Equity & Fixed Income Outlook June 2014

Federal Reserve Monetary Policy

At the next Federal Reserve meeting on June 18, we expect the Fed to leave rates unchanged between zero and 0.25%. It still looks like 2015 will be when the fund rate begins to shift higher.

Inflation

The year-over-year consumer price index (CPI) released in May shows inflation at 2.0%. This is another noticeable step up from the previous month, which was 1.5%, and 1.1% prior to that. We expect the release this month to remain near the 2% range.

Economic Activity

The European Central Bank (ECB), which is similar to our Federal Reserve, has implemented negative deposit rates. That means member banks have to pay to have their money on deposit. The ECB is trying to encourage banks to lend. The problem is there are not many interested borrowers. This could increase demand for U.S. Treasuries as a surrogate for depositing money with the ECB and keep U.S. rates low.

Companies have implemented many efficiency and cost reduction programs over the last few years to maintain earnings per share. Today these same companies are looking to leverage these cost-saving programs by seeking mergers and acquisitions, share buybacks and dividend increases. Low borrowing costs also help fund mergers, acquisitions and share buybacks.

Why do we mention merger and acquisition activity? These deals are revenue protection strategies that tend to correlate with late stage business cycles. Yes, there is the possibility that this activity is primarily driven by low interest rates, but we don't want to ignore the parallel relationship to past business cycles.

The Fed continues to taper its open market purchases. The continued upward movement in equities may suggest the market is shrugging off concerns that less liquidity from the Fed will hurt stock prices. If water is drained from a pool, it becomes obvious in the shallow end first. If there is a negative impact from the Fed, we may not know it in our large, deep market until the Fed gets closer to completing this phase.

Economic forecasters started the year with lots of enthusiasm. That was dulled a bit when news came out about the economy shrinking 1% annualized in the first quarter. Revisions to the first quarter results may go even lower when they are released on June 25.

The weather is getting the blame for much of the slow-down in the first quarter, but we feel the slow-down had more to do with limited consumer income growth and the need for more job growth.

Consumer confidence remains in a narrow range and is having trouble advancing beyond where it started the year.

Fixed Income

Rising tensions in Iraq and continued uneven economic recovery in the U.S. are holding bond yields low. In fact, bond yields have declined since the beginning of the year, which has helped the long Treasury bond return outperform the stock market.

The reported inflation rate is 2%. The yield on 5-year U.S. Treasury notes is 1.69%. The owner of this bond goes backward 31 basis points a year after accounting for inflation, even before taxes.

This remains a challenging environment in which to earn interest income.

Stock Market

Our outlook for stocks in 2014 was upward 5% to 9%, with the prospect of a downward movement of as much as 10% and an upward movement as much as 15%. As of the end of May, the S&P 500 is up 4.96% for the year.

Near-term support for stocks may continue, as Japan has announced it will increase stock allocations in some of the government retirement portfolios.

Greg Sweeney, CFA,
Chief Investment Officer

Tenure: 9/92

Years of Investment Experience: 28 years

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

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