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Mast Report *Making the Important Decisions*

JUNE 16, 2017

THE FED, TREASURY YIELDS, AND INFLATION

Last week's Report was largely devoted to speculation and expectations regarding what decisions on monetary policy might be made at the Federal Open Market Committee (FOMC) meeting that ended this past Wednesday. Not surprisingly, the Committee voted to raise its target for the funds rate by 25 basis points from a range of 0.75%-1.00% to 1.00%-1.25%. Projections made by Committee members and other senior Fed officials called for one more 25 basis point increase in the federal funds rate by the end of this year, followed by three increases of 25 basis points each in both 2018 and 2019. This would take the effective funds rate from its current 1.18% to about 1.4% at the end of 2017, to 2.1% at the end of 2018, and 2.9% at the end of 2019, with a longer run projection of 3.0%. These projections are the same as those made at the FOMC's March meeting.

These projections, as always, are dependent on assessments of the economy, employment conditions, and inflation. Recent assessments of these factors by the Fed are mostly unchanged since the last FOMC meeting. Economic activity continues to rise modestly and labor markets continue to strengthen. But inflation rates continue to struggle to reach the Fed's 2% target. This was underscored by May's consumer price report. The Fed's 2% target is for headline inflation, which includes all items. As discussed in these Reports over the past few months, getting headline consumer price inflation up to 2% will require one or both of two things. First, consumer energy prices would need to rise. Second, core inflation rates, which exclude food and energy, would need to accelerate further. Neither has happened. Just by tracking oil prices, one would have known that recent decline in oil prices would quickly be reflected in declining consumer energy prices. Since peaking in January, consumer energy prices have declined by 5.68%. And core inflation rates started to decelerate in February. (Details on the consumer price report and other economic reports released this past week are discussed below.)

The Fed continues to expect economic growth, based in rates of change in real GDP, of close to 2%, specifically 2.2% this year, 2.1% next year, 1.9% in 2019, and 1.8% over the longer run. These growth projections are essentially unchanged from those made by senior Fed officials in March. The unemployment rate is projected to be in the 4.2% to 4.3% range though 2019, down from projections of 4.5% in March. The Fed had long believed that growth in the economy and employment would bring more people back into the labor force. This has not occurred to the degree that the Fed had anticipated. The Fed has begun to realize that materially stronger labor force growth is less likely to occur, resulting on lower unemployment rates and tighter labor markets even with modest 2% economic growth.

Importantly, the FOMC also said it would start to reduce the amount of maturing principal on the Fed's holdings of Treasury securities and agency mortgage-backed securities that is reinvested. The FOMC will not immediately begin this process, but will start to do so by the end of this year. Maturing principal will be reinvested only to the extent the amount exceeds established caps. For example, when this process begins, the cap for Treasuries will be $6 billion per month for each of the first three months. Assuming maturing principal of Treasuries was, say, $10 billion in the first month, then only the $4 billion that is above the $6 billion cap would be reinvested. The initial cap for mortgage-backed securities is $4 billion per month. The cap for Treasuries will increase by $6 billion every three months, and by $4 billion for mortgage-backed securities. This will continue over the first twelve months. Thereafter, the monthly cap will be $30 billion for Treasuries and $20 billion for mortgage-backed securities.

Assuming amounts of maturing principal are reduced by the cap amount each month, then the amount not reinvested would total $300 billion in the first 12 months ($180 billion in Treasuries and $120 billion in mortgage-backed securities). In each 12 month period thereafter, the amount not reinvested would be $600 billion ($360 billion in Treasuries and $240 billion in mortgage-backed securities).

The Fed's securities' holdings are currently about $4.5 trillion. Assuming that reinvested principal from maturing securities is reduced by the established caps, the Fed's securities' holdings would fall to $4.2 trillion after one year, to $3.6 trillion after two years, to $3.0 trillion after 3 years, and by $600 billion each year thereafter until the program ends.

These plans, as with the Fed's projections for the federal funds rate, will depend on what happens with the economy, labor market, and inflation. Also, the Fed has not indicated the amount of securities that it will want to hold over the longer run. It is generally thought that the Fed will want to hold more securities than the approximate $800 billion it did just prior to starting quantitative easing programs in December 2008, but obviously less than the $4.5 trillion it now holds. Something in the $2.5-$3.0 trillion range is a reasonable guess.

There are different opinions on how the Fed's reductions in its securities' holdings will affect yields on intermediate and longer maturity Treasuries. The Fed feels it program will not have a significant and sharp impact on yields. Others think the impact will be greater. The total amount of Treasuries outstanding will continue to rise, and other buyers will have to buy greater amounts of Treasuries as the Fed reduces the amount it reinvests. Supply and demand suggests that nominal yields on longer maturity Treasuries will rise, especially when caps hit their maximum, which will likely be in the final quarter of next year. Also, unless there is a significant increase in inflation and inflationary expectations, most of any rise in nominal Treasury yields will come from higher real yields.

About five months ago, the "reflation" trade was all the rage. What a dud that turned out to be. Hopes for Trump-inspired faster economic growth has not panned out. At least as important, headline inflation rates have decelerated, not accelerated as expected. These factors have had more influence on yields on longer maturity Treasury, not future plans from the Fed to reduce the amount of maturing principal that is reinvested.

