

ECONOMIC OUTLOOK

Right now, there is a noticeable amount of geopolitical instability across the globe. Throw in a U.S. presidential election and a federal rate cut, presumably because the economy is weakening, and one would imagine there would be a fundamental uneasiness in the stock market.

That doesn't appear to be the case.

Because market correlations around elections and geopolitical events are not consistent or directional, they're hard to act on rationally. That's not to say these events are without market repercussions. Secondary or lagged effects may get investors' attention, influencing the near term one way or another.

Shipping strikes, artillery resupply, labor costs, disaster clean-up and post-disaster rebuilding all tend to put upward price pressure on the economy, leading to an inflationary bias. As I have previously mentioned, outside of the 14 years following the great financial crisis, there is not much history of inflation remaining stable in the range of the Fed's target of two percent. Three percent is closer to the long-term average.

This brings me to the Federal Reserve's "neutral" target rate. The neutral rate is a fed fund interest rate that neither stimulates nor hinders economic growth. If the 2% inflation rate is ultimately reached, it would suggest a neutral rate in the range of 2.5%. In our scenario where inflation settles in around 3%, we see the neutral rate being 3.5%. There is a correlation between the 2-year Treasury yield and the fed fund rate that suggests the Fed will likely settle around that 3.5% level.

Currently, the economy is still growing. Yes, federal deficit spending (around 6% of gross domestic product)

contributes to that growth, and many consider this level of deficit spending to be unsustainable. Without the political will from either major political party to rein in deficit spending, nobody knows how long it might take the U.S. bond market to step in and send a message – in the form of higher long-term interest rates – that enough is enough. Having said that, it looks like longer-term interest rates may have declined too much at this point. Our estimate for the coming 18 months is for the yield curve to return to normally sloped, with shorter-term Treasury yields around 3.5% and 10-year Treasury yields around 4.5%.

We all may wish we had a crystal ball to see what tomorrow will bring, but that is not the case. Instead, we have to work with imperfect data, assess the impact of that data, allow for a range of outcomes and then develop strategies and portfolio allocations that have a high probability of success. Sure, unexpected events will create short-term volatility, but over the long term, this process works well.

Thank you for your confidence in Bell!



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