Bell Bank Wealth Management

EQUITY & FIXED INCOME OUTLOOK JANUARY 2017

Federal Reserve Monetary Policy

The importance of monetary policy will decline in 2017 as fiscal policy takes on more importance. That does not mean three anticipated Fed funds rate hikes won't be noticed. At the present time, the market expects the Fed to increase rates three times in 2017. By comparison, the markets expected four rate increases in 2016 but only got one. The bottom line is that the Fed looks to data development when determining the level and number of rate increases. This may mean rate hikes could be delayed or not happen at all.

Inflation

Inflation year-over-year released in December was 1.7 percent as projected. We expect the release on February 1 to drift a bit higher again. Looking forward, we see inflation reaching the Fed's 2 percent target near the end of the first quarter. That could be close to the peak for all of 2017. We do not expect to see inflation get out of hand in the coming 12 months.

Economic Activity

December 16, 2015, the Federal Reserve raised interest rates .25 percent. The stock market traded in a fairly narrow range through the end of the year. As the calendar changed to 2016, the stock market continued to follow a fairly narrow range for a couple of days until it sold off 10 percent by January 20, 2016.

December 14, 2016, the Federal Reserve raised interest rates another .25 percent. The stock market traded in a fairly narrow range through the end of the year. Now, the calendar has changed to 2017, and we don't know what January will bring. What we do know is that a year ago the price/earnings (P/E) ratio of the S&P 500 was 18.87 times. Today, it is 21.05 times. The historical average P/E is about 16.5 times. We also know economists expected the economy to grow about 2.5 percent in 2016. The final growth for 2016 looks like it will be closer to 2 percent. Economists are currently expecting 2.2 percent economic growth in the U.S. for 2017, while developed countries across the globe are reducing growth estimates.

We want to be optimistic about the plans for economic growth under the new administration, but we also have to be realists. We support generating economic growth through fiscal stimulus rather than relying on monetary policy alone. We believe some tax cuts may help grow the economy. We also know that the federal government is running nearly trillion dollar annual deficits already, and both of these plans would make it worse.

The economy may be set up for a bit of an "over promise and under deliver" action at the moment. Blipping on the radar screen are geopolitical tensions, economic expansion at the long end of historical averages, elevated P/E ratios in the stock market, aging demographics around the world, productivity and household income.

Fixed Income

The move in interest rates pushes the outside range of historical averages. While the 2.45 percent yield on the 10-year Treasury does not go very far to support retirement income needs, it is much better than the 1.36 percent yield just seven months ago.

Bell's composite fixed-income returns beat the Bloomberg Barclays U.S. Aggregate Bond Index, a popular fixed-income benchmark, last year by about 60 basis points by holding a shorter average duration, which offers some protection against rising interest rates.

Stock Market

So far, the Dow has remained below 20,000. In the end, it is just another number to measure which way the market is moving and by how far.

After adding 5.75 percent in returns to the S&P 500 in the last two months, it could be time for a breather. Long term, stocks still look favorable compared to bonds, but the gap has been narrowed by higher interest rates on bonds and elevated P/E ratios on stocks.

Greg Sweeney, CFA,
Chief Investment Officer

Tenure: 9/92

Years of Investment Experience: 31 years

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