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Mast Report *Making the Important Decisions*

FINANCIAL MARKETS, THE FED, AND ECONOMIC REPORTS

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REVIEW OF FINANCIAL MARKETS

Global stock prices continue to rise. This is driven by several factors. Economic growth remains modest in the U.S. and will pick up some over the remainder of 2016. Growth in Europe is starting to improve. Investors seem to be less concerned about political risks from elements that are viewed as extreme. Liberal parties in the U.S., the U.K., and France continue to struggle to attract voters, baring a major surprise in the French elections. President Trump has backed away from some extreme views, such a trade agreements and immigration. Also, he too is struggling to follow through on many campaign promises. Many concerns persist, e.g. North Korea. But in general investors' anxiety levels have been reduced, which nearly always aids risky assets. Corporate earnings are rebounding. Yields and expected returns on low risk assets still provide little significant opposition to riskier assets. So when investors' risk aversion does subside, they return to riskier assets. Risky assets may be expensive, but they are not as expensive as low risk investments in the views of most investors.

Recent gains in global share prices have been led by Europe. Since a recent relative low on November 23rd of last year, the MSCI Europe Index has returned 22.0%. This is modestly better than the return of 15.2% on the MSCI Emerging Market Index since that date, and more significantly better than the return of 9.5% on the MSCI U.S. Index and 8.5% for the MSCI Pacific Index. If Mr. Macron wins the French presidential election, as is expected, markets will view this as a positive, but it also will likely be followed by a period when the recent outperformance of European shares cools off.

Within the U.S. stock market, relatively strong performance has come from growth stocks and from larger capitalization stocks. Smaller capitalization stocks and value stocks have underperformed. Since December 12th of last year, the Russell 3000 Growth Index has returned 11.25%, compared to 2.21% for the Russell 3000 Value Index. Although not as substantial a difference, the large cap Russell 200 Index has returned 7.81% since December 12th, compared to 2.28% for the small cap Russell 2000 Index. The best performing size/style category over this periods was large cap growth (Russell 200 Growth Index) with a total return of 12.95%, the worst was small cap value (2016's big winner) with a return since December 16th of last year of -1.00%, based on the Russell 2000 Value Index. As expectations for better U.S. economic growth in the second quarter emerge, small cap value stocks will likely perform better, and performance of large cap growth stocks will likely cool.

The recent improved performance of riskier assets, notably stocks, has been accompanied by weaker performance of low risk and safe haven assets. This began on April 19th, following recent lows in yields on Treasuries and a high in the price of gold on April 18th. Since that date, yields on the 5-year and the 10-year Treasury note have risen by 17 basis points, the yield on the 30-year Treasury bond is up 13 basis points, and the long TIPS yield is up 15 basis points. Also, the price of gold has declined 12.92% since April 18th.

Although the recent improved performance of stocks and the related declines in prices of Treasuries and gold reflect more sanguine expectations for economic growth, at least in the U.S. and Europe, oil and broader commodity prices have remained weak. After reaching a recent high of $54.45 on February, the price of oil has declined sharply, by 15.11% to $46.22. Oil was down by 6.30% this past week. The Dow Jones Commodity Price Index (spot prices) has fallen by 6.57% from its recent high on February 10th. If oil and commodity prices continue to decline, that will raise questions about improving economic growth. A rebound in oil and commodity prices would be a sign that growth is improving.

NO CHANGE FROM THE FED

The Federal Reserve's Open Market Committee (FOMC) met this past week and did nothing surprising. As expected, the target for the federal funds rate was kept at 0.75%-1.00%. The target was raised to this level at the March meeting. Senior Fed officials' assessment of the economy was little changed. Slow growth in the first quarter was seen as transitory, with the economy expected to resume expanding at a modest pace. As usual, the Fed's primary focus is on labor market conditions and inflation rates. The statement indicated that the Fed expects some further improvement in labor market conditions. With the unemployment rate falling to a 10-year low of 4.40% in April, and persisting slower growth in the labor force than in employment, it would be surprising if the Fed did not assess labor markets as becoming tighter. As for inflation, the Fed emphasizes its 2% target. This target is for headline inflation, not core inflation that excludes food and energy. As discussed above, the 15% drop in oil prices since late February will make it hard for headline inflation to get up to 2%, based on the Consumer Price Index. This means the Fed will see mixed conditions for the labor market and inflation at its next meetings on June 14th and on July 26th. The Fed has projected two more 25 basis point increases in the federal funds rate target by the end of this year. Labor market conditions would more point to raising rates twice and sooner. Inflation would more point to delaying increases until later in the year, and conceivably raising rates only once more this year. However, that runs a risk of convey concerns about economic growth.

