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

Mast Report

INVESTMENT STRATEGY

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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.

An Asset Allocation Worksheet is distributed with each Investment Strategy Report. This worksheet provides end of month information on major asset classes, specifically current yields and expected rates of return. These yields and expected rates of return are compared to yields on U.S. Treasury securities. This provides information on yields spreads and expected rates of return on asset classes that have greater risk than Treasuries. Historical information is included in the worksheet to show how current yields and expected rates of return compare to past norms.

CURRENT INVESTMENT ENVIRONMENT

Sources of investment risk fall into one of two categories. The first is duration risk. This indicates how much additional yield that markets are currently providing to own longer maturity and duration Treasury securities as opposed to holding short maturity Treasury bills. The second category of risk applies to asset classes with credit risk, convexity risk (mortgage-backed securities), or equity risk.

Looking at risk in this context is particularly important at present. Investors are generally optimistic about growth prospects for the U.S. economy, rebounding and strongly growing earnings, and persisting solid growth in dividends. Investors are also encouraged about tax cuts and reforms that have been proposed by Republicans, but this has a long and difficult road to negotiate to become reality. Compromise will be needed, something that has been lacking in the legislative and executive branches of the federal government.

Federal Reserve monetary policies continue to shift from more to less accommodative. The Fed will start its program to slowly and gradually reduce its massive holdings of securities in October. These asset holdings consist primarily of U.S. Treasuries and agency guaranteed mortgage-backed securities, which now total about $4.25 trillion. Also, the Fed will likely raise its target for the federal funds rate by 25 basis points in mid December to a range of 1.25%-1.50%. It would be the third 25 basis point increase in 2017, and senior Fed officials are currently projecting three more 25 basis point increases in its federal funds target next year, which would take the rate to a range of 2.00%-2.25% by the end of 2018. Reduced securities' holdings and federal fund rate increases would both tend to place upward pressure on Treasury yields across all maturities.

The performance of the economy and rates of inflation will have an impact on what the Fed does and how investors will invest. If the economy experiences stronger growth and if inflation rates get close to or above 2%, then the Fed is far more likely to stick to its current plans to raise the federal funds rate and to reduce its securities' holdings. This would tend to put more upward pressure on Treasury yields and make holding longer maturity and durations in fixed income assets unattractive.

Higher Treasury yields would have some negative impact on riskier asset classes, as higher Treasury yields would increase the competitive attraction of Treasuries. But unlike Treasuries, these riskier asset classes would reap the benefits of strength in the economy. Stocks would be the most significant beneficiary of improving growth in the economy and accompanying increases in corporate earnings and dividends. Corporate bonds would also benefit, especially those with lower credit quality.

Conversely, if economy growth does not improve much, and certainly if it falters, and if gains in corporate earnings slow down significantly, and inflation does not rise much and remains below 2%, then the Fed is likely to become more cautious in rate hikes and reductions in its securities' holdings. Were this to occur, then yields on Treasuries will not rise much. In this outcome, holding more duration and longer maturities within fixed income assets, and owning less of one's assets in stocks and corporate bonds would make sense.

Of course, investors are continuously making decisions on this and other pertinent factors and events. This was quite evident in the month of September. Treasuries with maturities of two years and longer posted negative total rates of return, ranging for -0.20% in the 2-year note to -2.52% for the 30-year Treasury bond. September was not a good month for taking duration risk. All major asset classes with more risk than their benchmark Treasuries provided better, or at least, less bad returns. The best performing U.S. asset class in September was stocks. Based on the S&P 500, stocks returned 2.06% in September, or 4.6 percentage points more than the 30-year Treasury bond. When stocks perform relatively well, below investment grade investment bonds also tend to perform relatively well. In September, the Merrill Lynch High Yield Index returned 0.88%, compared to a return of -0.84% on like maturity Treasuries (5-years). Other major risky asset classes did not provide positive rates of return in September, but they did provide better returns than their benchmark Treasuries.

The asset allocation strategy advised in these Investment Strategy Reports has had three main aspects. First, hold shorter than normal average maturities and durations within fixed income assets. A good benchmark for gauging this is the Bloomberg Barclay's Aggregate Bond Index, which had an average maturity of 8.14 years and an average duration of 5.88 years at the end of September. My advice is to hold and average maturity of about 5 years and an average duration of about 4 years in fixed income assets. The second major aspect of advised strategy has been to hold fixed income securities with credit risk, as opposed to owning Treasuries. The most attractive fixed income assets classes with credit risk have and continue to be corporate bonds and municipal debt securities. Municipal bonds are attractive for taxable assets, particularly of higher income individuals. Third, and most important, the advised strategy has been to own a good deal of common stocks.

Is sticking with this strategy advised? The answer is yes, but with less enthusiasm. I expect the economy to grow adequately and for inflation to pick up slightly, and this will keep the Federal Reserve on its planned course. This will result in further increases in Treasury yields. The increases in Treasury yields are expected to be moderate, not large. Continuing to maintain shorter than average maturities and durations within fixed asset classes is advised.

A growing economy, along with further growth in corporate earnings and dividends are reasons to continue to own stocks and fixed income securities with credit risk. However, this advice is made with less enthusiasm because investors and financial markets already reflect this positive environment to a substantial degree.

