MAST Investment Advisors LLC
Making the Important Decisions

1723 A Northfield Square
Northfield, IL 60093
847-501-3148
jhenderson@mastinvestment.com
www.mastinvestment.com

## Mast Report

**INVESTMENT STRATEGY**

**AUGUST 31, 2017**

The advised investment strategy in the monthly Investment Strategy Reports is directed at long-term investors with balanced portfolios and applies to assets of those investors that are not expected to be needed within the next three years.

Long-term investing essentially deals with the degree to which an investor should take various types of investment risk in the pursuit of earning higher rates of return. To accomplish this, investors need to develop an investment strategy based on a specified approach and process. The approach and process in these Investment Strategy Reports uses information from financial markets to measure expected rates of return on major classes of financial assets, notably equities and fixed income. With this information, one can then assess how attractive or unattractive market expected returns are, given one's assessment of the prevailing investment environment.

### CURRENT INVESTMENT ENVIRONMENT

It has been a good strategy to take investment risk throughout most of this year. Economic growth has picked up in the U.S. and around the globe. Corporate earnings have recovered strongly since the middle of last year. Trailing 4-quarters' operating earnings per share for the S&P 500 in the second quarter of this year are estimated to have increased by 18.1% from a year earlier. Annualized dividends per share for the S&P 500 Index at the end of August were 7.7% higher than a year earlier.

While the Federal Reserve has raised its target for the federal funds rate by 75 basis points since the end of November 2016 from 0.25%-0.50% to 1.00%-1.25%, yields on longer maturity Treasuries are currently about 30 to 35 basis points lower than they were at the end of 2016. About 60% to 65% of the drop in yields on longer maturity Treasuries has been the result of lower expected rates of inflation. Inflation expectations have declined in response to declining rates of inflation. Inflation has fallen not only from lower energy prices, but also from lower inflation excluding energy. This came as a surprise to markets and investors. The consensus view was that energy prices would continue to rise modestly this year and that inflation rates excluding energy would also rise, to 2% or and slightly higher.

Real yields, as measured by yields on Treasury Inflation Protected Securities (TIPS), have also declined, accounting for the remaining 35% to 40% of the decline in yields on longer maturity Treasuries. This was also a surprise to markets and investors. Since April 1998 when they were first issued, yields on long maturity TIPS have, on average, been very close to the average rate of growth in the U.S. economy, about 2%. Based on the year-over year rate of change in a 4 quarter average of real GDP, U.S. economic growth accelerated from 1.49% in the fourth quarter of last year to 1.89% in the second quarter of this year. Growth by this measure is expected to continue to accelerate towards about 2.25% by the end of this year.

At the end of 2016, the long TIPS yield was 0.98%, or only about 65% of the rate of growth in real GDP at that time. At the end of August, the long TIPS yield was down to 0.86%, or only about 45% of real GDP growth through the second quarter of this year.

Obviously one reason why real yields on long maturity Treasuries are so low in relation to the pace of U.S. economic growth is easy Federal Reserve monetary policies, particularly the huge buildup of securities' holdings by the Federal Reserve that had been amassed under its quantitative easing programs. Although the Fed stopped adding to its securities' holdings nearly three years ago, it has not yet started to reduce them. The Fed is expected to start reducing is holdings of securities by the end of September. Any reductions are anticipated to occur gradually and to be modest, as the Fed wants to avoid any sharp and significant rise in yields on longer maturity Treasuries that could be detrimental to the economy and financial markets. Clearly, financial markets and investors do not think real yields on longer maturity Treasuries will quickly move higher, as reflected in declining long TIPS yields so far this year.

The combination of improving economic growth, rebounding corporate earnings, continued solid growth in dividends, declining inflation expectation, and low and declining real yields on longer maturity Treasuries have been positive for common stocks. These conditions have also been positive for corporate bonds. Declining yields on Treasuries, especially over the past six months, have also attracted investors to assets that offer higher yields than Treasuries, notably municipal debt securities and preferred stocks.

As these assets outperformed Treasuries, their valuations relative to Treasuries became less attractive. For common stocks, expected future real rates of return fell to levels well below their historical norms. Expected equity risk premiums fell from modestly above historical medians to levels at or slightly below median levels. Yield spreads on corporate bonds narrowed from close to historical norms to levels that are now considerably narrower than historical norms. This has especially been the case for corporate bonds with below investment grade credit ratings. Similarly yield spread to like maturity Treasuries have narrowed to below historical levels for mortgage-backed securities and for municipal debt securities. Yield spreads on preferred stocks to 30-year Treasury bonds have narrowed from modestly above historical levels to levels that are close to average.

In short, there are no undervalued asset classes. Underlying this is the Federal Reserve, whose easy money policies have driven down real yields on Treasuries. The rational response to this by investors has been to seek higher rates of return and higher yields, compared to repressed yields on low risk Treasuries and investment grade cash equivalents.

