EQUITY & FIXED INCOME OUTLOOK JULY 2019

Bell Bank Wealth Management

Federal Reserve Monetary Policy

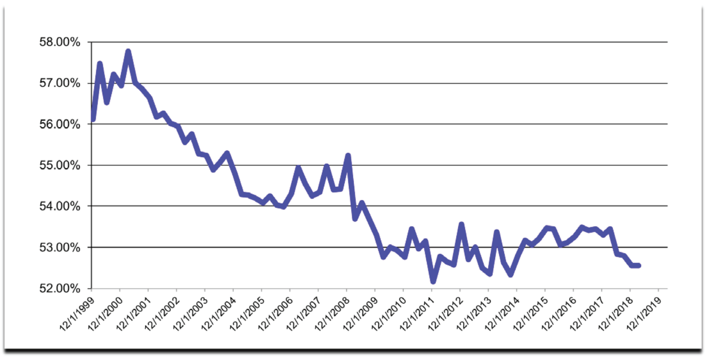
The Federal Reserve indicated it was considering interest rate cuts as soon as its July meeting. Our take is that there is noticeable market pressure to make a move in July. However, since the Fed would first like to see what second-quarter gross domestic product (GDP) looks like before making any changes, July may be a bit too early. The Fed Fund rate currently remains at 2.5 percent, with the next Fed meeting scheduled for July 31.

Inflation

The most recent year-over-year inflation rate was 1.8 percent. We look for the number released in July to be near 2 percent. Long-term inflation expectations remain muted, with most forecasters believing levels will remain below 2 percent. Low inflation is the case for developed economies around the globe. Monetary policy is the preferred tool to help drive inflation higher, but Japan's and Europe's experiences using the same strategy have not worked very well. We don't know why the results would be any different here. However, monetary policy does seem to work well in driving asset price inflation higher.

Economic Activity

Tax it, and there will be less of it. Our chart shows the last 20 years of personal income as a percentage of GDP.



Increases in employee productivity can influence this calculation, as can taxation. Income taxes tend to be the highest taxes paid by workers. It will be interesting to see if the Tax Cuts and Jobs Act of 2017 has any effect on the 20-year downward trend line moving forward.

It might not seem like it but there is quite a brawl going on regarding the future prospects for the economy. On one hand, declining interest rates suggest the economy is slowing, and investors will need bonds to protect their portfolios against the equity volatility that comes with a slowing economy. On the other hand, the stock market is touching new highs as it sees strong prospects for more economic growth and increasing corporate profits. A good analyst can make arguments for both outcomes, perhaps even putting the odds at close to 50/50 for either. One thing is sure: one of the perspectives is wrong.

Fixed Income

The Federal Reserve's willingness to inject more money into the financial system is a contributing factor in driving asset prices higher. The 2.22 percent yield on the 10-year U.S. government bond, noted in last month's outlook, is long gone. Today that yield is 1.97 percent.

Is the prospect for stable growth (but slower than long-term averages), low inflation and continued monetary support from the Fed enough to provide for a structurally driven economy, in which investors are satisfied with 2 percent interest on a 10-year investment? Even if this is so today, there are always external events (such as the housing crisis, financial crisis, tech stock bubble or Long-Term Capital Management crisis, to name a few from the past) or risks that could throw cold water on this concept of a permanently stable economy. What might these events be today? Developments in trade, a geopolitical event, a cyber attack on a mission critical network, or perhaps a good old-fashioned end to the current economic cycle could all have impact.

The additional yield investors receive for owning bonds other than U.S. Treasuries has also been declining, which means investors' compensation for risk in these asset classes is shrinking. In the end, we sort through the market environment, looking for the best opportunities we can find.

Stock Market

Forecasts for corporate earnings growth suggest second-quarter earnings will be down about 2.25 percent. Is this the type of news that should drive the stock market to new highs? No. That brings us back to the Fed and its willingness to inject money into the financial system. This Fed action tends to increase the value of nearly every asset class, regardless of the state of the economy or its underlying fundamentals. This is what makes portfolio management in this environment so difficult. Active managers, who are minding the signals and looking to buy securities with appropriate underlying fundamentals given the current economic conditions, are losing ground to passive investing that roots its confidence (perhaps unwittingly) in the Fed's disposition to providing its monetary elixir.

Greg Sweeney, CFA

SVP/Chief Investment Officer

Tenure: 09/1992

Years of Investment Experience: 33 years

Education: Greg holds a bachelor's degree in business from the University of North Dakota and is a CFA charter holder.