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Mast Report *Making the Important Decisions*

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WHY ARE STOCK PRICES AND LONG-TREASURY PRICES BOTH RISING?

This past week the yield on the 30-year Treasury fell by 10 basis points to 2.81%, as its price rose by 1.98%. The S&P 500 Index gained 0.96%, hitting another all-time high. About 60% of last week's increase in the 30-year Treasury's price came on Friday in response to the smaller than anticipated increase in employment in May. This lowered the odds of a Fed rate hike in two weeks.

The underpinnings of recent gains in stock prices over the past seven months initially were expectation of stronger economic growth from pro growth policies from the Trump administration and the Republican controlled Congress. Progress in that direction has not happened as quickly or to the degree anticipated, or with the expected certainty. This has been offset by signs of stronger economy growth in the U.S. economy, especially since the end of the first quarter, and improving growth abroad. Corporate earnings continue to recover in line with expectations.

This would explain some of the persisting rise in stocks prices. Since December 16th of last year, the S&P has risen by 8.05%. I'm guessing that when asked how much the price of the 30-year Treasury bond has increased since then, most would say it has been less than the S&P. Technically that is correct. The price of the 30-year Treasury bond is up only 7.95% since December 16, 2016.

Since December 16th, the yield on the 30-year Treasury has declined by 38 basis points from 3.19% to 2.81%. Given that inflation has not picked as much as expected, one might think that the drop in the 30-year Treasury's yield has come mostly from lowered inflationary expectations. But the 30-year expected rate of inflation has only dropped by 6 basis points to 1.94% from 2.00%, accounting for only 16% of the decline in the 30-year Treasury's yield. The other 84% has come from lower real yields; the long TIPS yield is down from 1.18% to 0.88%. Lower real yields on long Treasury bonds tend to be associated with slower economic growth. But why are long TIPS yields down over the same period that expectations for stronger economic growth have pushed stock prices up?

Part of the reason for the persisting rise in stock prices is valuations. This also runs against conventional wisdom that stock are substantially overvalued. But conventional wisdom insists that about the only way to value stocks is based on price/earnings ratios. This incomplete approach fails to factor in yields in Treasuries, especially their real yields. The expected real long-term rate of return on the S&P on December 16th of last year was 4.28%. At the past week's close it was 3.96%, a drop of 32 basis points. Long TIPS yield has declined by 30 basis points over the period. The expected long-term equity risk premium is essentially unchanged: 3.10% on December 16th and 3.09% now. Also, the median expected long-term equity risk premium since 1959 has been 3.12. If you believe that the expected equity risk premium is the more complete and better valuation metric for stocks, as I do, then stocks have risen largely as the result of declining real yields on long-Treasury bonds since mid December of last year. As to why TIPS yields have declined, a good explanation would be appreciated.

Returning to the past week, developed country stocks outside the U.S. rose, especially in Japan and in the Pacific region. The MSCI Pacific Index returned 2.63% for the past week. The MSCI Europe Index added 1.24%. Both returns are expressed in U.S. dollars, and returns were aided by weakness in the dollar. The U.S. dollar index fell by 0.75% for the week and is off 6.37% since December 20th of last year. This has been a significant factor in boosting U.S. investors' enthusiasm for non-U.S. equities, especially European shares. The yen rose by 0.84% against the dollar last week, and the euro by 0.89%. After a big gain a week ago, the MSCI Emerging Market Index posted a slightly negative return of -0.13% for the past week.

Within the U.S. equity market, growth stock continued to outperform value stocks. The Russell 3000 Growth Index returned 1.63% for the week and the Russell 3000 Value Index, 0.63%. Small cap stocks had a better week with the Russell 2000 Index returning 1.71%. Within the Russell 2000, growth stocks beat value stocks, 2.22% to 1.21%. The general pattern persists, large cap growth stocks continue as the best performing size/style category and small cap value as the worst performer. The relative performance between these two looks ripe for a reversal, but markets this past week said, "not yet".

