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Mast Report *Making the Important Decisions*

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NORTH KOREA - U.S. STANDOFF DOMINATES FINANCIAL MARKETS

Economic reports, earnings, Fed policies, health care, tax and regulatory reform, you name it. They were all pushed to the sidelines this past week. Verbal exchanges between Donald Trump and North Korea's Kim Jong Un became more frequent and heated this past week, especially on Thursday and Friday. There are lots of views and speculation as to where this situation is headed. No one is sure, but hopefully not badly. This Report will not add to speculation; it is not needed nor would it be well informed.

But, as always, we can look to markets to see what investors, collectively, seem to be saying. Of course, stock prices did fall, and around the globe. The magnitudes of changes were generally significant, but not extreme. They did look large in relation to recent low volatility. By the end of the week, investors were concerned, but not panicked. The majority appear to hope that the rhetoric will ebb in quantity and heat, but the two primary combatants do not have a history of such behavior.

Globally, developed country stocks posted a return of -1.46% for the week, based on the MSCI World Index. The MSCI Emerging Market Index returned -2.24%, possibly reflecting investors' not wanting to chase a market leader under current conditions. The MSCI Europe Index also returned -2.24%, while the MSCI Pacific Index was essentially unchanged, returning a scant -0.04% for the week. The MSCI U.S. Index posted a -1.41% return. As for major U.S. stock indices, the S&P 500, Nasdaq, and Russell 3000 were all down approximately 1.5%.

Among market capitalization size and style categories, prevailing patterns did not change. Large caps led and mid caps and small cap lagged, especially small caps. Growth stocks continue to outpace value stocks. The Russell 200 Index (large caps) returned -1.22% for the week, compared to -1.94% for the Russell Mid Cap Index and -2.67% for the Russell 2000 Index (small caps). The Russell 3000 Growth Index returned -1.14% for the week, while the Russell 3000 Value Index returned -1.89%. No size/style category posted a positive return for the week based on Russell indices. The best performing category was large cap growth, -0.87%; the worst was small cap value, -3.29%. The differential of 2.42 percentage points is sizable for a single week. A shift in market leadership towards small cap and mid cap stocks and towards value stocks looks to be due, but there is no evidence yet.

Among major U.S. economic sectors, all eleven posted negative rates of return for the past week. Only two saw small declines, utilities (-0.22%) and consumer staples (-0.32%). No surprise, these two sectors tend to be defensive, so investors were less inclined to sell them. Larger declines came from energy (-2.77%), financials (-2.48%), and basic materials (-2.20%).

As would be expected given the factor that drove financial markets this past week, prices of U.S. Treasuries rose, driving their yields down. Yields fell in the 6 to 8 basis point range across maturities. Yield declines of this magnitude are modest and do not reflect any panic by investors into low risk assets.

TIPS yields (real yields) for longer maturity Treasuries accounted for essentially all of the decline in nominal yields. Inflation expectations were essentially unchanged, as investors have been expecting little, if any acceleration in inflation rates. As discussed below, the 12-month rate of change in the consumer price index based on data through July was 1.93%. Expected 10-year and 30-year rates of inflation, based on differences between nominal yields and TIPS yields, were 1.82% and1.89%, respectively.

Yield spreads on corporate bonds did widen, which would also be expected with declines in stock prices. Also, prevailing spreads have been quite narrow compared to historical medians. This is particularly the case with below investment grade corporate bonds. Based on Merrill Lynch corporate bond indices, the spread on investment grade bonds widened by 5 basis points this past week, and below investment grade corporate bonds by a more sizable 29 basis points.

The U.S. dollar weakened further this past week, as its downward momentum persisted. The broad U.S. dollar index fell by 0.50%, bringing its drop to 9.86% from a recent high on December 20th of last year. Notably, the Japanese yen was up a hefty 1.37% against the dollar, and the Chinese yuan gained 0.99%. But the South Korea won was down 1.23% against the dollar this past week. The dollar does look ripe for a bounce, but conditions this past week were clearly not conducive for that.

Gold provided its safe-haven attraction, rising by 2.34% for the week to $1287.70. Gold has gained 6.54% from a recent low of $1208.60 on July 7th, little more than a month ago. Gold is again close to its recent high of $1294.40 on June 6th. Further geopolitical worries will push gold higher; the absence of them will push gold down. That's pretty obvious; who knows?

Oil fell by 1.53% for the week to $48.82. The recent high for oil was $50.17 on July 13th. The longer oil goes without exceeding that recent high, the more it reflects skepticism that oil will mount a sustained rise. As for broader commodities, the Dow Jones Commodity Index gained 0.86% for the week.

