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Mast Report

SEPTEMBER 22, 2017

TREASURY YIELDS HAVE STARTED TO RISE

Yields on Treasury securities have increased since September 8th. It looks as if markets have started to discount plans by the Federal Reserve to reduce its securities' holdings and to raise its target for the federal funds rate in December (see discussion in the next section). Sustained modest economic growth and a slight upturn in inflation are also putting some upward pressure on Treasury yields. Since September 8th through the end of the past week, the yield on the 2-year Treasury note increased by 17 basis points to 1.45%, and the 5-year note's yield was up 22 basis points to 1.88%. The 10-year note's yield has move up by 20 basis points to 2.26%, with the 10-year TIPS yield up 15 basis points to 0.39%. The yield on the 30-year was up a smaller 12 basis points to 2.80%, and the long TIPS yield increased by 7 basis points to 0.86%.

Since September 8th, U.S. stock prices have posted modest gains, and have outperformed Treasuries to a more significant degree. For example, the S&P 500 Index rose by 1.66% over this period, while the price of the 30-year Treasury bond declined by 2.41%. So, the S&P 500 has outperformed the 30-year Treasury by a little more than 4 percentage points over this period. Continuing decent economic growth and persisting gains in corporate earnings and dividends continue to be beneficial to stock prices.

As stocks have recently outperformed long-maturity Treasuries, stock have become somewhat more expensive. On September 8th, the expected real long-term rate of return for the S&P 500 Index was 3.94%; at the past week's close, it was 3.88%. The expected real long-term rate of return on the S&P 500 continues to be well below historical norms.

Investors and experts who follow and emphasize absolute valuations have been expecting stocks to decline because of rich valuations. While this has not yet occurred, eventually they will be right. But the valuation metric that will be of greater relevance in signaling a downturn in stocks is not the expected real long-term rate of return on stocks, or more conventional price/earnings ratios, it is the expected long-term equity risk premium. This gauge was 3.16% on September 8th, and was down to 3.01% at the past week's close. The historical median expected equity risk premium is 3.12%, so the current reading of 3.01% is not too worrisome, especially in a positive earnings and dividend environment. As noted below, one risk to stocks would be a sharp rise in yields on long maturity Treasuries, but a sharp rise in yields is not anticipated. Another risk would be decelerating rates of growth in earnings and dividends. There is no evidence of this.

WEEK IN REVIEW

Stock prices posted generally small gains over the past week. The MSCI World Index (all developed countries) posted a total rate of return in U.S. dollars of 0.36%, led by the MSCI Europe Index, up 0.75% and the MSCI Pacific Index, up 0.60%. The MSCI Emerging Markets Index was essentially unchanged over the past week. Among major U.S. stock indices, the S&P 500 Index added a miniscule 0.08% and the Nasdaq was down a small 0.33%.

Of more significance, within the U.S. stock market small cap stocks and value stocks are starting to lead, while large cap stocks and growth stocks are starting to lag. This past week, the small cap Russell

2000 Index returned 1.35%, compared to a return of 0.11% for the large cap Russell 200 Index. Value stocks again outperformed growth stocks. The Russell 3000 Value Index returned 0.60% for the week, compared to -0.10% for the Russell 3000 Growth Index. The best performing market capitalization/style category last week was small cap value (Russell 2000 Value Index) with a return of 1.56%. The worst performing category was large cap growth (Russell 200 Growth Index) with a return of -0.51%. From December 8th of last year through August 22nd, large cap growth outperformed small cap value by 24.4 percentage points. Since August 22nd, small cap value has outperformed large cap growth by 4.5 percentage points. The tide has turned in favor of small cap value and this will persist.

On the commodity front, gold fell by 2.05% for the week, closing at $1293.30. Gold is down 3.92% from its recent high of $1306.00 on September 8th. The recent jump in gold prices seems to be over. The price of oil has rebounded sharply by 19.12% from a low $42.53 on June 21st to $50.66 at the past week's close. Further gains in oil are likely, but also look to be limited. The Dow Jones Commodity Index was little changed for the week and is up 10.32% from a recent low on June 22nd. As with oil, further gains in broad commodity price indices look to be limited.

As for currencies, it looks as if the recent significant drop in the dollar is over or much closer to a low. The broad U.S. dollar index fell by 11.53% from a significant high on December 20th of last year to a recent low on September 8th. Since then the dollar index has rebounded by 0.86% and it looks like most of the drop in the dollar since December of last year is over. In today's unpredictable and uncertain political and tense military environment, predicting the direction of currencies, especially the U.S. dollar, is highly uncertain.

FED BEGINS ASSET REDUCTION; RATE HIKE LIKELY IN DECEMBER

The Federal Reserve remains committed to gradually withdrawing monetary stimulus from the U.S. economy and financial system. Monetary policy remains far from being tight, and this will persist for years to come, but the amount and degree of stimulus continues to be reduced.

At the past week's Federal Open Market Committee meeting, Committee members unanimously voted to start reducing the amount of securities held by the Federal Reserve beginning in October. Nearly all of the securities held by the Fed are U.S. Treasuries and mortgage-backed securities guaranteed by agencies of the federal government. As of September 20th, securities held outright by the Fed totaled $4.243 trillion. The program the Fed has approved will reduce securities' holdings by $10 billion per month over next three months, and then to gradually increase monthly reductions to $50 billion per month starting in October 2018. Over the next twelve months, reductions would total $180 billion, and then rise to $360 billion per year thereafter, until the Fed decides to end the program. Of course, this will dependent on the economy and financial markets, importantly including yields levels, especially on Treasuries. A reduction in the Fed's securities' holdings of $180 billion over the next twelve months would equal 4.2% of the current total amount of securities held by the Fed. In the second year, the percentage would rise to 8.9%.

