Bell Bank
Wealth Management

EQUITY & FIXED INCOME OUTLOOK MAY 2017

Federal Reserve Monetary Policy

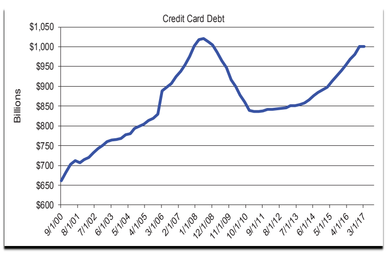
Market experts are estimating about a 70 percent probability that the Federal Reserve will raise rates when next it meets on June 14. Even though the Fed may raise rates again, monetary policy remains accommodative (designed to stimulate growth) if interest rates stay below the inflation rate.

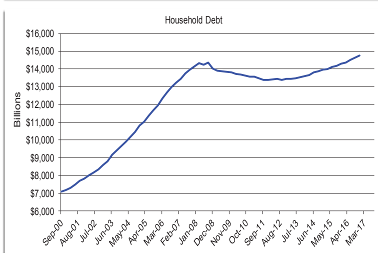
Inflation

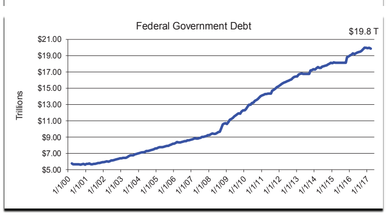
The year-over-year inflation rate for March, the latest data available, was 2.4 percent. This was a drop of 0.3 percent from the previous month. Price decreases in cars, wireless phone services and apparel were credited with having the most impact on the drop. We don't see this as the beginning of a decline in inflation, but we do expect inflation to stabilize around this number for the next several months.

Economic Activity

Economic growth for the first quarter of 2017 was only 0.7 percent, similar to that of the past few years. The average economist's growth forecast is too rosy. Credit card debt, household debt and student loan debt have risen to record or near record levels. Wages have increased around 2.5 to 3 percent, but the Fed's focus on reducing inflation to 2 percent leaves almost nothing for the consumer in terms of real wage increases after inflation. Neither debt nor wage levels suggest strong growth momentum. Lower unemployment may have the best chance of driving economic growth. It suggests there are more workers drawing paychecks and having money to spend.







Source: Bloomberg

As long as we are displaying debt levels, it has been quite some time since we provided an update on federal debt. It is currently $20 trillion and headed higher.

Real disposable income per capita has increased to $39,500, also a record high. This is consistent with economists' expectations that consumers are in a position to drive economic growth. However, savings rates have remained in the range of 5.5 percent for the last four years, suggesting consumers may already be spending their additional income.

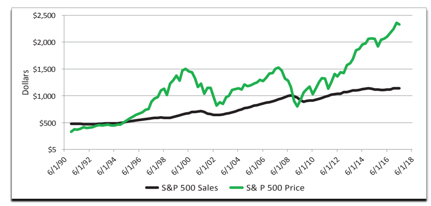
Fixed Income

It remains difficult for fixed-income investors to generate interest income from the bond market. After rising to 2.6 percent, the yield on the 10-year U.S. Treasury bond declined to 2.2 percent and is currently at 2.33 percent. Investors purchasing these bonds have a negative return after adjusting for inflation. By comparison, the dividend yield on the S&P 500 is 1.95 percent.

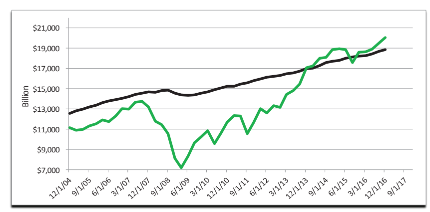
We see investors being forced into stocks, rather than drawn toward them for their attractive valuation. When investors become uncomfortable with being forced into stocks, the market can destabilize quickly.

Stock Market

We have been saying the stock market appears to be fully priced. Our graph shows the S&P 500 price per share compared to sales per share, illustrating that underlying corporate sales are not keeping up with share price valuations. Also note that valuations can remain elevated for quite some time.



This next graph shows the market cap of the S&P 500 compared to the U.S. gross domestic product (GDP). This also shows an elevated level.



Source: Bloomberg

The S&P 500 is up 5.53 percent year-to-date at the end of the first quarter on a price-only basis. This is an annualized rate of 24 percent. FAANG stocks continued to drive the S&P 500's year-to-date return:

Facebook is up 23.47 percent (133 percent annualized).
Amazon is up 18.23 percent (96 percent annualized).
Apple is up 24.04 percent (137 percent annualized).
Netflix is up 19.39 percent (104 percent annualized).
Google (Alphabet) is up 7.48 percent (34 percent annualized).

FAANG stocks accounted for 29.65 percent of the S&P 500's year-to-date return. Given these high returns, it seems the other 495 companies in the index may be a waste of time. It was nearly impossible to beat the index without being overweight in these five stocks. Active investors might question some of the lofty P/E levels on a couple of these stocks. Amazon is trading at 136 times its expected next 12-month earnings, and Netflix is at 148 times. The other three have more reasonable P/E ratios, with Facebook and Google trading near 27 times and Apple at 17 times.

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