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Mast Report

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INVESTORS' RISK APPETITE RETURNS

Over the prior few weeks, investors had become more cautious and their appetite for risk had waned. There was a lot to be worried about. Hurricanes and political storms in Washington and the persisting tensions with North Korea were at the top of the list. Underlying improvement in the economy and continued strong increases in corporate earnings and dividends provided enough support and optimism to keep stock prices from falling significantly, but they were not enough to offset these other concerns. This was all evident in financial markets prior to this past week. U.S. stock prices were weak, the dollar fell, and oil and commodity prices dropped slightly. Safe haven assets rose, notably gold and U.S. Treasuries.

This past week saw a complete reversal from prior week's pattern. There was relief that bad hurricanes could have been even worse, especially in Florida. President Trump got together with friends Chuck and Nancy to address the debt ceiling, spending, and possibly pressing issues on immigration. Several plans on taxes and tax reform are being worked on. Of course, all of this can and probably will change, at least once. But for a week, investors found this to be something of a soothing improvement. Kim Jong Un's latest missile launch over Japan was met with expected denunciation and North Korea's threats. But there was not much new in this episode. The markets' tepid reaction to another North Korean missile launch provided evidence of the law of diminishing marginal utility. This enabled investors to return some of their attention and focus to the economy and corporate earnings.

Save for a very slight decline in Pacific region developed countries' shares, stock prices rose this past week. The U.S. led with the MSCI U.S. Index returning 1.62%, followed by a return of 1.05% for the MSCI Emerging Markets Index and the MSCI Europe Index, up 0.88%. Positive relative return momentum continues for emerging market stocks and, to a lesser degree, for European shares.

As for major U.S. stock indices, both the S&P 500 Index and the Dow Jones Industrial Average hit all time highs. For the week the S&P rose by 1.58% and the Dow by 2.16%. The Nasdaq added 1.39%. The bigger gainers were recent laggards, small cap stocks and value stocks. The Russell 2000 Index returned 2.35% for the week, compared to returns of about 1.6% for both the large cap Russell 200 Index and the Russell Mid Cap Index. Value stocks had a good week. The Russell 3000 Value Index returned 2.24%, compared to a return of 1.18% for the Russell 3000 Growth Index. Returns on large cap growth stocks and small cap value stocks have often been at opposite extremes. Throughout most of 2016, small cap value was the big winner. Over the past nine months, large cap growth has led the pack, while small cap value has essentially been flat. This past week, the Russell 2000 Value Index returned 2.99%, while the Russell 200 Growth Index added a relatively small 1.08%. Still, positive relative return momentum remains on the side of large cap growth stock, but small cap value has at least stopped underperforming.

Among U.S. economic sectors, basic materials, energy, and telecommunications all posted returns of at least 3.0% this past week. Trailing the pack were real estate, 0.33%, and utilities, -0.32%.

Yields on U.S. Treasuries moved sharply higher. Yields on Treasuries with maturities of ten years and less rose by about 14 to 15 basis points. The yield on the 10-year note closed the week at 2.20%, up from

2.06% at the close of the prior week. Two-thirds of the increase in the 10-year note's yield came from higher real yields, the remaining third from higher inflation expectations. The price of the 10-year note fell by 1.20% for the week. The yield on the 30-year Treasury bond rose by 9 basis points to 2.77%, and 55% of the increase in its yield came from higher real yields. Its price dropped by 1.79% for the week.

Safe haven gold lost a bit of its luster that had built up in prior weeks. Gold fell by 1.90% for the week to $1320.40. Disruptions associated with hurricane Harvey were a factor in oil's 5.08% increase this past week. Oil closed the week at $49.89, up 8.55% from its recent $45.96 low on August 30th. Broad commodity prices also rose, as the Dow Jones Commodity Index added 1.72% for the week.

FED MEETING THIS COMING WEEK

The Federal Reserve's Open Market Committee meets this coming week, ending on Wednesday. Expectations continue to be that the Fed will announce the start of a program to reduce its holdings of assets, primarily comprised of Treasuries and agency guaranteed mortgage-backed securities. It would be a surprise if the Fed did not start to reduce asset holdings. It would be a much bigger surprise if the magnitude and pace of reductions were, at least initially, anything but small and slow. The Fed wants to show that it is committed to reducing asset holdings, and it has to illustrate that commitment. The Fed also wants to avoid disrupting financial markets, specifically a large jump in yields on intermediate and longer maturity Treasuries. Given that yields on Treasuries have fallen significantly since mid March of this year, markets appear to be comfortable with the Fed's plans.

What the Fed very likely will not do this coming week is raise its target for the federal funds rate. A rate hike was not anticipated, especially if the Fed announces the start of asset reductions. Two major hurricanes will take the probability of a rate hike down to essentially zero.

