Market Strategy
July 12, 2011

Investment Strategy Outlook

Please refer to Appendix – Important Disclosures.

Secular Risks High

Outlook Summary

Underweight Exposure to Stocks, Underweight Bonds

Risk/Reward Dynamics Argue for Caution

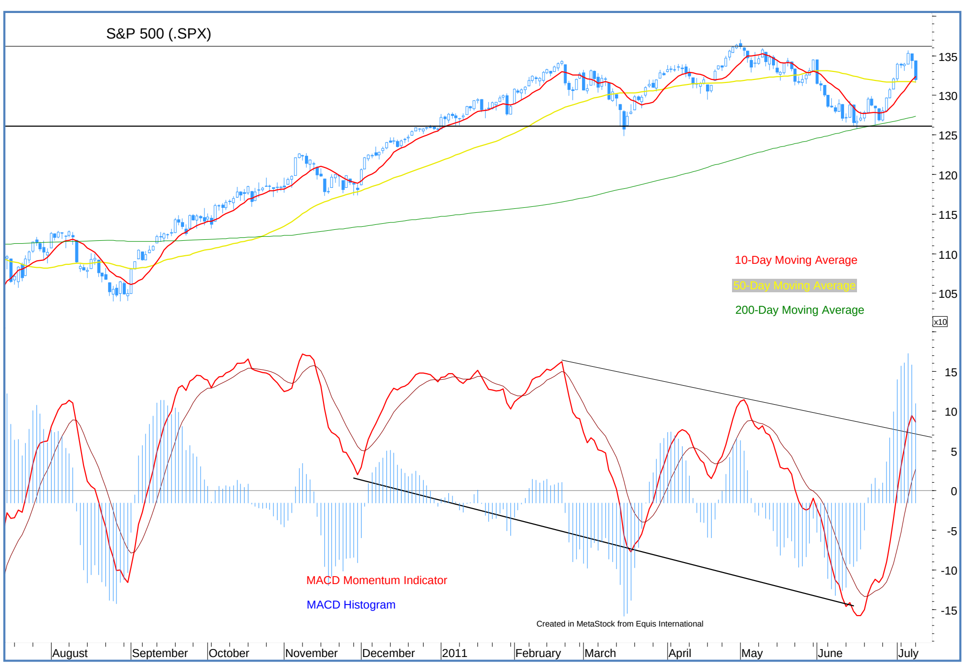
Near-Term Growth Outlook Clouded

Key S&P 500 Support Near 1250; Resistance Near 1365

Highlights:

- **Growth Forecasts Prove Too Optimistic**
- **Recovery To Be a Process, Not Event**
- **Investors Should Focus on Capital Preservation in Face of Risk**
- **Economic Fundamentals Downgraded to Bearish**
- **Technicals Supportive as Breadth Improves**

With 2011 now half over, let's step back and review from a macro perspective where we have been and where we are going. As 2011 began, the consensus expectation for growth for the year topped 3.5%, with many forecasters looking for growth to be even stronger. The Federal Reserve's own economic projections (based on the individual views of the Fed Governors and regional Presidents) called for growth of between 3.2% and 4.2% in 2011. The Survey of Professional Forecasters published in February had expectations for growth exceeding 3.0% in every quarter this year and accelerating growth in each subsequent quarter. These expectations were not out of line with the experiences seen coming out of recent recessions, and reflected the view that with the crisis event having passed, economic activity would expand at an accelerated pace to make up for the lost output during the recession (the gap between real output and potential output would be closed). Under this scenario, the pace of job growth would quicken, and the unemployment rate would move steadily lower. *If the recent recession were on par with other post-World War II recessions in the U.S. these expectations would be well-met and the efforts of the government to prime the pump of aggregate demand would have worked – the economy would have been stimulated.*

