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Market Update

Q3 2020 Review and Outlook

Markets marched upward. Growth continued to outpace Value and Large-Cap outperformed Small– and Mid-Cap equities. Bond markets posted modest returns and the 10 Year Treasury yielded 0.69% at quarter-end.

PWM Research

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The Markets at a Glance

Asset Class	Representative Benchmark	Q3 Return	YTD Return
US Large Cap	S&P 500	8.9%	5.6%
US Small Cap	Russell 2000®	4.9%	-8.7%
International	MSCI EAFE	4.8%	-7.9%
Commodities	Bloomberg Commodity	9.1%	-12.1%
Municipal Bonds	BBgBarc. Municipal	1.2%	3.3%
Taxable Bonds	BBgBarc. Aggregate	0.6%	6.8%
Cash	FTSE 3-Month T-Bills	0.0%	0.6%

Performance returns are as of 9/30/2020

Q3 Recap

Given the abundance of news and market action, recapping last quarter feels more like reviewing an entire year. Over just three months, there was huge decision-making on both the monetary and fiscal policy fronts, the market seesawed wildly, and the pandemic remained a constant. Still, stocks marched higher (if not always in a straight line), as accommodative policy, reopening progress, and vaccine optimism outweighed several notable headwinds.

Large-cap indices outperformed those down the cap-scale, while Growth again outpaced Value. Discretionary, Materials, and Industrials outperformed, while Energy lagged significantly. International equities rallied, as well, though performance was bifurcated. Emerging markets did well in 3Q, as strength in heavier-weighted Asian markets more than made up for weakness elsewhere. A weakening US Dollar continued to be a tailwind for international stocks.

The broad fixed income market returned 0.6% on the quarter. Risk-on momentum from Q2 carried over, as High Yield (4.6%), Global (4.2%) and Investment-Grade (1.5%) debt outperformed. The challenged municipal market also showed some life, returning 1.2%. Yields remained fairly calm, as the 10-year Treasury ended at 0.69%.

The Stock Market has No Party

Election Imminent

Though COVID-19 has rightfully demanded much of our attention the past few months, we are now somehow less than a month from the 2020 Presidential election – as if this year weren't volatile enough already. A lot rests on this race; our nation is embroiled in a devastating pandemic, heightened geopolitical tensions, and country-wide social unrest. The next four years are critical to America's future. But there is one major thing that should not rely on the election outcome – your portfolio.

True or not, the partisan divide in our country feels as wide as ever. The debate is noisier, the rhetoric is harsher, and social media has a way of amplifying the loudest and most controversial voices. Politics is an emotional game. Unfortunately, some of our worst biases and behavioral mistakes show up when we let emotions drive our decision-making.

The Market is Apolitical

This is particularly true in investing. There are too many stories about Republicans going to cash in 2008, or Democrats selling out in 2016. **Put simply, the stock market has no party**.

The chart to below says it all – equities have historically trended higher regardless of which party held the Presidency and/or Congress, whether unified control or split government. Presidents likely get far too much credit for the good and far too much blame for the bad when it comes to the economy and market.

That is not to say policies do not matter. Tax rates, tariffs, geopolitics – all affect the bottom line of US companies to varying extents. But stocks are affected by countless factors – technological innovation, demographics, interest rates, to name a few – many of which have more influence than the politics of the day.

Put simply, the long-term market trend is higher regardless of the party in power, and nearly anyone who sold out due to an election going against their candidate has been worse for the wear. Politics are impassioned and intense, while investing should be rational and fact-based. They do not, and should not, mix.

Figure 1:

