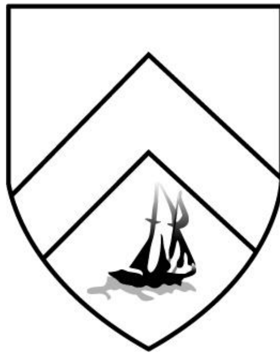

Mast Investment Advisors LLC

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

Mast Report *Making the Important Decisions*

REVIEW OF FIANCIAL MARKETS AND ECONOMIC NEWS

MAY 12, 2017

LOW STOCK VOLATILITY

The volatility of U.S. stock prices has been declining since June 2012. The standard deviation of monthly rates of return on the S&P 500 Index over the prior 60 months was 5.50% at that time. This was the highest level of volatility based on this measure since January 1959. The mean 60-month standard deviation of monthly returns on the S&P 500 from January 1959 through April 2017 was 4.13%. In April 2017 the standard deviation of monthly returns on the S&P 500 over the prior 60 months was 2.92%, or about 47% less than its high in June 2012. The lowest standard deviation over 60-month periods since 1959 was 2.44%, recorded on August 2008. Many investors over estimate the volatility of stock prices, often thinking that volatility has been high or will be abnormally high in upcoming times. The very high volatility of stock prices from mid 2008 through mid 2012 was associated with the severe drop in stock prices that began on October 2007 and ended in early March 2009. Even as stock prices recovered sharply from March 2009 lows, prices experienced above average volatility for another three and a quarter years. Then, volatility started to decline and has continued to decline to well below average levels.

The most popular measure of U.S. stock price volatility is the Chicago Board Options Exchange (CBOE) Vix Index. The Vix measures the imputed volatility of prices of options on the S&P 500 Index. Since January 2, 1990, the Vix Index has averaged 19.57. When the S&P 500 Index was at its last major low on February 11, 2016, the Vix was 28.14. This past Monday, May 8th, the Vix was 9.77, its lowest level over at least the past five years. This is barely higher than its low of 9.31 since 1990.

Many in the popular financial media, as well as many investors, are very concerned that prevailing low stock price volatility, especially recent very low levels on the Vix Index, reflects investors' complacency. With the primary focus on President Trump, his administration, the FBI, et al, shouldn't stock prices be going crazy, they ask? After all, these are the main stories that are being covered by the media.

Instead of questioning why the Vix Index is so low, perhaps the reverse question should be asked. What is the low Vix telling us? Perhaps improving economic growth, rebounding corporate earnings, continued solid increases in dividends, still low interest rates, relative contentment with the Federal Reserve, and low inflation that so far is not perking up much are the ingredients that make investors generally comfortable with having some risk in their investment portfolios.

Leaving Washington and politics aside, which is sometimes, if not often a wise thing to do, there are still some things to be concerned about. First, all of the non-political things noted above that may be the causes of low stock price volatility could deteriorate. There are always possible scenarios that could drive stock down and cause volatility to rise, e.g. a recession, falling earnings, escalating inflation rates. Betting on such forecasts could pay off big if one is right; or be disastrous if one is wrong. For now, it is better to

watch for storms on the horizon, instead of acting as if one will soon occur. Prevailing conditions are reasonably good and this is logically accompanied by low stock price volatility.

Second, low volatility also means that the positives in economies, earnings, dividends, inflation, etc. are reflected in stock prices. Historically, valuations on stock prices are significantly influenced by past volatility. Declining and low volatility means higher valuations (price/earnings ratios). High recent rates of return on stocks are also, and not surprisingly, related to high valuations on stocks. A valuation model for the S&P 500 Index that is based on volatility (standard deviation of S&P 500 returns over the prior 60 months), and past rates of return on the S&P 500 Index over prior five year periods, the long TIPS yield, and the expected long-term rate of inflation, estimate a current fair value on the S&P 500 of about 2240. The S&P closed the past week at 2391, or 6.7% overvalued, even when volatility low and strong past rates of return are factored in.

Related to this, the expected real long-term rate of return on the S&P 500 at the past week's close was 4.04%, compared to an historical median of 5.03%. A one percentage point difference is substantial. The expected long-term equity risk premium at the past week's close was 3.03%. While only slightly below its historical median of 3.12%, a lot of that is due to a very low long TIPS yield, which is a critical factor in why stock valuations have been high. Since 2007, the expected long-term equity risk premium has rarely been below 3%.

All of this, including prevailing low volatility of stock prices, leaves us where we have been over the past six months. Conditions are good for riskier assets, notably stocks. These positive conditions are expectedly accompanied by lofty valuations and relatively low expected real returns on stocks that leave little room for things going awry. There are two risks in owning risky assets, notably stocks and corporate bonds with low credit ratings. The first risk is owning them; the second is the opportunity risk of not owning them. I nervously side with taking the risk of owning them, especially stocks.