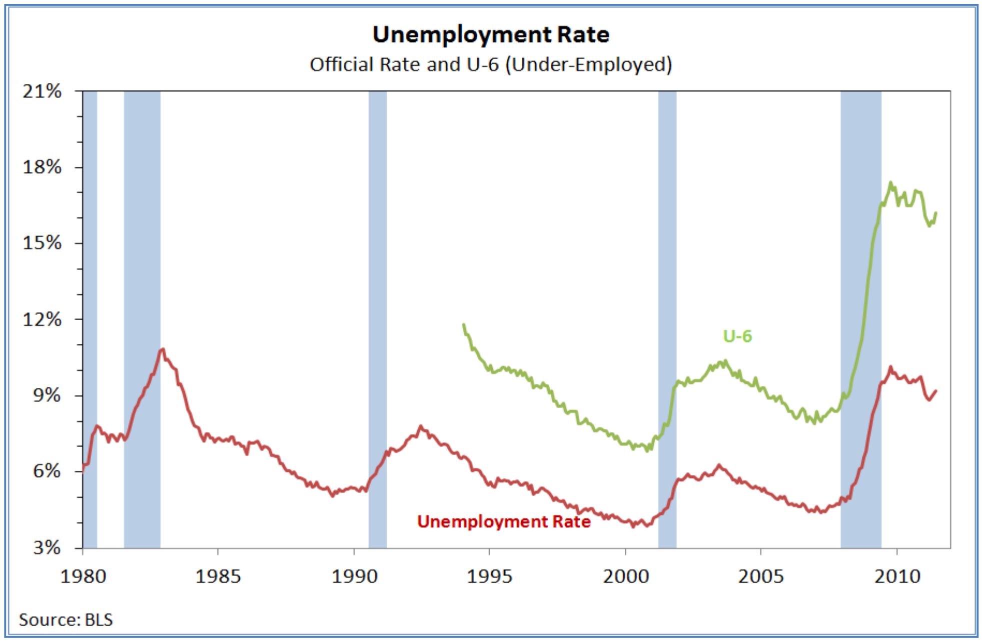


What has been seen instead has been reported growth of just 1.9% in the first quarter, with growth in the second quarter expected to be similar. The employment picture improved modestly in

Bruce Bittles
Chief Investment Strategist
bbittles@rwbaird.com
615.341.7114

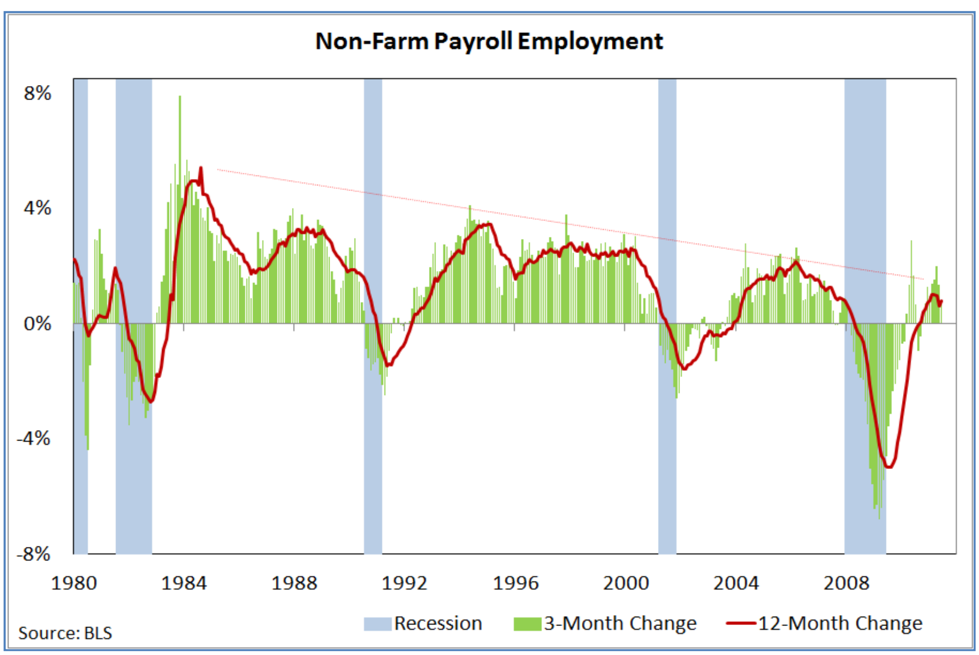
William Delwiche, CMT, CFA
Investment Strategist
wdelwiche@rwbaird.com
414.298.7802

the first quarter (payroll growth was barely robust enough to produce a decline in the unemployment rate) before deteriorating dramatically in the second quarter. The unemployment rate, now at 9.2%, is at its highest level of the year, weekly initial jobless claims are stuck above 400,000 and the economy added a total of 43,000 new jobs in May and June combined. Nominal hourly wages actually fell by a penny in June, and when the meager job growth is combined with the shortened average work week, total hours worked in the economy actually declined in June.

