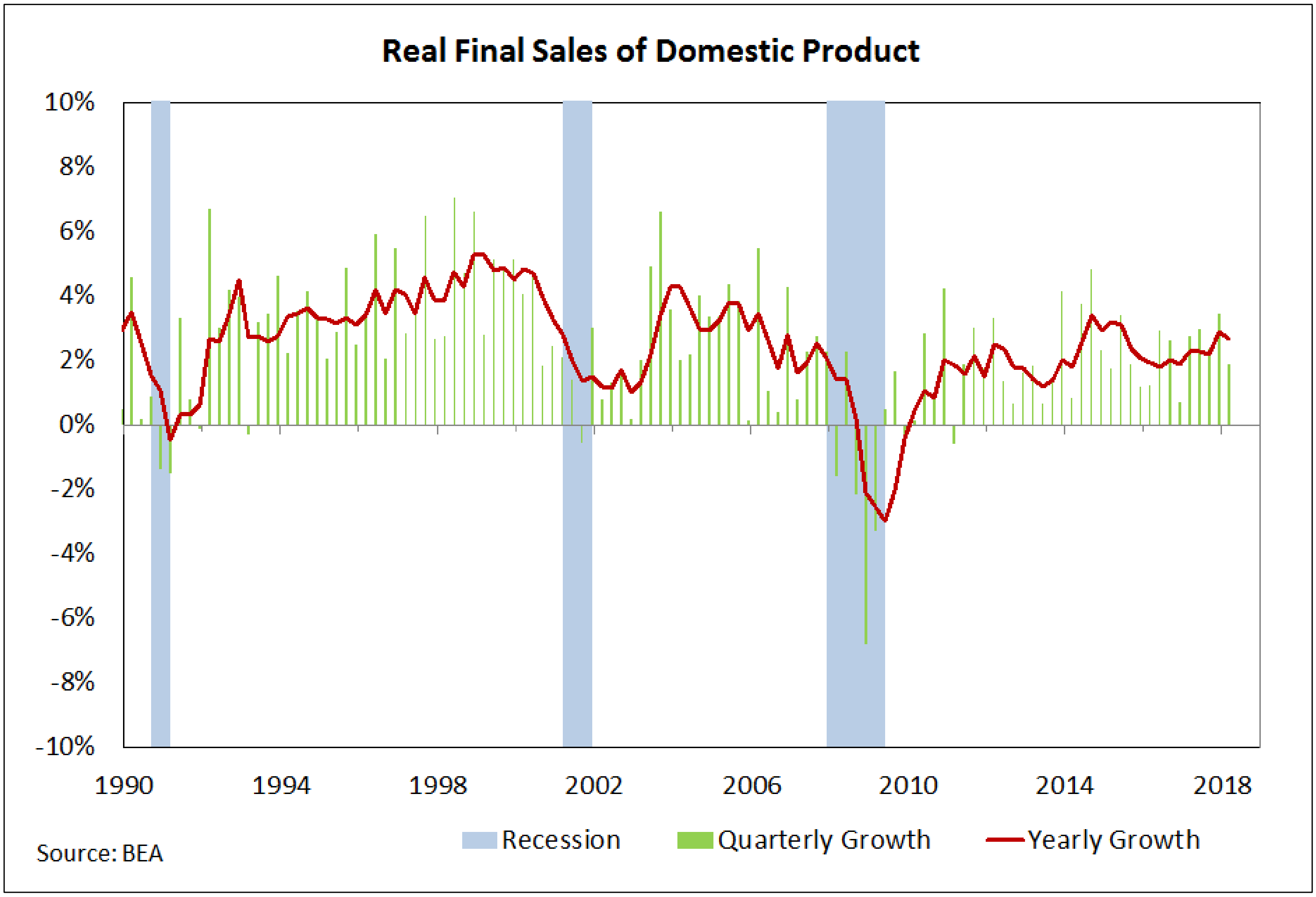
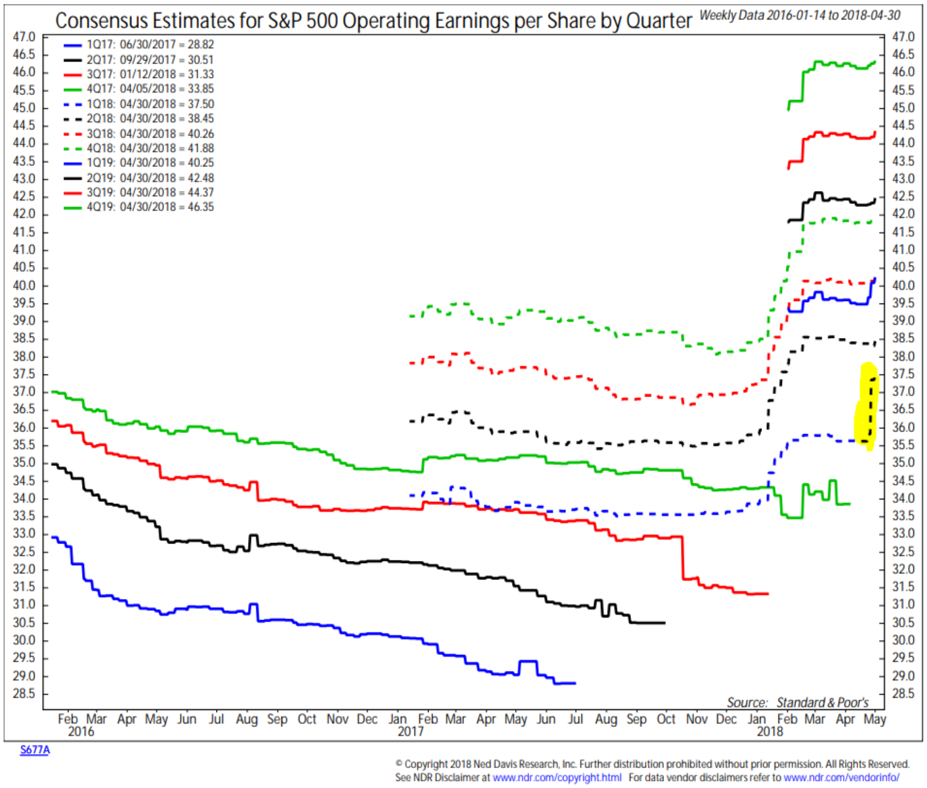
While headline GDP growth moved higher on a year-over-year basis in the first quarter, some of the details argue for a more cautious view. Yearly growth in fixed investments fell for the first time in six quarters. This helped contribute to a downtick in the yearly growth in final sales. Fixed investment spending typically follows business confidence, and business confidence remains high (although it is no longer expanding). If the historical pattern holds, investment spending could reaccelerate later this year. Without a sustained increase in investment spending, it may be hard to fuel a surge in productivity growth. That could keep final sales growth, and GDP growth overall, from moving above 3% on a sustained basis.



