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Making the Important Decisions

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Mast Report

AUGUST 25, 2017

WEEK IN REVIEW

The past week saw more turmoil in and from Washington. At a campaign rally, President Trump said he would shut down the federal government if Congress does not provide funding for the wall on the Mexican border. Mr. Trump has also returned to his earlier position to tear up NAFTA, while negotiations among Canada, Mexico, and the U.S. are going on.

The federal government will run out of money sometime in October, unless Congress raises the debt ceiling and passes spending bills. Doing these things would allow the federal government to continue to operate, of course, subject to the President's threats. How will this play out? Who knows? But financial markets did not react much. This could reflect complacency, as many think, or markets might be saying that these things will blow over or will not end badly. Congress raises the debt ceiling, passes a spending bill that includes funds for more surveillance on the Mexican border, but not for a wall, and Trump backs off of his threat to shutdown the government.

The future of NAFTA remains uncertain. Hopefully, Mr. Trump will allow ongoing negotiations to continue. The U.S.' pulling out of this trade agreement would have negative economic consequences for all three countries. It would not be the boon to U.S. economic growth, employment, and manufacturing that those calling for the U.S. to leave NAFTA think. History is replete with examples of how placing barriers to trade and cancelling trade agreements, as opposed to negotiating mutually advantageous improvements, had disastrous consequences for economies. Wonder what the anti-trade, closed economy crowd thinks of Smoot-Hawley?

With health care repeal/reform hung back up in the closet, at least for the rest of the year, Mr. Trump will make speeches this coming week on the next big topic to come to the plate, tax reform. We will all wait and see, especially on the specifics. For the President and Republicans, a replay of health care has to be avoided. Specifics on tax reform are a necessity and specifics have proven to be a major weak point for the Trump administration. Regardless of what specifics are provided, the Democrats will almost certainly cry that these are "tax cuts for the rich", since this is what they always do. If the Republicans are no better at dealing with tax reform than they were at health care, then tax reform may suffer the same fate. Hope this outcome can be avoided.

At the Federal Reserve Bank of Kansas City's annual event at Jackson Hole, WY, Federal Reserve Chair Janet Yellen and European Central Bank President Mario Draghi made presentations. Hopes were that they would provide more specific information on withdrawing monetary stimulus by slowing growth in or reducing their central banks' asset holding and raising their short-term lending rates. Instead, both addressed the need to avoid significantly reducing and easing regulations on big banks and to support global trade. Ms. Yellen's remarks on regulation conflict with President Trump's and many Republican's positions to significantly roll back regulations on big banks and to take a much tougher stance on global trade. Ms. Yellen's term as Fed Chair will end in early February of next year.

Financial markets saw little reason to drive prices either significantly higher or lower, although there was some positive reaction to tax reform finally getting an at bat. With the exception of developed countries in the Pacific region, global stocks rose. Emerging market shares continued on a tear, as the MSCI Emerging Market Index posting a total return of 2.47% for the week. That Index has returned 31.3% since December 23rd of last year, compared to 12.1% for the MSCI World Index (all developed countries). The MSCI Europe Index returned 1.05% for the week and the MSCI U.S. Index, 0.80%. Among major U.S. stock indices, the S&P 500 rose by 0.72% and the Nasdaq by 0.79%.

Small cap stocks and value stocks had a better week, slightly outperforming large caps and growth stocks. The Russell 2000 Index returned 1.42% for the week and the Russell 2000 Value Index was the best performing size/style category with a return of 1.82%. But more evidence is needed to signal a shift in investors' preference away from large cap and growth. Except for consumer staples, all U.S. economic sectors posted positive returns for the week, led by real estate, telecommunications, and basic materials.

Yields on U.S. Treasuries with maturities of five years and longer declined slightly, mostly due to lower real yields. The yield on the 10-year note closed the week at 2.17% and the 30-year bond at 2.75%. The long TIPS yield was 0.90% at the end of the week. Yields on longer maturity Treasuries (10 years and longer) clearly do not reflect expectations for dramatically higher inflation. Inflation is expected to remain slightly below the Federal Reserve's 2% target.

Real yields on long maturity Treasuries remain quite low, below 1%, even with U.S. economic growth getting back closer to 2%, and possibly moving slightly higher. Historically, real long Treasury yields and the pace of economic growth had been similar prior to 2009. Since then, real yields have been repressed by easy Fed monetary policies, including massive purchases of Treasury and agency mortgage-backed securities. It is widely expected that the Fed will announce at its September 20th FOMC meeting that it will begin to reduce its securities holdings. As of August 16th, the Fed held outright approximately $4.25 trillion of securities. Soon, we will be able to see how much that starts to change and how yields on Treasuries, especially real yields, respond.

