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Mast Investment Advisors LLC

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

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WEEK IN REVIEW

Broad stock indexes were generally little changed for the past week, up or down by about a quarter of a percent or less. Outside the U.S., emerging market shares reversed some of the prior week's decline, as the MSCI Emerging Market Index returned 0.97% in U.S. dollars.

Things were not as calm within the U.S. equity market. A good deal of what went on can be traced back to performance among the four largest economic sectors measured by market capitalization. On the plus side, the health care sector posted a total return of 3.74% for the past week. Also up strongly was the technology sector, with a return of 3.74%. On the other side was energy with a return of -2.71%, and financials, -1.19%. Although not as large a market cap sector compared to four just noted, telecommunications had a tough week with a return of -2.57%. These sector returns are based on Dow Jones U.S. sector indices.

Along the growth/value spectrum, technology and health care tilt more towards growth, and energy and financials more towards value. This past week, the Russell 3000 Growth Index returned 1.19% compared to -0.69% for the Russell 3000 Value Index, a difference favoring growth of 1.88 percentage points.

What was driving this? In the case of the energy sector, obviously it is largely the continued slump in oil prices, which is mostly attributable to rising supplies and production in the U.S. Oil fell by another 4.36% this past week to $43.01. It was at a recent low of $42.53 on Thursday, which was 17.37% lower than its recent high of $51.47 just a month ago on May 23rd. Energy stocks look cheap, but they are not going to outperform until the price of oil gets low enough to curtail U.S. production. Everyone is trying to figure out what that price is.

The drop in oil prices has led analysts to reduce earnings' estimate for many companies in the energy sector. Since oil was at a high $54.45 on February 23rd of this year, analysts' operating earnings per share estimates for the second quarter for energy companies in the S&P 500 have been cut by 16.6%. Estimates for both the third quarter have been reduced by just under 10%.

In the case of the financial sector, a flattening of the yield curve continues to be an important factor. Financials have underperformed the broad Dow Jones U.S. market index by 4.84% since December 8th of last year. On that date the yield on the 30-year Treasury bond was 3.09%, or a spread of 260 basis points to the 0.49% yield on the 3-month Treasury bill. Two 25 basis point increases in the federal funds rate pushed the 3-month Treasury bill rate up to 0.95% at the end of the past week. Meanwhile, the 30-year Treasury bond yield has declined by 38 basis points to 2.71%. As a result, the spread between the 30-year bond's yield and the 3-month bill's yield has narrowed to 176 basis points, or 84 basis point narrower than it was on December 8th.

For the financial sector to outperform, the yield curve has to steepen by long Treasury yields rising. One thing that would likely cause this would be a rise in oil prices, as this would boost expected rates of inflation. This might explain why performance of the energy sector and the financial sector has been related.

Also, the drop in the yield on the 30-year Treasury bond, while the 3-month Treasury bill's yield has risen, probably reflects some concerns about growth the U.S. economy not picking up as fast or as much as many investors had expected. Hopes for stronger growth arising from pro-growth policies and legislation from the Trump administration and Republicans in Congress have withered. While there are exceptions, value stocks, especially those with small capitalization, tend to outperform growth stocks when the economy grows faster and inflation rises. This has not happened of late. From December 12th of last year through June 2nd, the Russell 3000 Value Index underperformed the Russell 3000 Growth Index by 10.61%. However, since early June value stocks have held their own, even outperforming growth earlier this month.

If energy stocks are underperforming largely due to lower oil prices, and financials partly due to a flattening curve, and many value stocks due to failure of stronger economic growth and higher inflation to emerge, then what is driving growth stocks. Yes, we know money has been ploughed in several big cap tech stocks. But underneath this is strong earnings growth, notably in the technology and health care sectors. Operating earnings per share for S&P 500 technology companies were up 28.8% in the first quarter of 2017 from a year earlier. Technology sector earnings for the second quarter are estimated to rise by 33.7%, and by 28.6% for the full year 2017. Although operating earnings for the health care sector fell by a slight by a slight 0.1% in the first quarter, they are forecast to rise by 20.1% in the second quarter and by 19.2% for the full year.

The consensus strategy for U.S. stocks is generally to favor large cap, growth, and an emphasize health care and technology sectors. The out of favor strategy is small caps, value, the energy and financial sectors. The keys to a reversal in this pattern are rising long Treasury yields, signs of stronger economic growth, higher inflation, and rising oil prices. All are possible, even somewhat probable, but still lacking in supporting evidence. As they say, "things will stay the same until they change". This guidance suggests recent momentum will prevail for a while, as signs of reversal have not sufficiently emerged. But this won't last forever. It never does.

Also this past week, commodity prices continued to decline. The Dow Jones Commodity Index (spot prices) fell by 2.07%. Since it recent high on February 2nd its low this past Thursday, the DJCI had fallen by 9.80%. Growth in demand for commodities generally remains modest, with decelerating growth in demand from China. As for gold, its price was little changed this past week, closing at $1256.20. The current price of gold is 2.95% lower than its recent high of$1294.40 on June 6th.