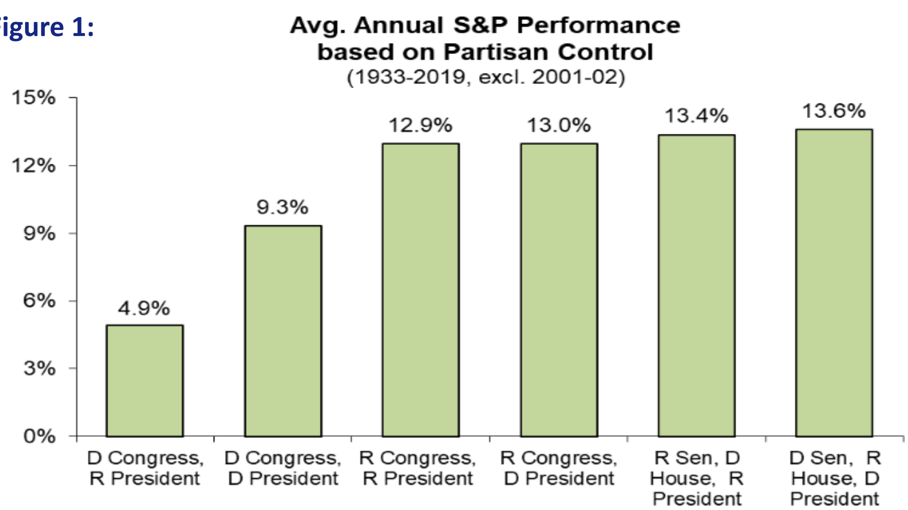
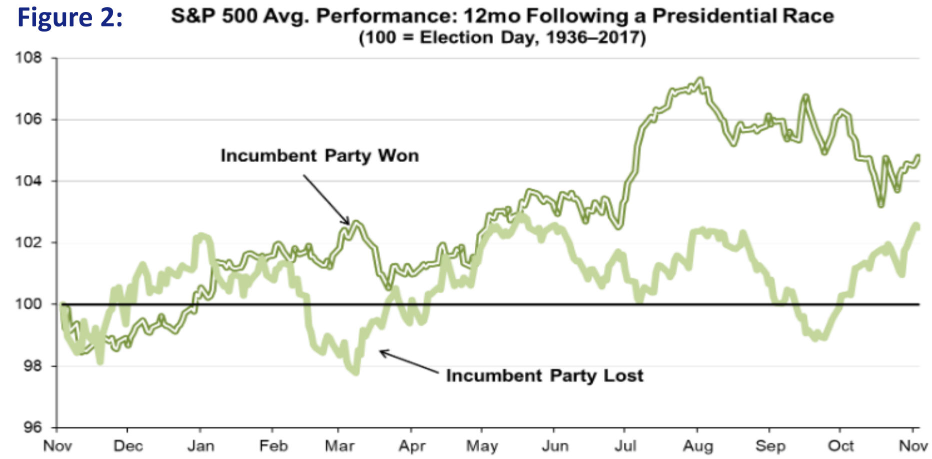


Figure 2:



Volatility Possible (If Not Likely)

Let's look at one more chart - how has the stock market performed after a presidential election? Well, it depends. When an incumbent loses, the market does tend to gyrate a bit more over the ensuing months. This makes sense – equities ultimately despise uncertainty, and it takes time for the stock market to get comfortable with a new regime.

But once again, we can see that if we look at the history of this country, stocks tend to react positively (one year out) whether the incumbent wins or loses. There are ups and downs along the way, but the market ultimately moves on from election day regardless of the outcome – there are simply bigger fish to fry.

Still, if you are worried about your portfolio heading into November, reach out to your Baird Financial Advisor today. Volatility is higher during election years, and, as we've discussed, political intrigue can gyrate the stock market at times. We just lived through the fastest bear market in 100 years, and now we face a heated presidential election – this is not an easy time to invest. Your advisor is here to help navigate this challenging environment and keep you on the path to your long-term financial goals.

Equity Markets

US Equity Market Benchmarks

Equities	Representative Benchmark	Q3 Return	YTD Return
US Large	S&P 500	8.9%	5.6%
US Mid	Russell Midcap®	7.5%	-2.4%
US Small	Russell 2000®	4.9%	-8.7%
US Value	Russell 3000 Value	5.4%	-12.2%
US Growth	Russell 3000 Growth	12.9%	23.0%
Dev. Int'l	MSCI EAFE	4.8%	-7.1%
Emg. Int'l	MSCI EM	9.6%	-1.2%

Performance returns as of 9/30/2020

Equities at a Glance

Equity markets moved broadly higher this quarter as optimism surrounding monetary and fiscal policy overshadowed the uncertainty of COVID-19 and the upcoming election. The S&P 500 hit new highs, ultimately gaining 8.9% in Q3 and clocking a positive return of 5.6% YTD. Growth outpaced Value and Large-Cap outperformed Small- and Mid-Cap companies. Outside the US, Emerging Markets rallied due to tech stocks while Developed International benefited from a weaker dollar.

