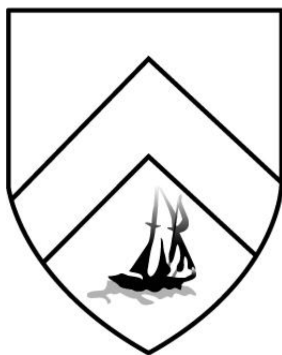

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Mast Report

Making the Important Decisions

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THE FED AND THE CURVE

The Federal Reserve's Open Market Committee (FOMC) will meet this coming week. Within the context of the Fed's assessments of and expectations for the U.S. economy and the rate of inflation, the FOMC will decide to maintain or change its monetary policy, focusing on its target for the federal funds rate and on its holdings of Treasury securities and agency mortgage-backed securities.

The release following the end of the FOMC meeting this coming Wednesday will likely say that the U.S. economy continues to grow at a moderate pace with further improvement expected in labor market conditions. It will also likely note that the rate of inflation continues to run at rates that are below the Fed's 2% inflation target.

Given this assessment, the Fed is somewhat more likely to raise its target for the federal funds rate from 0.75%-1.00% to 1.00%-1.25% than to keep the target at its current level. A decision not to raise its target for the federal funds would tell us, or infer several things. First it would infer that the Fed has some reservations about the current rate of growth in the economy, such as May's smaller growth in employment. FOMC members would also likely state that keeping the fed funds rate at its prevailing level will help to stimulate growth. Second, a no rate hike decision would also infer that keeping the federal funds rate where it is now will help to raise the inflation rate closer to the Fed's 2% target.

An increase in the federal funds rate will tell us that the Fed sees economic growth improving and that this will lead to somewhat higher inflation rates. It could also infer some things about the Fed's assessments that are not likely to be specifically included in the statement released at the end of the FOMC meeting. It might infer that the modest pace of economic growth is likely to persist but not improve, significantly due to increasing shortages of labor, which easy monetary policies cannot much remedy. An increase in the federal funds rate would also infer that easy Fed monetary policies cannot raise headline inflation rates, when higher inflation would require higher energy prices, over which the Fed has little influence. Subdued energy prices, notably oil, are likely to persist, making it difficult to get headline inflation rates above the Fed's 2% target.

Given that the Fed believes that it needs to "normalize" the federal funds rate, i.e. raise the fed funds rate to levels that are more neutral in relation to the pace of economic growth and inflation, it seems more likely that the Fed will raise its target for the federal funds rate.

Over the past six months or so, the Fed has made more comments about reducing its holdings of Treasuries and mortgage-backed securities. The Fed had dramatically increased its holdings of securities as part of its quantitative easing programs (QE) to provide liquidity to the economy and to hold down yields on intermediate and longer maturity fixed income securities in an effort to promote economic growth.

Although the Fed ended its last quantitative easing program at the end of October 2014, it has continued to reinvest principal from maturing security holdings. The Fed's asset holdings still total about $4.5 trillion, but holdings have represented a modestly declining percentage of nominal GDP since QE ended. The Fed wants to reduce its securities' holdings, implemented by gradually reducing the amount of maturing principal that is reinvested, rather than by outright sales of assets.

When the Fed raises the target for the federal funds rate, it impacts yields on short-term Treasuries, notably Treasury bills, relatively quickly and in proportion the amount of the increase in the federal funds rate. When the Fed ended QE at the end of October 2014, the midpoint of its fed funds target was 0.13%, the 3-month T-bill yield was a scant 0.02%, and the yield on the 30-year Treasury bond was 3.06%. When the Fed first raised it target for the federal rate to 0.38% on December 16, 2015, the 3-month T-bill yield was 0.25%, and the 30-year bond's yield was 3.00%. The Fed raised its federal funds rate on December 14th of last year to 0.63%. On that date the 3-month bill yield was 0.53% and the 30-year bond's yield was 3.15%. And on March 15th of this year, the fed funds rate was raised to 0.88%, and the 3-month bill yield was 0.74% and the 30-year bond's yield, 3.19%.

Since the midpoint of the Fed's target was last at 0.13%, the target midpoint has been increased by 75 basis points. The yield on the 3-month Treasury bill is up 98 basis points. The yield on the 30-year Treasury bond has increased by only 13 basis points from its yield when QE ended to the date of the Fed's last rate hike on March 15th of this year. Since then, through the end of this past week, the yield on the 30-year Treasury bond has declined to 2.85%. The yield on the 3-month T-bill has moved to 1.00%. The 3-month T-bill yield has tended to be at bottom of the Fed's new fed funds target range just prior to the rate hike. This suggests that the Fed will raise its target to 1.00%-1.25% this coming Wednesday, given that the 3-month Treasury bill yield is currently 1.00%.

More importantly, the yield curve, computed by the difference between the yield on the 30-year Treasury bond and the 3-month Treasury bill, has flattened dramatically since QE ended in October 2014, from 304 basis points to 185 basis points at the past week's close.