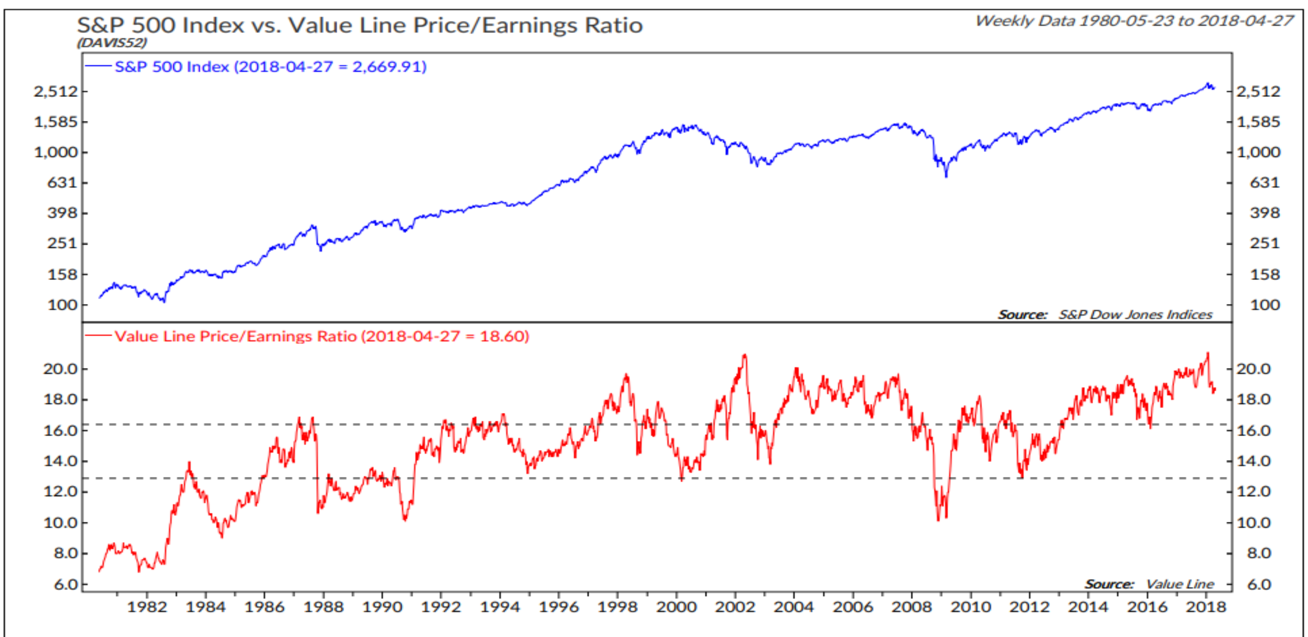


Earnings for the first quarter have been coming in stronger than expected, driven by both strong sales (the best in seven years) and improved profit margins (the best in a decade). So far, the uptick in earnings expectations for 2018 as a whole has been due to upward revisions for the first quarter. If expectations move higher for the remaining three quarters, it may reflect some confidence that economic conditions are continuing to improve and that the macro tailwinds are enough to offset rising labor and energy costs.

From a stock market perspective, these improving growth trends could help relieve the elevated valuations that emerged as fundamental improvements lagged price gains.



Source: Ned Davis Research



S&P 500 Index Performance Full History: 1980-05-23 to 2018-04-27		
Value Line P/E Ratio is	% Gain/ Annum	% of Time
Above 16.4	4.37	39.67
12.9 - 16.4	10.71	37.79
Below 12.9	13.47	22.54
Buy/Hold = 8.75% Gain/Annum		

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