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## Viewpoint

Baird Investment Management (BIM) manages high-quality portfolios for high-net-worth individuals and institutional clients.

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Management

*“Investing is the only business I know that when things go on sale, people run out of the store.”*

**- Mark Yusko**

A stock market correction and the accompanying increase in volatility have grabbed hold of investor attention in recent weeks. Several factors are at work, including; a slowing pace of global economic growth, underscored by the recent tepid U.S. GDP numbers; the uncomfortable political debate over raising the U.S. debt ceiling; and a downgrade in the quality rating of U.S. Treasuries by Standard & Poor's. New concerns have emerged over the drop in consumer confidence and potential for a negative wealth effect should equity market weakness continue.

In our view, the best course of action during periods of such uncertainty, and the best way to serve our clients, is to focus on what we can control. Our investment process is built on a long-term investment horizon, the construction of appropriately diversified portfolios, and strong fundamental analysis to identify businesses that we believe are positioned to deliver attractive profitability and growth through the course of business cycles.

To be clear, macro conditions are important to an investment outlook and the issues outlined above are meaningful and present a challenge to the economic recovery. We believe the economy finds itself in a soft patch for growth - one that is deeper than we expected. However, recoveries don't always move forward in a linear fashion as we experienced during a growth slowdown in mid-2010, and while downside risk to growth has increased, we believe the economy will expand in the second half.

Our outlook for improved growth is built on several factors. Importantly, in the recently completed reporting cycle, earnings of nearly two-thirds of companies in the S&P 500 exceeded expectations. In addition, overall profitability remains high despite a less than robust environment. In this recovery, businesses in general have done an exemplary job of managing cost, evidenced by the \$1 trillion in cash on the balance sheets of S&P 500 companies. The accommodative rate posture of the Federal Reserve combined with high cash levels should allow strong businesses to continue investing for future growth. We would also note that the bond yield curve retains a positive slope, a condition typically not associated with recession.

As we mentioned in our prior newsletter, we still see opportunity for improvement in manufacturing, specifically in the important automotive sector in the back half of the year. Vehicle production schedules in the U.S., hampered by parts shortages and assembly shutdowns resulting from the Japan earthquake, are recovering but have not yet been revealed in reported production data. We note that Japanese vehicle production is already in the midst of a sharp recovery. Meaningful improvement in U.S. production numbers should assist domestic GDP and employment in upcoming quarters.

The news coverage of sovereign debt problems, both here and abroad, will likely continue at a mind-numbing pace. We believe the debate on how to resolve these issues will result in actions to better structure and ultimately/perhaps reduce debt burdens. It will take real courage and leadership to accomplish these goals, but dialogue about how to tackle debt challenges is finally taking place.

In sum, there is understandable concern over the challenges facing the U.S. economy and market volatility may well remain elevated. A sustainable improvement in stock market performance will require evidence that the economy is making progress. Areas of particular focus will continue to be employment trends, bank lending and manufacturing activity. We are closely watching this pause in economic activity, but expect the resumption of better economic trends in the coming months.

Uncertainty typically finds its way into the valuation of companies and the overall market. Based on the recent 2011 estimate for earnings of approximately \$95, the S&P 500 trades at a low double-digit price-earnings ratio. We think this level is reasonable, even if the estimate is revised lower to account for a more modest growth outlook. The current valuation level is lower than that seen last year during the economic slowdown.

We are patiently looking to add to existing positions where we have identified strong fundamental opportunities. We are also using this market correction as an opportunity to revisit quality companies that we believed had previously become too expensive. Thank you once again for your support of Baird Investment Management.

**To learn more about Baird Investment Management (BIM) and our products, please contact us at 800-792-4100 or 414-765-7246. Visit us online at [bairdinvestmentmanagement.com](http://bairdinvestmentmanagement.com).**

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