A flattening yield curve has historically tended to dampen the pace of subsequent economic growth, or at least to not be followed by significantly stronger growth. From this perspective, the Fed's apparent intention to reduce its asset holdings may be intended to raise yields on long-term Treasury bonds, at least more in line the Fed's increases in the federal funds rate. A further flattening of the yield curve, resulting from higher short-term interest rates and no increase or further declines in long Treasury bond yields, might not be good for economic growth. It certainly would not be good for net interest profitability for banks and other financial businesses that make money essentially by borrowing short and lending long.

The decision by the FOMC that might be most positive for the economy would be a decision to raise its target for the federal funds rate and also to immediately start reducing its asset holdings by lowering principal reinvestment. This is counter to consensus views and expectations. Following a possible initial negative reaction that the Fed is stepping up its pace of monetary policy tightening, it might be seen as positive for stocks and negative for long-Treasury yields. By early Wednesday afternoon, we'll see if any of this turns out to be accurate or not.

WEEK IN REVIEW

With the exception of emerging markets, stock prices fell this past week with non-U.S. developed country stocks posting larger declines. The MSCI Europe Index returned -1.21%, and the MSCI Pacific Index, -1.14%, both expressed in U.S. dollars. In the case of European shares, returns in expressed in U.S. dollars were hurt by a 1.16% decline in the pound sterling and a 0.75% drop in the euro. The pound's decline resulted from Prime Minister May's Conservative Party surprisingly losing its majority in Parliament. The MSCI U.S. Index returned -0.34% for the week. The MSCI Emerging Market Index posted a small positive return of 0.36%.

Activity within the U.S. equity market was headlined by a selloff in technology shares, notably in dominant large capitalization stocks. Also, small cap stocks outperformed large cap stocks. These patterns

started to emerge last week and represent a reversal from the pattern from mid December of last year through the end of May. During that period, large cap stocks significantly outperformed small cap stocks and growth stocks significantly outperformed value stocks. The best reflection of this was that the best performing size/style category over that period was large cap growth and the worst performing category was small cap value. As noted in these reports over the past two to three weeks, the relative performance of both of these size/style categories had become extended - large cap growth on the up side and small cap value on the downside. Apparently some traders/investors shifted portfolios last week in an expectation of a reversal in these two segments of the U.S. equity market. It was strongly reflected in the past week's performance. The Russell 200 Growth Index (large cap growth) returned -1.32%, while the Russell 2000 Value Index (small cap value) returned +2.29%.

As noted, much of this was related to the selloff in large cap technology shares. Among all major U.S. economic sectors, based on Dow Jones sector indices, the worst performing sector last week was technology with a return of -2.42%. Sectors that have recently sold off got a bounce. The best performing sectors for the week were financials, up 2.34%, energy, up 1.90%, and basic materials, up 1.36%. It looks as if some traders and investors are starting to shift towards wanting to buy reversal opportunities and sell stocks that have enjoyed recent strong positive price/return momentum.

Last week's Report discussed that prices of U.S. stocks and prices of longer maturity Treasury securities had risen by nearly identical percentages since mid December of last year. Add another week to that general pattern. Yields on Treasuries with maturities of 2 years and longer all rose by a relatively small 4 basis points. Again, all of this came from higher real yields. In fact TIPS yields rose more than nominal yields, resulting in slight declines in expected inflation rates. The 10-year Treasury note's yield ended the past week at 2.20%, as its price fell by 0.34%. The 30-year Treasury bond's yield was at 2.85%, and its price was down 0.78%. For perspective, the S&P 500 Index off a small 0.30% for the week.

As for commodities, gold fell by 0.65% for the week, closing at $1268.50. Gold reached a recent high of $1294.40 this past Tuesday, but fell by 2.00% over the remainder of the week. Another example of selling recent winners? The Dow Jones Commodity Index (spot prices) hit a recent low this past Wednesday, at that point down 7.41% from a recent high in on February 2nd. The DJCI rebounded by 0.93% over the remainder of the past week. Further gains in commodity would be an encouraging sign of improving global economic growth and a sign that efforts to deleverage the Chinese economy are not taking a larger toll on its economy, including a related weaker demand for commodities. Realistically, however, Chinese efforts to reduce debt and debt ratios will persist. The question and risk is that this will not be an orderly process.

The downward pressure on oil prices persists. Amid stagnant demand in major developed countries and modest increases in global demand, oil supplies and inventories are rising. U.S. production is rising, as production costs of shale have declined. Increases in U.S. production are offsetting production cuts among OPEC members and by Russia. U.S. producers want to gain global market share and to significantly increase exports. Many OPEC countries, notably Saudi Arabia and Russia, desperately need higher oil revenues to fund their governments. Raising production, while the U.S. is doing the same, will drive down prices more than production will rise, resulting in lower revenues. At present, it looks as if getting oil prices above $50 on a sustained basis will be difficult. A popular range for oil of $50-$60 prevailed only a few months ago. Expectations now are calling for a $45-$55 range.