REVIEW OF THE PAST WEEK

Global stock prices were mixed this past week. Investors continue to favor shares in emerging markets, as the MSCI Emerging Markets Index returned 2.48% for the week. Since December 23rd of last year, the MSCI Emerging Markets Index has returned 19.92%, about 7.3 percentage points more than the 12.61% return on the MSCI World Index (all developed countries). Further outperformance from emerging market stocks is likely.

The MSCI Pacific Index posted a positive return of 1.09% for the past week. However, Pacific region shares have been underperforming since early November of last year. Since November 3rd 2016, the MSCI Pacific Index has returned 7.48%, or about 7.3 percentage points less than the MSCI World Index's 14.77% return over this period. Continued underperformance of Pacific region stocks is also likely.

European stocks have been strong performers recently. The MSCI Europe Index posted a slightly negative return of 0.04% for the past week. However, since November 23rd of last year the MSCI Europe Index has returned a whopping 21.97%, or 10.2 percentage points more than the 11.75% return for the MSCI World Index over the same period. While there is a good deal of optimism for European shares, supported by improving economic growth in Europe, a good deal of this is already reflected in prices of European stocks. Piling into European shares at this point is not likely to be nearly as rewarding as it has been over the past five plus months. Some caution is advised.

U.S. stocks generally posted small declines this past week. The broad Russell 3000 Index returned -0.38% and the S&P 500 Index fell by 0.35%. The Nasdaq rose by 0.34%, aided by continued strong performance of the technology sector, which returned 1.18% for the week, based on Dow Jones U.S. sector indices. Technology continues to be the sector with the strongest price momentum.

Among market capitalization size and style categories, small cap stocks continue to struggle, especially small cap value stocks. The Russell 2000 Value Index retuned -1.45% for the week. At the other extreme, strong relative performance continues to come from large cap growth stocks, the category that includes

many big technology stocks. The Russell 200 Growth Index posted a slightly positive return of 0.08% for the past week, but it was the only size/style category with a positive rate of return.

Since December 8th of last year, the Russell 200 Growth Index has returned 13.78%, the highest among all size/style categories. The Russell 2000 Value Index has returned -3.19%, the worst among all categories. The Russell 3000 Index has returned 6.47% over this period. If news of stronger second quarter economic growth emerges, as is anticipated, close monitoring of the relationship between large cap growth stocks and small cap value stocks is advised. Watch for a flip between these two size/style categories that favors small cap value shares.

Yields on both nominal and inflation-adjusted Treasuries were very little changed this past week. At the close of the past week yields were as follows: 2-year note, 1.30%; 5-year note, 1.72%; 10-year note, 2.33%; 30-year bond, 2.99%; and long TIPS, 1.01%. The Federal Reserve's Open Market Committee meets on June 14th, and an increase in the Fed's target for the federal funds rate to 1.00%-1.25% from the current 0.75%-1.00% is widely anticipated. While inflation struggles to get up to the Fed's 2% target, the unemployment rate has declined to a 10-year low of 4.44%, accompanied by building evidence that labor market conditions have improved to the point that they are tight. This, plus news better second quarter economic growth, leaves little reason for the Fed not to raise the federal funds rate. These factors are expected to exert modest, but not significant upward pressure on yields on Treasuries.

Among commodities, oil rebounded by 5.10% for the week to $47.84. But oil faces significant challenges to a rebound to $55. Supplies remind abundant, as U.S. shale operators continue to produce as their production costs continue to fall. While economic growth has improved in developed countries, it is still relatively modest. Growth in energy demand in China is decelerating, as the government tries to curtail speculative lending and borrowing and slow growth in debt. This leaves OPEC with the burden of curtailing production in an attempt to support and increase oil prices. Sustaining oil prices above $55 will be challenging.

Gold was little changed for the week, closing at $1226.20. This past Tuesday gold fell to its recent low of $1214.30, down 5.99% from a recent high of $1291.70 on April 8th. With stock prices continuing at or close to all-time high levels, and with stock price volatility declining, gold as a safe haven seems less of a need. Perhaps not coincidentally, the Vix Index stood at 15.99 on April 14th, just prior to the recent high in gold prices on April18th. By May 8th, the Vix had dropped by 38.8% to 9.77. Broad commodity prices have picked up recently. The Dow Jones Commodity Index (spot prices) has rebounded by 1.91% since May 4th, which is a sign of a pickup in economic growth.

TRACKING THE U.S. ECONOMY

Changes in producer prices have accelerated. There is some evidence that inflation rates have started to accelerate. Producer prices rose by 0.54% in April from May. Excluding food and energy, producer prices rose by 0.45%. Three-month annualized rates of change capture the recent acceleration. This measure for producer prices was 3.27% in April, a substantial acceleration from 0.73% in October of last year. Producer energy prices saw a 9.66% annualized increase, although rates of change in producer energy prices have begun to decelerate. Excluding energy, producer prices posted a 3-month annualized rate of change of 3.04% in April, up from a slight 0.36% last October. This indicates that the accelerating rate of change in producer prices is broader than just energy.

