PARSONS CAPITAL MANAGEMENT, INC.
A tradition in money management

PERSPECTIVES

Quarter 2 2011

The emerging pattern of investor behavior in 2011 is one of sudden sprints toward and away from risk. In May, world markets began an abrupt shift from the pattern of the previous seven months, signaling another retreat from risk. As political events created mounting unease, stocks were sold in favor of bonds and gold. The result was a quarter reminiscent of the same period in 2010, when a growth scare initiated a 15% market decline from April to August before a strong year-end rebound.

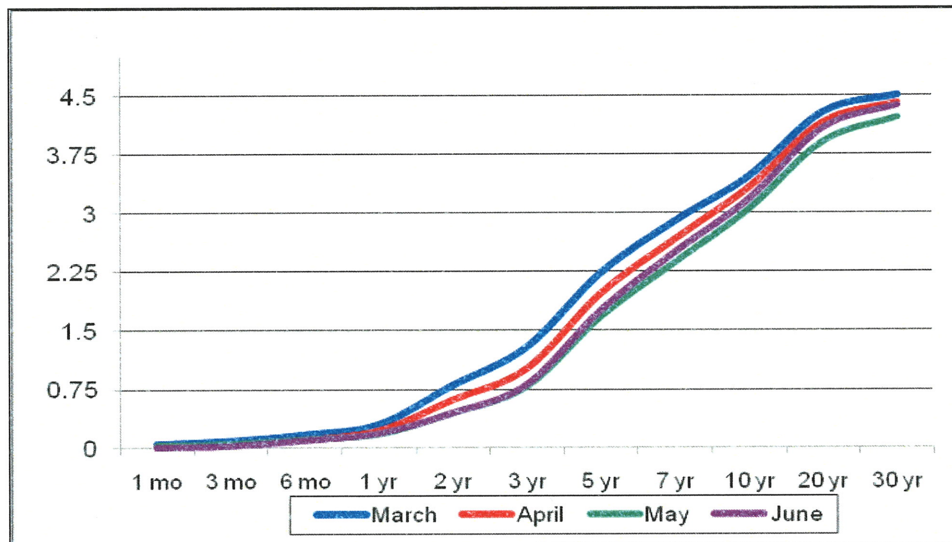
Data as of June 30, 2011	Qtr. 2 June '11	Qtr. 2'11	YTD '11
S&P 500	-1.67%	0.10%	6.02%
MSCI AC World Index (incl. US)	-1.54%	0.68%	5.62%
MSCI EAFE (Europe, Asia, Far East)	-1.23%	1.83%	5.35%
MSCI EM (Emerging Markets)	-1.50%	-1.04%	1.03%
Russell Largecap	-1.75%	0.12%	6.37%
Russell Largecap Growth	-1.43%	0.76%	6.83%
Russell Largecap Value	-2.05%	-0.50%	5.92%
Russell Midcap	-2.09%	0.42%	8.08%
Russell Smallcap	-2.31%	-1.61%	6.21%

Fixed Income Markets

All categories of bonds outperformed stocks in the second quarter. Already low interest rates fell even further, underscoring how little investors would accept in exchange for avoiding perceived stock market risk. Municipal bonds posted surprisingly strong returns (BC Muni index +3.89% for the quarter and +4.42% year-to-date), as worries about state insolvencies abated due to tax revenue tracking higher than budgeted. Quarterly/year-to-date returns for Treasuries were +2.39%/+2.22%; for the broad bond market +2.29%/+2.72%; and for high yield +1.05%/+4.97%.

US Treasury Yields

The steepness of the yield curve, specifically the difference between 2-year and 10-year yields, is historically a reliable directional predictor of economic growth. As money flowed from stocks into bonds, all interest rates fell during the quarter but the steep shape of the curve was retained – portending continued economic growth even with the second quarter slowdown apparent.



