Bell Bank Wealth Management

EQUITY & FIXED INCOME OUTLOOK MARCH 2017

Federal Reserve Monetary Policy

U.S. markets are wrestling with whether the Federal Reserve will raise the federal funds rate in March. Raw data suggests inflation is nearing the Fed's target, while economic growth is still struggling to gain forward traction. If we put it all in a pot and stir it together, our expectation is that the Fed leaves rates unchanged at 0.75 percent when it announces the results of its next meeting in mid-March.

Inflation

Inflation year-over-year released in February was 2.5 percent. The core rate, which excludes food and energy, was up 2.3 percent over the last 12 months. We are looking for the inflation rate to move higher again this month and expect the core rate to remain more stable. The Federal Reserve tends to look at personal consumption expenditures (PCE) when judging the progress of inflation. The most recent 12-month PCE was 1.7 percent, which is below the Fed's target rate of 2 percent.

Economic Activity

Most economists consider full employment to be an unemployment rate below 5 percent. It is now at 4.7 percent. The labor force participation rate of 63 percent suggests there is an ample supply of workers available to help keep wage inflation in check, removing one of the Fed's inflation concerns.

Be patient. It looks like the prospect for near-term tax cuts and a fiscal spending stimulus is further down the road than the markets initially anticipated. So far, the equity market is holding up, and yields on U.S. Treasury bonds have stabilized. If patience grows thin, we expect to see stocks drop and bond prices rise (with yields going lower). Whatever happens, we do not expect to see U.S. economic growth much above 2 to 2.25 percent for all of 2017.

Rather than forecast where the economy, bonds and stocks will be in the future, it may be more beneficial to ask more microeconomic questions:

- When will the Fed raise interest rates? By how much?
- How fast will inflation rise, if at all from this point?
- Will the tax code be revised? Rates lowered? Will it all be negated by widening the definition of taxable income?
- Will any trade wars develop? With whom? Is it significant?
- Will corporate profits grow? By how much?
- How many countries will begin the process of exiting the European Union? Will they succeed?
- Will there be a program to repatriate corporate profits held overseas? If there is, will companies simply repurchase their own stock?
- What potential disturbances are simply unknown?

It appears there is quite a list of variables that suggest a broad range of potential outcomes in the coming year or two.

Fixed Income

Fixed income yields have settled into a fairly narrow trading range since the beginning of the year, suggesting they are waiting for new information before setting out in a particular direction. The prospect of delayed tax and stimulus packages appears to have a higher probability in the eyes of the bond market than it does in the stock market.

U.S. interest rates are still some of the highest among developed countries around the globe. This, combined with the forces of demographics, suggests interest rate increases could be less than many economists believe.

Just in case, our bond allocations tend to have a more conservative duration than the market while capturing as much interest income as we can.

Stock Market

"Confidence is high, uncertainty is high … something has to give." This was a headline from an economist the other day, and it does a good job of capturing the current market conditions. We tend to agree that stock market prices are hovering in the fully priced arena. Markets can remain this way for a long time, which reminds us of the longstanding maxim: "Markets can remain irrational longer than investors can remain solvent."

Passive index investing has been getting a lot of attention, but the price/earnings (P/E) ratio on some of the popular indexes might suggest some active investment management that looks for stocks with more conservative P/E ratios. Long-term average market P/E ratios are around 16.5. Here is a list of current P/E ratios as of the February 27 market close:

- S&P 500 is 21.8
- Russell 1000 is 21
- S&P 500 growth index is 24
- S&P mid cap index is almost 26
- S&P small cap index is 27.5

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.