Bell Bank Wealth Management

EQUITY & FIXED INCOME OUTLOOK JUNE 2019

Federal Reserve Monetary Policy

The Federal Reserve continues its “wait and see” approach to future interest rate changes. The market continues to anticipate that the next Fed move will be to decrease rates. We don’t feel the current economic environment warrants a Fed move, but we are mindful of the presence of much lower rates in developed foreign countries. The Fed Fund rate currently remains at 2.5 percent.

Inflation

The most recent year-over-year inflation rate was 2.0 percent, reaching the level we predicted in last month’s outlook. Federal Reserve chair Jerome Powell has suggested that low inflation over the past few months has been temporary and that moving forward, it will remain closer to 2 percent. Looking at the near-term horizon, we anticipate the inflation number released in June to remain near 2 percent.

Economic Activity

Consumers appear to be on firm footing, as consumer confidence is reported at an 18-year high. It does not appear, however, that consumer confidence is carrying over to the automobile industry. After peaking in October 2017, the auto sales trend line has been sloping downward. Consumer confidence does not appear to have migrated to the housing market, either. That is surprising, given that mortgage rates are much lower, too.

We see trade negotiations taking longer than markets anticipate. This suggests more stock market volatility during the summer as news about trade negotiations ebbs and flows.

Trade negotiations continue to be the main headline cited for moving the markets on a daily basis. The belief is that markets will return to positive momentum after a trade deal is reached. Our concern is that any trade deal may be the start of more volatility instead. With trade no longer the scapegoat, markets may look to the underlying fundamentals and find a fully valued equity market, tight credit spreads and lackluster earnings forecasts. Simply put, the fundamentals are not as strong as they used to be.

Fixed Income

Ten-year government bonds are trading with negative yields in Germany (-0.17 percent), Switzerland (-0.49 percent) and Japan (-0.08 percent). Seven developed foreign countries also have 5-year government bonds with negative yields. With all the discussion about stimulating economic growth via monetary policy, the question persists about possible negative rates in the U.S. at some distant future. The 10-year U.S. Treasury bond yield is currently 100 basis points lower than it was in November, suggesting negative yields could be a possibility someday. Whatever the case, this condition is counter intuitive. There is about $10 trillion in total developed country debt with negative yields. Investors purchasing this debt and holding it until maturity will receive less money back than they initially invested.

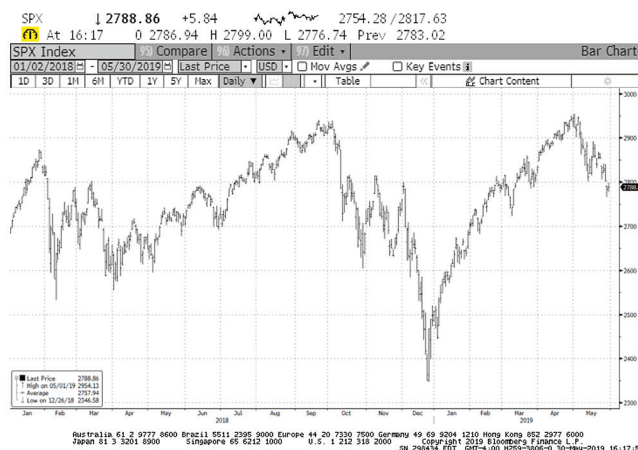
In the U.S., the 6-month Treasury bond has a yield of 2.38 percent, while the 5-year Treasury bond has a yield of 2.02 percent. The longer security, more sensitive to interest rates, is 36 basis points lower. Even the 10-year U.S. Treasury yield of 2.22 percent is 16 basis points less than the 6-month maturity. This is called an inverted yield curve. Sustained inverted yield curves tend to have predictive qualities that precede recessions. It is too early to tell if this will be the case today.

In general, we remain defensive in the bond markets with shorter average maturities, without sacrificing interest income in the current yield curve environment. This also results in attractive portfolio roll to take advantage of any disruptions that might provide additional opportunities.

Stock Market

Is the porridge too hot? First-quarter earnings growth looks like it will be less than 1 percent. With a few companies left to report, the earnings growth rate is 0.7 percent so far. Current expectations are that second-quarter earnings will be down 2.45 percent.

The S&P 500 spent the last year and a half going up and down, but today, it is no further ahead of where it was in January 2018. The annualized return since the January 2018 high was a loss of 0.36 percent.



Remember the low yields on bonds back in January 2018, which led to investors foregoing bonds and purchasing stocks instead? The annualized return of the Bloomberg Barclays Government Credit Index was 3.93 percent over the same time period.

This serves as a subtle reminder that holding a portfolio allocation consistent with each investor’s profile tends to be productive over full market cycles.

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Tenure: 09/1992

Years of Investment Experience: 33 years

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