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KEEPING THINGS ELEGANTLY SIMPLE: MARY ELLEN STANEK ADDRESSES BAIRD ADVISORS INSTITUTIONAL INVESTORS CONFERENCE

KOHLER, WI September X, 2016 – For the 17th straight year, Baird Advisors hosted its annual Institutional Investors Conference in Kohler Wisconsin. Attendees listened to Manpower Chairman CEO Jonas Prising discuss global employment trends and former Ford and Boeing CEO Alan Mulally address innovation and management topics. Baird Advisors Managing Director and Chief Investment Officer Mary Ellen Stanek provided Baird's annual investment outlook.

Said Stanek, "We try to keep it elegantly simple. We aren't economists, we are practitioners. We sort through the work of a variety of economists and strategists, look for the missing pieces in the puzzle, and find the opportunity." Following are the highlights of her remarks.

2016 Market Review

Looking back at the past year, there was a lot about the macroeconomic environment we got right in our forecast. The broad based, durable U.S. expansion continued. The U.S. economy faced considerable headwinds from other parts of the world and while the current expansion has been disappointing in magnitude, it remains one of the longest in post-World War II history. Furthermore, there is convincing evidence that the expansion should continue with housing improving, solid job growth and the U.S. consumer in good shape.

Last year we didn't talk about the expected Fed actions as tightening, but more as normalizing interest rates away from the "emergency" zero rate policy that had been in place for almost seven years. Back in December 2008 the Fed launched extraordinary monetary policy by moving interest rates to zero in an attempt to ease financial conditions and move investors off the sidelines (cash), out the yield curve and into other "risk" assets classes like equities. Coming into this year, with modest growth, unemployment continuing to fall, and wages showing early signs of rising, the Fed was poised to enact a series of quarter-point increases in the Fed Funds rate to finally give it some breathing room off of zero. But the markets took exception to the Fed's plans and got spooked by its expected path of ELEVEN additional rate hikes over the next three years.

The sharp decline in energy and commodity prices that began in 2015 also intensified early in the year, to such an extent that hope for stronger growth in the U.S. faded into concern that global growth was faltering. In the first six weeks of the year, a decisive *risk-off* mood came over investors and volatility surged, equities plunged and credit spreads gapped wider. This severe market reaction acted like a speed bump to an already subpar U.S. economic expansion, and real GDP for the first half of 2016 fell to just 1% after averaging 2% since the end of the 2008-2009 recession.

A decline in productivity has contributed to subpar U.S. growth. The primary driver in our view has been muted business investment/capex during this expansion. Cautious business leaders have decided to hire more people in lieu of investing in productivity enhancing machines and other technology. Other contributors include fewer start-ups and less dynamism in the economy given increased regulation and the loss of the experience and “institutional knowledge” of retiring baby boomers. This decline in productivity points to why job growth in the U.S. has remained robust at the same time GDP growth has only been subpar post crisis.

While globalization increased real incomes overall, it has had clear winners and losers. Winners include the Asian middle class, primarily the Chinese, and the top 1% globally. The middle and lower-middle income classes in the U.S. and Western Europe were the losers and have seen little real wage growth in over 20 years. The evidence of their frustration is the rejection of the political establishment which embodies the status quo, as we’ve seen here in the U.S. with the rise of Bernie Sanders and Donald Trump, and movements toward nationalism and away from globalization.

Arguably the most convincing sign of this wave of rejection of the establishment because of their support of globalization was Brexit, which took the markets by surprise and further reduced estimates and prospects for global economic growth, especially in the UK and the European Union countries. This surprise headwind to global growth caused bond yields around the globe to decline and sent central banks scrambling to find new and creative ways to further stimulate faltering economies. The Bank of England reversed course and lowered short-term rates. The ECB began buying corporate bonds in the open market. Bank of Japan redoubled their easing efforts and introduced a large scale fiscal stimulus program. This wave of fresh stimulus buoyed stock and bond markets and pushed credit spreads tighter, largely bringing us to where we are today.

