Bell Bank
Wealth Management

EQUITY & FIXED INCOME OUTLOOK AUGUST 2017

Federal Reserve Monetary Policy

The Federal Reserve is expected to begin shrinking its balance sheet after its September 20 meeting. What does this mean? The Fed will begin selling U.S. Treasury and agency bonds (or not repurchasing bonds that mature) acquired over the last nine years under the quantitative easing monetary policy, which was designed to stimulate the economy. Shrinking the balance sheet is another way of reducing liquidity in the economy, similar to increasing the Fed Fund rate, which currently stands at 1.25 percent after four rate increases since December 2015.

Inflation

The year-over-year inflation rate for June, the latest data available, was 1.6 percent – a 0.3 percent drop from the previous month. The rate for July is expected to rise to 1.8 percent. Due to rising employment, some high-profile forecasters are calling for the near-term return of inflation above 2 percent. Our review of the underlying job data shows most employment increases are coming from lower-wage sectors and part-time employment, which suggests there will not be much upward inflation pull from increased employment. We see inflation remaining around 2 percent or a bit lower. Rising inflation may come from the dollar's declining value in world markets, making imported goods more expensive.

Economic Activity

Previously sustained levels of liquidity provided by the Federal Reserve are coming to an end as the Fed raises interest rates and begins shrinking the balance sheet. This may not seem important, since most of the effects of quantitative easing failed to reach the consumer, but it is important to remember what the policy did affect. It provided large corporations access to inexpensive sources of capital, which they used to issue cheap debt while repurchasing stock with the proceeds. In a period of stagnant top-line revenue increases, these share repurchases allowed corporations to report rising earnings per share – not because of productive business models, but because they simply reduced the denominator in the mathematical calculation. This liquidity also inflated asset prices across the board, including stocks, bonds and real estate.

Will the methodical reduction in liquidity be taken in stride by the market? Perhaps. Could the Fed change its mind and keep assets on its balance sheet? Yes. But what happens if methodical and smooth Fed action is met with something a bit more concerning to the markets? More provocations from North Korea, record-high consumer debt, failure by Congress to raise the federal debt ceiling, wage growth that falls short of expectations, or an economy that begins to slow – all could challenge economic strategies. While we continue to look to the positives to sustain forward traction in the markets, it seems like the list of challenges may be expanding.

Fixed Income

Bond market investors appear concerned about the rising prospect of market risks, as evidenced by sustained low interest rates on U.S. Treasury bonds – even with the threat of a rising inflation rate, which tends to erode the value of bonds. Corporate bond spreads also remain tight, meaning investors expect little risk of default from this investment class.

We don't know many investors who are happy with the low yield and high valuation of the bond market, but there aren't suitable alternatives for bonds' defensive nature during potentially unstable markets.

Stock Market

Second-quarter earnings reporting has started. Popular indexes, like the Dow Jones Industrial Average and the S&P 500, seem to report record levels on a regular basis.

The market continues to be a valuation puzzle:

- How does the market continue to reach new highs when valuations already appear to be stretched?
- Has the economy become less cyclical?
- Is inflation permanently low?
- Is the stock market more growth-oriented than it has been in the past?
- Are more investors participating in the market?
- Are stock market highs driven by the rise of passive investing, which does not follow any valuation metrics?
- Is some sort of technological advancement driving the market?

These are some of our questions as we navigate the current state of the stock market. To us, it sounds a lot like the late 1990s into 2001, when some thought the tech stock bubble was a paradigm shift, and economist and former Federal Reserve chairman Alan Greenspan warned about "irrational exuberance" among investors. Greenspan's warning came two years before the market responded with a meaningful selloff – a reminder that current market conditions can continue to exist, especially if interest rates remain low and there are limited competing investment opportunities.

Proper portfolio allocation consistent with each investor's personal profile is the best way to reach your investment goals.

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Tenure: 9/92

Years of Investment Experience: 31 years

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