Bell Bank
Wealth Management

EQUITY & FIXED INCOME OUTLOOK MAY 2019

Federal Reserve Monetary Policy

The Federal Reserve is expected to maintain its "wait and see" approach to future interest rate changes. First-quarter gross domestic product (GDP) of 3.2 percent was a positive surprise. A strong second quarter above 3 percent could suggest that the Fed's next interest rate change might be an increase, rather than the decrease currently expected by the markets. The Fed funds rate currently remains at 2.5 percent.

Inflation

The most recent year-over-year inflation rate was 1.9 percent. The increase over last month was higher than we anticipated. Energy and transportation were the biggest contributors. Across most components, the increase for the month was around 0.3 percent, so it was broadly based. We anticipate the next data release, scheduled for May 10, to show a slight uptick – probably touching 2 percent as oil and gas prices have pushed higher again.

Economic Activity

Trade tensions and the lack of progress in negotiations continue to make headlines and often receive the blame for volatility in the stock market. We doubt this is the only reason for volatility, but it is a convenient one. Trade negotiations have been in the news for so long now that we would not be surprised if the stock market sells off after an agreement is announced (trade the rumor, sell the news).

First-quarter GDP was higher than even the most generous estimate. Critics are concerned that inventory, built up by companies looking to avoid increased tariffs, may have benefitted first-quarter numbers at the expense of second-quarter results. Only second-quarter GDP will answer that question.

Housing should add to U.S. economic strength, if interest rates remain low as housing affordability drifts higher. The challenge continues to be finding enough housing inventory for first-time homebuyers.

Consumer spending makes up two-thirds of the GDP – and from the consumer's perspective, things look good. Employment is high, job opportunities are plentiful, wages are rising, and personal debt levels appear to be reasonable.

Fixed Income

The bond market is signaling that something doesn't seem right. When interest rates on the 10-year U.S. Treasury bond drop from 3.25 percent in November of last year to 2.45 percent five months later, it suggests that something has shifted. At the beginning of the year, the Federal Reserve changed its mind and decided to curtail its campaign of increasing short-term interest rates. Was it because by that time, the 10-year Treasury interest rate had already dropped by nearly 75 basis points from its November high yield? Or did the Fed act independently, shifting for other reasons to a "wait and see" approach on short-term interest rate changes? Either way, there was enough data to move both the market and the Fed toward a more conservative stance, at least from the bond market perspective.

Today, we know that the first-quarter gross domestic product (GDP) increase was higher than even the best forecast. Unemployment is still below 4 percent, wages are increasing at nearly twice the rate of inflation and there are currently 7.5 million job openings. This is not data that suggests caution is warranted – yet 10-year interest rates remain low, and the Fed remains on hold.

Stock Market

Stock market activity since the beginning of the year suggests a completely different story than the bond market. Nearly unchecked enthusiasm pushed the stock market to new highs, in spite of the fourth-quarter sell-off. First-quarter earnings were good, and the outlook remains positive – consistent with the GDP, unemployment, jobs and wages data already cited.

Generally, the perspective would be that one of the market responses is right, and the other is wrong. Instead, what are the chances that both markets are correct? The bond market reflects the low interest rates present in developed countries around the globe (there are six countries with negative 5-year government bond rates), and the stock market reflects prospects for continued growth moving forward. We don't have any way to know for sure why things stand where they are. We do know enough to be on guard for continued economic data that favors one theme over the other.

Some of the market data we are watching include share buybacks. Share buybacks reduce the number of shares outstanding. This strategy has been used liberally over the last few years to help corporations report favorable earnings per share. A company that earns the same amount of money year over year can magically report increased earnings per share by reducing the number of shares outstanding. When the numerator is not increasing fast enough, simply reduce the denominator for favorable results. Other strategies to increase earnings include cost cutting and taking advantage of tax reform. If these strategies were the drivers of corporate profits over the past few years, will it become increasingly difficult to meet or beat earnings expectations moving forward? This is one of the questions the market is currently digesting.

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