**Bell Bank**
**Wealth Management**

# EQUITY & FIXED INCOME OUTLOOK OCTOBER 2016

## Federal Reserve Monetary Policy

The drama about a possible rate hike by the Federal Reserve has been delayed once again, as the Fed Fund rate remained unchanged in September. The next formal meeting date is November 2. With the election around the corner, we expect rates to remain the same at 50 basis points. Most of the market is now focused on the December 14 meeting, but once again, it would not be a big surprise if rates were to remain unchanged.

## Inflation

Inflation year-over-year was 1.1 percent. The Consumer Price Index report later this month likely will show annual inflation near 1 percent again. The inflation rate targeted by the Fed is 2 percent. Absent some significant influence changing, we do not see this level of inflation on the horizon. At this point, we do not know what that change would be.

## Economic Activity

Harvard's endowment fund reported a 2 percent loss on invested assets for its annual fiscal year ending June 30. The allocation to public equities (stocks) lost 10 percent over a one-year period. The University of Pennsylvania lost 1.4 percent. Most college endowment fund returns are teetering on either side of zero over this time period. An allocation to 60 percent S&P 500 and 40 percent Barclays Government/Credit bond index would have returned about 5 percent. Index returns are in the fifth year of doing better than active management.

Inflation is likely to remain low. One of the main goals of the Fed's low-interest-rate strategy is to stimulate corporations to expand, which in turn will create more jobs, creating more wage earners who will increase demand. This is intended to help grow the economy. However, manufactured goods are already being overproduced worldwide. More supply in the face of stable or declining demand tends to remove upward pricing pressure. In this type of environment, inflation tends to remain low.

Economic textbooks suggest low rates will stimulate growth. These textbooks, however, fail to address the human response. For example, when interest rates and returns are low, people currently in the workforce and saving for retirement tend to spend less and save more in order to make up for lower return rates. Likewise, people who are already retired and living off of their savings spend less simply because their interest income is lower.

Twenty years ago, if investors wanted to earn 7.5 percent, all they had to do was buy U.S. Treasury bonds and collect the interest. Ten years ago, if investors wanted that same return, about half of the portfolio could still be in bonds, supplemented with 20 percent in U.S. large cap stocks, 5 percent in U.S. small cap stocks, 15 percent in non-U.S. stocks and a small component in real estate and private equity. Today, bonds would be down to about 10 percent of the portfolio, with one-third of the allocation to U.S. large-cap stocks, 8 percent in small-cap stocks, 22 percent in non-U.S. equity and a full 25 percent represented by real estate and private equity. The risk of a portfolio looking to return 7.5 percent has increased dramatically. Investors today are forced to accept about three times more volatility compared to 20 years ago to generate the same return. This is not a comfortable spot for most investors.

## Fixed Income

It is no secret that interest rates are already low – so low that government bond yields are actually negative in countries like Germany, the Netherlands, Switzerland and Japan. To help drive interest rates even lower, some central banks have been using their money-printing capability to purchase corporate bonds. Plus, the Bank of Japan (Japan's central bank) purchased a record 123 billion yen worth of stocks in August! If this is not considered a manipulated market already, at what point does it become one?

## Stock Market

The stock market has become the T.I.N.A. (There Is No Alternative) market. It is not that stocks offer great value based on underlying fundamental metrics. Instead, stocks are being viewed as the cleanest dirty shirt of existing market options. They have some potential for growth, their dividend yield is 25 percent higher than the yield on the 10-year Treasury bond, and they are inexpensive to trade. As investors, we need to remember they are still stocks. They have the volatility of stocks, they still need to be diversified, and they still need to be properly allocated in relation to an investor's personal investment profile.

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.



bellbanks.com Not FDIC insured | May lose value | Not financial institution guaranteed | Not a deposit | Not insured by federal government agency

0-13999