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Mast Report

SEPTEMBER 8, 2017

INVESTOR UNCERTAINTY

Recent changes in prices and yields of major asset classes indicate rising uncertainty and related caution among investors. The strongest evidence of this can be seen in gold, the U.S. dollar, and yields on longer maturity Treasuries. Gold rose by another 1.62% last week, closing at $1346.00. Gold is up 19.35% from its last significant low of $1127.80 on December 16th of last year. Gold is not rising because it is a hedge against higher rates of inflation. Inflation rates and expectations for future inflation are subdued and have recently declined. It is rising because investors see gold as a haven against uncertainty.

The U.S. dollar is declining against other currencies. The broad U.S. dollar index fell by another1.59% this past week and is down 11.54% since its recent high on December 20th of last year. The recent high in the dollar and the recent low in gold occurring at close to the same time last December may be a coincidence. But it could also reflect rising caution and related uncertainties among investors.

Yields on longer maturity Treasury bonds have declined significantly since March 13th of this year. On that date the yield on the 30-year Treasury bond was 3.19%. At the past week's close its yield was 2.70%. The 30-year Treasury's yield fell by 9 basis points this past week. The yield on the long TIPS has dropped from 1.18% on March 13th to 0.78% at the past week's close. The decline in the long TIPS yield since March 13th has accounted for 82% of the drop in the yield on the 30-year Treasury bond; lower inflation expectations accounted for only 18% of the drop. This suggests that investors have moved assets into TIPS, as uncertainties have led investors to become more cautious.

Rising gold prices and declining Treasury yields have traditionally reflected investors' seeking safe havens from deteriorating economic conditions and from falling prices of riskier financial assets, notably stocks. But the economy has been improving with a pickup in the pace of growth since the end of last year. Corporate earnings continue to rise strongly from levels in the second quarter of 2016, and dividends also continue to rise strongly. Stock prices have risen as a result of these factors. However, since the yield on the 30-year Treasury bond hit its recent high on March 13th, the price of the 30-year Treasury bond has risen by 11.13%, while the S&P 500 Index has risen by a considerably smaller 3.71%. This suggests that something is bothering investors, but it is not primarily the stock market, and by inference, not the economy or corporate earnings.

Caution on the part of investors has also driven them out of the U.S. dollar, which is traditionally seen as the largest and most liquid safe haven currency. Investors have shunned to dollar, even as the U.S. economy continues to improve with accelerating growth.

One understandable reason for investors' caution is the tense and uncertain conditions surrounding North Korea. However, currencies of other countries involved in and affected by the North Korean situation have appreciated against the U.S. dollar since mid December of last year. The Japanese yen is up 9.59% and the Chinese yuan has gained 7.37%. Even the South Korean won has gained 4.83% against the dollar since the middle of last December.

This brings the focus of the reason for investors' caution and uncertainties to the political environment in the U.S., particularly within the federal government. Although not entirely, most of these uncertainties center on President Trump. While investors and financial markets would prefer certainty, they realistically do not expect it. President Trump has been a source of rising uncertainty. Candidate Trump ran on a promise of shaking things up in Washington. And he has delivered. But in the view of most, the shaking up has not led to nor delivered changes or improvements that were promised and that many had hoped for. The shakeup and the President's chaotic behavior have increased uncertainty. It is very hard to see this changing, as the President's behavior will likely continue to be unpredictable, while producing sufficient offsetting benefits. If so, all of this will continue to impact prices, yields, and valuations of financial assets that will tend to favor lower risk asset classes.

WEEK IN REVIEW

Global stock prices were mixed over the past week. Stocks in developed countries outside the U.S. posted modestly positive returns for the week, aided by the 1.59% drop in the dollar index, which benefitted U.S. dollar investors. The MSCI Europe Index posted a return of 1.03% and the MSCI Pacific Index, 0.48%. The MSCI Emerging Markets Index was essentially unchanged, and the MSCI U.S. Index returned -0.62%.

Among major U.S. stock indices, the S&P 500 Index fell by 0.61% and the Nasdaq was off 1.17%. The Russell 3000 Index posted a total return of -0.67%. Differences in rates of return among market capitalization size and style categories were relatively muted. Growth continued to outperform value. The Russell 3000 Growth Index returned -0.41%, compared to -0.93% for the Russell 3000 Value Index. As for size, the large cap Russell 200 Index posted a return of -0.64, somewhat less negative than the -0.98% for the small cap Russell Index. Positive momentum still resides on the side of large cap stocks and growth stocks.

Among major U.S. economic sectors, the most significant loser was the telecommunications sector with a sharp decline of -4.47%, followed by financials, -1.88%. The best performing sector for the week was health care with a return of 1.33%. The energy sector enjoyed a small rebound with a return of 1.15%. Oil prices rose by a slight 0.40% for the week, closing at $47.84. The Dow Jones Commodity Index (spot prices) fell by a slight 0.24%.

