Bell Bank Wealth Management

EQUITY & FIXED INCOME OUTLOOK DECEMBER 2019

Federal Reserve Monetary Policy

At its December 11 meeting, the Federal Reserve is expected to leave the fund rate unchanged at 1.75%. Presently, there is no suggestion the market expects to see further cuts for the next few months.

Inflation

The most recent year-over-year inflation rate was 1.8%, with the next release scheduled for December 11. Surveys suggest inflation will reach 2%. We agree that direction will be upward, but it could land a tick on either side of this estimate.

Economic Activity

Even though no trade agreement has been signed, market fears of an impending recession seem to have disappeared. Equity markets recorded new highs, and the inverted yield curve – which suggested to some an impending recession – has returned to a normal, upward slope. It goes to show that predicting the future in a world of randomly occurring events is no better than a coin toss. Maybe the only thing predictable about forecasts is that they are predictably inaccurate. We prefer to look at long-term averages, with the prospect of the economy and markets gravitating back toward the mean.

Leading economic indicators are hovering near record highs. CEO and small business owner optimism has firmed up. The total number of people working in the U.S. reached 158.5 million (it has never been higher). The Institute of Supply Management's new business orders are still lagging, but perhaps growing business confidence will strengthen that number. As a whole, core economic indicators suggest the economy is still doing fine.

Fixed Income

Debt per share for S&P 500 companies increased 82% over five years for the period ending December 2018. That same calculation from the end of 2013 to today shows debt per share has increased 136%. By comparison, earnings before interest, taxes, depreciation and amortization (EBITDA) on the S&P 500 is up 31% over the same time period. Book value per share has gone up 25%. Net debt as a percentage of EBITDA has gone from 1.05 times at the end of 2013 to 1.89 times today.

What is the point of all of this? Debt has become a much larger portion of the corporate capital structure than in the past. Why does this matter? There is less equity as a percentage of the capital structure for weathering economic slowdowns or industry volatility. In short, increased risk has been migrating to bond holders without them realizing it. In addition, low interest rates bring an additional amount of volatility to bond holders in the form of lower income, offsetting any price volatility that occurs in the bond market. For this and other reasons, we have been looking toward increasing overall credit quality in our bond allocations.

Stock Market

At this writing, the S&P 500 is hovering near record highs. Most companies have reported earnings for the third quarter, and they are down -3.97% compared to the same quarter last year. Expectations for earnings growth in the fourth quarter are currently 7.5%. Failure to reach this target could put downward pressure on stocks.

For the time being, the biggest theme supporting stocks appears to be the prospect of progress on trade negotiations. There could be a light at the end of the tunnel, if politicians decide to get this issue resolved before it becomes a campaign trail topic.

From a price/earnings ratio perspective, stocks still look reasonably priced as long as earnings hold up. Other metrics suggest stocks are fully priced. The moral of the story is, don't be overly aggressive in equities at the present time.

Greg Sweeney, CFA
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Tenure: 09/1992

Years of Investment Experience: 34 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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