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***

POLITCAL RISKS VERSUS GOOD AND IMPROVING FUNDAMENTALS

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FINANCIAL MARKETS AND POLITICAL RISKS

In recent weeks investors have appeared to be complacent as it relates to rising political risks. Near record low readings on the CBOE's Vix Index, the so-called fear index, were cited. Last week's Report also noted that the volatility of monthly rates of return on the S&P 500 Index have been subsiding since 2012. That Report also raised the possibility that declining S&P return volatility and low Vix readings might also be a reflection of improving economic growth in the U.S., Europe, and even in Japan. The rebound in corporate earnings and the sustained solid growth in dividends, combined with persisting modest inflation and apparent agreement by investors with the Federal Reserve's policies are further possible reasons for investors' absence of panic from political risks.

This past week we were given a sense of how political risks impacted prices of financial assets. The most important examples came from the U.S. and Brazil. In the U.S., as we all know, questions and concerns are rising, the result of the Trump Administration-FBI-Russian, et. al. situations. Markets responded this past Wednesday, with the S&P 500 Index falling by 1.82%, the price of the 30-year Treasury bond rising by a 1.88%, gold up 2.35% from its Monday close, and the U.S. dollar index down 1.51%, also from Monday's close.

After the close this past Wednesday, the obvious question was what would happen over the remainder of the week and beyond. For the beyond part, the volume will persist and probably louder. We know what happened on the final two trading sessions of the past week. The S&P 500 rebounded by 1.05%, the price of the 30-year Treasury fell by a slight 0.16%, gold was down an immaterial 0.31%, and the dollar index fell by an additional 0.28%. These moves certainly did not reflect significant rising concerns, nor did they indicate any euphoria. In sum, the past week did not change much for U.S. markets. For the full week the S&P 500 fell by 0.38%, the price of the 30-year Treasury bond rose by 1.38%, a solid gain, gold added 2.19%, and the dollar index was down 2.09%. Of all these, only the drop in the dollar was of significant magnitude.

Things in Brazil were considerably more unsettled. Brazilian President Temer was allegedly caught on tape offering bribes to silence the speaker of Brazil's lower House. This was another chapter of political turmoil in Brazil, whose economy remains in a severe recession. The MSCI Brazil Index fell by 14.66% this past Thursday in U.S. dollars, as the Brazilian real fell by 7.12%, accounting for nearly half of the decline. The difference between Brazil and the U.S. is that the level of political turmoil is greater and has been lasting longer in Brazil and that its economy is in bad shape, compared to the generally good and improving condition of the U.S. economy.

Beyond the U.S. and Brazil, European stocks continue to boom and attract investors' assets. This past week the MSCI Europe Index rose by 1.60% in U.S. dollars, with the majority of the gain coming from strength in the euro, up 2.52% against the dollar, and the British pound, up 1.16%. The MSCI Pacific Index fell by a small 0.10% in U.S. dollars and the drop would have been larger had it not been for a 1.88% increase in the Japanese yen. The MSCI Emerging Market Index returned -0.63% in dollars, with the declines in Brazilian shares and currency accounting for some of that decline.

Returning to U.S. stocks, there were relatively small degrees of dispersion among market capitalization size and style categories and among economic sectors. There was virtually no performance difference between growth and value stocks, as the Russell 3000 Growth Index and the Russell 3000 Value Index both returning about -0.35%. Momentum continues to favor growth over value, but the possibility of a reversal of this pattern is increasing. Small cap stocks continued to lag, as the Russell 2000 Index posted a return of -1.09%. While large cap stocks, especially large cap growth shares, continue to lead equity markets, the possibility of a reversal is increasing that would favor small cap stocks, especially small cap value. Among economic sectors, real estate turned in the best performance for the week with a return of 1.27%. Returns among all other sectors fell in a relatively narrow range of +0.61% for utilities and -0.66% for technology.

