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## Mast Report

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**INVESTORS ABOARD THE BIG MO TRAIN**

Investors have a lot more confidence in the reasons for stock prices going up than going down. They see the economy continuing to grow at moderate, if not rapidly accelerating rates. They see corporate earnings continuing to rebound. S&P 500 operating earnings per share were up 18.7% in the second quarter of this year from a year earlier and are estimated to have increased by 14.8% in the third quarter. They see the dividends they receive on their stocks continuing to grow. Annualized dividends per share on the S&P 500 as of the end of this past week were 8.3% higher than a year ago. They generally have confidence that the Federal Reserve will gradually and slowly reduce monetary stimulus and that this will not be significantly disruptive to financial markets and the economy. They have some hope for federal tax cuts and reforms, but have learned not to expect very much from Washington politicians.

The main concern that they have, or have been told by experts, is that stocks are overvalued. But they have heard this often and for a long time, while stock prices have continued to rise. More investors seem, finally, to understand that relative valuations, not absolute valuations, are the ones that are more important and should be watched more closely. Absolute valuations, almost always in the form of price/earnings ratios, certainly are high in relation to historical norms. But stock valuations in relation to prevailing yields on low risk assets, while definitely not attractive, are also not so unattractive to shun stocks in an environment of offsetting positives.

Of course, at some point in time and at some levels of stock prices, things will turn for the worse. One can always conjure up some reason why the stock market "could" go down sharply. Usually, the anticipated cause is a single outcome, such as sky rocketing inflation or ballooning federal government budget deficits or a collapse in the economy. But making big investment and portfolio bets on a single major negative future outcome that is uncertain is a bad and dangerous way to manage investment assets.

This leaves us watching for changes in those factors that investors have become more confident in, and watching relative valuations, such as yields spreads on fixed income asset classes with credit risks and expected long-term equity risk premiums on stocks. As the "old timers" told me nearly 50 years ago, "they don't ring a bell before the start of a bear market." Since we can't listen for bells to ring, watch the things that are driving stocks higher. So far, I do not see enough that is negative. Treasury yields are rising, but only slowly, and yields are not high enough to attract investors. The expected long-term equity risk premium has dipped to 2.86%, compared to its historical median since 1959 of 3.11%. Certainly this needs to be watched, but taken alone it's not low enough to sell stocks.

This past week, stock prices generally continued to rise, led by emerging market and U.S. shares. The MSCI Emerging Market Index returned 1.99%, and the MSCI U.S. Index, 1.22%. The MSCI Pacific Index was up 0.55%, but the MSCI Europe Index fell by 0.38%. Among major U.S. stock indices, the S&P 500 Index gained 1.19% and the Nasdaq added 1.45%.

Within the U.S. equity market, differences among market capitalization size and style categories were much smaller than those witnessed in recent weeks. Small cap stocks still slightly outperformed, with the

Russell 2000 Index posting a return of 1.32% for the week. The large cap Russell 200 Index returned 1.31% and Russell midcap Index, 1.17%. After underperforming in recent weeks, growth stocks slightly outperformed value stocks this past week. The Russell 3000 Growth Index returned 1.42%, compared to a return of 1.13% for the Russell 3000 Index. Looking ahead, small cap stocks and value stocks are expected to outperform large cap stocks and growth stocks.

Except for energy, all major U.S. sectors turned in positive rates of return for the past week. The best returns came from the basic materials sector, up 1.97%, and technology, up 1.87%.

Yields on U.S. Treasuries continued to rise modestly. This has been ongoing since recent lows in yields on June 26th, just over three months ago. Since then, yields on Treasuries with maturities of two years and longer have increases by 20-23 basis points. Yields have not yet reached their highs on December 16th of last year. For example, the yield on the 10-year Treasury note has risen from its June 26th low of 2.13% to 2.37% at the close of this past week, but is still 23 basis points below its recent December 16, 2016 high of 2.60%. This has not attracted much attention, and seems unlikely to, at least until yields rise above mid December 2016 levels.

Real yields, as measured by yields on TIPS, continue to be perplexing, at least to me. Of course, TIPS yields have been repressed by Federal Reserve monetary policies. But the Fed started raising its target for the federal funds rate in December 2015, and the program to reduce the Fed's securities' holding has begun. The long TIPS yield closed the past week at 0.96%. But it was 1.18% in mid December of last year. Normally, real yields on long-term Treasuries tend to average about the same as rates of growth in real GDP over longer periods. Growth has averaged just under 2% for nearly 18 years.

