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Mast Report

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THIS WEEK'S CONFLICT

A week ago, financial markets were roiled by rising tensions between North Korea and the U.S., as Kim Jong Un and Donald Trump launched verbal missiles at one another. Fortunately, they both lowered the temperature early this past week, and markets settled down. Just as nature abhors a vacuum, new problems arose with violence in Charlottesville, Virginia and Barcelona, Spain. President Trump's response to events in Charlottesville was unsettling to many and to financial markets. Whether one agrees with the President's views and comments or not, he has shown himself to be disruptive and chaotic, similar to his behavior in the presidential campaign and debates. His supporters thought he would be successful and productive in office because he would "shake things up" in Washington. But his approach to doing this has, for better or worse, significantly undermined the accomplishing his agenda and goals. Tax and regulatory reforms and infrastructure investment may still be some of the next items on his agenda. But right now, tax reform seems unlikely. At best, further regulatory reforms and more infrastructure investment will be delayed. Specifics continue to be lacking.

Stocks in developed countries fell this past week, but not by much. As was the case a week ago, U.S. shares led the decline with the MSCI U.S. Index down 0.6%. The MSCI Pacific Index was off 0.2%, and the MSCI Europe Index gained 0.2%. Emerging market shares continue to outperform, as the MSCI Emerging Market Index returned a solid 1.6% for the week.

Over the past two months, since June 15th, U.S. stocks have underperformed non-U.S. stocks and the dollar has declined. For U.S. dollar investors, some of the better performance of non-U.S. shares has come from strength in foreign currencies. Since June 15th, the MSCI Emerging Markets Index has returned a hefty 6.5%, followed by the MSCI Pacific Index, 2.8%, and the MSCI Europe Index, 2.4%. Over this period, the MSCI U.S. Index is down 0.1%.

This is a short period of time and the return differences are not all that substantial. The global economy is doing better, which may be helping non-U.S. shares more. Corporate earnings are improving globally. Non-U.S. shares are generally viewed as being relatively undervalued compared to U.S. stocks. All of these things can explain some of the relatively weak returns on U.S. stocks since mid June. But could it also reflect a "Trump" effect. There was a big, positive Trump effect following last November's election. Since November 4th of last year, just prior to the election, the MSCI U.S. Index has returned 18.1%. But since the end of May, the return has been negligible. Has Trump fatigue set in; has the Trump effect switched from a plus to a minus? Who knows the answer? But increasingly it is an important question and possibly a source of increasing investor concern.

Getting back to U.S. stocks, both the S&P 500 Index and the Nasdaq fell by about 0.65% this past week. The Russell 3000 Index returned -0.6%. Patterns within market capitalization size and style continue to be the same, favoring large caps over small caps and growth over value. The Russell 3000 Growth Index outperformed the Russell Value Index by 0.54 percentage point for the week. The large cap Russell 200 Index returned -0.6%, while the small cap Russell 2000 Index returned -1.2%. The best performing size/style category, again, was large cap growth, with a return of -0.4% for the week; the worst, again, was small cap value, -1.4%. Since December 2, 2016, the Russell 200 Growth Index has returned 18.0%; the Russell 2000 Value Index, -5.8%. At some point getting out of large cap growth stocks and into small cap value stocks will be a good move. So far it hasn't been.

Among major U.S. economic sectors, only utilities posted any significant positive return this past week, 1.4%. On the down side, declines were led by energy, -2.5%; telecommunications, -1.8%; and consumer discretionary, -1.7%.

Nominal yields on U.S. Treasuries were little changed this past week. Real yields on longer maturity Treasuries were up a bit, while expected rates of inflation continued to decline. Declining inflationary expectations will probably add to the evidence the Federal Reserve is watching closely. The Fed wants to start reducing its asset holdings and an announcement that this will begin is likely in about a month at the next Open Market Committee meeting. Especially with inflation rates and expectations falling, the Fed does not want to announce a start to asset reduction and a rate hike at the same time. The next rate hike will not likely come until December, and that will become less probable if inflation continues to lag and remain below the Fed's 2% target.

Gold was essentially unchanged this past week, closing at $1285.70. Gold has attracted interest as a safe haven asset arising from potential military action related to North Korea and U.S. political turmoil. But gold still has not moved above its June 6th high of $1294.40. Oil was down 0.6% for the week to $48.51. Oil remains below its recent high of $50.17 at the end of July. The Dow Jones Commodity Index was also down for the week, by a small 0.5%.

IS PASSIVE TOO RISKY?