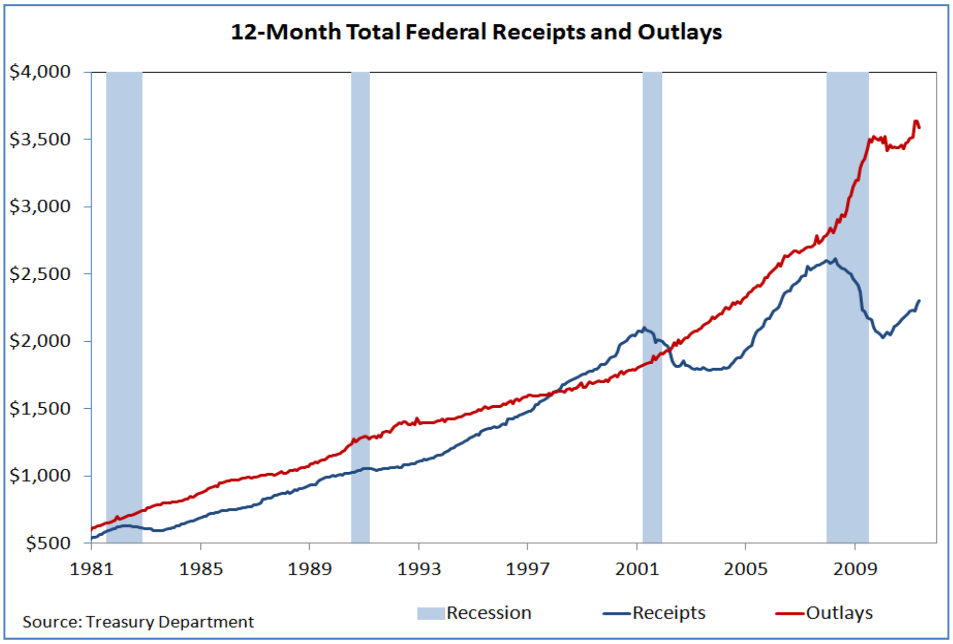


Other data showed similar struggles in the second quarter. The ISM Purchasing Managers' Index averaged 61 over the first four months of the year, and 54 over the past two months. Various manufacturing surveys done by the regional Federal Reserve banks echo this deterioration, although many of those surveys show an outright decline in activity (whereas the ISM data merely shows a slowing in growth). Looking below the headlines, output in the second quarter appears to have outpaced demand, meaning that businesses are again seeing inventories build.