With riskier asset classes overvalued to varying degrees, they are vulnerable to conditions and events that cause investors to reduce risks. The month of August was a good example of this. The risks did not come from global economies or from worries about corporate earnings or from concerns about the Federal Reserve moving away from easy money policies. The risks came mostly from political uncertainties and disappointments in Washington and from rising military tensions, especially between North Korea and China, on one side, and the U.S., South Korea, and Japan on the other side.

When investors get nervous they move money into cash and Treasuries. When inflation is not one of those risks, investors particularly move money into longer maturity Treasuries and gold. For the month of August, the 30-year Treasury bond posted a total rate of return of 3.84% and gold rose by 3.96%. But investors did not move out of riskier assets to the point that their August returns were significantly negative. Their returns in August generally tended to be slightly positive in a range of 0% to 1%.

## CURRENT ASSESSMENTS

It's recommended that long-term investors go through a process of assessing various sources of investment risk to determine if and to the degree that potential rewards are worth taking, given prevailing conditions. Those potential rewards are measures by yields and, for stocks, expected rates of return, compared to yields on benchmark Treasuries.

**Duration Risk:** A good starting point is to determine whether it is attractive to own duration, or longer maturities, within fixed income assets. Because duration risk is different from credit risk or equity risk, duration risk is based on yields on Treasury securities, which effectively have no credit risk.

Two measures are used to assess duration risk. The first is the term structure of the yield curve, which measures differences in yields between long maturity Treasury bonds (30-years) and short-term (3-month)

Treasury bills. At the end of August the yield on the 30-year Treasury bond was 2.72%, while the yield on the 3-month Treasury bill was 1.01%, or a difference of 171 basis points. This is very close to its historical mean since 1959 of 179 basis points. In general, the greater the difference, the more attractive longer maturity Treasuries are compared to short-term Treasury bills.

The second measure is the real yield on long Treasury bonds, measured by the long TIPS yield, currently 0.86%, as noted and discussed above. The current yield on long TIPS is well below its mean of 2.11% since April 1998. Also as discussed above, average yields on long maturity TIPS and average rates of growth in real GDP since 1998 are very similar. If growth in real GDP move towards 2.25%, and if the Fed's reductions in its securities holdings exert even slight upward pressure on real yields on long maturity Treasuries, then higher long TIPS yields are likely to move higher. Even if the long TIPS yield were to increase to about 55% of a 2.25% rate of growth in real GDP, the long TIPS yield would be approximately 1.25%, or about 40 basis higher than it was at the end of August. Higher real yields on long maturity Treasuries make them more attractive. Prevailing real yields are unattractive.

Taking both the yield curve and real yields on long maturity Treasuries into account, my advice is to hold a modestly shorter than average maturity and duration within fixed income assets. A good gauge for setting an average or normal maturity and duration for fixed income assets is to use the Bloomberg Barclays Aggregate Bond Index as a benchmark. At the end of August, the average maturity of the Bloomberg Barclay's Aggregate Index was 8.06 years and the average duration was 5.85 years. My recommendation for investors with an average tolerance for risk is about a 5 year average maturity and a 4 year average duration.

**Fixed income asset classes with spread risk:** The major fixed income asset classes other than Treasuries are corporate bonds, mortgage-backed securities, and municipal bonds. These fixed income asset classes trade at yields higher than like maturity Treasuries because they are riskier. In the case of corporate bonds and municipal bonds, they have more credit risk than Treasuries. In the case of mortgage-backed securities that are guaranteed by federal government agencies, their higher risk arises from the tendency for their durations to rise when yields rise and fall when yields fall. This is a negative feature, which has to be compensated with higher yields compared to like maturity Treasuries.

**Corporate bonds** benefit from improving economic growth and from rising corporate earnings. Expectedly, their yield spreads to Treasuries narrow under these conditions. This is currently the case. At the end of August, the yield on the Merrill Lynch All Corporates Index (investment grade corporate bonds) was 3.09%, or a spread of 116 basis points over the 1.93% yield on like maturity Treasuries (just under 7 years). The historical median spread is 146 basis points. This is unattractive, but it is compensated for by the prevailing positive environment. The risk in corporate bonds would increase were the environment to become less positive. There is no sign of this, so I advise maintaining portfolio positions in investment grade corporate bonds, but with the expectation that rates of return will be in line with their current yield.

Below investment grade corporate bonds benefit even more from improving economic growth and rising corporate earnings. At the end of August the yield on the Merrill Lynch High Yield Index was 5.63%, or a spread of 385 basis points over the 1.78% yield on like maturity Treasuries (about 5 years). The historical median spread has been 515 basis points. Also of importance, the yield spread on this index recently hit a low of 336 basis points on July 25th. So yield spreads on below investment grade corporate bonds have widened over the past five weeks, despite a good and improving economic and corporate earnings environment. My advice for investors who can tolerate at least an average amount of investment risk is to hold smaller than average allocations in below investment grade corporate bonds. For investors with lower risk tolerances, I advise not owning below investment grade corporate bonds.