TRACKING THE U.S. ECONOMY

Inflation rates remain low. July reports on both consumer and producer prices were released this past week. The major question continues to be if and when inflation rates are going to pick up? The Federal Reserve continues to expect this, believing that easy money policies will boost demand, and with it stronger labor markets, including accelerating growth in wages, which will then push inflation rates higher. There have been several weak links in the line of reasoning. First, demand in the economy has not accelerated much. The rate of growth in real GDP, measured as the year-over-year rate of change in a 4-quarter moving average, remained below 2% for data through the second quarter, although the pace has picked up modestly since the final quarter of 2016. Second, although nonfarm payroll employment continues to post monthly increases of 200,000+, which seems to be the criterion for "strong growth", 12-month rates of change in employment have been decelerating for about two years, since August 2015. Low unemployment rates are the result of slow growth in the labor force as much as rising employment. Third, despite clearly tightening supplies of labor, rates of change in average hourly and weekly labor compensation have not been accelerating and remain slightly below 2.5%.

The Consumer Price Index for All Items (CPI) is the most closely followed measure of prices of consumer goods and services in the U.S. economy. Rates of change in the CPI are often referred to as "headline inflation", as this is what is reported by the popular media. The annualized 3-month rate of change in the CPI in June was -0.37%. In February of this year, it was 3.66%. Clearly, these measures do not indicate any pickup in inflation rates.

Declining consumer energy prices are a major reason for the decelerating 3-month rates of change in the CPI since February. The annualized 3-month rate of change in consumer energy prices in July was -15.37%; in February it was 24.70%. This was a dramatic swing, but the recent drop in consumer energy prices likely ended in July. There is also a second reason. The annualized 3-month rate of change in consumer prices excluding energy was only 0.89% in July, compared to 2.34% in February.

This leaves things essentially in the same place they have been over the past five months. To get inflation rates measured by the CPI accelerating to closer the 2.0% level, consumer energy prices have to rebound and rates of change in consumer prices excluding energy have to pick up. Some pickup in both seems likely over the next few months. The bigger question is can any increases be sustained to affect inflation rates over longer periods. Although the 12-month rate of change in the CPI was up to 1.93% in July, it is going to have a difficult time rising above 2% anytime soon.

Producer prices have been rising faster than consumer prices, but rates of change in producer prices have actually started to decelerate. The annualized 3-month rate of change in producer prices was 1.79% in July, but this measure is down from 3.29% in February. And while the 12-month rate of change in producer prices has been accelerating since January 2016, it stood at only 1.64% in July.

In sum, it is very hard to make an argument for higher inflation based on recent rates of change in consumer and producer prices. Financial markets seem to see thing much the same way. The expected 10-year rate of inflation, measured by the difference between the yield on the 10-year nominal Treasury note and the 10-year TIPS, averaged 2.08% in February of this year. In July the average 10-year expected rate of inflation was down to 1.78%. While these are expectations, they tend to show that investors are significantly influenced by recent inflation data. Still, financial markets are not indicating higher future inflation rated.

Rising job openings highlight June "Jolts" report. The Bureau of Labor Statistics' Job Openings and Labor Turnover (Jolts) report for June showed that the number of job openings in the nonfarm business sector rose at an annualized 18.48% over the past three months. The ratio of job openings to total nonfarm payroll employment averaged 3.94% over the past twelve months. At its recession-related low in February 2010 the percentage was only 1.85%. The percentage in July was the highest for any 12-month period since these data have been collected starting in 2000. There are lots of job openings that employers are trying to fill.

By comparison, the annualized 3-month rate of change in new hires fell at a 2.95% annualized rate in July. This is a reason why openings are rising rapidly. Those openings are not being filled very fast. The ratio of hires to total nonfarm payrolls averaged 3.63% over the past twelve months through June. This percentage is slightly higher than the historical average. Also this percentage is relatively stable over time. Still, employers have not been able to accelerate the pace of new hires to keep pace with rising openings. One speculation as to why this is occurring is that employers are finding it increasingly difficult to find qualified candidates. If this is the case, employers also cannot afford to lose experienced employees. Both of these factors should be driving compensation levels up. But rates of change in hourly and weekly compensation are not accelerating. Labor markets continue to improve and supplies of workers continue to tighten in relation to demand for workers. As noted in a recent report, as recently as five years ago the U.S. economy did not have enough jobs for workers who wanted them. Increasingly over the past eighteen months, there are not enough workers to fill available jobs.

Productivity has improved, but remains relatively low. Productivity (real output/hours worked) in the nonfarm business sector of the U.S. economy rose at a 0.92% annualized rate in the second quarter of this year from the first quarter. The 4-quarter rate of change in productivity has improved from -0.05% in the third quarter of last year to 0.77% in the second quarter of this year. While an improvement, the 0.77% increase in productivity compares to an annualized increase of 1.80% since the end of 1999. The 0.77% four-quarter increase in productivity resulted from a 2.19% increase in output and a 1.41% increase in hours worked.

Why productivity gains in the U.S. economy have been chronically weak over the past six and a half years remains somewhat of a mystery. Clearly, modest rates of growth in output are one reason. But even adjusted for rates of growth in output, productivity gains have been weak. Looking ahead, an aging labor force and shortages of workers with skills and abilities across many industries point to continued modest growth in hours worked. Without stronger productivity gains, stronger growth in the economy and in real hourly labor compensation will be difficult to achieve.

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