Yields on longer maturity Treasuries have declined since the peak of the "reflation" trade on January 26th. On that date, the yield on the 10-year Treasury note was 2.51%, consisting of a 0.39% ten year TIPS yield and a 2.12% ten year expected inflation rate. By the end of the past week, the yield on the 10-year Treasury note had declined by 36 basis points since January 26th. It was entirely the result of a 42 basis point drop in expected inflation over the next 10 years from 2.12% to 1.70%. The 10-year TIPS yield rose by 6 basis points to 0.45%.

On January 26th the yield on the 30-year Treasury bond was 3.09%, consisting of a long TIPS yield of 0.93% and a thirty-year inflation expectation of 2.16%. Since then the yield on the 30-year Treasury bond has fallen by 31 basis points to 2.78%. The expected rate of inflation was down 33 basis points from 2.15% to 1.82%, while the long TIPS yield rose slightly to 0.96%.

At some point over the upcoming months inflation rates will settle down and stop decelerating, and the Fed will start to cut back in reinvestment of maturing principal. This will likely result in modestly higher nominal yields, with most of any increase coming from higher real yields.

WEEK IN REVIEW

Declining inflation expectations, as just reviewed, dominated financial markets this past week, sending yields on Treasuries with maturities of ten years and longer down and their prices up. For the week, the price of the 10-year note rose by 0.37% and the price of the 30-year Treasury bond was up a more substantial 1.46%. The yield on the 2-year Treasury note was little change, ending the week at 1.33%. The yield on the 5-year note fell very slightly to 1.77%.

In general, stock prices changed little this past week. The MSCI World Index (all developed countries) returned 0.06%, led by the MSCI Pacific Index with a return of 0.54%. The MSCI U.S. Index returned a miniscule 0.11%. On the downside the MSCI Europe Index posted a return of -0.28%, and the MSCI Emerging Markets Index, -1.42%. All returns are expressed in U.S. dollars, and the U.S. dollar index fell by a slight 0.14% for the week.

Within the U.S. equity market, selling pressure continued on technology shares with the Dow Jones U.S. technology sector index posting a return of -1.32% for the past week. Also on the downside, the basic materials sector returned -1.42%. Among better performing sectors, utilities returned 1.65% and real estate, 1.49%, both benefitting from declining yields on longer maturity Treasury bonds. The industrials sector returned 1.32% for the week.

Among market capitalization and style segments, small cap stocks did not sustain their better performance from the past two weeks, returning -1.00% for the week, based on the Russell 2000 Index. Again, the worst performing size/style category was small cap value with a return -1.22%, based on the Russell 2000 Value Index. The inability of the U.S. economy to show sustained improved growth and sluggish inflation continues to have a greater negative impact on small cap value shares than on other categories.

Among commodities, the major news is the inability of oil to stem further declines. Production and supplies continue to exceed demand. Oil fell by another 2.37% for the week to $44.74. So far, U.S. production continues to increase, but at some price, further production will become less profitable, if not unprofitable. OPEC members and Russia have not been able to implement production cuts sufficient to keep oil prices from falling further. At its current price, oil is close to bottom of its prices channel, approximately $44, but falling. The current estimated price of oil, based on its price channel, is down to $47.30 from $54.75 on March 7th. Oil prices continue to look for a bottom.

Gold closed the week at $1254.00, down 1.14% for the week and down 3.12% from its recent high of $1254.40 on June 6th. The Dow Jones Commodity Index also continued to decline, off 1.09% for the week and down 7.57% from a recent high on February 17th of this year. Declining commodity prices are also a sign of sluggish growth and related persisting low inflation. Softer gold prices may also be reflecting some of this.

TRACKING THE U.S. ECONOMY

Decelerating consumer inflation rates. The most important economic report released this past week was May's report on consumer prices. The Consumer Price Index fell by 0.13%, essentially all due to a 2.72% drop in consumer energy prices, including a 6.42% decline in gasoline prices. Excluding food and energy, consumer prices rose by a small 0.06%. Annualized three month rates of change (the change versus three months ago in 3-month averages) tell the story. The annualized 3-month rate of change in the CPI in May was 0.18%, down from a 3.66% in February. The cause of this deceleration was obvious. The annualized 3-month rate of change in consumer energy prices was 24.70% in January. Such high rates of increase are rarely sustained, and those weren't. In May, annualized rate of change in consumer energy prices was -10.51%. Decelerating rates of change in core consumer prices, which exclude food and energy, rose at an annualized 0.75% in March, down from 2.69% in February.

Trends in inflation rates, measured as 12-month rates of change, show the CPI up 1.81% in May, and this measure has accelerated from a low of just 0.12% in December 2015. This is the measure to look at when assessing the Federal Reserve's 2% inflation target. The 12-month rate of change in the CPI has yet to get up to 2%. Prospects of consumer inflation reaching 2% anytime soon are low, given declining consumer energy prices and recent decelerating rates of change in core consumer prices.

