Bell Bank
Wealth Management

EQUITY & FIXED INCOME OUTLOOK SEPTEMBER 2018

Federal Reserve Monetary Policy

The Federal Fund rate remains at 2 percent, and the Fed remains on track to increase the rate another 25 basis points to 2.25 percent at its September 26 meeting. There is a growing chorus in the market that feels the Fed may be moving too far too fast in its quest to raise interest rates as a response to the prospect of rising inflation in a strong economy.

Inflation

The most recent year-over-year inflation rate is 2.9 percent. Look for inflation to recede to 2.8 percent when the new data is released on September 13. Despite fears that inflation will develop, there is no sign of it taking root in a meaningful way.

Economic Activity

Recent tax cuts, combined with personal savings rates higher than previously believed, are encouraging businesses to increase production and inventories. Add this to the government spending package from Congress this past March, and everything is in place for economists to raise their full-year 2018 economic growth projections to 3 percent or even a bit higher. The cloud of prospective tariffs that could dampen this growth outlook seems to be mostly ignored by the stock market, suggesting the skirmish is not a threat to progress for the time being.

While U.S. growth is on a solid path, it is becoming decoupled from developed economies around the globe. Euro-area annual economic growth in the second quarter was 2.2 percent, down from a high of 2.8 percent two quarters ago, while Japan's growth remains under 2 percent. There is some concern that the U.S. won't be able to sustain a growth advantage that is eluding other countries.

After closing at a high of 639 on May 17, lumber futures have declined to 429 as of Aug. 31. Copper futures were at 330 in June and as of Aug. 31, sit at 269. As two of the building blocks of the economy, these futures may indicate some softening in economic growth. Third-quarter gross domestic product growth won't be 4 percent like it was in the second quarter. Some inventory build-up and tax-cut-influenced spending pushed this number above the recent average. Look for third-quarter growth to be closer to 3 percent, but don't use that report as confirmation that the economy is slowing.

While some of this information may suggest an element of caution, we still expect to see reasonable economic growth for the remainder of the year.

Fixed Income

This prospect of economic softening is also partially validated by the flattening yield curve, where longer-term interest rates on U.S. Treasury bonds are nearly equal to shorter-term rates.

With the exception of only a few days, the yield on the 10-year Treasury bond has been between 2.8 and 3 percent for the last six months. At the short end of the yield curve, the 3-month Treasury bill has risen from 1.6 percent to 2.1 percent as the Federal Reserve aims to balance its dual mandate: full employment and reasonable inflation. The limited movement in the 10-year yield suggests the market disagrees with the Fed to some degree.

Stock Market

There seems to be a growing sense of uneasiness in the stock market, even though the return on the S&P 500 was 7.08 percent over the last two months. We don't know if this is due to the length of the current economic cycle, the slow progress of tariff negotiations, the pull-back in Fed monetary policy or something else entirely. Stock market valuations are stretched, but that is also the case for other investment options such as bonds or real estate.

Concern about the prospect of a market adjustment is natural when the market is reaching new highs. The reality is that nobody knows when the stock market might enter an adjustment phase. That's why proper portfolio allocation is so critical.

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