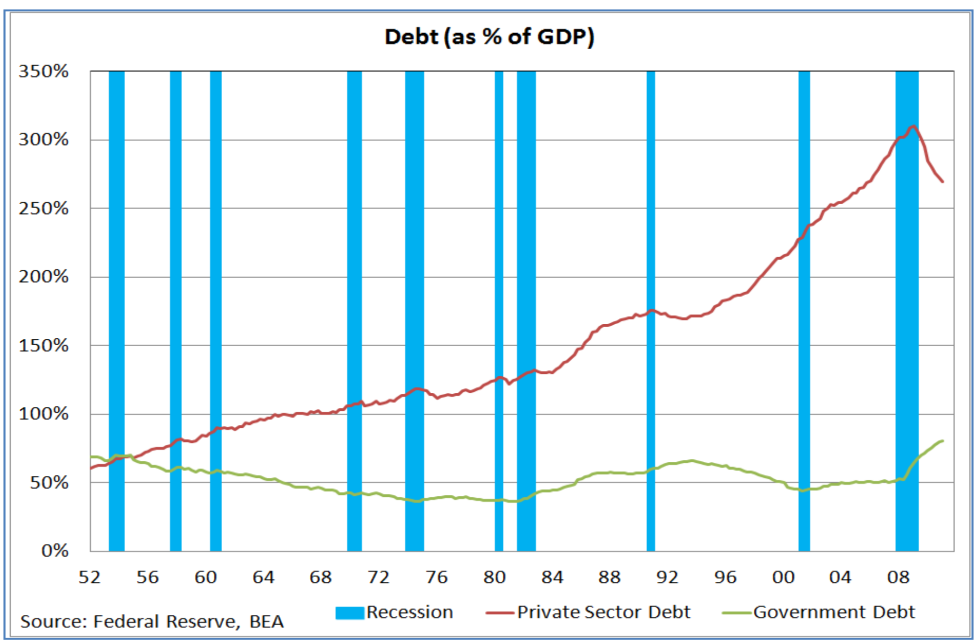
The point here is not to bash individual forecasts, but rather, point out the uncertainty of forecasting in general. In this specific case, though, there is also a lack of recognition of a larger reality. Many a forecast has been victim to unforeseen events. The Japanese disaster has almost certainly dampened global output as supply chains have been disrupted. Similarly (although on a smaller scale), flooding and tornadoes seen in the United States in the first half of 2011 also represented economic headwinds. These dislocations will likely prove temporary, and the recovery from them may provide some boost to growth in the second half. *However, it is unlikely that the bulk of the disappointment in growth in the first half of the year can be attributed to new, unanticipated developments.*



While on the surface the recent recession and recovery to date has mimicked the experience of past recessions in some respects, the root cause has been significantly different. We have witnessed an inventory adjustment cycle, but that has not been the dominant feature of this experience. **Rather, this has been a balance sheet recession that was years in the making and may be years in recovery.** Academic research shows that recovery from financial crises of this sort is slow and uneven. *Many forecasters continue to compare this recovery to those in the recent past, producing elevated expectations and befuddlement when the data comes in sub-par.* Likewise, efforts to stimulate the economy have produced no follow-through because the excesses of the past (elevated levels of debt) have yet to be worked off. Short-term stimulus, funded by additional borrowing, has actually exacerbated the longer-term debt problem, while offering only dubious near-term positives. It is important to realize that the economy continues to work through a deleveraging *process*. **While the 2008 crisis events have passed, secular risks remain high as the problems with debt, both domestically and overseas, are only now beginning to be discussed and addressed**. *This is an important step that begins to lay a hopeful foundation that the process will continue to unfold. A stable economic base, built on savings and investment rather than consumption and debt, can be built, though patience will be required.* **The key is to view this as an unfolding process, not a discrete and complete event.**



The ongoing deleveraging process at the household and business level, policy tools that appear ill-equipped for strengthening the economy, and a mismatch between growth expectations and reality produce an investing environment in which secular risks are elevated even at times when the shorter-term technical condition of the market is improving. This environment is susceptible to bouts of heightened volatility and macro-related stresses. When these emerge, degrees of risk do not matter as virtually all risky assets become highly correlated. The benefits of diversification (and perceived liquidity) break down at precisely the time they are needed most. Our answer to investors struggling with an appropriate stance toward a stock market that enjoys a favorable technical and monetary backdrop (as will be seen when we review the weight of the evidence below) but must contend with the high risks due to the global debt bubble is straightforward: **preservation of capital in a high-risk environment trumps other considerations.**



This starts at the asset allocation level. From a strategic standpoint this means underweighted exposure to stocks and bonds and overweighted exposure to cash. For the average investor we recommend equity exposure of 55%, with 35% exposure to bonds and 10% exposure to cash. *Both stock and fixed income investors should not reach for returns, but instead balance risk and return.* Periods of volatility can lead to tactical whips-saws as the markets lurch en masse from risk-on to risk-off trades. *More tactically minded investors need to always keep the bigger picture in mind and not get caught only looking at the details, not matter how compelling they may seem in the moment.*