Relatively low volatility of the S&P 500 Index also reflects expectations that U.S. stocks are more likely not to decline significantly nor go up much. Downside risks from political events would be offset to some degree by the positive economy, earnings, dividends environment. But these same positive factors are also reflected in stock prices. This can be seen in key valuation metrics. The expected real long-term rate of return on the S&P 500 is currently 4.06%, well below historical norms. It hasn't been under 4% since late August 2001. The expected long-term equity risk premium is currently 3.14%. Although it is close to is historical median, it hasn't been under 3% since mid December 2007. A 4% expected real rate of return would put the S&P 500 at 2415, as would a 3% equity risk premium and a long TIPS yield of 1%. The S&P has not, so far, moved much above 2400 for any sustained period.

Among other asset classes, both oil and broader commodity prices rose this past week, which is encouraging as it reflects better economic growth. Oil rose by a strong 5.20% to $50.33. This first time oil has been above $50 since April 20th. Oil has rebounded by 10.57% from a recent low of $45.52 on May 4th. The price of oil has benefitted from comments by Russia and Saudi Arabia about extending production cuts, and also from lower inventory levels of crude oil in the U.S. Still, it looks to be a struggle for oil to get back to and remain above $55. As for broad commodity prices, the Dow Jones Commodity Index (spot prices) rose by 1.63% for the week and is up 3.57% from a recent low on May 4th.

TRACKING THE U.S. ECONOMY

Strong growth estimated for second quarter. Real GDP grew at only a 0.69% annualized rate in the first quarter of this year. However, stronger growth has been anticipated for the current quarter. This looks to be occurring, based on estimates from the Federal Reserve Bank of Atlanta's GDP Now analysis as of May 16th. Real GDP is estimated to increase at a 4.1% annualized rate in the second quarter. If this turns out to be accurate, and assuming no revision for the first quarter, then real GDP will increase at very close to a 2.4% annualized rate over the first half of this year. This would clearly keep growth in the U.S. economy as a positive factor for stocks and corporate bonds. It might be negative for yields on Treasuries if stronger growth is accompanied by higher inflation and an increased likelihood of faster and more frequent increases in the Federal Reserve's target for the federal funds rate. Still, big increases in Treasury yields seem unlikely.

Based on the Atlanta Fed's analysis, estimated real GDP growth of 4.1% in the second quarter would include a 2.9% annualized increase in consumer spending, a big 6.5% annualized increase in nonresidential fixed investment, and an 8.3% annualized increase in residential fixed investment. Real domestic private final sales, which combine these three areas of the economy, are currently estimated to increase at a 3.7% annualized rate. A larger accumulation of real business inventories is estimated to add 1.20 percentage points to second quarter GDP growth. On the negative side, real net exports and a small decline in real government consumption and investment are estimated to reduce real GDP by a combined 0.2%.

Improving industrial production heads week's U.S. economic news. Industrial production, which measures real output of the nation's manufacturers, utilities, and mines, rose by 0.98% in April from March, following a 0.41% increase in March. The annualized 3-month rate of change (the annualized rate of change from three months ago in a 3-month moving average) was 3.51%, up from a 0.49% annualized decline in November of last year. Industrial production has been struggling to post any sustained increases for some time. The 12-month rate of change has not been positive since October 2015 and posted its most significant decline of 1.88% in August 2016. With recent improvement, the 12-month rate of decline subsided to -0.22% in April. This is a move in the right direction. A positive and accelerating 12-month rate of change in industrial production would be encouraging, as production would join other key measures of real economic activity displaying sustained growth.

The plant capacity utilization rate improved to 76.73% in April, up from a recent low of 75.38% in March 2016. The 12-month average utilization rate was 75.86% in April and has increased slightly since last November. The rate of change in plant capacity receives hardly any attention in the media, but it is an important gauge of whether and the degree to which plant capacity is being added or reduced. More rapid increases in capacity reflect more optimism from businesses about boosting capacity to meet future demand. The year-over-year change in plant capacity was -0.03% last August, reflecting little perceived need for businesses to add to their productive capacity. In April the year-over-year change was 0.74%. This reflects improvement and some optimism from businesses.

Unemployment insurance claims continue to fall, reflecting continued improvement in the labor market. The 13-week rate of change (not annualized) in initial claims for unemployment insurance benefits were -2.52%, and this measure has been decelerating. The 52-week rate of change in initial claims showed an impressive 7.12% drop, and this measure has also been decelerating. This same improving pattern is also evident in continued claims (the number of workers continuing to receive unemployment benefit payments). The 13-week rate of change in continued claims was -2.98%, and the 52-week rate of change was -6.43%, and both are decelerating. Over the past thirteen weeks, the number of workers dropping off of the rolls of those receiving benefits has exceeded to number of initial claims by 5.44%. All of these reflect continued improvement in the labor market.