Nine of the eleven major U.S. sector indices from Dow Jones posted rates of return of more than 1% this past week, led by telecommunications with a return of 2.36%. Investors continue to like technology shares, notably the big name, large cap ones. These stocks have been the major factor driving the strong relative performance of large cap growth stocks. Energy was the worst performer last week with a return of -2.33%, continuing its weak performance. This can be explained largely by oil prices, which fell to $47.66, down 4.30% for the week and off 7.40% since May 23rd. The financial sector posted a slightly negative return of -0.02% for the past week. The decline in long Treasury yields has resulted in a much flatter yield curve, which is negative for operating profitability of many financial companies, notably banks.

Gold closed the past week at $1276.80, up 0.71% for the week. However, gold remains slightly below its recent high of $1291.80 on April 18th. Broader commodity prices remain weak, falling by 2.08% over the past week and down 6.90% since a recent high on February 10th, based on the Dow Jones Commodity Index. Weaker demand from China continues to be a major cause of commodity price weakness.

TRACKING THE U.S. ECONOMY

Smaller employment gains in May. Nonfarm payroll employment rose by a smaller than expected 138,000 (0.09%) in May from April. Private sector employment rose by 147,000 (0.12%). Employment from the Household Survey, which is used to compute the unemployment rate, fell sharply by 233,000, and the civilian labor force declined even more, by 429,000. As a result, the unemployment rate fell to 4.29%, because the labor force fell more than employment. Monthly data from the Household Survey can be rather volatile, so looking at the average unemployment rate over 12-month periods smoothes things out. The unemployment rate over the past twelve months was 4.71%, the lowest since February 2008.

May's smaller increase in nonfarm payroll jobs continues a pattern that has been in place since August 2015. Employment has been rising, but at decelerating rates. The 12-month rate of change in total nonfarm employment was 2.11% in August 2015; in May it was down to 1.65%. Similarly, the 12-month rate of change in private sector employment has decelerated from 2.39% in August 2015 to 1.78% in May. Decelerating rates of growth employment is a reflection of an economic recovery/expansion that will celebrate its eighth anniversary at the end of June. Economic expansions do not die of old age, although many in the financial media seem to think so when they say that the probability of recession rises with and because of the age of an expansion. Recessions start for a reason. At present odds of a recession remain quite low. At the same time, there is scant evidence that the U.S. economy can grow at a 3% rate over any sustained period.

One of the major constraints on the pace of growth in the economy is increasingly inadequate growth in the labor force. The 12-month rate of change in the labor force was 1.15% in May, down from 1.31% in

December of last year. The labor force has and continues to increase at a slower pace than employment. It was hoped and expected that as the economy and employment grew, this would bring more people back into the labor force. If that had occurred, then we would see in rates of growth in the labor force closer to rates of growth in employment. This has not happened, and as a result the unemployment rate has declined to very low levels. All of this means that rates of growth in employment will continue to decelerate, primarily because there is an increasing scarcity of available labor. If this were to change for the better, we would see it in faster growth in the labor force.

Also on the labor front, claims for unemployment insurance benefits continue to improve. Based on data as of March 27th, the 13-week rate of change in initial claims was -1.12%, and for continued claims, the 13 week rate of change was -3.89%. As a result, over the past 13 weeks the number of workers dropping off of the rolls of those receiving unemployment benefits exceeded those making initial claims by a significant 4.50%. This has driven the percentage of all workers covered by state unemployment insurance programs who are receiving benefits to all time lows - only 1.42% on average over the past thirteen weeks.

This is all positive, especially for workers who had been receiving unemployment benefits and have since returned to work. However, the continued decline in the number of workers who are receiving unemployment benefits and the low and declining percentage of covered workers who are receiving benefits indicate that the supply of workers tightening.

Consumer spending picked up in April. Real personal consumption expenditures rose by 0.22% in April from March. As a result, the 3-month annualized rate of change improved to 1.14%, from only 0.64% in March, when consumer spending was weak. The major reason for the improved 3-month rate of change was a rebound in real consumer spending for durable goods, which rose to a 1.18% annualized rate in April from a 1.45% annualized decline in April. Also, annualized 3-month rates of change in disposable personal incomes have also improved, to 2.95% in April from a 0.43% annualized decline in January of this year. All of this points to stronger growth in real consumer spending in the second quarter from only a 0.64% annualized increase in the first quarter.