**Mortgage-backed securities** are unattractive in my assessment. At the end of August, the yield on the S&P Mortgage-Backed Securities Index was 2.55%, or a spread of 82 basis points above the yield of 1.73% on like maturity Treasuries (5 years). The historical mean spread is 115 basis points. The spread on the S&P Mortgage-Backed Index fell below its historical average at the end of April 2014. It has remained below its historical average since then. From the end of April 2014 through the end of August of this year, the S&P Mortgage-Backed Index returned 7.93% (not annualized). The rate of return on a 5-year Treasury note over this period was 8.63%. Less return for more risk tells investors that mortgage-backed securities tend to underperform like maturity Treasuries when their yield spreads are narrower than average.

**Municipal bonds:** The S&P AMT Free National Municipal Bond Index posted a return of 0.86% in August compared to a return of 1.69% on like maturity Treasuries (10-years). But as noted above, risk aversion on the part of investors in August boosted returns on longer maturity Treasuries. Over the past 3, 6, and 12-month periods, the S&P National Muni Index outperformed the 10-year Treasury note, and this does not take into account the benefit of the federal income tax exempt status of interest on most municipal debt securities. The offset to recent better returns and beneficial tax status is that yield spreads on municipal bonds are somewhat narrower than historical average. At the end of August, the yield on the S&P Muni Index was 2.82%, or 70 basis points higher than the 2.12% yield on the 10-year Treasury note. The historical mean spread has been 84 basis points. This is not very attractive, but factoring in the exemption of interest on municipal bonds from federal income taxes, I advice investors to continue to own municipal bonds in portfolios that hold taxable assets.

**Common stocks** are not attractive by measures of absolute valuation, which seem to be the only valuation measure that most investors and experts look at. But common stocks have three things going for them. First, stocks benefit the most from improving economic growth and rising corporate earnings. Second, stocks are the only asset class that significantly benefits from rising dividends. Third, while expected real rates of return on stocks are unattractive compared to historical norms, they are not significantly over valued relative to long-term Treasuries. At the end of August, the expected real long-term annual rate of return on the S&P 500 Index was 3.92%. That's about 140 basis points lower than the long rum median of 5.33%. But the benchmarks for assessing all risky asset classes are yields on Treasuries. For stocks, the benchmark is the yield on long TIPS. As discussed above, the long TIPS yield at the end of August was 0.86%. The expected long-term equity risk premium at the end of August was 3.06%, which is only slightly less than its long run median of 3.12%. That's not much of a give up to get all the prevailing benefits of stocks. On a relative basis, stocks continue to be the most attractive asset class, despite offering well below historical median real rates of returns.

**Preferred stocks** provide a way to get higher yields on long duration assets. Preferred stocks have a good deal of duration risk, similar to longer duration Treasuries. A good way to assess preferred stocks is to compare their yields to the yield on the 30-year Treasury bond. At the end of August, the yield on the S&P Preferred Stock Index was 6.21%, or a spread of 349 basis points above the 2.72% yield on the 30-year Treasury bond. That is essentially the same at its historical mean spread of 345 basis points. As with other classes of riskier assets, preferred stocks did not keep pace with returns on long maturity Treasuries in August. Prior to August the S&P Preferred Stock Index had been outperforming the 30-year Treasury bond. My advice is to own a modest position in preferred stocks.

In sum, expected returns on all asset classes are not attractive. This is largely the result of easy money policies from the Federal Reserve that have repressed real yields on U.S. Treasury securities. In response to low real yields on benchmark Treasuries, investors have sought higher yields and expected returns from riskier financial assets. This has driven their prices up and their yields and expected returns down. Yields spreads to like maturity Treasuries have narrowed to below historical norms on corporate bonds, mortgage-backed securities, and municipal bonds. Yield spreads on preferred stocks and the expected equity risk premium on common stocks are now close to their historical norms. An important off set to the absence of attractive valuations on riskier financial assets is a positive and improving economic environment and strongly rising corporate earnings and dividends. The asset class that benefits the most from this environment is common stocks. And, with the exception of preferred stocks, valuations on common stocks are the least unattractive relative to Treasuries. Common stocks continue to be the more attractive asset class in an environment that offers unattractive returns across all asset classes.