The Fed has been reinvesting or rolling over principal from its maturing holdings of agency mortgage-backed securities and Treasuries. Those holdings total approximately $4.5 trillion. The Fed has started to discuss reducing its securities' holdings, probably by reducing the amount of maturing principal that is reinvested as opposed to outright sales. For now, the policy of reinvesting all maturing principal on securities holdings continues. The Fed's statement released at the close of the past week's FOMC meeting indicated that the current policy on principal reinvestment would continue "until normalization of the level of the federal funds rate is well under way". Guided by the trusty rule that things tend to remain the same until they change, one can infer that the process of normalizing the federal funds rate has started but is not as yet well under way. This tells us that the Fed will continue to proceed with caution when removing monetary stimulus.

TRACKING THE U.S. ECONOMY

Labor market tightens. Total nonfarm payroll employment rose by 211,000 (0.14%) in April from March. Private sector employment increases by 194,000 (0.16%). Employment based on the Household Survey, which is used to compute the unemployment rate, rose by 156,000 (0.10%), while the civilian labor force increased by only 12,000. This drove the unemployment rate down to 4.40%. The last time it was this low was in March 2007. The average unemployment rate over the past twelve months was 4.74%, the lowest for this measure since March 2008.

Twelve month rates of change (year-over-year change in 12-month averages) show that employment continues to rise, but at decelerating rates. This measure of total nonfarm payrolls indicated an increase of 1.66% in March, down from 2.11% in August 2015. This measure for private sector employment saw a 1.79% increase in March, down from 2.39%, also in August 2005. Similarly, the 12-month rate of change for employment from the Household survey was 1.50% in March, down from 1.93%, again in August 2015.

But the 12-month rate of change in the labor force in March was only 1.14%. Unless the labor force starts to grow faster, and at rates closer to rates of change in employment, employment gains will continue to decelerate, because the prevailing low unemployment rate indicates there is not much slack in the labor force.

Expectations have been that as the U.S. economy has grown, employment will increase and this will draw more people into the labor force. But this has not happened to the degree many anticipated. The percentage of all people aged 16 and over who are employed was 60.16% in April and averaged 59.82% over the past twelve months. At its lowest point associated with the past recession, the 12-month percentage was 58.32%. At its highest level in the prior economic expansion, the 12-month average percentage of the civilian population 16 and over that was 63.20% in March 2007. At that time the 12-month average unemployment rate was 4.57%, only 0.17 percentage point lower than at present. The current unemployment rate that is essentially the same as it was in March 2007 is associated with 60.16% of the population 16 and over having jobs. In March 2007, that percentage was 63.20%, approximately 3 percentage points higher. This illustrates the impact that and aging population and other factors has on growth in employment and in the overall economy. The reason the U.S. economy is growing just under 2%, and not the desired 3%+, is not just, or even mostly the tax code, burdensome regulation, and underinvestment in infrastructure.

In other news on the labor market, data on unemployment insurance claims continue to improve. The 52-week rate of change in initial claims as of April 29th was -6.29%, which is a very sizable drop. The 52-week rate of change of people continuing to receive unemployment insurance benefits was -6.13%, also a sizable drop. Out of all people covered by state unemployment insurance plans, only 1.46% were receiving unemployment benefits over the past thirteen weeks. This is an all-time low. This indicates that many workers who were getting unemployment benefits have returned to the work force. Many of them not have the best or ideal job with the pay they want. But a lot more are working now. Average weekly earnings for production and nonsupervisory workers rose by 2.30% over the past year. And the rate of increase has begun to accelerate slightly since February of last year. Labor market conditions in the U.S. continue to improve, and they have improved to the point that there is increasing tightness.