Stimulus Improves Expectations

The market's heroic rebound coincided with mixed economic data. The US experienced its deepest contraction on record in Q2 with a 31.7% plunge in GDP. The worst has likely passed as the economy added nearly 4 million jobs in Q3, and the unemployment rate fell to 7.9%. The US housing market also picked up steam thanks to record low interest rates and an increased demand for square footage as more families work from home. Composite PMIs also expanded though appear to be losing momentum. Certainly, the economy and markets have benefited from the extraordinarily accommodative policies of the Federal Reserve. The Fed indicated its intention to keep rates near zero and will allow more flexibility in its inflation and employment targets. Fed Chair Jerome Powell iterated that Congress should pass fiscal stimulus in coordination with the Fed's easy monetary policies in order to support a sustained economic recovery.

Styles Persist For Now

The S&P 500 YTD performance paints a rosy picture against a disorderly economic backdrop. However, the market cap-weighted index disproportionately benefited from its outsized exposure to the juggernaut Growth factor. The S&P 500 Equal Weighted index, which represents how the average constituent has performed, still sports a -4.8% YTD return. The market cap-weighted index only bested its equal-weighted counterpart by 2.1% in Q3 as market breadth improved. A continued broadening of the advance could indicate that this market has legs.

After leading in Q2, small-cap underperformed larger counterparts in Q3. The Russell 2000 returned 4.9% vs. 7.5% and 9.5% for the Russell Mid Cap and Russell 1000, respectively. Small-Cap trails Large-Cap by over 14% and Value trails Growth by a whopping 35% this year.

Though the dominance of Large-Cap and Growth has been prolonged, history shows these trends change over time. As shown in Figure 3, Value beat Growth handily in the early 2000s after the tech bubble burst. Similarly, Small-Cap outperformed Large-Cap for much of the 2000s (see Figure 4). Throwing in the towel on Large-Cap and Growth would have been a mistake in the late 2000s. A rotation into Small-Cap and Value could happen again, which is why diversification remains an important part of investing for the long-term.

International Equities Mixed

Developed International trailed domestic equities, with just a 4.8% return in Q3. However, Emerging Markets rallied 9.6% and managed to outperform the US thanks to strong performance from Asian tech giants. Performance was weak across Indonesia, Spain, and Brazil, which are struggling from the global pandemic. Like the US, the divergence between Growth and Value in International has been significant. Value trails Growth by 23%, the widest gap ever for international equities.

Figure 3: Value vs. Growth Leadership (Rolling 12-Month Periods)

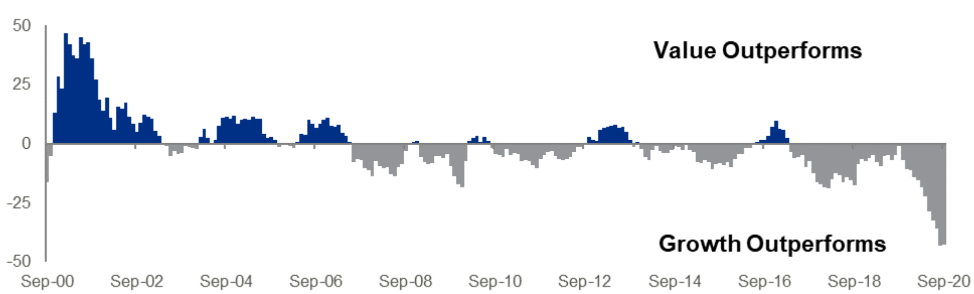


Figure 4: Large vs. Small-Cap Leadership (Rolling 12-Month Periods)

Fixed Income

U.S. Fixed Income Benchmarks

Fixed Income	Representative Benchmark	Q3 Return	YTD Return
Taxable	BBgBarc. Aggregate	0.6%	6.8%
Treasury	BBgBarc. Treasury	0.2%	8.9%
Corporate	BBgBarc. Corporate	1.5%	6.6%
High Yield	ICE BofAML US HY	4.7%	-0.3%
Municipal	BBgBarc. Municipal	1.2%	3.3%
Int'l	BBgBarc. Global Agg.	2.7%	5.7%