However, as with employment, rates of change in real disposable personal incomes over longer 12-month periods continue to decelerate, from 3.92% in June 2015 to 2.23% in April of this year. But, the 12-month rate of change in real consumer spending in April was 2.84%, a modest pickup from a 2.61% increase in September of last year. The relatively faster rates of growth in real consumer spending compared to real disposable personal incomes meant that consumers has to increase borrowing and reduce savings to pay for some of the higher levels of real spending. Data on personal savings rates bear this out. The personal savings rate was at a recent high of 6.22% in March of last year, and then fell to only 4.55% last December. The savings rate has since increased to 5.26% in April. Consumers were uncomfortable with such a low savings rate last December, and decided to save more. This was a major reason for the slow rates of growth in real consumer spending in the first quarter, and especially for the -1.45% annualized rate of decline in real consumer spending for durable goods.

Sustaining rates of growth in real consumer spending at a 2.84% rate, based on the 12-month rate of change in April, will be very difficult to achieve. Employment growth has decelerated, the 12-month rates of change in real disposable personal incomes was a slower 2.23% and decelerating, and personal savings rates are still somewhat low.

Motor vehicle sales rolled over in May. April's modest 1.77% increase in unit light motor vehicle sales proved to be short-lived, as it was followed by a 3.98% decline last month. Unit LMV sales have weakened considerably since last December. At that time the annualized 3-month rate of change in LMV sales was18.04%, a rate that was impossible to sustain, as the annualized 3-month rate of change in May was -21.88% reflected. This rate of decline is also unlikely to persist, which increases to probability of a short-term rebound.

The much bigger issue is the weakening in LMV sales over longer periods. The 12-month rate of change in LMV sales peaked at 7.06% in February 2015. In May the 12-month rate of change was -1.04%, and has been negative since January of this year. In May unit LMV sales were 16.582 million (seasonally adjusted annual rate). Average annualized sales from May 2014 through December 2016 were 17.245 million units. Twelve-month average sales peaked at 17.574 million in February 2016 and have since fallen to 17.333 million units in May. These data indicate that strong demand for new light motor vehicles since the economy began to recover in the second half of 2009 has, to a significant degree, now been met. Since early 2016, a higher portion of LMV sales has been for replacement than to meet new demand. With LMV sales averaging 17.333 million over the past twelve months, and still declining slightly, it looks as if unit sales at or only slightly above the 17 million level are likely to persist for a while.

ISM Manufacturing Survey indicted expansion continues, but not at an accelerating pace. The Purchasing Managers Index (PMI) from that survey was 54.9 in May, essentially the same as in April, and down from a recent high of 57.7 in February. Also, the PMI's 3-month average was 55.63 in May, off of its recent high of 56.97 in March. The 12-month average was 53.90 in May and has risen from 50.13 last August. These data show how the expansion in the U.S. manufacturing sectors has improved since the end of 2015, but the pace of expansion has leveled out since February of this year.

Home prices continue to rise. The Case-Shiller national home price index (seasonally adjusted) rose at a 5.36% annualized rate on the first quarter of this year from the final quarter of 2016. The Case-Shiller index of home prices in 20 major metropolitan areas increases at a considerable faster 10.19% annualized rate over the same period. Over the past year both of these home price indices have increases by 5.3% and at modestly accelerating rates. Continued increases in home prices at modestly accelerating rates seem likely to persist. Although higher prices raise the cost of homeownership, those costs are still attractive to those for renting. Employment and real incomes continue to improve, bolstering demand for new and existing homes, while supplies struggle to increase. These conditions place upward pressure on home prices.

Second quarter GDP update. The rate of growth in real GDP in the second quarter continues to look strong and considerably faster than the 1.15% annualized growth in the first quarter. The Federal Bank of Atlanta's GNP Now analysis estimates second quarter growth of 3.4%, based on economic reports released through June 2nd. However, the current 3.4% estimated increase is down from 4.1% on May 16th. The reduced estimated rate of growth in second quarter GDP comes from smaller estimated increases in private sector fixed investment, primarily for residential fixed investment and nonresidential fixed investment for equipment and structures. Even with lower estimated growth in these areas, real domestic private final sales (the sum of real consumer spending and real private sector fixed investment) is expected to increase at a solid 3.35% annualized rate in the second quarter, up from a 2.74% annualized rate in the first quarter. The heart of the U.S. economy, measured by consumption and fixed investment in its private sector, continues to perform quite well.

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