Indicator Review

Fundamental Factors		
Federal Reserve Policy	Bullish	+1
Underlying Economic Fundamentals	Bearish	-1
Valuations	Neutral	0
Technical Factors		
Investor Sentiment	Neutral	0
Trends/Seasonal Tendencies	Bearish	-1
Tape/Breadth	Bullish	+1
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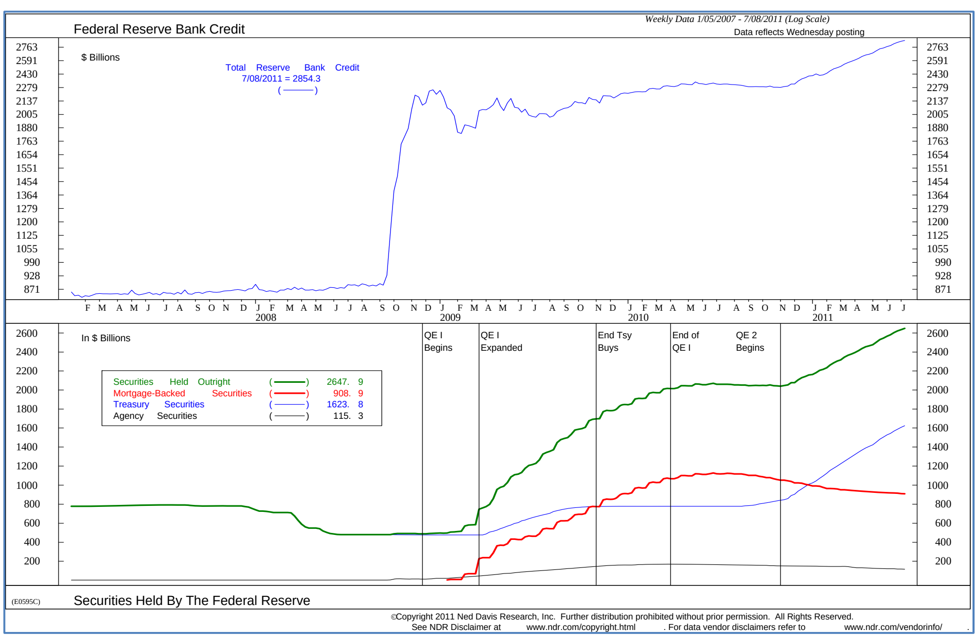
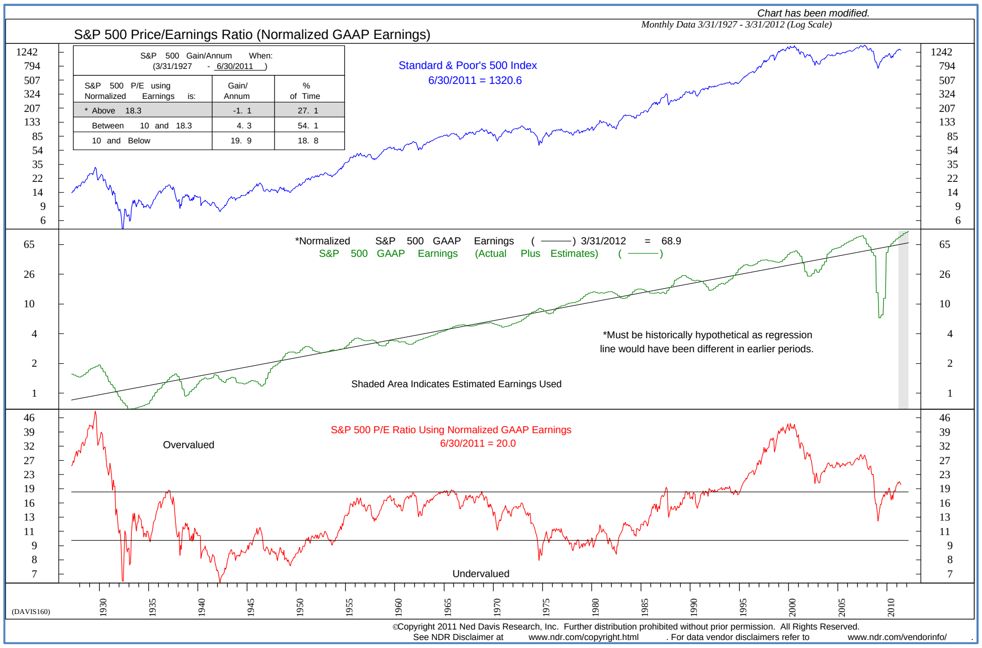
Weight of the Evidence	Neutral	0