Performance returns as of 9/30/2020

Fixed Income at a Glance

The broad US bond market, as measured by the Bloomberg Barclays Agg Index, delivered 0.6% in Q3. Despite volatile equity markets, fixed income remained calm this quarter. Policy intervention suppressed rate volatility as economic and virus-related concerns mounted. Economic data remains a mixed bag and sentiment shifted late in the quarter as new COVID-19 cases rose, choppy equity markets created angst, and political theatrics escalated. Rates were range-bound with the US 10 Yr. Treasuries finishing the quarter at 0.69%. Dire real growth prospects pushed yields on the short end of the curve lower, reintroducing some steepness as the 2s/10s curve finished at 55 bps.

Dovish Global Central Banks

Policy initiatives were quite dovish. During the FOMC's annual Jackson Hole meeting, Chair Powell introduced a new framework that uses an average inflation reading to assess monetary policy needs. He indicated the federal funds rate will be at current levels (0.00%-0.25%) until maximum employment is achieved and inflation moderately exceeds 2% for some time. A less than optimal growth outlook and material debt overhang continued to weigh on real interest rates, pushing them further into negative territory. As seen in Figure 5, the deflationary trend of real interest rates was offset by a rise in inflation expectations. Optimism about the future, an ever-growing fiscal deficit, and a weak USD further lifted longer dated inflation expectations. Across Europe, a clearer path to fiscal unity was brought to fruition by the agreement for a €750B Recovery Fund. Despite objections from frugal member nations, the outsized benefit to peripheral countries, Italy, Spain and Greece, significantly influenced their sovereign yields. Fiscal relief pushed rates lower across the periphery while also supporting a stronger euro. Both factors served as tailwinds for US investors allocated to that region. The Eurozone delivered 6.0% to investors for the quarter.

Credit Markets Rise

Credit markets rewarded investors during the quarter as spreads grinded tighter. Corporate issuers took advantage of liquid capital markets, flooding the new issue calendar with record supply bringing YTD totals to roughly $2T. The risk-on sentiment and tighter spreads supported High Yield Bonds and Leveraged Loans, which delivered 4.7% and 4.1% respectively.

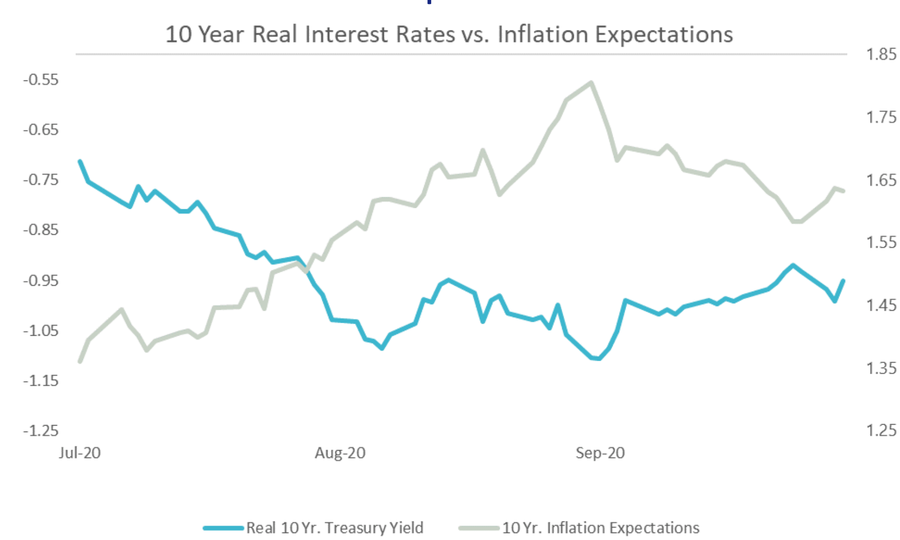
Securitized Debt Delivers

Securitized debt remains well supported and delivered decent risk-adjusted performance in Q3. Agency MBS continued to benefit from sustained Fed purchases of $40B per month, which have largely offset any increase in prepayment risk or additional supply. Commercial mortgages saw delinquencies decline 20% from their peak in May and returned 1.9% in Q3. Demand for consumer related asset-backed debt supported tighter spreads and returns of 0.8% during the quarter.