Data on productivity and costs in the nonfarm business sector for the first quarter indicated that productivity (unit output per hour worked) fell at an 0.36% annualized rate in the first quarter of 2017 from the final quarter of 2016. This decline was the result of a 1.03% annualized increase in output and a 1.61% increase in hours worked. Total real compensation for workers rose at a 0.83% annualized rate.

It is popularly believed that weak or declining productivity gains hurt real labor compensation. But productivity fell in the first quarter, while real labor compensation rose. Since the first quarter of 2007, productivity has increased at a mere 0.64% annualized rate, comprised of a 2.60% annualized increase in output and a 1.94% annualized increase in hours worked. One might have expected very small increases in real labor compensation due to weak productivity gains. But in fact, real labor compensation has increased at a 2.82% annualized rate since the first quarter of 2010, modestly faster than the growth in unit output. This relationship suggests that growth in real labor compensation is more specifically related to, if not caused by the rate of growth in output.

Real personal incomes and real consumer spending improved in March. A major concern for economic growth over the remainder of this year is real consumer spending, which rose at only a 0.30% annualized rate in the first quarter. The good news is that consumer spending ended the first quarter than it began. Real consumer spending rose by 0.28% in March from February. Even more important, real disposable personal income rose by a faster 0.47%. This raised the personal savings rate to 5.88% in March from 5.24% in December of last year. This means that consumers are feeling better about adequate savings, which removes and impediment to future spending.

Twelve-month rates of change show that real disposable personal incomes and real personal consumption expenditures continue to at decent rates, but the rates of change also continue to decelerate. The 12-month rate of change in disposable personal incomes was 2.56%, down from 3.92% in June 2015. The 12-month rate of change in real consumer spending was 2.84% in March, down from 3.48%, also in

June 2015. Prevailing rates of change in real disposable personal incomes and real consumer spending are consistent with moderate economic growth. However, rates of change will more likely continue to decelerate slowly due to tightening labor market condition, importantly including relatively slow growth in the labor force.

Motor vehicle sales rebounded somewhat in April, but have declined slightly over 12-month periods. Total unit light motor vehicle (LMV) sales rose by 1.79% in April from March to a 16.811 million seasonally adjusted annual sales rate. This followed an abysmal first quarter, with LMV sales in March 9.85% lower than in December of last year. Twelve-month rates of change show a continued and significant slowing in unit sales. The 12-month rate of change for LMV sales peaked at 7.06% in February 2016, a pace that could not have been sustained. By April of this year, the 12-month rate of change was -1.03%.

The mix of LMV sales between autos and light trucks, which includes SUV's, show that buyers continue to favor light trucks. The 12-month rate of change in autos peaked at 18.92% over four years ago in December 2012. By April of this year the 12-month rate of change in unit auto sales was -10.28%. Light truck sales picked up market share and continued to rise sharply. The 12-month rate of change in light trucks reached 13.14% in February 2016, but has since slowed to a still solid 5.67% in April. But the 12-month rate of change in total LMV sales turned slightly negative in January of this year. This suggests that a good deal of strong demand for light motor vehicles over the past five to seven years has been met. LMV sales have averaged 17.376 million units over the past twelve months. Unit sales are likely to remain at about this level for awhile longer.

ISM Surveys for April brought mixed news. The Institute of Supply Management April survey of the U.S. manufacturing sector indicated that the Purchasing Managers' Index (PMI) fell to 54.8 in April from 57.2 in March. The recent high reading was 57.7 in February. The PMI averaged 56.57 in March, down slightly from 56.97 in March. The 3-month average has improved substantially from a recent low of 48.20 in January 2016. The 6-month average (55.62) and the 12-month average (53.58) continue to improve. These data show that the U.S. manufacturing sector continues to expand at a solid, but slightly decelerating pace.

The ISM survey of the nonmanufacturing sector shows a continued strong pace of expansion. Readings on the Nonmanufacturing Index averaged over the past 3, 6, and 12 month periods rage from 55.6 to 56.8 and all continue to rise slightly.

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