We continue to rely on the overall weight of the evidence, which is largely neutral. In the current environment the message from the markets (both equity and fixed income) about what is happening matters even more than usual. Fundamental indicators, which offer insight into what should happen, are of less importance. Because short-term technical indicators can be swayed by a single day's market action, investors should focus on the longer-term trend. *A break below 1250 on the S&P 500 would indicate that the cyclical rally that began over two years ago has lapsed, while a rally to new highs (1365 on the S&P 500) would suggest that the market is looking past the headline risk in the economy and that rally remains intact.* Movements within that range may just be noise.

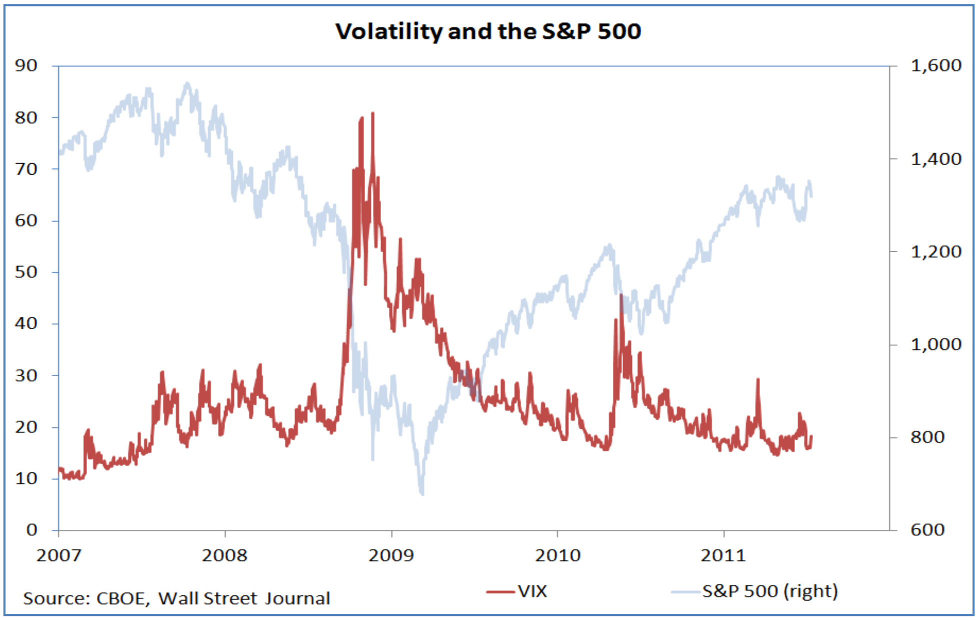
Federal Policy is bullish, even though the second round of quantitative easing has been wrapped up. The Fed will maintain the size of its balance sheet indefinitely, meaning that it will make new purchases of Treasuries as existing holdings mature. While bank lending conditions have improved somewhat, the efforts to induce new lending through QE2 have not been broadly successful. Banks have been willing to keep excess reserves at the Fed rather than lending them out. When those reserves have been put to work, it has largely been in the stock and commodity markets, which have been the primary beneficiaries of the Fed's largesse. *We continue to believe that another round of quantitative easing (QE3) will be forthcoming, although the form and timing are uncertain.* While it is politically unpalatable for the Fed to discuss it now, a 10% decline in equities and/or a negative quarterly print in GDP could force the Fed's hand. To be clear, this is our view of what will happen, not what should happen.