More experts and prognosticators are expecting no increase in the target for the federal funds over the remainder of this year. The major reason is low and decelerating inflation that has resisted the Fed's efforts to move inflation higher. I think this view is somewhat myopic. For one, decelerating inflation occurred in only a few months from February through July, and was largely the result of falling energy prices. Also, inflation rates based on the Consumer Price Index, both overall and excluding food and energy, over longer 12-month periods are already at 2.0%, the Fed's inflation target.

Also, labor markets are quite tight and getting tighter, leaving little room for significant additional improvement. Increases in wages remain modest, frustrating the Fed. But the lack of accelerating increases in wages may be the result of the retirement of older workers who have been more highly compensated. This would tend to hold down average hourly and weekly earnings and tend to moderate increases. I still expect the Fed to raise its target for the federal funds a rate to 1.25%-1.50% at the FOMC's December meeting.

TRACKING THE U.S. ECONOMY

The economic impact of hurricanes Harvey and Irma will start to be reflected in data for September. While Harvey made landfall in the Houston area on August 25th, its impact was reflected in some economic reports for August. Reports for September will also reflect further impact from Harvey and the impact from Irma. The impact of these two hurricanes will likely continue to affect data on the economy for several more months.

Initial claims for unemployment insurance benefits rise. The impact of Harvey was seen in sharply higher levels initial unemployment insurance claims for the week ending September 2nd, then fell slightly the next week. Continued claims for unemployment insurance claims have not yet increased. Based on data through September 2nd, the percentage of all workers covered by state unemployment plans who were receiving unemployment benefits averaged 1.39% over the prior 13 weeks. This percentage remained close to its all time low.

Job Openings and Labor Turnover: The latest Jolts Report with data through July indicated that job openings continued to rise, up at a 13.33% annualized rate over the prior three months. Over the past twelve months, the ratio of the number of job openings to total nonfarm payroll employment averaged

3.95%. The historical mean is 2.89%. This indicates that there continue to be a high level of job openings in relation to employment level. This is a sign of strong labor market conditions.

However, strongly rising job openings have generally not been matched by the number of new hirings, although the relationship between openings and hires did show some signs of improving over the past three months, as hires rose at a 22.03% annualized rate. Faster growth in hires needs to persist, as the 12-month rate of change in hires remained at a sluggish 1.08%, compared to the 3.23% increase in job openings. Over the past twelve months, the ratio of new hires to total nonfarm payroll employment averaged 3.64%, which is barely higher than the historical mean of 3.52%. Perhaps the most encouraging signs we could see would be continued strong growth in new hires, as witnessed over the past three months, and a significant rise in the ratio of new hires to employment. Still, the relatively slow increases in hirings are a sign of tight labor markets.

The number of workers quitting jobs has also picked up over the past three months. The 12-month rate of change in quits through July was 5.68%. The ratio of quits to employment averaged 2.13% over the past twelve months, modestly above its historical mean of 1.85%. Higher levels and rising numbers of quits are actually a sign of strength for the economy and labor markets, as quits are a voluntary decision by workers, often to take a better job.

Layoffs and discharges continue to decline with a 12-month rate of change of -4.04%. The ratio of layoffs and discharges to total nonfarm payrolls averaged 1.14% over the past twelve months, compared with an historical mean of 1.36%. These are also positive numbers.

A good bottom line assessment of the U.S. labor market, based on data provided by the Jolts report, is obtained by adding together job openings, new hires, and quits and then subtracting layoffs on discharges. When this number is rising more strongly and is at a higher level in relation to total nonfarm payroll employment, it is a positive sign for the economy and labor markets. The 12-month rate of change in this aggregated number was 3.93% in July. This is good, but the12-month rate of change has slowed from 16.38% in April 2015. But this deceleration needs to be looked at in the context of the ratio of this aggregate to total nonfarm payroll employment. Over the past twelve months, this ratio was 8.53%. That's the highest since the data contained in the Jolts report was first collected in November 2000. At its lowest, this percentage was 4.51% in December 2009, when employment conditions were at their worst from the severe recession. This is an impressive degree of improvement. In fact the improvement has been so significant that the biggest and most significant challenge is not getting people back to work, but finding able people to fill available jobs. The competition of among employers to fill open positions continues to intensify.

Retail sales fell in August. Nominal dollar retail sales fell by 0.21% in August from July. The Census Bureau, which collects and reports retail sales data, indicated that hurricane Harvey did not significantly affect its ability to collect retail sales data, nor did it mention if there was any significant impact on retail sales in August. This implies there was not much of an impact. Retail sales in September will almost certainly be negatively affected by both hurricanes.

Augusts' drop in retail sales was significantly the result of a 1.60% decline in retail sales of motor vehicles and parts. This was no surprise, given the 4% decline in unit sales of light motor vehicles last month. As noted in past the two Reports, real disposable personal incomes have not been rising as fast as real consumer spending, and consumers and households have dipped into savings and taken on more debt to sustain growth in consumer spending. This tends not to persist and tends to be followed by cutbacks in spending, mostly for some larger ticket item. This was a major reason why light motor vehicle sales and retail sales of motor vehicle fell sharply in August.