Uneasiness and unpredictability associated with the Trump administration continues to place downward pressure on the U.S. dollar. The U.S. dollar index fell by another 0.97% last week and is down 10.39% since its high on December 23rd of last year. Among major currencies, the euro has risen the most against the dollar, up 14.79% since December 23rd.

Gold continues to attract attention. Gold traditionally is seen as an inflation hedge and a safe haven against economic downturns, political events/risks, and wars. Inflation is not much of a risk and global economies are improving. This leaves political events and risks as the current primary driver of gold prices. Gold rose by 0.52% for the past week to $1292.50. Gold is now very close to its recent high of $1294.40 on June 6th.

Oil fell by 1.62% this past week to $47.87. Oil continues to struggle to move above its recent high of $50.17 on July 28th. The longer it fails to exceed its recent high, the less likely that will any time soon. As for broader commodities prices, the Dow Jones Commodity Index was little changed this past week, but remains 7.18% above its recent low on June 22nd. This is attributable to improving global economic growth, especially outside the U.S. and China.

TRACKING THE U.S. ECONOMY

Chicago Fed measure indicates continued modest growth. The Federal Reserve Bank of Chicago's National Activity Index provides a broad overview of real economic activity in the U.S. The Index is based on 85 monthly measures of the economy and combines them into a single measure. Data on the Index starts in March 1967. Measures on the Index are centered on zero, which corresponds to an annualized rate of growth in real GDP of 2.76% since the end of the first quarter of 1967. Positive readings on the Index indicate faster than annualized growth since March 1967, and negative readings indicate slower growth. It takes a reading of about -0.9 or lower to indicate no growth or a recession.

As with most monthly measures of the economy, data for a single month do no tell us much. Average readings over several months provide more insight on how the economy is doing. Over the past three months through July, the average reading on the Index was -0.05, which would correspond with annualized growth in real GDP of 2.73%. However, readings on the Chicago Fed's Index have recently been over estimating the rate of growth in real GDP, by about 1.0%, when looking at 3 month and 6 month periods, and by about 0.8% when looking at 12 month periods. Adjusting for this, it looks as if real GDP grew at a 1.75% annualized rate over the three month period ending in July. Average readings on the Index over the past twelve months indicate that economy has grown at a 2.00% annualized rate.

The Chicago Fed's National Activity Index does not tell us where the economy is headed. But we all hear or see assessments or assertions that the economy is doing better, or doing worse, often based on little more than what someone writes or says. The Chicago Fed's Index provides gauge of how the overall economy has been performing, based in actual statistical data that has been released. Recent readings indicate that U.S. economy continues to be about a 2% grower.

Home sales have weakened. Sales of both new and existing homes have declined recently. In July, new home sales fell by a sharp 9.37%, and existing home sales were down smaller 1.27%. Annualized rates of change over the past three months also show declines, with new home sales down at a 5.11% annualized rate, and existing home sales down at a 3.77% annualized rate.

These recent declines are affecting more important 12-month rates of change. This measure of existing home sales showed a modest 3.55% increase, compared to a 6.58% increase in January 2016. Sales of existing homes have generally not grown nearly as fast as sales of new homes. A major reason continues to be declining numbers of existing homes for sale, which experienced a substantial 8.12% twelve-month decline for data through July. However, the 12-month rate of change in existing home sales was slightly faster in July than in June. This provides a glimmer of hope that rates of change in sales of existing home have stopped falling.

As for new homes, the 12-month rate of change remains strong at 11.14% in July. But the 12-month rate of change got as high15.67% in March of this year. That rate of growth would have been hard to maintain. Still, it increasingly looks as if the highest rates of growth in sales of new homes are now past.

New durable goods orders continue to slowly improve. Despite a huge 19.01% drop in July of new durable goods orders in the transportation sector, new orders excluding transportation continue to gradually improve. New orders ex transportation increased at a respectable 4.29% annualized rate over the past three months. More important, the 12-month rate of change on new durable goods orders other than transportation was up 3.69% in July, compared to a 3.55% decline in December 2015. The 12-month rate of change in total new durable goods orders have also improved from -0.47% just three months ago to 3.19% in July. While not booming, accelerating 12-month rates of change in new durable goods orders are an encouraging sign for the overall U.S. economy.

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