Current Environment and Outlook

While the U.S. economy continues to chug along amidst numerous headwinds, it still looks strong compared to other developed economies around the globe. We expect fewer rate hikes as the Fed has to be careful about how fast they raise rates – they can’t diverge too much from other central banks that continue to ease policy because it would likely invite unwanted additional strength in the dollar, which could destabilize emerging markets, particularly China.

Prior to the Brexit vote, the UK was on a similar growth path as the U.S. The question now is how much will it diverge going forward? The Eurozone and Japan continue to experience very slow growth, contributing to weakness in global growth overall.

Although this current expansion has been below average in terms of strength, it continues to be above average in longevity. In the past 50 years there have been seven prior business cycles, four of which have been associated with low inflation. Each of those four cycles averaged 98 months or a little over eight years. During these low inflation cycles, the Fed could allow the U.S. economy to run for an extended period because rising inflation was not a concern. The current recovery falls into this low inflation category and likely has room to run.

We see convincing evidence that the expansion in the U.S. will continue. First, job creation continues to be solid. Though job growth has decelerated over the last three years, it still remains well above the 75,000 to 100,000 jobs per month of net new entrants needed in the labor force and thus the unemployment rate continues to fall.

At 4.9%, we are getting closer to “full employment” and we would expect job growth to modestly slow. But there is likely additional slack in the labor force if you look at the U-6 unemployment rate that includes those who are working part-time and want to work full-time, and job seekers who haven’t actively looked in the last four weeks but still want a job. Many consider this the “real” unemployment rate, which is close to 10%.

Despite the slowing, we still believe the U.S. expansion will continue. First, the housing market continues to improve. Existing home sales remain firm and prices are rising at a sustainable pace. Home ownership rates have likely bottomed at a sustainable level and the cost differential between owning and renting a home continues to widen in favor of home ownership. This cost advantage of owning should support continued improvement in the housing market.

Second, a healthy banking system provides a good foundation for growth. Banks are profitable and there has been a significant increase in loss absorbing capital, which makes them safer and increases their capacity to lend. Non-performing loans are back to manageable levels and loan growth has been steady and healthy.

The single biggest factor cutting both ways for the US economy is a more cautious consumer. On the positive side, the U.S. consumer has been saving more and spending less. In the long run this is a very good thing as consumers are not over-extended and are in good shape to continue to support the current recovery as consumer spending represents 70% of U.S. GDP. However, lower spending is an ongoing headwind to stronger growth and, since the financial crisis, consumers have been reluctant to take on additional debt.

Unfortunately, the only type of consumer debt that is growing at unsustainable levels has been student loans. We mentioned last year how the burden of student loans has kept many recent entrants into the job market from being able to buy a home. This student loan burden will be carried primarily by the Millennial generation for a long time.

The Environment and Where We See Value

It looks like it could be "slower for longer" for the economy and "lower for longer for interest rates;" Treasury yields have fallen even further this year. While we were calling for some flattening of the yield curve and short yields did come up a bit as expected, what surprised us (and pretty much everyone else) was the sharp decline in long-term rates. This is why we don’t make top-down interest rate calls by actively managing portfolio duration versus the stated benchmark index. It is very hard to get these calls consistently right, and many got it wrong this year yet again.

Unprecedented bond buying by central banks is the other significant factor driving U.S. and global rates lower. The result of all this bond buying has been an astounding increase in central bank balance sheets. In total, global central bank balance sheets have increased over $9 trillion dollars. The Fed alone has increased their balance sheet by $3.6 trillion, but proportionately that is nothing compared to what the Bank of Japan has done. The BOJ increased its balance sheet to the same size as the Fed even though the Japanese economy is just a quarter the size of the U.S. The value of the assets they hold on their balance sheet is now almost equal to their annual GDP. Bond buying by central banks has clearly distorted global market yields.