BLACK SWANS TAKE A DIVE

In the context of financial markets, "black swans" refer to rare events, such as major declines in the stock market. The most recent and widely-noted black swan example was the decline in stocks from their peak in early October 2007 to early March 2009. Based on the S&P 500 Index, U.S. stocks declined by 56.8% from their high October 9, 2007 to their low on March 9, 2009. Since the end of 1926, a period of over 90 years, there have been five "superbear" markets, which saw the S&P 500 Index decline by at least 45%. This averages one every 18 years. The worst one was from October 10, 1929 through June 1, 1932, during which the S&P 500 fell by 85.7%. The October 9, 2007 through March 9, 2009 decline was the second worst of the five.

As in nature, black swans are also rare in financial markets, which is why they are called "black swans". When people have financial plans prepared by financial advisors and wealth planners, much of that plan is based on simulations of what futures rates of return might be on major classes of financial assets, e.g. stock and bonds, and on portfolios comprised of those asset classes.

Where do the inputs for these simulations come from? With rare exception they come from historical rates of return. Past rates of return, say for annual or monthly periods, have some tendency to conform to a normal distribution, or a "bell curve", so called because a graph that plots the frequency of returns looks like a bell. For example, the number of historical annual rates of return on the S&P 500 Index that fall in a range of 8%-10% is a lot larger than the number in the 20%-22% range or the -10% to -12% range. So "black swan" events fall on the extreme edges, or tails, of the bell curve. The left edge is where the most negative returns are found. Black swan events are also at the right edge of the bell where very positive rates of return reside. However, in practice, "black swan" events are associated with extremely negative returns.

These simulations are of some help. They can tell you the probability of the S&P 500 Index experiencing a decline of, say, worse than 20% in any 12 month period, based on historical rates of return. What this type of simulation does not and cannot address is the conditions that that tend to precede large declines, or gains. In other words, these simulations can tell you the general probability of something happening, but not on how that probability might differ under different conditions.

People find it hard to relate to comments such as "there is only a 3% probability that the S&P 500 will decline by more than 20% in any 12-month period." The impression left is that the probability the same for any and all 12-month periods. In reality, most people think and behave as if recent conditions will continue and will persist in the immediate future. This behavior is not lost on some who sell investment products.

An article in this past Wednesday's Wall Street Journal aptly titled, "Years After Crisis, Hunt Is Ending For Black Swans", addressed this. The crisis the article referred to was the October 2007-March 2009 superbear stock market. It seemed obvious to many people at that time that it would be good idea to invest in funds and products that provided protection against such an extremely negative "black swan" event, given that one had just happened. And some hedge funds and other providers of investment services made products available that would provide such protection.

According to the WSJ article, data compiled by CBOE Eurekahedge indicated that people who invested in these so called "tail-risk funds" saw the performance of those funds peak in October 2011. However, they have since lost 55% of their money. The expectation of investors who bought these products sometime shortly after the bottom in U.S. stocks on March 9, 2009, was that the market would continue to decline, or that shortly after a temporary rebound, stocks would again nosedive. In other words, the massive declines in stock prices in the recent past were believed to be a prelude to more of the same.

Based on the information provided by CBOE Eurekahedge to the Wall Street Journal, it would seem that most investors were probably quite pleased with these tail-risk funds when their performance peaked in October 2011. Did that assessment and conclusion make sense? If you are a regular reader of these Reports, you know that considerable emphasis is placed on expected rates of return that are based on information from financial markets, notably prices and yields.

Here are some data from October 3, 2011. On that date the S&P 500 Index was at 1099. The expected real long-term rate of return for the S&P 500 on that date was 6.75%. This is computed by dividing my estimate of normalized operating earnings per share for the S&P 500 by the Index's level. This estimate is based entirely on known and available market information at that time. The 6.75% expected real long-term rate of return on October 3, 2011 compared to an historical median of 5.33%. Also, the 6.75% expected real rate of return on the S&P 500 compared to a real yield on long-term Treasury bonds of 0.84% at that time, resulting on an expected real long-term equity risk premium of 5.95%. That compared to an historical median expected long-term equity risk premium of 3.12%.

These observations indicated that stocks were quite attractive in early October 2011, and were even more attractive than low risk Treasury bonds. While the odds of a sharp decline in stock prices are never zero, the odds in early October 2011were lower than normal given the well above average real expected rate of return on the S&P 500 Index and, even more, given the attractive expected long-term equity risk premium. This information would have been sufficient to at least raise a question about remaining in "tail-risk" funds and investment products at that time.

So how have things worked out since October 2011. From the end of September 2011 through the end of August 2017, the S&P 500 Index posted an annualized rate of return of 16.60%, compared to 3.68% for the 30-year Treasury bond. That's a difference of 12.92% per year in favor of the S&P 500. That realized return difference was even better than the expected long-term equity risk premium at the start of that period. Those who held on to tail-risk funds to protect against declines in stock prices have experienced huge losses, and they have also missed huge opportunities. The main reason was that they based their decision to buy these products on recent sharp declines in stock prices. They should have based their decisions on expected rates of return derived from market prices and information.