The aging of the population and the work force may be one reason why real yields on Treasuries are low. People generally take less risk in their investment portfolios, and lock in real rates of return, albeit low ones, after they retire and grow older. I do not think long TIPS yields are going to rise to 2%, or even anything close to that. But a long TIPS yield below 1% seems too low.

The U.S. dollar again rose this past week, by 0.77%, based on the U.S. dollar index, and is up 2.68% since its recent low. Further modest gains in the dollar are expected. As for commodities, gold has lost its upward momentum. Gold closed the past week at $1271.60. It is down 5.53% from its recent high of $1346.00 on September 8th. Gold prices are strongly driven by investor sentiment, as reflected in price momentum, both up and down. We are now in a down price momentum phase. Oil fell sharply this past week, down 4.61% to $49.29. Oil recently peaked at $52.22 on September 25th, when the price of oil moved above the top of its price channel. This indicated a likely in its price, which has occurred. Based on it price channel, oil is in a price range of about $44 to $53.

## TRACKING THE U.S. ECONOMY

**Nonfarm payroll employment fell in September, reflecting significant impact of hurricanes.** September's employment report is of limited use to analyze ongoing labor market conditions in the U.S. This is because employment in September was dominated by the impact of severe hurricanes Harvey and Irma. Total nonfarm payroll employment fell by 33,000 from August, and private sector employment was down 40,000. The drop in private sector employment included an 111,000 decline in the leisure and hospitality sector, of which 105,000 came from drinking and food service, almost entirely the result of the hurricanes. Employment in those areas will gradually rebound in October and upcoming months.

Employment from the Household Survey, which is used to compute the unemployment rate, actually rose by 906,000 in September. This survey asks people if they are employed and responses tend not to reflect temporary conditions, such as hurricanes. But information collected in this survey can be volatile from month to month. This tendency was seen in the September employment report, as the unemployment rate dropped to 4.22%. This can make all of this employment data somewhat confusing.

Better insights come from 12-month rates of change and averages over 12-month periods. Here, the picture remains much the same. Employment continues to grow, but at decelerating rates. The 12-month rate of change in total nonfarm payroll employment was 1.53% in September, but down from 2.11% in August 2015. The 12-month rate of change in private sector employment was 1.69% in September, down from 2.39%, also in August 2015. The 12-month rate of change in the civilian labor force was 0.90% in September, down from 1.31% in January of this year. Over the past 12 months the average unemployment rate was 4.52%, and it was last this low in August 2007. Lastly, the ratio of employment to the civilian population aged 16 and over averaged 60.01% over the last twelve months. That is a slight pickup from 58.39% in January 2012, but still well below levels prior to 2007.

Piece all of this information together and here is what is says, at least in my assessment. Labor market conditions in the U.S., including employment, continue to improve, but at decelerating rates. Faster growth in employment continues to be constrained by an aging labor force, which also limits increases in the ratio of employment to the civilian population. These factors show that growth in employment is primarily being constrained by an insufficient supply of workers, not a lack of jobs. More people over age 65 are working, but this is hard to sustain as the percentage of the population over 65 increases. Labor participation rates of those aged 25-45 have not been increasing. Growth in the labor force from immigrants is under pressure from political pressures and decisions. All of these factors appear to point continued decelerating rates of growth in employment. If this turns out to be the case, and absent a significant improvement in labor productivity, it is hard to see significantly stronger sustained rates of growth in the U.S. economy.

**Data on unemployment insurance claims remain positive**, although they, too, have recently been negatively affected by the impact of hurricanes. For example, the 4-week average of initial claims for unemployment benefits as of September 9th was 13.31% higher than the 4-week average on August 26th. But in the past two weeks, initial claims have begun to subside. The 4-week average of continued claims actually fell by a small 0.21%, and as a result, the number of workers dropping off of the rolls of those receiving unemployment benefits exceeded the number of initial claimants by 1.17%. This indicates continued strength in labor markets.