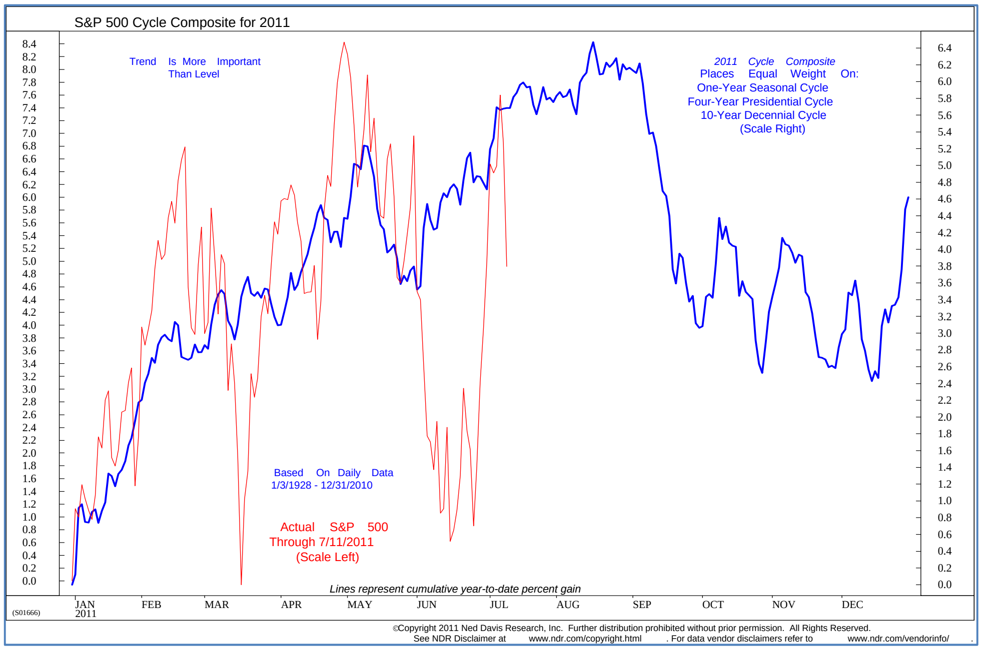


Economic Fundamentals are bearish. As we discussed above, the economy is stuck in slow-growth mode while expectations are for average to above-average growth. While the passing of some transitory effects may provide some boost to output in the second half, the longer-term trend in growth appears closer to 2.0% than 3.0%, a view that is not yet widely shared. The next few months may provide insight into just how much of the first-half weakness was temporary, but with business activity slowing, the housing market still in recession, job growth stalling, and governments laying off workers and cutting budgets, the case for sustainable strength in the second half seems beset with opportunities for disappointment. Slow and steady economic growth can be good for stocks, but slow growth that has hints of deflation and consistently fails to match expectations can be a headwind for equities.

Valuations are neutral. Valuation measures based on expectations are neutral to positive, suggesting that if expectations for earnings are met and the market values these in line with recent history, stocks may be somewhat cheap (although by no means a bargain). However, earnings expectations are coming down and it is dubious to us that the market should value earnings in the current cycle (driven as they have been by Fed stimulus and margin expansion more than organic growth) on par with those seen in the past. Moreover, longer-term valuation measures show that stocks are fairly valued at best and may tend towards the expensive side. The nearby` chart, showing normalized earnings, shows that stocks are in an overvalued range.



Sentiment is neutral. The pessimism that built up in advance of the late-June rally (which produced the best five-day gains in the indexes in over two years) has dissipated. Optimism has re-entered although it remains shy of the excessive levels that typically cause trouble for the stock market. Surveys of both individual investors and advisory services show more bulls than bears (around 40% bulls and 25% bears). A ratio of two bulls for every bear would suggest excessive optimism. Active investment managers have moved cash back into the equity markets, although overall exposure remains shy of the April peak. The VIX volatility index has been subdued of late and even when it rises it hardly suggests that fear has entered



the marketplace. Put/call ratios have been generally high as investors have been quick to hedge exposure with protective puts. One area of concern is the lack of cash on hand at mutual funds. While these liquidity ratios are in a longer-term down-trend, they are also at lows within that trend. *With little cash in reserve, mutual fund managers are not in a position to provide support if stock prices fall, and selling could be exacerbated if redemptions accelerate.*

Seasonal Patterns/Trends are bearish. The easy gains in the composite cycle are in the past, with the next several quarters suggesting headwinds from a seasonal perspective. Longer-term trends have deteriorated, although the S&P 500 has overcome a series of lower highs and lower lows (by definition, a down-trend). If the up-trend that began in March 2009 is still intact, the equity indexes should be able to surpass their April peaks. Longer-term momentum trends are generally moving lower, while the price trends for the first half of 2011 are broadly sideways. From a longer-term perspective, any rally or weakness that fails to break out of this range (between 1250 and 1365 on the S&P 500) will be inconclusive.

