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

Mast Investment Advisors LLC

Mast Report ***Making the Important Decisions***

MAY 26, 2017

CONDITIONS FOR STOCKS REMAIN POSITIVE

Investors continue to assess conditions for stocks to be attractive. Global economic growth is improving. Corporate earnings are recovering. Operating earnings per share for companies in the S&P 500 Index are estimated to have increased by 21.2% in the first quarter of this year from a year ago, and second quarter earnings are forecast to increase by 21.7%. Trailing four quarters' earnings through the first quarter were 12.9% above a year earlier. The current annualized dividends per share for the S&P 500 are running about 6.5% higher than year ago levels. Yields in low credit risk U.S. Treasuries remain low. At the past week's close the yield on the 10-year U.S. Treasury note was 2.25% and the 30-year bond's yield was 2.91%. Investors are comfortable with the Federal Reserve's plans to gradually and modestly raise its target for the federal funds rate. This comfort will persist so long as earnings and dividends rise faster than Treasury yields. This has and looks likely to persist.

Of course, this positive environment keeps stock prices rising and results in less attractive valuations on stocks. At the past week's close, the expected long-term real rate of return on the S&P 500 was 4.00%. It has not been persistently below 4% since July 2001. Due largely to low real yields on long-term Treasury bonds, the expected long-term equity risk premium is not significantly below average. The long TIPS yields at the past week's close was 0.95%, resulting in an expected equity risk premium of 3.05%. The median expected equity risk premium since 1959 has been 3.12%.

This tells us two things. First, despite a positive economic/earnings/dividends environment, stocks are expected to generate below historical average real rates of return from the present over time periods of at least 3 years and longer. Second and related, the fate of stock prices depends on whether or not the positive environment can support prevailing valuations on stocks. Stock valuations are not so high, as they were in the late 1990's and early 2000, that rich valuations alone are enough to drive stock prices sharply lower. But valuations are high enough that negative surprises on economic growth and aggregate corporate earnings would cause a drop in stocks.

WEEK IN REVIEW

Stock prices generally rose this past week. As expected, shares in emerging market countries continued to rise, with the MSCI Emerging Market Index posting a total return of 2.17%. The MSCI U.S. Index returned 1.47% and the MSCI Pacific Index, 0.79%. The MSCI Europe Index returned a slightly negative return of -0.10%. All of these returns are expressed in U.S. dollars. There has been a parade of momentum chasing investors into European stocks. This has been driven by signs of better economic growth in Europe and assessments that valuations on European shares are more attractive than on U.S. stocks. But as noted in last week's Report, price channel analysis of the MSCI Europe Index relative to the MSCI World Index suggest that the recent strong relative performance of European shares has become extended and is likely to run out of steam. However, this does not yet appear to be the case with emerging market stocks.

Within the U.S. stock market, recent patterns among market capitalization size and style categories are persisting. The major pattern that emerged last December has continued with large capitalization stocks outperforming small cap stocks and growth stocks outperforming value stocks. This has surprised many investors who thought the strong relative performance of small cap stocks and value stocks in 2016 would continue into this year with better economic growth and rebounding corporate earnings anticipated. If fact these positive conditions have persisted, but small caps and value stocks have not followed.

This was again reflected in the past week's performance. Based on FTSE/Russell total return indices, growth stocks (Russell 3000 Growth Index) posted a return of 1.88%, compared to a return of 0.93% for value stocks (Russell 3000 Value Index). Large cap stocks also continued to outperform small cap stocks, but by a modest amount. The Russell 200 Index returned 1.55% for the week, compared to 1.11% for the Russell 2000 Index. Extremes among capitalization size/style categories continue to be captured by the relative performance between large cap growth stocks (Russell 200 Growth Index) and small cap value stocks (Russell 2000 Value Index). As has been the recent pattern, this past week large cap growth stocks posted the highest return, 2.11%, and small cap value stocks the lowest return, 0.88%, among all size and style categories.