Over longer 52-week periods, initial claims showed a 6.82% drop from a year ago, and continued claims were down by 7.88% from a year earlier. Averaged over the past thirteen weeks, only 1.40% of all workers who are covered by state unemployment insurance plans were receiving benefits. The all time low was 1.39% on July 22nd of this year. At the worst point of the past severe recession on July 11, 2009, the percentage was 4.81%. This is one of a number of measures that show the substantial degree of improvement in the U.S. labor market over the past eight plus years.

**ISM's September survey indicted stronger rates of expansion in both U.S. manufacturing and nonmanufacturing.** The Purchasing Managers Index (PMI) from the Institute of Supply Management's September survey of the U.S. manufacturing sector rose to a reading of 60.3. That's up from 54.8 since April of this year. In December 2015, when there were fears and expectation that the manufacturing sector might fall back into recession, the PMI was 48.0. September's 60.3 reading was the highest since April 2011. Over the past three months the PMI averaged 58.4, and is rising, as are both the 6 month and 12 averages. These are strong numbers from the U.S. manufacturing sector.

Similarly, the Nonmanufacturing Index (NMI) from the ISM's survey of that sector of the U.S. economy improved from 53.9 in July to 59.8 in September, the highest since July 2007. The 3, 6, and 12 month averages of the NMI are all at about 56.5 and all are rising, clearly a positive pattern.

**Motor vehicle sales rebounded in September.** Light motor vehicle (LMV) sales rebounded by 15.26% in September from August to an 18.470 million seasonally adjusted annual unit sales rate. This followed a drop of 11.23% from 18.051 million units in December of last year to 16.024 million units in August. Three factors accounted for September's rebound. Even though LMV sales have stagnated at just over 17 million units, some rebound from declines over the first eight months of this year seemed likely. Second, sales almost certainly got a boost from sales to replace badly damaged or destroyed vehicles due to hurricanes. Third, vehicle makers and dealers are offering lots of incentives to move 2017 models.

Unit LMV sales probably will fall back starting in November. LMV sales average 17.188 million units over the past twelve months through September, and sales likely will recede towards that level over upcoming months. One important reason for this is the recent deceleration in rates of change in disposable personal incomes (DPI). The 12-month rate of change in real DPI was a very strong 4.60% in September 2015, but slowed considerably to only 0.90% in August of this year. Accompanying this, the 12-month average personal savings rate fell from 6.11% in November 2015 to 3.80% August of this year. Prior stronger growth in real disposable personal incomes and higher personal savings rates provided money for consumers to spend on such things as motor vehicles. That had largely played out by the end of last year. September's big jump in LMV sales is not the start of sustained higher levels of sales, in my assessment.

**Real GDP is estimated to have grown at a 2.2% annualized rate in the third quarter.** Based on the Federal Bank of Atlanta's GDP Now analysis as of October 6th, real Gross National Product was estimated to have grown at a 2.2% annualized rate in the third quarter of this year. This would represent a slowdown from a 3.02% annualized increase in the second quarter. Real personal consumption expenditures are estimated to have increased at a 2.20% annualized rate in the third quarter, down from a 3.27% annualized rate in the second quarter. Real nonresidential fixed investment is estimated to have increased at a 3.33% annualized rate, versus 6.70% in the second quarter. And real residential fixed investment is estimated to have declined at a 5.00% annualized rate, compared to a 7.32% annualized decline in the second quarter.

Real domestic private final sales (the sum of real personal consumption expenditures and real private sector fixed investment) rose at a strong 3.34% annualized rate in the second quarter of this year and was estimated to have increased at a slower 2.08% rate in the third quarter.

Based on these estimates, it appears as if the U.S. economy continues to be unable to extend stronger rates of growth beyond more than a quarter or two. The tendency has been for growth U.S. economic growth to quickly revert closer to a 2.0% rate of growth. A good measure of rates of growth in the U.S. economy over somewhat longer periods is a year-over-year rate of change in a 4-quarter average of real GDP. Based on the Atlanta Fed's most recent estimate for the third quarter, growth in real GDP by this measure was 2.05% in the third quarter of this year. Although still modest, that's an improvement from 1.49% in the fourth quarter of 2016. I continue to expect the U.S. economy to grow at a modest 2.00%-2.25% rate over periods of several quarters. However, this is decent growth, which is slightly better than annualized growth in real GDP of about 1.9% since the end of 1999. Hopes and expectations for sustained growth of 3% or more continue to be overly optimistic, in my assessment.

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