Bell Bank Wealth Management

EQUITY & FIXED INCOME OUTLOOK NOVEMBER 2016

Federal Reserve Monetary Policy

November 2 came and went with no change to the federal funds rate. As December draws closer, the market predicts the probability of a rate hike around 70 percent. There are three Fed member banks that still believe rates will remain unchanged in December. We feel a failure to increase rates in December would hurt the Fed's credibility. Keep in mind that the rate would move from 50 basis points up to 75 basis points, so it is still low compared to historical averages.

Inflation

Inflation year-over-year was 1.5 percent. This was an unexpected rise driven by housing and energy price increases. (Isn't it funny how the double-digit increases in health-care insurance never show up as a reason for inflation in the data released?) Expect to see inflation remain around this new level for the remainder of the year. As we move into 2017, we expect to see a small increase continue.

Economic Activity

It is not unusual to hear people say, "There is nowhere to invest." Additional gains from the market appear to be in question, while the prospects for volatility seem to be increasing. Uncertainties surrounding the economy, monetary policy, politics and the market have dented investors' confidence. These are time periods when asset correlations tend to be high. This means that portfolios with a mix of bonds and stocks, with the idea of bonds holding their value if stocks go down or vice versa, may not work as intended. Unfortunately, the best way to protect value is to hold assets, namely cash, that are insensitive to risk. This is a poor way to reach long-term goals, and history has repeatedly shown that timing the market (moving between cash and invested assets) is also a poor performer. Asset allocation may not work in short spurts of time, but it is still a good way to meet long-term goals.

The current economic expansion, while slow, is now 88 months long. This is in the top five of the longest economic growth cycles dating back 150 years. Historical averages suggest that a slowing economy may be near. It is thinking like this that leads to the old joke that economists predicted nine of the last five recessions. The reality is that various events lead to changes in economic activity, but nobody knows what or when that might be. Dollar cost averaging (committing to regularly investing regardless of what the market is doing) is a good way to move toward long-term goals.

If you have read this far, you might be detecting a theme. The biggest challenge to reaching long-term investment goals is our own human behavior. We tend to be greedy when things are going well and allocate more to the stock market than our risk profile suggests we should. When the markets get rough, that excessive stock allocation leads to more portfolio losses than we are comfortable with, and we tend to get fearful. Then we shift our allocation to be more defensive. Unfortunately, these actions occur in precisely the wrong order. Successful long-term investors tend to be disciplined and consistent. Ideally, they get greedy when others are fearful and fearful when others are greedy.

Fixed Income

Rising interest rates hurt the value of fixed-income investments. For example, the 10-year U.S. Treasury bond lost 8.8 percent of its value from July 8, when the yield was 1.36 percent, to October 31, when the yield increased to 1.82 percent. That is a noticeable loss on an asset that is considered "risk free." Chances are good that your fixed-income portfolio did not fall in value by that much. With the prospect of a federal funds rate hike in December, we expect some volatility in the bond market but do not feel that interest rates will deviate materially from where they are now. The small chance Congress could pull together a fiscal stimulus package could put upward pressure on interest rates as well.

Stock Market

There are indications the stock market is struggling to make further advances. Technical indicators show the market rolling over. Options that protect against declines in the market cost nearly twice as much as options that bet on market increases. Active investment managers are holding higher levels of cash in their stock portfolios. Price/earnings ratios remain elevated compared to historical averages, and top-line revenues and profits are struggling to impress investors. On the other hand, there are some great values to be had if you like dividends. We feel that stocks paying attractive dividends are a good place to be in a low-yield environment, because the dividend stream goes a long way toward providing returns.

Greg Sweeney, CFA,
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Tenure: 9/92

Years of Investment Experience: 31 years

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