This pattern has also become extended, increasing the likelihood that small cap stocks and value stocks will start to outperform large cap stocks and growth stocks. But investors are still favoring large caps and growth stocks. We need some evidence of a shift in relative performance in favor of small cap stocks and value stocks, but investors and traders remain in hot pursuit of the large cap growth rabbit.

This past week, oil fell by 1.72% to $49.80, as plans for production cuts from OPEC member countries, Russia, and several other non-OPEC counties did not meet market expectations. Oil prices continue to struggle to reach $55, let alone be sustained above that level. The trend in oil prices has been down since early March. Similarly, but not to the same degree, broad commodity prices fell slightly this past week, down 1.05% based on the Dow Jones Commodity Index (spot prices). The trend in this commodity index is also down, though not as sharply as for oil.

This has occurred despite signs of improving economic growth in most developed countries, notable European countries, the U.S., and Japan. However, while growth in improving, it is at best moderate. China remains the most critical country. Its huge demand and consumption of energy and commodities in recent years has moderated significantly. China is shifting from a country whose growth has primarily come from state-driven investment in infrastructure, construction, and manufacturing of a magnitude that resulted in is too much supply and a resulting explosion of debt taken on to build all of this. One reflection of this has been the downward trend in commodity prices and energy prices, which seems more likely to generally persist than reverse. The deleveraging of debt levels in the Chinese economy is a force that will work against materially higher headline inflation rates, which will work via persisting downward pressure on energy and commodity prices. This is why OPEC and Russia are now willing to cut production and give up market share in an effort to support prices. It is their best chance to maintain revenues badly needed by their economies.

This environment was reflected in the past week's performance among major U.S. economic sectors, based on Dow Jones total return sector indices. The worst performing sector was energy, down 2.41%. Telecommunication was the only other sector with a negative return, -0.14%. Among the remaining nine sectors, basis materials posted to smallest return, 0.64%. The top returns for past week were utilities, 2.54%; consumer staples, 2.39%; and everyone's current favorite, technology, 2.29%.

TRACKING THE U.S. ECONOMY

First quarter GDP growth revised up slightly; stronger second quarter growth still expected. Annualized growth in real Gross Domestic Product (GDP) for the first quarter of this year was revised up slightly to 1.15% from an initial estimate of 0.69%. The major reason for the upward revision was stronger growth in real nonresidential fixed investment to an 11.38% annualized rate from an initial estimate of 9.40% annualized rate. Real consumer spending increased only slightly in the first quarter, up at a 0.64%

annualized rate. Real residential fixed investment rose at a strong 13.74% annualize rate. Real domestic private final sales (the sum of private sector fixed investment and personal consumption expenditures) rose at a revised 2.74% annualized rate, down only modestly from a strong 3.36% annualized rate in the final quarter of last year.

The other components of gross domestic product are government consumption and fixed investment, net exports, and changes in business inventories. Government spending and investment fell at a 1.14% annualized rate in the first quarter. Changes in business inventories reduced first quarter growth by a significant 1.07 percentage point, and real net exports added a slight 0.13 percentage point to growth. Although alarming to staunch fiscal conservatives, more government investment should not be dismissed as a source of future economic growth. Changes in business inventories are volatile, and are expected to make a positive contribution to second quarter growth.

Net exports are more complex. The simplistic and dangerous view is that if we place higher tariffs and taxes on imports, then imports would decline and domestic production of previously imported goods and services would boost economic growth. At the same time, exempting exports from taxation would boost them, also raising economic growth. Sounds good, right? But this presumes that the rest of the U.S. economy and inflation rates would not be affected and that other countries and trading partners would not respond. These are not reasonable presumptions.

Level playing fields that tax imports and exports the same, lower tax rates on business, adoption of territorial taxation of foreign profits, "fair" trade agreements, reduced and less anti-business government regulation, and immigration policies that would boost growth in the U.S. labor force would all help to improve net exports and overall economic growth, and would provide some offset to forces and factors have contributed to slower growth since 1999.

