Bell Bank Wealth Management

EQUITY & FIXED INCOME OUTLOOK NOVEMBER 2018

Federal Reserve Monetary Policy

The next prospective rate increase is projected to occur in December. The market currently is placing a 75 percent probability on a 25 basis point rate hike, which would bring the target rate to 2.5 percent. There is much talk about what rising Fed funds rates are doing to the stock market. Keep in mind the goal of the Fed is to maintain maximum employment and reasonable inflation.

Inflation

The most recent year-over-year inflation rate was reported at 2.3 percent. We expect it to rise to 2.4 to 2.5 percent when the data is next released on November 14. Once again, we do not see inflation rising in a meaningful way above 3 percent. There is a possibility that annual inflation could move closer to 2 percent for a month or two in the first quarter of next year.

Economic Activity

The primary drivers of the U.S. economy are employment and wages. The number of employed people in the U.S. currently stands at a record high of 150 million. The Atlanta Fed Wage Growth Tracker shows wages increasing at 3.5 percent. Third-quarter gross domestic product growth was recently reported at a 3.5 percent annualized rate. The good news is that a recession does not look like it is threatening to appear anytime soon.

The International Monetary Fund (IMF) reduced its expectations for worldwide growth this year from 3.9 to 3.7 percent, citing rapidly rising short-term rates and continued trade tensions. We would add elevated government and corporate debt levels to that list. The IMF's growth forecast for the United States remained at 2.9 percent, supporting the idea that there is no threatening recession in the foreseeable future.

Homebuilding stocks were mostly stable through the first two Fed interest rate increases this year, but the third increase (in September) was met with a 15 percent decline. Nationally, both new and existing home sales have drifted lower throughout the year as the Case-Shiller 20-city composite index shows housing prices have increased about 5 percent through August, the latest data available. Thirty-year mortgage rates are around 4.75 percent, up about 1 percent from a year ago. The level is about as high as it has been since 2011 but still lower compared to longer-term averages.

Fixed Income

Our expected yield for the 10-year U.S. Treasury bond is a range of 2.9 to 3.4 percent. This should be good news to prospective home buyers because it suggests mortgage rates should remain fairly stable as well. Interest rates rising above this range will likely put downward pressure on the stock market. Why? If longer-term rates increase, bonds become more attractive to investors, and they may look to take risk off the table by selling stocks and buying bonds. Also, rising rates will cost corporations more in the way of interest costs. This means largely leveraged balance sheets will result in higher interest costs, decreasing net income and hurting future earnings per share. Interestingly enough, rates going below this range also may put downward pressure on the stock market. Why? Because the bond market would be signaling the prospect of an economic slowdown in the future, which would not be good for the stock market, either. You could call this the "Goldilocks" range – not too hot and not too cold.

Stock Market

Last month, we mentioned the stock market had touched on record highs. Today, market activity throughout the month has nearly eliminated year-to-date gains. As of October 31, the market has recovered a bit from recent lows.

Regular readers may recall that our September *Outlook* mentioned a growing sense of unease in the stock market, and our October *Outlook* called attention to a couple of bellwether industrials that announced in advance that they did not expect to meet third-quarter earnings forecasts. With earnings announcements about two-thirds complete, they look pretty good; however, expectations had been high, and some of the announcements dented confidence a bit.

Where does the economy go from here? We expect more volatility – whether due to trade concerns, interest rates, perceived inflation, length of the economic cycle, changing consumer sentiment or unforeseen circumstances that suddenly appear in the mix. There was a long period of complacency in the stock market when low interest rates pushed investors into riskier assets. Volatility reminds investors to ask whether their asset selections and portfolio allocations are proper.

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