Recent acceleration in producer price changes continues to be reflected in 12-month rates of change, which are better at gauging trends. The 12-month rate of change in producer prices was 1.14% in April, still low, but up from a decline of 0.89% on January 2016. Excluding energy, producer prices recorded a 12-month change of 1.18% in April, up from 0.49% in February 2016. With the recent acceleration in 3-month rates of change, 12-month rates of change in producer prices will accelerate further.

Changes in consumer prices, however, remained more modest. Consumer prices rose by a modest 0.17% in April, and by a smaller 0.07% excluding foods and energy. In contrast to producer prices, 3-month rates of change have been decelerating. Overall consumer prices rose at a modest 1.76% annualized

rate over the past three months, down from 3.66% in February. A good deal of this deceleration was the result of much slower rates of increase in consumer energy prices, which rose at a mere 0.87% annualized rate over the past three months, compared to a 24.70% annualized rate in January of this year. This attests to the very high level of volatility in energy prices. Importantly, consumer prices excluding energy have also not been accelerating of late. The annualized 3-month rate of change in consumer prices excluding energy has eased from 2.34% in February to 1.83% in April.

Key 12-month rates of change in consumer prices continue to show higher rates of change, from 0.12% in December 2015 to 1.74% in April. A good deal of this is attributed to rising consumer energy prices. The 12-month rate of change in consumer prices excluding energy was 1.94% in September of last year, but has since eased slightly to 1.85% in April.

Perhaps the recent acceleration in producer prices will flow through to consumer prices. This bears close attention. But so far, 12-month rates of change in consumer prices have not risen to the 2% level, which is the Federal Reserve's target inflation rate. Consumer energy prices have eased and have ceased to put upward pressure on headline consumer inflation rates. Also, twelve-month rates of change in consumer prices excluding both food and energy got close to 2%, but failed to reach that level, and have recently decelerated slightly.

We can see if financial markets are becoming concerned about higher inflation rates by computing expected rates of inflation based on nominal and real yields on Treasury securities. Those inflation expectations have been relatively steady of late. So, the overall assessment is that even with the recent pickup in producer prices, there is insufficient evidence that consumer inflation rates are about to move above 2%.

Retail sales revived in March and April. There were concerns about the slowdown in consumer spending in the first quarter. However, real personal consumption expenditures were reported a week ago to have increased by 0.28% in March. On this past Friday, retail sales were reported to have increased by 0.39% in April. Data on retail sales were revised at the end of April, and showed a small 0.12% increase in March. April's increase included an encouraging 0.75% increase in retail sales excluding motor vehicles and parts.

The declines in retail sales and real consumer spending in the first two months of this year appear to have been temporary, as consumers and households raised savings rates. Because of the inherent volatility of energy prices, looking at retail sales excluding gasoline, provides a better assessment of consumer spending. The 3-month annualized rate of change in retail sales excluding gasoline was 2.05% % in April, down from 5.23%. The more important 12-month rate of change was 3.78% in April, down from 5.73% in March 2015.

Estimated real retail sales (nominal retail sales/Consumer Price Index) were up 0.22% in April and 0.41% in March. The annualized 3-month rate of change in estimated real retail sales decelerated sharply from 3.34% December of last year to 0.84% in April, but this measure will quickly accelerate. The 12-month rate of change in estimated real retail sales decelerated from 3.09% in March 2015 to 1.75% on February of this year, but has recovered a bit to 1.89% in April.

Retail sales, both nominal and real, have improved over the past two months and should continue to improve in upcoming months, which is encouraging. But 12-month rates of change have decelerated to modest level, which still do not support rates of growth in the economy materially above 2%.

Labor market conditions continue to improve. The Federal Reserve Board's Labor Market Conditions Index showed further improvement in April. Recent revisions in the index showed a very slight deterioration in the first half of 2016, but since then a moderate degree of improvement has occurred. The cumulative percentage point change in the index since June 2009 is the largest recorded since data on the index started in 1976.

Essentially all measures of the labor market, including employment data and the Fed's Labor Market Condition Index, which includes measures of employment, indicate that the U.S. labor market is strong. If there is a problem, it is the increasing tightness in labor markets and shortages of workers. This is the most significant impediment to substantially stronger U.S. economic growth.

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

Factual materials are obtained from sources believed to be reliable, but John R. Tilton is not responsible for any errors or omissions contained herein. Any recommendations are not a guarantee of future performance. Reprinting, copying, and distribution of this Report and related, supporting materials and information are by permission of John R. Tilton only.
© Copyright 2017 by John R. Tilton