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Mast Report

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U.S. STOCKS EDGE HIGHER

Propelled by investors' optimism on U.S. economic growth and corporate earnings and by potential tax cuts/reforms, U.S. stock prices continued to advance this past week. The S&P 500 Index, the Nasdaq Composite Index, the Russell 2000 Index, and the Value Line Composite Index all closed the past week at all time highs. Outside the U.S., stock prices were mixed. The MSCI Europe Index was barely changed for the week, while the MSCI Pacific Index fell by 0.21%. The MSCI Emerging Market Index posted a more significant decline of 1.83%, hurt by slightly higher yields on U.S. Treasuries and a stronger dollar. These two factors tend to make U.S. financial assets more attractive to U.S. dollar investors, especially in relation to stocks in emerging countries.

Again this past week, return differences among market capitalization size and style segments of the U.S. equity market were significant. Leadership has shifted in favor of small cap stocks and value stocks and away from growth stocks and large cap stocks. Stronger economic growth, rebounding earnings, and tax cuts and reforms would tend to generally favor smaller companies, especially those whose businesses and profitability are more sensitive to the economy. However, these factors have been in place for some time, in fact propelling small cap stocks and value stocks to strong gains in 2016. But these market segments significantly underperformed large cap stocks and growth stocks from early December of last year through the later part of September.

But since then small cap stocks, especially small cap value stocks, have been on a tear. Since September 22 through the end of this past week, the Russell 2000 Value Index returned 9.26%, while the broad market Russell 3000 Index returned 3.54%. Often small cap value stocks and large cap growth stocks are at the opposing extremes of performance among capitalization size and style segments. Since September 22nd, the Russell 200 Growth Index returned 2.19%, or a little over 7 percentage points less than the Russell 2000 Value Index. From December 8th of last year through September 22nd, large cap growth stocks outperformed small cap value stocks by 24.4 percentage points. Small cap value stocks will continue to outperform large cal growth stocks, in my assessment.

The same set of factors that have driven stock prices higher is also boosting the U.S. dollar. The broad U.S. dollar index rose by 0.98% this past week, bringing its gain to 2.87% since an important low on September 8th. On the flip side of rising stock prices and a stronger dollar, gold prices have retreated, down 0.91% for the past week and by 4.79% since a recent high of $1346.00 also on September 8th. Gold closed the past week at $1281.50.

Oil prices continue to rebound, with renewed hopes for production cuts from OPEC countries. Oil rose by 1.99% for the past week to $51.67. From its low of $42.53 on June 21st to a recent high of $52.22 this past Monday, oil rose by 22.78%. U.S. producers will find the recent sharp price rise in oil attractive and will continue with plans to boost production. The recent sharp gain in the price of oil looks to have largely run its course.

Yields on U.S. Treasuries again rose this past week with larger yield increases on maturities of 10 years and longer. For example, the yield on the 2-year note was up by only 3 basis points to 1.48%, while the yield on the 10-year note rose by 7 basis points to 2.33%. The consensus has clearly shifted towards expectations for a 25 basis point increase in the Federal Reserve's federal funds rate target to 1.25%-1.50% in mid December. The start of the Fed's program to slowly and gradually reduce its asset holdings start on this coming Monday, October 2nd. Both of these factors appear to be placing mild upward pressure on Treasury yields.

FEDERAL TAXES

Republicans have presented a partial outline for federal income tax rates and some tax reforms. Many more specifics need to be provided, such as income levels that will apply to various federal income tax brackets. The plan includes reduced tax rates for both individuals and corporations. One major reform calls for the U.S. joining most of the rest of the world by moving closer to a territorial corporate tax approach, under which foreign earnings of U.S. companies would not be fully taxed again in the U.S., if those earnings were moved to the U.S.

A second major reform proposed by the Republicans is the disallowance of state and local government taxes as a deduction from federal taxes. Generally, Democrats are opposed to tax cuts on higher incomes, favor smaller cuts in corporate tax rates, and want to keep higher tax rates on foreign earnings of U.S. corporations. Democrats in some states, e.g. New York, California, and New Jersey, are also opposed to eliminating the deduction of state and local taxes from federal taxation. New York and California are, of course, huge states, that are governed by Democrats and have very high state and local taxes, especially state income tax rates.

How this plays out will tell us a good deal about how far the federal government will go towards tax reforms of lowering marginal tax rates and broadening the tax base to which tax rates will be applied. If the rate of growth in the U.S. economy is to meaningfully benefit from tax reforms, it will need lower marginal federal income tax rates with a broader tax base. We'll see what happens.