Worries that investors have moved lots of assets into index funds and that this will lead to price bubbles have been around for a while. A front page article in the August 14th Financial Times addressed this topic. These concerns are primarily related to huge flows of money into ETF's, some $2.8 trillion since the start of 2008, according to the FT. The article also indicated that the period since the start of 2008 coincides with one of the longest "bull runs" in U.S. stock market history. Not to be picky, but the first 15 months of that period was a significant part of one of the worst bear markets in U.S. stock market history. The annualized rate of return on the S&P 500 Index from the end of 2007 through July of this year was 7.89%. But what worries those concerned about a possible bubble in stock prices is how much and how long stocks have risen since the March 9, 2009 low. The FT seems to share the concern held by many that investors in stocks have become complacent.

The concern about the coinciding rise in stock prices and massive money flows into index-tracking ETF's was captured in a quote in the FT article from Howard Marks, co-founder of Oaktree Capital, "When the management of assets is on autopilot, as it is with indexed ETF's, then investment trends can go to great excess." Mr. Marks makes a good point, but more related to word "autopilot" than to ETF's as an investment vehicle. There were no ETF's for tulip bulbs in Holland in the 1600's, or on Wall Street in 1929, or even in March 2000. Euphoria was able to become excessive without ETF's as a cause or vehicle.

One could also add other relevant words and terms to "autopilot", notably "irrational exuberance" and "panic". But autopilot is totally different from the last two. Autopilot means not needing to pay attention. The other two suggest paying extreme attention, based on subjective and obsessive optimism or pessimism. Mr. Mark's quote seems to relate to investors not paying attention. However, investors' move into indexed ETF's, and also index mutual funds, seem to reflect that they have quite rationally been paying more attention to high fees and poor relative performance of actively managed funds. Still, I think his description of investors being on autopilot. i.e. not needing to pay attention, is quite important and relevant.

What investors seem not to be paying attention to is asset allocation. This was evident in the second article, which appeared in the August 14th Wall Street Journal. The article reported that Vanguard has introduced a target- date retirement fund for investors who plan to retire in 2065. It was not that a retirement date nearly a half century into the future that was of interest. It was that the article provided a good opportunity to review how target-date funds are managed. The basic investment strategy is that the longer the time period to retirement, the larger the percentage of the fund's assets will be invested in riskier assets, notably stocks, and the smaller the percentage in lower risk assets, notably fixed income.

Then the article states, "they [referring to target-dated funds] automatically shift their asset allocation to what the industry considers a more age-appropriate, conservative mix of stock and bonds." The key work in that quote is "automatically", which is similar to "autopilot". In fact, the automated shift in a target-date funds' asset allocation away from stocks and into fixed income as one approached retirement is often referred to its glide path. By analogy, target-date funds are like aircraft that both fly and land automatically and on autopilot.

The article also noted that target-date funds with a retirement date of 2010 lost an average of 30% in 2008. Jude Boudreaux, founder of Upperline Financial Planning in New Orleans, was quoted in the WSJ article, "the problem with target-date funds is that they are in large part very aggressive." He goes on to say that investors in target-date funds "are going to freak out and sell at the worst possible time and that's going to do far more damage."

I'm assuming that Mr. Bourdreaux's assessment that target-date funds with far off retirement dates being very aggressive relates to their high portfolio weightings in riskier assets. In addition, and possibly more important, is that the mix of assets in target-date funds are determined automatically and are on autopilot. This would seem to also apply to nearly all portfolios offered and managed by robo-advisors and to many portfolios managed by financial advisors and wealth managers.

Looked at this way, portfolios that are managed too passively or automatically may be quite risky. This is nearly the opposite of how this type of asset management is portrayed and sold. It is sold as being less risky, because it invests in index funds (which is valid), and asset allocation reflects the investor's needs, goals, and risk tolerance, which presumably makes it less risky, and that the manager does not engage in the risky tactic of dreaded "market timing".

Another quote from the WSJ article came from Matthew Tuttle, portfolio manager at Tuttle Tactical Management, "The market-timing hall of fame is always going to be empty, but you can react to what the market is telling you. Target date funds fail to do so." Mr. Tuttle is absolutely spot on, and I would broaden that to include all investment managers who treat asset allocation as an autopilot and automatic activity. If readers of these Reports ever wonder why I so frequently discuss and emphasize expected rates of return derived from market information, it's because I'm listening to markets to provide critical information for managing investment assets. Investment management, and especially asset allocation, is not done on autopilot, like flying on a day with good weather. You constantly have to be able to react to what markets are telling you.

If you engage an investment manager, financial planner or advisor, or wealth manager to manage your assets, ask them how they come up with projections of rates of returns for major asset classes for wealth planning purposes and for ongoing asset allocation decisions. Beware if they do not know, or if the answers are historical returns for wealth planning and recommendations of periodic, i.e. by the calendar, rebalancing as the asset allocation methodology. That does not require listening to markets. Find someone who can and does, or learn how to yourself.