Each monthly Investment Strategy Report that I provide begins with a statement that long-term investing boils down to identifying sources of investment risk and assessing what expected rates of returns markets are providing to take those risks. The best measure of risk associated with owning stocks is the expected equity risk premium. Good advice is to use this information to help manage your portfolio, or find a registered investment advisor who does. The times to hedge risks in stocks are those when expected longer-term equity risk premiums are very low and well below their historical norms. Such times have never come just after a huge decline in stock prices. To the contrary, it rather consistently comes around market peaks when investor euphoria is high.

Related to this, remember that nearly all of the financial and wealth plans and portfolios recommended by those who provide them are based on a distribution of historical returns that is normal. They are not conditional on prevailing expected rates of return. Yes, this sounds wonky, but it is very important and makes a huge difference in how portfolios are constructed and managed.

TRACKING THE U.S. ECONOMY

It was a light week for economic reports on the economy. Three report of interest were released: The Federal Reserve's Beige Book report, motor vehicle sales for August, and the Institute of Supply Management's August survey of the nonmanufacturing sector.

Labor markets are tight and worker shortages are being reported. The Federal Reserve's Beige Book report provides anecdotal inputs from businesses across industries and economic sectors in all Federal Reserve Bank districts. Information is collected on economic activity, employment and wages, and prices. The most recent report was released on September 6th and was based on information collected since the prior Beige Book, released on July 12th.

The September 6th Beige Book report indicated that economic activity expanded at a modest to moderate pace. This was the same general characterization as in recent reports. The most interesting and important comments were those related to employment and wages. Although economic activity has been increasing at a modest/moderate pace, employment growth slowed some, with labor markets characterized as tight and with worker shortages indicated in numerous industries, notably construction and manufacturing. These comments about tight labor markets and worker shortages are not new; they have been increasingly noted in recent months and appear to be becoming more widespread and severe. Were real economic activity growing at 3% to 4%, or higher, tight labor markets and increasing labor shortages would be more expected. But this has happened as the U.S. economy is still growing at close to 2%.

The main reason for this is a relative inadequate supply of workers. This can be seen in relatively slow growth in the civilian labor force and in the absence of any increases in labor market participation rates. Part of this is demographics. An aging population and workforce are the major reasons for relative slow growth in the labor force. Labor force participation rates for those over 65 are actually rising, although the level of participation of those over 65 is lower than the overall percentage. Participation rates of those under 65 are falling. Males in this age group have participated in the labor force at declining rates for years, especially since the start of the severe recession in early 2007. Participation rates of all workers aged 25-45 are also declining, with a recent study citing rising opioid addiction as a significant and increasing cause.

The shortage and lack of employable workers has become the most significant cause and barrier to the U.S. economy not growing as fast as it could.

Unit sales of light motor vehicles peaked in February 2016 at 17.570 million units, based on the 12-month average ending at that time. Since then, the 12-month average has declined to 17.120 million in August. There continues to be a shift in buyers' preferences away from automobiles and toward light trucks. Pick-up trucks have become more popular and SUV's have become a more popular body style compared to autos. SUV's are categorized as light trucks. Twelve-month rates of change illustrate buyers increasing preference for light trucks over autos. The 12-month rate of change for unit auto sales was -10.82% and has been decelerating since December 2012. But a lot of the drop in auto sales was accounted for by rising unit sales of light trucks. In August of this year, the 12-month rate of change in unit light truck sales was 4.07%. But that was down from a 13.16% increase in February 2016.

The slowing rate of increase in light truck sales, when combined with declining unit auto sales, has resulted in declining unit sales of total light motor vehicles, as noted above. There would appear to be two reasons for this. First, there was a boom in light motor vehicle sales from the end of 2010, when the 12-month average in sales was 11.555 million, until April 2016, when the 12-month average was 17.557. In terms of longer term trends, a good deal of demand for light motor vehicles had become satiated by the spring of last year. Second, recent rates of growth in real personal disposable personal incomes have been noticeably slower than rates of growth in real consumer spending. In order to sustain consumer spending, personal savings rates have declined significantly and consumers have taken on more debt. A continued drawdown of personal savings and further taking on more debt to buy more light motor vehicles is not likely. Both of these factors indicate that the drop in unit light motor vehicle sales has not ended.

The pace of expansion in the nonmanufacting sector remains solid, but it's not accelerating. The Nonmanufacturing Index (NMI) from the Institute of Supply Management's August survey was 55.3 in August, up from 53.9 in July. This indicated a fairly strong pace of expansion. The 3-month average in the NMI was 55.5, down from 57.3 in June. The 6-month average was relatively stable at about 56.0. The 12-momth average was 56.2 and continues to rise slowly. These are good readings, although they do not show an accelerating rate of expansion in the nonmanufacturing sector of the U.S. economy.

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