A good measure of U.S. economic growth is the year-over-year rate of change in a four quarter average of real GDP. This smoothes out the variability in rates of growth over a single quarter or two. By this measure, real GDP grew at a 1.73% rate for data through the first quarter of 2017. That is a slight improvement from growth of only 1.59% by this measure in the third quarter of 2016, but down from a recent high 2.92% in the second quarter of 2015.

Another useful measure of U.S. economic growth is the Federal Reserve Bank of Chicago's National Activity Index, which combines 85 various monthly measures of the economy. Readings are centered on zero, which equates to average growth in the economy of about 2.6% since 1967. Positive readings indicate above average growth; negative readings indicate below average growth. Over the past 3 months the average reading on the Chicago Fed's index was +0.12, and over the past 6 months, +0.08. This would indicate slightly above average growth. However, readings on the Chicago Fed's index have recently been estimating rates of growth that were higher than what they turned out to be. Adjusting for this, recent readings indicate growth has been close to 2%, which is close to growth in real GDP. April's reading on the index was +0.23, up from zero in March. Further improvement in the Chicago Fed's National Activity Index would obviously indicate stronger growth in the economy.

And stronger growth seems to be occurring, based on another useful gauge of the U.S. economy, which comes from the Federal Reserve Bank of Atlanta's GDP Now analysis. This analysis estimates the rate of growth in real GDP in the current quarter, based on monthly economic reports that have been significant related to specific parts of the economy, for example retail sales' relationship to consumer spending.

Based on economic releases through May 26th, the Atlanta Fed's GDP Now analysis estimates that real GDP will increase at a 3.7% annualized rate in the second quarter. If this estimate is accurate, then real GDP will have increased at a 2.42% annualized rate in the first half of this year. As noted above, the year-over-year rate of change in a 4-quarter average of real GDP was 1.73% for data through the first quarter of this year. But this would improve to be 2.06% in the second quarter, again assuming that the Atlanta Fed's estimate for second quarter annualized growth of 3.7% is accurate. So, U.S. economic growth has improved since mid 2016, but only back to very slightly over 2%. The challenge continues to be getting growth above 2% over a sustained period.

New durable goods' orders are improving, but a lot more is needed. Despite a 0.30% drop in new durable goods' orders in April from March, new orders have been improving, although from persisting declines that ended only recently. New durable goods' orders are extremely volatile, especially for transportation equipment. To remedy this, year-over-year rates of change in 12-month averages of new durable goods' orders, excluding transportation, shed light on trends. This measure of new orders, ex transportation, was up 1.58% in April, and readings only turned positive on February of this year. The positive is that the rate of change by this measure of new durable goods' orders has steadily, although only slowly improved from a 3.55% decline in December 2015. The trend is getting better, but more is needed before new durable goods' orders are signaling stronger growth in the economy.

Home sales continue to be mixed: new homes good, existing homes, not so much. Sales of new homes fell by 11.37% in April, but a lot of this was due to recent and unsustainable strength. Again, the 12-month rate of change reveals trends. By this measure, new home sales were 14.41% higher than a year ago. In May of last year, this measure was up a smaller 5.16%. The 12-month rate of change in new homes for sale was 10.29%, and has declined from a 12.74% increase in October of 2016. Rates of change of new home sales and new homes for sale are not significantly out of balance. However, a further and more significant deceleration in rates of change in new homes for sale could begin to negatively affect new home sales. Home builders have been confronting longer times needed to get permits for new home construction. Rates of change in permits have been slowing markedly. And increasing shortages of experienced construction workers are being cited. These are examples of things that can work against stronger growth in the economy.

The news for existing home sales continues to be negative. The 12-month rate of change in existing home sales is still positive, 3.28% in April. But this is down from a 6.88% increase in January 2016. The major reason is obvious. The 12-month change in existing home for sale in April was -7.54%, down from an increase of 4.10% in October 2014. Fewer home for sale means prices of existing homes are rising, and at an accelerating pace, and it also means there are fewer sales of existing homes.

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