Breadth is again bullish. Strong broad market participation in the rally that closed out the first half provided a marked improvement in the percentage of industry groups in up-trends and carried the sector-level and index-level advance/decline lines to new highs. Strong breadth trends provide important underlying support to the indexes, painting a technical picture that would argue for a breakout above the April index highs. While the secular risks may limit the upside for the indexes, broad market strength may also limit the downside.

Tactical Investment Implications: A more complete discussion of current tactical leanings will be in the forthcoming Q3 Tactical Call piece. Following is a brief summary:

- An elevated risk environment and deterioration in the weight of the evidence has led us to move to an underweight position for stocks (leaving us underweight stocks and bonds, and overweight cash).
- Tactically minded investors could use the identified range on the S&P 500 to lean towards stocks as the index tests support and lean away from stocks as the index tests resistance, recognizing that a break below or above those levels would be cause for re-consideration.
- Equity exposure should be tilted toward domestic stocks. Both developed and emerging international indexes face significant headwinds, and in periods of stress otherwise-low correlations could rise and dampen diversification benefits.
- Gold has held up well as investors increasingly favor it relative to both the euro and the U.S. dollar. Momentum trends are improving and a new price high is looming.
- Bond allocations should remain short in maturity and focused on high-quality corporates. Euro-area concerns (and domestic economic weakness) have pushed the yield on the benchmark 10-year T-Note below 3.0%. A rise above 3.5% could provide an opportunity to lengthen maturities.
- In a high-secular risk environment, capital appreciation may be a less important component to total portfolio return than in the past. While not reducing portfolio quality by chasing yields (and overall returns), investors (particularly those needing to generate income) should construct portfolios that balance the yield opportunities across asset classes.

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Model Portfolio	Mix: Stocks / (Bonds + Cash)	Risk Tolerance	Strategic Asset Allocation Model Summary
All Growth	100 / 0	Well above average	Emphasis on providing aggressive growth of capital with high fluctuations in the annual returns and overall market value of the portfolio.
Capital Growth	80 / 20	Above average	Emphasis on providing growth of capital with moderately high fluctuations in the annual returns and overall market value of the portfolio.
Growth with Income	60 / 40	Average	Emphasis on providing moderate growth of capital and some current income with moderate fluctuations in annual returns and overall market value of the portfolio.
Income with Growth	40 / 60	Below average	Emphasis on providing high current income and some growth of capital with moderate fluctuations in the annual returns and overall market value of the portfolio.
Conservative Income	20 / 80	Well below average	Emphasis on providing high current income with relatively small fluctuations in the annual returns and overall market value of the portfolio.
Capital Preservation	0 / 100	Well below average	Emphasis on preserving capital while generating current income with relatively small fluctuations in the annual returns and overall market value of the portfolio.

Baird's Investment Policy Committee offers a view of potential tactical allocations amongst equity, fixed income and cash, based upon a consideration of U.S. Federal Reserve policy, underlying U.S. economic fundamentals, investor sentiment, valuations, seasonal trends, and broad market trends. As conditions change, the Investment Policy Committee adjusts the weightings. The table below shows both the normal range and current recommended allocation to stocks, bonds and cash. Please consult a Baird Financial Advisor in determining if an adjustment to your strategic asset allocation is appropriate in your situation.

Asset Class / Model Portfolio	All Growth	Capital Growth	Growth with Income	Income with Growth	Conservative Income	Capital Preservation
Equities:						
Suggested allocation	95%	75%	55%	35%	15%	0%
Normal range	90 – 100%	70 - 90%	50 - 70%	30 - 50%	10 - 30%	0%
Fixed Income:						
Suggested allocation	0%	15%	35%	45%	50%	60%
Normal range	0 - 0%	10 - 30%	30 - 50%	40 - 60%	45 - 65%	55 – 85%
Cash:						
Suggested allocation	5%	10%	10%	20%	35%	40%
Normal range	0 - 10%	0 - 20%	0 - 20%	10 - 30%	25 - 45%	15 - 45%

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