TRACKING THE U.S. ECONOMY

Real GDP grew at a 3.06% annualized rate in the second quarter, based on the third and final estimate from the Bureau of Economic Analysis. There was essentially no change from the previous estimate. Real domestic private final sales (the sum of real personal consumption expenditures and real private sector fixed investment) rose at strong 3.34% annualized rate. Real personal consumption expenditures rose at a 3.27% annualized rate, with real nonresidential fixed investment increasing at a 6.70% rate, and real residential fixed investment declining at a 7.32% annualized rate.

The trend of growth in real GDP improved in the first half of this year, as measured by the year-over-year rate of change in a four quarter moving average of real GDP. Growth by this measure had slowed from 3.23% in the second quarter of 2015, the fastest since the end of the recession in mid 2009, to only 1.49% in the fourth of last year. Since then it improved to 1.89% in the second quarter of this year.

Since the end of 1999 through the second quarter of this year, real GDP grew at a 1.87% annualized rate. Since the end of the recession in mid 2009, real GDP has grown at a 2.18% annualized rate. Significantly faster growth of 3% or more over a sustained period remains an unrealistic target, in my assessment, even with a magic mix of tax cuts and reforms. An aging population and a related slowing rate of growth in the labor force will make it increasingly difficult for U.S. economic growth to reach the 3% level over a period of several years.

Real consumer spending fell slightly in August. The 3.27% annualized rate of growth in real consumer spending in the second quarter is not going to be sustained. The annualized 3-month rate of change in real consumer spending peaked at 3.51% in May and has slowed to 1.79% in August. This is part of a pattern that has been unfolding over the past two years. The 12-month rate of change in real consumer spending peaked at 3.79% in September 2015. The 12-month rate of change in real disposable personal income peaked at 4.60%, also in September 2015. The 12-month rate of change in estimated real personal saving peaked at 19.37% in February 2015, and a 12-month average of the personal savings rate hit a high of 6.11% in November 2015. Strong growth in real disposable personal income and real personal saving resulted in high personal savings rates. All of this provided lots of fuel for strong growth in real consumer spending that peaked in September 2015.

The situation is now much different. The 12-month rate of change in real disposable personal incomes in August was only 0.90%. The 12-month rate of change in estimated real personal savings was -31.68%. The personal savings rate averaged only 3.63% over the past twelve months. There is much less fuel for consumer spending. This is very likely to persist in upcoming months. As a result, real consumer spending is expected to increase at a much slower pace in the third quarter, compared to the second quarter's 3.27% annualized rate, and slower growth in real consumer spending will likely persist in the fourth quarter.

The Chicago Fed's National Activity Index indicates that economic growth has remained modest. This measure combines 85 monthly measures to provide an overall assessment of the U.S. economy. The index is centered on zero, with positive readings indicating growth above the 2.7% annual rate of growth in real GDP since March 1967. Negative readings indicate slower than average growth since March 1967.

Recent readings on the Chicago Fed's index have averaged close to zero over recent 3, 6, and 12 month periods. This suggests growth that is close to 2.7%. But the index has recently over estimated growth in real GDP by roughly one percentage point. Adjusting for this, the Chicago Fed's index shows the U.S. economy growing at close to a 2% rate.

New home sales and home prices continue to rise. Despite a 3.45% drop in August, new home sales continue to rise over more relevant 12-month periods. The 12-month rate of change in new home sales was a solid 9.81% in August, although the rate of change has moderated from 15.67% in March of this year. Continued rates of growth in new home sales at a high single digit pace are likely. Unlike existing homes, where there is a dearth of homes for sale, the supply of new homes for sale has kept pace with sales. The 12-month rate of change in new homes for sale was 11.22%, just slightly faster than the pace of growth in new home sales.

Home prices continue to rise at a slightly accelerating pace. Based on the S&P Case-Shiller home price indices, home prices are rising by just under a 6% annual rate. The latest data for these home price indices are for the May-July 2017 periods. The seasonally adjusted Case-Shiller home price index covering 20 major metropolitan areas was up by 5.88% from the May-July 2016 period, an acceleration from a 5.06% increase in October 2016. The seasonally adjusted national Case-Shiller home price index rose by 5.99% from a year earlier, up from 5.03% in August 2015. It looks as if home prices can sustain annual increases at a 5%-6% pace.

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