See the Asset Allocation Strategy Key Metrics for reference on the next page and related to the above calculations and observations.

| ASSET ALLOCATION STRATEGY | | | | | | | |
|---|---|---|---|---|---|---|---|
| KEY METRICS | | | | HISTORICAL MEASURES | | | |
| 8/31/2017 | CURRENT | CURRENT vs | 8/31/2017 | | | STANDARD | |
| | 8/31/2017 | AVERAGE | NORMALIZED | MEAN | MEDIAN | DEVIATION | HISTORICAL DATA PERIOD |
| **U.S. FIXED INCOME** | | | | | | | |
| **U.S. TREASURY SECURITIES** | | | | | | | |
| DURATION RISK | | | | | | | |
| 1) TERM STRUCURE | | | | | | | Jan 1959 - June 2017 |
| 30-YEAR TREASURY BOND YIELD | 2.722% | -3.699% | -1.42 | 6.421% | 5.985% | 2.600% | |
| 3-MONTH TREASURY BILL YIELD | 1.011% | -3.624% | -1.15 | 4.635% | 4.720% | 3.146% | |
| YIELD DIFFERENCE: 30-YEAR - 3 MONTH | 1.711% | -0.075% | -0.05 | **1.786%** | 1.775% | 1.470% | |
| | | | | | | | |
| 2) REAL 30-YEAR TREASURY BOND YIELD (TIPS) | 0.863% | -1.249% | -1.19 | **2.112%** | 2.073% | 1.052% | Apr 1998 - Mar 2017 |
| | | | | | | | |
| **U.S. FIXED INCOME ASSETS WITH SPREAD RISK** | | | | | | | |
| **CORPORATE BONDS** | | | | | | | |
| **INVESTMENT GRADE CORPORATE BONDS** | | | | | | | 8/31/1998 - 6/30/2017 |
| YIELD | 3.090% | -2.020% | -1.30 | 5.151% | **5.110%** | 1.585% | |
| YIELD ON LIKE MATURITY TREASURIES | 1.930% | -1.720% | -2.48 | 3.553% | 3.650% | 0.654% | |
| YIELD SPREAD | 1.160% | -0.300% | -0.32 | 1.598% | **1.460%** | 0.931% | |
| | | | | | | | |
| **BELOW INVESTMENT GRADE CORPORATE BONDS** | | | | | | | 8/31/1998 - 6/30/2017 |
| YIELD | 5.630% | -2.880% | -1.25 | 9.193% | **8.510%** | 2.855% | |
| YIELD ON LIKE MATURITY TREASURIES | 1.780% | -1.580% | -23.63 | 3.429% | 3.360% | 0.070% | |
| YIELD SPREAD | 3.850% | -1.300% | -0.47 | 5.763% | **5.150%** | 2.785% | |
| | | | | | | | |
| **MORTGATE-BACKED SECURITIES** | | | | | | | 3/31/2009 - 6/30/2017 |
| YIELD | 2.550% | -0.125% | -0.22 | 2.675% | 2.617% | 0.559% | |
| 5-YEAR TREASURY NOTE YIELD | 1.726% | 0.198% | 0.38 | 1.528% | 1.540% | 0.526% | |
| YIELD SPREAD | 0.824% | -0.322% | -1.13 | **1.146%** | 1.108% | 0.286% | |
| | | | | | | | |
| **NATIONAL MUNICIPAL BONDS** | | | | | | | 9/7/2007 - 6/30/2017 |
| YIELD | 2.820% | -0.664% | -1.24 | 3.484% | 3.365% | 0.535% | |
| 10-YEAR TREASURY NOTE YIELD | 2.121% | -0.528% | -0.69 | 2.649% | 2.504% | 0.766% | |
| YIELD SPREAD | 0.699% | -0.136% | -0.32 | **0.835%** | 0.815% | 0.420% | |
| | | | | | | | |
| **U.S. STOCKS** | | | | | | | |
| **COMMON STOCKS** | | | | | | | Jan 1959 - June 2017 |
| EXPECTED REAL LONG-TERM RATE OF RETURN | 3.919% | -1.407% | -1.06 | 5.990% | **5.326%** | 1.954% | |
| LONG TIPS YIELD | 0.863% | -1.871% | -2.15 | 2.648% | **2.734%** | 0.832% | |
| EXPECTED LONG-TERM EQUITY RISK PREMIUM | 3.056% | -0.065% | -0.04 | 3.342% | **3.121%** | 1.798% | |
| | | | | | | | |
| **PREFERRED STOCKS** | | | | | | | 10/13/2005 - 6/30/2017 |
| YIELD | 6.207% | -0.982% | -0.33 | 7.189% | 6.728% | 1.601% | |
| 30-YEAR TREASURY BOND YIELD | 2.722% | -1.020% | -1.16 | 3.742% | 3.690% | 0.836% | |
| YIELD SPREAD | 3.485% | 0.037% | 0.04 | **3.448%** | 3.409% | 1.769% | |

Jack Tilton
Financial and Economic Research
847-285-1423
jrtilton@comcast.net