This is clearly seen in yield spreads on corporate bonds, municipals bonds, and mortgage-backed securities, as well in expected rates of return on stocks. This is most evident in below investment grade corporate bonds. At the end of September the yields spread on the Merrill Lynch High Yield Index to like maturity Treasuries (approximately 5 years) was 354 basis points. This was well below its historical median of 511 basis points. Current yields spreads on investment grade corporate bonds are also much narrower than historical norms. The yield spread on the Merrill Lynch All Corporates Index at the end of September was 106 basis points, compared to an historical median of 145 basis points. Current yield spreads on both municipal bonds and mortgage-backed securities are also narrower than historical norms, especially for mortgage-backed securities.

The prevailing spread on below investment grade corporate bonds is insufficient to the degree that only investors with higher risk tolerances are advised to own them and for these investors to not add to their positions in below investment grade corporate bonds. Similarly, yields spreads on mortgage-backed securities are insufficient to the degree that investors should limit their holdings to amounts needed to obtain some additional portfolio diversification from this major asset class.

Expected real rates of return on stocks are also well below historical norms. At the end of September the expected real long-term rate of return on the S&P 500 Index was only 3.85%, compared to an historical median of 5.31%. But the real yield on long-term Treasury bonds (long TIPS) was 0.91%. The resulting long-term equity risk premium was 2.94%. This was below its historical median of 3.11%, but only modestly so. Again, and largely only by default, stocks remain the asset class that is more attractive than the alternatives.

This is no time for investors to be complacent. Treasury yields are expected to rise, if only modestly. Yield spreads on fixed income securities with credit risk or convexity risk (mortgage-backed securities) are considerably narrower than normal, as investors have sought higher yields in an environment in which Federal Reserve monetary policies have repressed yields on Treasuries. This has begun to change. Expected real rates of return on common stocks have also been driven down, as investors have sought higher rates of return.

Investors need to base their expectations for future rates of return on prevailing yields and on expected returns on stocks, not on past rates of return. This is always good advice. At present, it is especially important.

See next page Asset Allocation & Strategy Key Metrics.

ASSET ALLOCATION STRATEGY							
KEY METRICS				HISTORICAL MEASURES			
9/29/2017	CURRENT	CURRENT vs	9/29/2017			STANDARD	
	9/29/2017	AVERAGE	NORMALIZED	MEAN	MEDIAN	DEVIATION	HISTORICAL DATA PERIOD
U.S. FIXED INCOME							
U.S. TREASURY SECURITIES							
DURATION RISK							
1) TERM STRUCURE							Jan 1959 - Sep 2017
30-YEAR TREASURY BOND YIELD	2.860%	-3.546%	-1.36	6.406%	5.960%	2.605%	
3-MONTH TREASURY BILL YIELD	1.055%	-3.565%	-1.13	4.620%	4.707%	3.148%	
YIELD DIFFERENCE: 30-YEAR - 3 MONTH	1.805%	0.019%	0.01	**1.786%**	1.775%	1.470%	
2) REAL 30-YEAR TREASURY BOND YIELD (TIF	0.913%	-1.183%	-1.12	**2.096%**	2.054%	1.054%	Apr 1988 - Sep 207
U.S. FIXED INCOME ASSETS WITH SPREAD RISK							
CORPORATE BONDS							
INVESTMENT GRADE CORPORATE BONDS							8/31/1998 - 9/29/2017
YIELD	3.160%	-1.920%	-1.24	5.128%	**5.080%**	1.590%	
YIELD ON LIKE MATURITY TREASURIES	2.100%	-1.530%	-0.87	3.535%	3.630%	1.651%	
YIELD SPREAD	1.060%	-0.390%	-0.42	1.592%	**1.450%**	0.926%	
BELOW INVESTMENT GRADE CORPORATE BONDS							8/31/1998 - 9/29/2017
YIELD	5.490%	-2.980%	-1.28	9.151%	**8.470%**	2.864%	
YIELD ON LIKE MATURITY TREASURIES	1.950%	-1.410%	-0.84	3.411%	3.360%	1.743%	
YIELD SPREAD	3.540%	-1.570%	-0.57	5.740%	**5.110%**	2.777%	
MORTGATE-BACKED SECURITIES							3/31/2009 - 9/29/2017
YIELD	2.670%	-0.004%	-0.01	2.674%	2.620%	0.551%	
5-YEAR TREASURY NOTE YIELD	1.938%	0.401%	0.77	1.537%	1.560%	0.521%	
YIELD SPREAD	0.732%	-0.405%	-1.41	**1.137%**	1.091%	0.287%	
NATIONAL MUNICIPAL BONDS							9/7/2007 - 9/29/2017
YIELD	2.890%	-0.579%	-1.08	3.469%	3.302%	0.536%	
10-YEAR TREASURY NOTE YIELD	2.328%	-0.311%	-0.41	2.639%	2.480%	0.760%	
YIELD SPREAD	0.562%	-0.268%	-0.64	**0.830%**	0.798%	0.416%	
U.S. STOCKS							
COMMON STOCKS							Jan 1959 - Sep 2017
EXPECTED REAL LONG-TERM RATE OF RETUF	3.850%	-1.464%	-1.09	5.981%	**5.314%**	1.955%	
LONG TIPS YIELD	0.913%	-1.816%	-2.06	2.641%	**2.729%**	0.838%	
EXPECTED LONG-TERM EQUITY RISK PREMIUN	2.937%	-0.177%	-0.10	3.340%	**3.114%**	1.795%	
PREFERRED STOCKS							10/13/2005 - 9/29/2017
YIELD	6.226%	-0.943%	-0.31	7.169%	6.712%	1.591%	
30-YEAR TREASURY BOND YIELD	2.860%	-0.863%	-0.97	3.723%	3.667%	0.835%	
YIELD SPREAD	3.366%	-0.081%	-0.02	**3.447%**	3.407%	1.750%	

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