Out of all workers who are covered by state unemployment insurance plans, some 139.5 million, only 1.36% were receiving unemployment benefit payments on May 6th, and over the past thirteen weeks the percentage receiving benefit payments averaged 1.44%. Both are all time lows. This also indicates positive and further improving labor market conditions in the U.S. However, but not surprisingly, these data are accompanied by evidence of increasing shortages of workers, which will be an impediment to achieving faster growth in the U.S. economy.

Leading economic indicators have been improving. The Conference Board's Index of Leading Economic Indicators (LEI) posted a strong annualized 3-month rate of change of 5.56% in April, up from an annualized decline of 1.29% in March 2016. Twelve-month rates of change in the LEI have not been as strong, 1.88% in April, and have yet to accelerate much. Similarly, the 12-month rate of change in the Index of Coincident Economic Indicators (CEI) was 1.74% in April, and this measure has been steady over the past four months. These persisting modest rates of change in the CEI point to continued modest growth on the U.S. economy, especially over 12-month periods. Perhaps the recent acceleration in rate of the LEI will persist and will be followed by stronger rates of change in the CEI. Wait for the evidence.

Housing starts and permits for new home construction fell in April. Total housing starts were down 2.58% in April from March, all due to a sharp 9.16% drop in multi-family units. Single-family starts rose by a small 0.36%. Permits were down 2.46%.

Due to sizable volatility in monthly residential housing data, a focus on 12-month rates of change is needed to observe important trends. The 12-month rate of change in single-family starts in April was a still respectable 7.05% increase, although this was only about half of the 14.50% twelve-month rate of change in March 2016. Still, single family starts, along with new home sales and home prices, are the strongest aspects of the residential housing sector.

The 12-month rate of change in multi-family housing starts was 11.54% in February 2016, but has sharply decelerated to an increase of only 0.42% on April of this year. As has been noted in discussions of residential housing in these Reports over much of the past year, the boom in multi-family housing construction activity is over. This segment, notably apartments, have become overbuilt, as expectations were extrapolated that younger adults would continue to strongly prefer renting over buying. This preference resulted in significant increases in the ratio of rental costs to the costs of buying and owning a home, to the point that buying was significantly cheaper than renting in many cases. As a result, recent increases in new household formation are primarily the result of younger adults buying homes. Expectedly, home prices have been rising at accelerating rates. Multi-family starts and construction will remain relatively weak until rental cost become cheaper relative to the cost of buying and owning homes.

Another important factor is the decelerating rates of increase in permits for new home construction. The 12-month rate of change in permits has decelerated from 12.25% in January 2016 to 3.32% in April. Demand for housing is strong, but there are problems on the supply side. Builders have expressed reservations about obtaining permits given increasing shortages of skilled construction workers and continued frustrations with obtaining permits on a timely basis. Also, costs of some building materials are rising more rapidly. A recent example that has attracted attention is a significant increase in import tariffs on Canadian softwood.

It's more than just housing. Unfortunately, similar conditions are being seen in an increasing number of businesses and industries. Demand is there and is increasing, but the ability to supply that demand is becoming more challenging and difficult. Many of these challenges are found in three areas. There are shortages of labor, for workers across a spectrum of skill levels. These shortages are exacerbated by a chilling view of immigration. Reducing immigration is often seen as a way of boosting domestic employment and accelerating growth in the economy. Imports tend to be viewed negatively, as imports are seen as reducing domestic production and employment, reducing the rate of economic growth. Only exports are seen as boosting employment and growth.

These views and beliefs of how the economy functions are increasingly hard to square with real world conditions, and also with widely accepted economic theory and abundant historical economic evidence. Increases and improvements in the ability to increase the supply of goods and services are needed. This requires an adequate supply of labor, some of which requires more immigrants. Tax reforms are also needed. Reducing burdensome rules and regulations is needed to improve the ability, timeliness, and often the costs of supplying goods and services. But all of these are controversial and problematic, given strongly held differing political views.

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