One might wonder, with the US 10-year Treasury yield falling to just 1.57%, “who in the world would still find that attractive?” In fact, a lot of people in the world do! Ten-year US Treasury yields still look pretty attractive relative to other alternatives around the world, with several countries currently at negative yields. Over $13 trillion in market value, or 37% of all government debt, is trading at negative yields. An additional $14 trillion is yielding less than 1%. So combined, over 75% or $27 trillion of government debt is trading at yields of less than 1%.

The result is that a wave of foreign cash has washed up on the U.S. shoreline in search of positive yields, and those foreign investors are not just buying Treasuries. In the past, foreign buyers in the U.S. bond market would generally limit their purchases to U.S. Treasuries and U.S. government agencies including agency MBS. What we are seeing today is very significant buying of U.S. corporate bonds of investment grade quality given the significant yield advantage versus European corporate bonds. Foreign buying of U.S. investment grade corporate bonds is estimated to be almost $500 billion in 2016.

U.S. companies have been issuing debt to take advantage of low rates; new issue supply of investment grade debt is expected to set a new record of over $1.3 trillion. But the roughly $500 billion of foreign purchases comes pretty close to taking care of the expected NET new supply of $640 billion this year. So the supply/demand technicals in the U.S. corporate market are quite strong given this additional demand from foreign investors.

At the same time credit fundamentals remain solid. Though no longer at peak levels, revenue, profits and free cash flow remain strong and interest coverage remains solid. The one area of credit fundamentals we are paying particular attention to is the increase in overall leverage. Much of this increase in leverage came from two sources: M&A activity at large, higher quality companies and an increase in leverage for commodity sensitive companies given their huge short-term drop in earnings.

While yield spreads widened early in 2016, the favorable supply/demand technicals coupled with solid credit fundamentals have driven spreads tighter year to date.

There remains a lack of liquidity in the secondary markets as dramatically lower bond dealer inventories no longer act as a “shock absorber” for the corporate bond market. This can create opportunity for us to provide liquidity during selling pressure and we try to put this structural imbalance to work for our investors.

Recently we’ve also seen some unintended consequences of increased regulation on the short end of the curve. As a result of the long-awaited money market reforms becoming effective in October, we’ve already seen $700 billion move from prime money market funds into government money market funds and it’s expected to exceed $1 trillion by year-end. This movement has caused the TED spread (LIBOR spread versus same maturity U.S. Treasury bill) to rise sharply. Three month LIBOR has risen to over 0.8% after hovering around 0.25% for the last several years. We’ve taken advantage of this opportunity in our shorter duration portfolios and have exposure to floating rate issues that are priced attractively over LIBOR.

We remain overweight to corporate credits across our portfolios, but our exposure is very well-diversified. We maintain our overweight to financial intermediaries – with tighter regulation and higher capital requirements in this sector, we feel well protected as bondholders. This has been somewhat of a long-term overweight, which my colleague Gary Elfe is fond of saying goes back *only* to 1991.

If the credit cycle were a nine-inning baseball game, we would say we are probably in the seventh. With credit fundamentals still sound, we want to stay for the entire game and recognize that like many ball games, these later innings could last a while. We still see good opportunities in the bond market, especially in short and intermediate maturities.

In summary, although the global economic environment remains challenging, the central banks around the world are fully aware and engaged to do all they can to sustain at least modest, but importantly, positive growth. The U.S. economy, as the star among developed nations, looks to be on a path of continued growth that will further extend this already lengthy expansion. The Fed, while seeking to normalize monetary policy, realizes they don't act in a vacuum and have lowered the path of expected future rate hikes to the more gradual and realistic pace the market had expected. The political backdrop in the U.S. and abroad warrants particular focus for signs that the protectionist, anti-globalization forces don't go too far, threatening the pace of growth here or elsewhere. The slow and lower for longer theme for 2017 remains our base-case expectation, but the many years of collective experience of the Baird Advisors team has taught us that surprises will certainly occur. We stand ready to meet those challenges for the benefit of our clients, as we have done for each of the 17 years we have gathered together at this conference. Risk management is the foundation of all that we do. As the world grows increasingly complex, we will continue to keep our singular goal of meeting our clients' needs "elegantly simple."