TRACKING THE U.S. ECONOMY

Continuing moderate improvement in labor market conditions. The Federal Reserve Board' Labor Market Conditions Index provides an overall assessment of the U.S. labor market by combining 19 monthly readings across a range of measures. This index gets little broad attention, partly because the Fed does little to promote it and also because monthly readings are reported as percentage point changes from the prior month. Although called an index, it has no set starting point. One way to deal with this is to look cumulative percentage point changes over periods of improving or deteriorating labor market conditions.

The cumulative percentage point change since improving labor market conditions stopped deteriorating in June 2009 has been the largest recorded since information on the index was first provided in August 1976. This does not mean that prevailing labor market conditions are necessarily the best they have ever been since August 1976. I does mean that the degree of improvement since June 2009 has been the largest. Until a year to two ago, the widespread view was that employment was weak and wages were increasingly slightly, if not declining. Data on labor market conditions, including the Fed's index, provided a more favorable assessment. Although conditions were improving, the degree of month-to-month improvement was modest. But it has persisted for a long period of time, eight years at the end of this month. This is why the cumulative improvement over nearly eight years has been quite sizable.

The improvement in the index did stop, and in fact reversed slightly, in the first half of 2016. But a year ago, modest improvement resumed. Still, the pace of improvement has slowed somewhat since the end of 2015. The unemployment rate dipped below 5% for the first time in the ongoing economic expansion in January 2016. At that time, the rate of growth in nonfarm payroll employment started to gradually decelerate. But this was accompanied by rates of growth in the civilian labor force that were noticeably slower than employment growth. Evidence of tightness in supplies of workers began to emerge, first in more skilled positions in several industries, but increasingly across the broader economy. In my assessment, the moderating degree of improvement in U.S. labor market conditions over the past eighteen months have increasingly been the result of labor shortages more than slowing demand for workers.

Also on the labor front, data on unemployment insurance claims continue to be favorable. The 52-week rate of change in initial claims as of June 17 was -5.99% and decelerating slightly. Fewer initial claims are positive. Similarly, the 52-week rate of change in the number of workers who continue to receive unemployment payments was -7.00%, and also decelerating. This is also positive. The percentage of all workers covered by state unemployment plans who are receiving unemployment payments was 1.41%, averaged over the prior thirteen weeks. This percentage is at an all-time low percentage. If this percentage starts to turn up, it will be a sign that further improvement in labor market conditions are becoming more difficult to attain.

The Conference Board's Index of Leading Economic Indicators (LEI) has been improving. Annualized three-month rates or change in the LEI have recently been quite positive, reaching 5.48% in March and a still strong 4.32% in May. As a result, the 12-month of change improved from 1.42% last December to 2.03% in May. The Index of Coincident Economic Indicators (CEI) is supposed to improve following stronger increases in the LEI. However, subsequent rates of change in the CEI have tended not to be as strong as rates of change in the LEI. This has been the story of the economic recovery/expansion that began in July 2009 - relatively slow but persisting. The 12-month rate of change in the CEI was 1.76% in May, essentially the same rate it has been since November of last year.

Recall that real GDP has grown at a 1.9% annualized rate since 2000. In 2011 there were concerns that the U.S. economy would fall back into recession. This even had its own title for those predicting it, "double dip recession" Didn't happen. On the opposite side, other forecasters saw a true boom in the economy with growth of 4%, even 5%-6% over several years. Those forecasting the boom eagerly cited "green shoots" of economic measures that were turning up. Sustained growth in the 4%-6% didn't happen either. President Trump's election gave rise to forecasts of U.S. economic growth of 3% or greater. So far, that hasn't happened. Give it some time, but continue to include me among the skeptics that the U.S. economy will grow at or above 3% for a sustained period of a year or more.

New home sales remain strong; existing home sales, not as good. Sales of new homes rose by 2.87% in May from April, and at a 20.74% annualized rate over the past three months. Good numbers, but given monthly volatility in home sales, it has to follow through to impact 12-month rates of change. The 12-month rate of change new home sales was up an impressive 14.73% in May and 12-month rates of change in the mid teens have been sustained for several months. This is clearly positive.

If one is to be concerned about new home sales, keep an eye on 12-month rates of change in new homes for sale. While the 12-month rate of change in new home sales was 14.73% in May, the 12-month rate of change in new homes for sale was up a relatively slower 9.88%. This is a good increase, but it is quite a bit less rapid than new home sales. Were this relationship to persist it could start to reduce the rate of growth in new home sales, due to lack of sufficient supply.

Conditions for existing homes are far less bright. The 12-month rate of change in existing home sales in May was 3.21%, and has shown a steady deceleration from 6.88% in January 2016. It is not hard to see why. There is a relative scarcity of existing homes for sale. The 12-month rate of change in existing home for sale did reach 4.10% in October 2014. But since then it has been downhill. The 12-month rate of change in existing homes for sale was -7.79% in May. The 12-month average of existing homes for sale recently peaked at 2.142 million units in May 2015. Since then it has declined by 11.06% to 1.905 million units in May. Among the reasons for this are an aging labor force and deceased mobility of the labor force that result in lower turnover and fewer existing homes for sale. If existing homes for sale continue to decline, rates of change in existing homes for sale will also continue to decelerate.

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