Although receiving less attention, producer prices do not entirely show the same pattern as consumer prices. One thing is the same; energy prices at the producer level declined in May, by 3.03%, and fell at an annualized rate of 6.04% over the past three months. But 12-month rates of change in producer prices, while still lower than those for consumer prices, are still accelerating. Should this persist, it would likely have some impact on consumer prices. However, we would need to see 12-month rates of change in producer prices at least get up to levels of consumer prices to warrant much attention.

Retail sales were weak in May. Total nominal dollar retail sales fell by 0.25% in May, but most of the drop was due to a 2.44% decline in retail gasoline prices, which was largely due to declining consumer gasoline prices, as just noted. Also, retail sales of motor vehicles were down 0.23%, not surprising given declines in unit motor vehicle sales last month. But even stripping out gasoline and motor vehicles, retail sales still fell by 0.06% in May.

Clearly, falling oil and gasoline prices and down-trending motor vehicle sales are negatively affecting rates of change in retail sales. Removing these two components, the annualized 3-month rate of change in the rest of retail sales was a solid 4.56% in May and the 12-month rate of change was 3.72%, down only slightly from a recent high of 3.86% in November 2016. Most followers of the economy, including the financial media, focus on nominal retail sales. Rates of change in nominal retail sales aren't going to accelerate until oil prices firm and auto and light truck sales pick up. There is not much optimism for either of these things happening soon.

Estimated real retail sales (nominal retail sales/Consumer Price Index) fell by 0.13% in May. The annualized three-month rate of change was 1.19%, down from 3.34% last December. Clearly, this is not showing the accelerating growth many were expected. The 12-month rate of change was a decent 1.91% in May, and it was up from 1.65% in September 2016. But this measure needs to show better growth if stronger growth in the economy is to be realized.

Industrial production was flat in May but has picked up recently. The annualized 3-month rate of change in industrial production improved to 3.85% in May, despite not increasing in May from April. Despite optimism on the economy and continued improvement in labor market conditions, industrial production has still not shown any measurable growth over twelve month periods. The 12-month rate of change in industrial production turned negative in November 2015 and hit a low of -1.88% in August 2016. It has since improved, turning positive in May, but the rate of change was only 0.08%.

Clearly, growth in industrial production this has to improve for the economy to show stronger growth and for inflation rates to rise. Aside from its direct impact on the economy, faster growth in industrial production is needed to drive plant capacity utilization rates higher. The utilization rate was 76.59% in May and averaged 75.93% over the past twelve months. Plant capacity rose by 0.84% from a year ago. Production has to grow faster than plant capacity in order for utilization rates to rise. Prevailing utilization rates remain well below levels that are needed to spur fixed investment in industrial capacity and to trigger price increase, especially at the producer level.

Housing starts and permits declined in May. Total housing starts were down 5.54% from April. Multifamily starts were down 9.70%, and single family starts fell by 3.87%. Permits for new home construction declined by 4.89%.With lots of volatility in monthly data on starts and permits, 12-month rates of change provide needed insights. The picture is mixed. The 12-month rate of change in total housing starts was 3.95% in May, down from 13.42% in March 2016. Much of this came from lower multifamily housing starts. The 12-month rate of change in multifamily starts peaked at 20.69% in October 2014. In May, it was -2.08%.

The 12-month rate of change in single family starts has held up much better, but it still has decelerated, from a recent high of 14.50% in March 2016 to 7.12% in May of this year. The 12-month rate of change in permits has also slowed substantially, from a recent high of 12.25% in January 2016 to 3.80% in May, although this measure of permits has recently picked up a bit. Decelerating 12-month rates of change in housing starts and permits for new home construction mean that growth in real residential fixed investment will also slow and contribute less to overall economic growth.

For the economy - generally more of the same. While economic growth is still expected to pick up in the current quarter from the first quarter, based on real GDP, estimates for the rate of growth in the second quarter have moderated a good deal just since the first of June. The Atlanta Fed's GDP Now analysis estimated second quarter GDP growth of 4.0% on June1st. By the end of the past week the estimate had been reduced to 2.9%.

The Atlanta Fed's estimate is based on monthly economic releases; it's not a forecast. This past week's batch of economic news, along with several prior releases in April and May, show continued modest economic growth, some signs of decelerating growth in residential construction and motor vehicle sales, and persisting low growth in industrial production. This has been accompanied by persisting modest core inflation rates. In light of falling oil prices and modest recent declines in broader commodity prices, it's hard to see higher inflation rates on the horizon. Labor market conditions continue to improve, but the negative aspect of this is that labor supplies have tightened, even at 2% growth in the economy. Despite tightening labor supplies, 12-month rates of change hourly wages of production and nonsupervisory workers have been stuck at 2.50% since November of last year.

Six months ago, there was great enthusiasm and expectations for materially faster growth in the U.S. economy, accompanied by higher inflation rates. I did not agree with that enthusiasm, but the persisting general sluggishness in the economy since the end of the first quarter, the absence of any acceleration in core inflation rates, and the sharp decline in oil prices have been a surprise. The economy needs to be watched closely, not just for signs of stronger growth, but also for more signs of sluggishness.

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