Bell Bank Wealth Management

EQUITY & FIXED INCOME OUTLOOK DECEMBER 2017

Federal Reserve Monetary Policy

The next Federal Reserve interest rate increase is expected to be announced December 13. It would increase the top range of the Fed funds rate from 1.25 percent to 1.5 percent. It's possible the prospect of incoming chairman Jerome Powell could change the chances for a rate increase, but we do not see that happening.

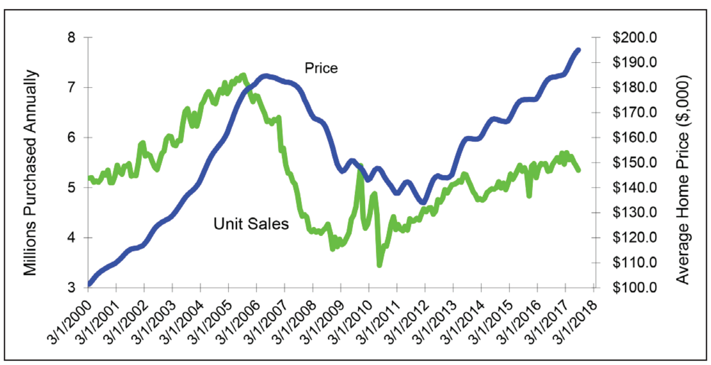
Inflation

The year-over-year inflation rate for October was 2 percent – in line with the Fed's target rate. We expect that rate to continue for the rest of the year. It will be interesting to see the rate released in mid-February, as it could drop below 2 percent. The Federal Reserve looks at personal consumption expenditures (the measure of consumer spending on goods and services) to measure its inflation target. That figure remains at 1.32 percent.

Economic Activity

Consumer activity has been strong, but it looks like it has been supported by declining savings rates and increased debt. We question the sustainability of consumers' buying power under these circumstances.

Housing continues to be a source of economic strength. The average home price today is now above the previous high – from just before the mortgage crisis. Unit sales have not reached the same level, and we don't expect them to, as annual home sales have averaged around 5 million units for quite a while. The limited supply of new and existing homes for sale is one of the reasons unit sales are not higher.



Source: Bloomberg

Fixed Income

The bond market continues to ignore expert market predictions that long-term interest rates will rise. The 10-year U.S. Treasury bond reached a high of 2.63 percent in March and traded as low as 2.04 percent in September. The rate is currently 2.33 percent. The 10-year Treasury bond yield has been declining, even as the Fed funds rate has increased from 0.5 percent near the end of 2016 to 1.25 percent today.

One reason for declining longer-term interest rates is that pension funds have migrated out of stocks and into bonds as they locked in gains from the equity market over the last few years. A rising stock market is not often cited as the reason for declining interest rates.

Stock Market

Stock market valuations are more stretched than normal across many different assessment methods. This trend is driven by reasonable earnings growth estimates, low interest rates, central banks' monetary policy, low inflation and low market volatility. Good economic news, such as low unemployment, solid consumer confidence and stable economic growth expectations, also helps.

Extended valuations tend to get investors wondering when stock prices will peak. While we would love to have this crystal ball as much as anyone else, the reality is nobody knows. Some indications the market may be reaching a peak include increased volatility, rotation to value or defensive stocks, and a strong buying finale (similar to the end of a fireworks show) followed by decreased cash flow into stock purchases. While we feel the stock market is later in its current cycle, these possible indicators have not given us much advance notice so far.

Another way the stock market reverses course is an unexpected shock, known as a "black swan" event. At the present time, this type of event may be a bigger risk to the stock market than elevated valuation saturation.

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Years of Investment Experience: 32 years

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