There was an offset to lower retail sales of motor vehicles. Retail gasoline sales rose by a sharp 2.52% last month. This was mostly the result of higher retail gasoline prices, which were up 6.30% at the consumer level. Stripping out retail motor vehicle sales and gasoline sales, nominal retail sales fell by a slight 0.09% in August.

Excluding motor vehicles and gasoline, nominal retail sales posted an annualized 3-month rate of change of 1.67% in August, down from 5.16% in March. The 12-month rate of change has steadily slowed from 5.26% in March 2015 to 3.56%.

Looking at estimated real total retail sales (nominal retail sales/Consumer Price Index), the annualized 3-month rate of change slowed to only 0.20% in August from 2.97% last December. The 12-month rate of change in estimated real retail sales has held steady at close to 2.00% in recent months, but this will be hard to sustain with recent decelerating rates of growth.

Industrial production fell in August, mostly due to hurricane Harvey. Industrial production declined by 0.90% in August, but the Federal Reserve, which collect and report data on industrial production, estimated that Harvey reduced production by 0.75 percentage point. This indicates that absent Harvey's impact, industrial production would have declined by 0.15%. Assuming this, industrial production would have risen at a 3.20% annualized rate over the past three months, down from 5.66% in June. The 12-month rate of change would have continued to improve, from a -1.88% decline in August of last year to a 0.94% increase in august of this year. While these rates of change are estimates, they provide a more realistic assessment of the gradual but sustained improvement in industrial production over the past year.

Real GDP is estimated to grow at a 2.2% annualized rate in the third quarter. After growing at a tepid 1.24% annualized rate in the first quarter, real Gross Domestic Product posted much stronger annualized growth of 3.03% in the second quarter. Hopes and expectation were high for continued annualized growth of at least 3% in the third quarter. Those hopes and expectations have faded, but some of that will be due to the impact of the two major hurricanes.

Based on estimates compiled by the Federal Reserve Bank of Atlanta's GDP Now analysis as of September 15th, real GDP is estimated to increase at a 2.2% annualized rate in the third quarter. Estimated growth based on economic releases through August 16 was a much higher 3.8%. The major reasons for reduced estimates have been slower growth in industrial production, declines in light motor vehicle sales, and weaker retail sales. The drop in industrial production in August was largely due to hurricane Harvey, as noted above. Weak light motor vehicle sales and retail sales were the result of relatively slow growth in real personal incomes, low personal savings rates, and higher consumer debt levels.

It is going to be difficult for many parts of the economy to avoid lower levels of activity in September due to two major hurricanes. However, economy activity may spring back in the fourth quarter due in part to spending to clean up, repair, and replace things damaged and lost. If real GDP is going to increase by 2.25% from the fourth quarter of 2016 to the fourth quarter of 2017, and if real GDP were to increase at a 1.5% annualized rate in the third quarter, then annualized growth in the fourth quarter would need to be about 3.25%. This seems realistic. What remain less realistic are expectations for sustained growth at or above 3%.

Inflation is starting to pick up. All the talk on inflation is how low inflation is and how inflation rates have fallen. At times, it has seemed that the Federal Reserve is at wits end because inflation persists at levels below its 2% target and has recently been falling further below that target. And there is evidence showing this. The annualized 3-month rate of change in the Consumer Price Index (CPI) in was -0.37% in August. Yes, falling consumer energy prices accounted for much of this. But, core consumer inflation rates based in the CPI excluding food and energy, showed an annualized 3-month rate of change of only 0.56% in August.

But August saw some larger increases of 0.40% for the overall CPI, and 0.25% for the CPI ex food and energy. Significant factors for the larger rise in the overall CPI were a 2.84% rise in consumer energy prices and a 6.30% in consumer gasoline prices. The Bureau of Labor statistics indicated that the hurricanes had very little impact on consumer prices in August. The annualized 3-month rate of change in the overall CPI in August picked up to 0.61%, and to 1.38% for the CPI ex food and energy. These are still very low rates of inflation, but they have started to accelerate.

One is always cautioned about placing too much emphasis on data for a single month or even a few months, and that applies to the rebound in consumer prices in August. A better perspective is provided by looking at 12-month rates of change. Both the overall CPI and the CPI excluding food and energy recorded a 2.00% increase by this measure in August. That's right, most of the consternation about very low inflation rates came from small increases from February through July when the CPI fell by 0.17% (not annualized), while largely ignoring the 1.56% increase from July of last year through January of this year. Extrapolating rate of change over short time periods amounts to chasing normal gyrations. With the 12-month rates of change in both the overall CPI and core consumer price inflation at 2%, inflation is not below the Fed's target.

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