TRACKING THE U.S. ECONOMY

Retail sales increased strongly in July. Total nominal dollar retail sales rose by a strong 0.60% in July from June, and retail sales in June were revised significantly higher. This has contributed to faster growth in retail sales in recent months. The annualized 3-month rate of change in retail sales has improved from 1.51% in May to 2.73% in July. Even better, the 12-month rate of change has picked up from 2.54% in August 2016 to 4.03% in July. This improvement has come despite declining retail sales of gasoline, which largely reflects falling gasoline prices. Excluding gasoline, retail sales have grown faster, with the 12-month rate of change rising at an annualized rate of 4.71% over the past three months.

After adjusting for inflation, based on the Consumer Price Index, estimated real retail sales have also increased more rapidly in recent months. The 3-month annualized rate of change has accelerated to 3.11% in July from only 0.71% in April of this year, and the 12-month rate of change has improved from 1.66% in August of last year to 2.06% in July.

However, these improving rates of change in retail sales and also in real consumer spending have come despite notably slower rates of growth in real disposable personal incomes. As a result, more rapid growth in retail sales and real consumer spending has come in part from personal savings, which caused the personal savings rate to drop to low levels, and also from increasing consumer debt.

This means that continued strong rates of growth in retail sales will, at some point, have to come from stronger growth in personal incomes. Although this is likely to occur to a degree, it is likely that recent strong growth in retail sales will start to moderate.

Industrial production continues to improve. Despite only a modest increase in July, industrial production has been rising at more rapid rates in recent months. Over the past three months, industrial production rose at a strong 4.06% annualized rate, and this measure has shown positive increases since December of last year. Prior to that, it was a tough road for industrial production in 2015 and 2016. The 12-month rate of change in production fell to -1.86% in May of last year and only turned positive in March of this year. The 12-month rate of change was still a slim 0.60% in July, but should continue to gradually improve in upcoming months.

Declining industrial production in 2015 and nearly all of 2016 pushed down plant capacity utilization rates to well below historical average levels. Even with the recent improvement in production, the plant capacity utilization rate was only 76.7% in July. This is way below the 82%-83% rates that have historically been associated with significant acceleration in inflation rates. This is one reason, and one that is seldom mentioned, why inflation remains subdued.

Also and possibly related, the mean plant capacity utilization rate from 1948 through 1999 was 82.4%. Since 2000 the mean has been 76.9%. Perhaps it is a coincidence, but higher utilization rates from 1948-1999 were accompanied by higher levels of productivity in the nonfarm business sector. Could it be that part of the answer for smaller gains in productivity since 2000 has been persisting relatively low plant capacity utilization rates?

Economic Indicators continue to be encouraging. The Conference Board's Index of Leading Economic Indicators (LEI) has recently increased at more rapid rates. The annualized 3-month rate of change in the LEI was 4.62% in July and the 12-month rate of change was 2.55%, up from 1.42% in December of last year. The pattern that has prevailed throughout the economic recovery starting in the second half of 2009 has been that stronger increases in the LEI have not fully been translated into growth in the Index of Coincident Economic Indicators (CEI). The 3-month rate of the change in the CEI was 2.11%, quite a bit slower than that for the LEI. This is not a surprise. But what we want to see is a pickup in 12-month rates of change in the CEI, as this would be a sign of sustained faster growth in the broader economy. This is starting to occur, but only very slightly. The 12-month rate of change in the CEI has improved to 1.79% in July from 1.72% in February, hardly enough to be noticeable.

Housing starts and permits show strength in single-units and weakness in multi-units. Total housing starts fell by 4.8% in July from June and total permits for new home construction were down 4.1%. However, multi-unit starts were down 15.3%, while single-unit starts were off only 0.5%. Similarly, multi-unit permits were down 11.2% while single-unit permits were unchanged.

This pattern started in about March 2016. Prior to that date, there was strong demand for apartments as new and younger households couldn't afford owner-occupied homes or couldn't get financing, or did not want to take on the higher risks of home ownership. This triggered a boom in apartment construction and caused rents to rise sharply, both absolutely and in relationship to costs of home ownership. All of this came to a peak and started to reverse in the spring of 2016.

Twelve-month rates of change capture this. This measure showed an 11.54% increase in multi-unit starts in February 2016, by July of this year it was -5.65%. The 12-month rate of change in single-unit starts was 8.01% in July, a pickup from 6.46% in March of this year. Similarly, the 12-month rate of change in permits for multi-unit construction has slowed from 17.71% in January 2016 to -6.87% in January of this year. But since then, multi-family permits have at least ceased to decline. This may indicate that apartment construction may not drop much further. Twelve-month rates of change in single-unit permits remain strong, up 9.03% in July. Still, single-unit housing remains the stronger part of the residential housing sector.

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