TRACKING THE U.S. ECONOMY

ISM Nonmanufacturing Survey indicates further expansion but at a slightly decelerating pace. The Nonmanufacturing Index (NMI) from the Institute of Supply Management's May survey was 54.9, essentially the same as in April and down slightly from a recent high reading of 57.7 in February. Over the past three months the NMI averaged 55.63, down from a recent high of 56.97 in February. The 12-month average was 53.90, and still rising gradually from 50.13 in August of last year. These readings and patterns indicate further decent expansion in the nonmanufacturing sector, but the pace of expansion has slowed slightly over the past three months.

<u>Jobs openings and labor turnover.</u> Labor market conditions are always important, and particularly at times when employment is declining and unemployment rates are high. Condition are and also quite important at times when unemployment rates are low and labor markets are tightening following extended periods of employment growth. Prior to and even up until last November's elections, the popular Main Street assessment was that unemployment was high and employment was declining. Although this view was not supported by data, selected anecdotal evidence grabbed substantial and broad attention, which became a significant part of a campaign platform that elected the current president.

Data on labor market conditions continue to show growth in employment, although at decelerating rates, combined with relatively slower rates of growth in the civilian labor force. This has resulted in a 4.29% unemployment rate in May, the lowest since March 2001. This indicates tightening labor market conditions in which the supply of labor is increasingly falling short or demand.

The Bureau of Labor Statistics provides a monthly report titled Job Openings and Labor Turnover, or JOLTs. The report is released with a lag to about 5 weeks to the end of the latest month covered. The JOLTs report for April was released this past Tuesday. Also, history on the data included in this report start fairly recently in December 2000.

Still, the report has useful information on various aspects of the labor markets, notably job openings, hires, quits, and layoff and terminations. Each of these measures moves in a cyclical pattern coincident with levels of employment and rates of growth in the broader economy. Logically, levels of job openings and new hiring move up and down with employment and the broader economy. The number of employees who voluntarily quit their jobs also moves up and down with employment, as a higher number of quits conveys greater confidence of workers to get new and presumably better jobs. Layoffs and termination move inversely with employment.

A simple measure that adds openings, hires, quits, and subtracts layoffs and terminations provides a single composite to gauge the labor market based on these four factors. Rates of change in the four components and the composite of all four provide insights. Rates of change in these measures, especially 12-month rates of change (year-over-year rate of change in twelve month averages) are the most useful. Assessments for data though April follow.

Job openings have risen strongly since December of last year, up 9.12%. This indicates that it has recently become harder to fill jobs. However, this comes against a backdrop of a declining number of job openings over longer 12-month periods. The 12-month rate of change in opening has slowed from 22.49% in April 2015 to 2.91% in April of this year.

New hires have been falling, down by 6.88% since January of this year. The same pattern is seen in 12-month rates of change in hires, which have decelerated from 9.00% in February 2015 to only 0.27% in April. If rates of increase in hires slow, it tends to reflect or be followed by slower growth in employment.

Quits have declined at a 6.26% annualized rate over the past three month and the 12-month rate of change has decelerated only modestly from 9.11% in October of last year to 6.37% in April. Declining quits and slower quits tend to be related with decelerating rates of employment growth.

Layoffs and terminations are falling, obviously a good sign. The 12-month rate of change has gone from a 4.54% increase in June 2015 to a decline of 6.38% in April.

The 12-month rate of change in the composite, which combines openings, hires, quits, and layoffs and terminations, was 3.94% in April, a modest improvement from a 3.70% increase in March. But the 12-month rate of change peaked at 16.38% in April 2015. This is further evidence that labor market conditions continue to improve, but clearly at decelerating rates. This indicates a maturing economic cycle, which does not necessarily portend of slower economic growth, but seriously asks the question, how can the economy grow significantly faster over sustained periods with decelerating rates of improvement in major aspects and measures of the labor market and a tightening supply of workers?

Second quarter real GDP growth. It still looks as if the annualized rate of growth in real GDP in the second quarter will be much better than the first quarter's 1.15%. However, the estimated rate of growth for the second quarter has moderated since the end of May, based on the Federal Reserve Bank of Atlanta's GDP Now analysis. Based on monthly economic releases through May 31st, annualized growth in second quarter real GDP was estimated to be 4.0%. Based on economic releases through the end of the past week, estimated annualized growth had been reduced to 3.0%. The major reasons for less rapid growth in the second quarter are smaller increases in real non residential fixed investment for equipment and structures and a smaller change in business inventories. Should real GDP increase at a 3.0% annualized rate in the second quarter, annualized growth in the first half would be 2.1%. It remains difficult for the U.S. economy to grow much faster than 2% over a sustained period of more than a year. This should not be a surprise as real GDP has grown at a 1.9% annualized rate since 2000. Improving that rate of growth by a percentage point will be far more difficult than the optimists anticipate.

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