How will the Fed's reduction in its securities' holdings impact yields on longer maturity Treasuries? As recounted above, the impact thus far appears to have been modest, and both nominal and real yields on Treasuries remain low. Of course, growth in the economy and inflation rates will also have an impact on Treasuries, as well as on the Fed. Projection made by senior Fed officials released at the end of the FOMC meeting call for real GDP to rise by 2.4% from the final quarter of last year to the final quarter of this year. Inflation, based on the personal consumption expenditure price index, is projected to rise by 1.6%. This would imply a rate of increase in nominal Gross Domestic Product of slightly more than 4.0%. Over the next three years and over the longer run, senior Federal Reserve officials project real GDP to increase at close to a 2% annualized rate with inflation at close to 2%, resulting in nominal GDP growth of close to 4%.

Historically, annualized rates of change in nominal GDP over longer time periods and average yields on 30-year Treasury bonds have been nearly identical. However, over periods of several years, rates of change in nominal GDP and average yields on 30-year Treasuries have been quite different. In recent years, yields on the 30-year Treasury bond have been much lower than rates of change in nominal GDP.

Similarly, average real yields on long-term Treasuries (TIPS) have tended to be very close to average rates of growth in real GDP over longer periods, about 2.1% for both since TIPS were first issued in April 1998. As with the relationship between rates of growth in nominal GDP and average yields on 30-year Treasury bonds, in recent years long TIPS yields have been much lower than rates of growth in real GDP.

The major reason for this relationship in recent years has been very easy monetary policies by the Federal Reserve. Although the Fed has raised its target for the federal funds from near zero in late 2015 to 1.00%-1.25% at present, and likely to 1.25%-1.50% in mid December, yields on longer maturity Treasuries have declined by about 35 basis points since March 10th of this year. This was partly due to decelerating rates of inflation and related comments from the Fed that it was worried and perplexed about persisting low inflation.

However, it looks as if inflation is starting to pick up a bit, helped by oil prices that have recovered to around $50. Also, 12 of 16 senior Fed officials expect a rate hike by the end of the year, most likely in December. This was a mild surprise to some investors and financial market experts who thought the Fed's concerns about inflation would keep the Fed from raising its target until next year.

The Fed's message to markets is that given prevailing and projected modest rates of growth in the economy and modest inflation, investors and financial markets can expect a continued, slow, and measured withdrawal of monetary stimulus. Given this, it seems more likely that nominal and real yields on longer maturity Treasuries will rise modestly. This is why limiting average maturities and duration in fixed income holdings continues to be advised. Sharp increases in yields are not expected, as that would cause the Fed to put rate hikes and reduction in securities' holdings on hold.

Modestly rising yields on Treasuries would also be a headwind for stocks. But stocks have an engine in the form of rising earnings and dividends. Both are in good operating shape, enough to overcome modest headwinds from rising Treasury yields.

TRACKING THE U.S. ECONOMY

Leading economic indicators continue to improve. The Conference Board's Index of Leading Economic Indicators (LEI) continues to improve. The annualized 3-month rate of change in the LEI in August was 5.15%. The 12-month rate of change was 2.82%, up from 1.42% last December. This is encouraging for future growth and the rate of growth in real GDP has accelerated since the end of last year.

However, rates of change in the Index of Coincident Economic Indicators (CEI) do not show accelerating growth. The annualized 3-month rate of change in the CEI in August was 1.98%, down from 2.35% in June. The 12-month rate of change was 1.85%, with only a slight improvement from 1.72% in February. The pattern throughout the recovery/expansion from the severe recession has been for comparatively less rapid growth in measures that move coincidentally with the economy compared to growth in measures that tend to lead the economy. This pattern persists.

Residential housing data continue to be mixed. Single-family housing starts and permits remain strong, while multi-family starts continue to fall and permits are flat. The 12-month rate of change in single-family housing starts was 9.25% in August, up from 6.46% in March. These are strong numbers. However, the 12-month rate of change in multi-family starts was -7.45% in August, down from a small 1.83% increase in January of this year. At its lowest point following the end of the severe recession, the 12-month average number of multi-family housing starts was only 92,000 units (annualized rate) in March 2010. By February of this year, the 12-month average was 402,000 units. Booming demand for apartments led to overbuilding in some metropolitan areas. The boom in demand and construction of multi-family housing units was accompanied by rapidly rising rents. Excess supply and rising rents have reduced demand, and since February, the 12-month average of multi-family housing starts has dropped by 8.2% to 369,000 units.

Permits for new home construction show similar patterns. The 12-month rate of change in permits for single-family units was 9.31% in August, up from 7.96% in May of this year. Permits for multi-family units appear to have bottomed out, but have not yet rebounded much. The 12-month rate of change in multi-family units has improved from a 6.87% drop in February to a slight 0.93% increase in August.

Sales of existing homes continue to increase a modest pace. The 12-month rate of change in existing home sales was 3.49% in August, but that's down significantly from 6.88% in January 2014. The major reason for much slower growth in sales of existing homes, compared to sales of new homes, is a dearth of supply. While existing home sales posted a modest 12-month rate of change of 3.49%, the 12-month rate of change in existing homes for sales was -7.67%. With that degree of decline in existing homes for sales, it is hard to generate much growth in sales.

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