Munis Outperform Taxable

Municipal bonds returned 1.2% in Q3, outpacing its taxable peers by 60 bps. Uncertainty surrounding much needed additional fiscal support, rising interest rates and less favorable technicals limited upside during the quarter. Risk sentiment spilled over to the municipal universe with high yield municipal bonds delivering 3.1%. Investors preferred lower quality exposure, leading to higher quality general obligation bonds underperforming the group, returning 0.9% in the quarter.

Figure 5: Interest Rates vs. Inflation Expectations



Source: Bloomberg, Baird Analysis

Appendix Definitions and Disclosures

Benchmark and Asset Class Definitions

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 3000® Growth Index (All Cap Growth / Growth Stocks): Measures the performance of the 3,000 largest U.S. companies based on total market capitalization with higher price-to-book ratios and higher forecasted growth values.

Russell 3000® Value Index (All Cap Value / Value Stocks): Measures the performance of the 3,000 largest U.S. companies based on total market capitalization with lower price-to-book ratios and lower forecasted growth values.

Russell 1000® Growth Index (Large Growth): Measures the performance of those Russell 1000® Index companies with higher price-to-book ratios and higher forecasted growth values. These are equity securities of large capitalization ($7 billion plus market cap) companies having growth stock characteristics (high price to earnings, high return on equity and low dividend yield.

Russell 1000® Value Index (Large Value): Measures the performance of those Russell 1000® Index companies with lower price-to-book ratios and lower forecasted growth values. These are equity securities of large capitalization ($7 billion plus market cap) companies having value stock characteristics (low forecasted price-to-earnings ratio, low price-to-book ratio, high dividend yield).

Russell Midcap® Index (Mid Cap / Mid Core): Measures the performance of the 800 smallest companies of the Russell 1000® Index, which represent approximately 31% of the total market capitalization of the Russell 1000® Index. These are equity securities of middle capitalization ($2-7 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 securities of small capitalization (<$2 billion plus market cap) companies having growth and value characteristics.

Russell Micro Cap Index (Micro Cap): Measures the performance of the 1,000 smallest companies in the Russell 2000® Index, which represent approximately 3% of the total market capitalization of the Russell 3000® Index.

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.

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). Sub-indices include Petroleum, Grains, Industrial Metals, Livestock, Precious Metals, and Softs

MSCI Emerging Markets Index Net (Emerging Markets): A free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. As of May 27, 2010 the MSCI Emerging Markets Index consisted of the following 21 emerging market country indices.

MSCI Country Indices (Country-Specific Markets): To construct an MSCI Country Index, every listed security in the market is identified. Securities are free float adjusted, classified in accordance with the Global Industry Classification Standard (GICS®), and screened by size and liquidity. MSCI then constructs its indices by targeting for index inclusion 85% of the free float adjusted market capitalization in each industry group, within each country. By targeting 85% of each industry group, the MSCI Country Index captures 85% of the total country market capitalization while it accurately reflects the economic diversity of the market. This includes the MSCI Japan Index. International indices.

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 Global Aggregate Bond Index (Global Bonds): Provides a broad-based measure of the global investment-grade fixed income markets. The three major components of this index are the U.S. Aggregate, the Pan-European Aggregate, and the Asian-Pacific Aggregate Indices. The index also includes Eurodollar and Euro-Yen corporate bonds, Canadian government, agency and corporate securities, and USD investment grade 144A securities.

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.

BBgBarc U.S. High Yield Bond Index (High Yield): Covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets (e.g., Argentina, Brazil, Venezuela, etc.) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures, 144-As and pay-in-kind bonds (PIKs, as of October 1, 2009) are also included.

BBgBarc U.S. Treasury Bond Index (Treasury Bonds): Comprised of U.S Treasury securities with at least one-year maturities.

Appendix Definitions and Disclosures

GICS

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Appendix – Important Disclosures and Definitions.

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