Commodities

Middle East unrest gave way to returning concerns about European sovereign debt default as the headline worries of the moment. Oil retraced most of the first quarter price increase, and virtually all commodites experienced the steepest price declines since 2008. The national pump price of gas reached a post-recession high of $3.96 the week of May 18, then fell nearly 10% from that point by quarter's end.

Commodity	Qtr. 2 '11	Year to Date '11
Oil	-12.52%	3.87%
CRB (broad index)	-6.30%	1.50%
Gold	5.81%	6.00%

Gold acted differently from other commodities. Closing in on all-time highs in price, the precious metal played one of its classic roles as a haven in times of currency uncertainty.

Economic Overview

On March 11, the Kobe earthquake and ensuing Tsunami hit Japan. The economic ripple effects spread globally, ushering in a "soft patch" of reduced production stymied by supply disruptions. Leading economic indicators in the US and developed countries turned negative, while emerging economies were forced by inflationary pressures to rein in growth through tightening monetary policy. By quarter's end, the question became whether the slowdown was transitory or persistent.

The picture darkened with the re-emergence of sovereign debt concerns in developed countries, specifically Europe and the US. In crisis, the European Central Bank (ECB) cannot function as unilaterally or comprehensively as the US Federal Reserve can, because of the political independence of the participating countries. The ECB focus is on interest rate policy, and their bias is toward fighting inflation (i.e. tightening rather than easing, and massive easing is what rescued the US from the brink of financial disaster in 2009). The spectre of default and credit contagion loomed while action was dependent on multi-country negotiations. In the US, impasses in negotiating the federal deficit ceiling increasingly unnerved markets.

Employment, consumption and confidence

On balance, late second quarter business indicators in the US showed widespread improvement in conditions outside of construction, setting up a significant third quarter recovery from the setback caused by the Japan disaster. Globally, the value of world trade was up +53% since hitting bottom in February 2009 (+48% in the Group of 7 developed countries and +58% in the rest of the world). Initial second quarter earnings reports continued the strong upward momentum since the depths of 2009, on track to reach the all-time peak established in 2007.

Employment has not followed suit. Only 260,000 jobs were created in the second quarter, punctuated by the disappointing number of just 18,000 in June. Growth in the working age population continued to outstrip job creation; the civilian labor force participation rate fell to 64.1% in June.

The employment market is bifurcated, which indicates structural, not transitory imbalances. The dividing line in job availability is globalization; industries that benefit from it are hiring and their employees are faring relatively well. Confidence and spending follow. Domestically oriented economic sectors such as construction and government continue to contract. Education is the dividing line in employee fitness for this economy, and those who lack the knowledge and skills necessary find little demand for their abilities. With credit conditions tightening, an important resource for past spending has disappeared.

Confidence also underlies hiring and spending decisions. Virtually all measures of employer and consumer confidence fell at an accelerating rate as the second quarter progressed.

Investment Implications

The global economic backdrop for the markets is one of generally improving commerce and business profitability temporarily derailed by the Japan disaster, monetary tightening in emerging countries (notably China) and rising oil prices stemming from Middle East unrest. The headwinds from all of these factors have begun to fade. Copper's price increase, a clear directional proxy for economic activity, illustrates this development.

Layered over the landscape is general pessimism and uncertainty concerning the seeming inability of developed country leaders to cope with the issues of governing which face them. When economics moves into the political arena, risks rise across all markets. Volatility can be expected to stay at high levels.

Stocks: With S&P composite earnings on track to reach an annualized rate of $96, the overall price/earnings ratio is under 14 times earnings. This is historically a very attractive valuation for new investment in a low interest rate environment. It reflects investors' general pessimism and reluctance to take risk despite the momentum of an eighth quarter of significant earnings increases. Earnings growth like we have seen in the last two years would normally spur hiring and P/E expansion, but both of those require confidence which is lacking. There is a sense that if we get the macro issues wrong, the budding economic recovery would be shattered. If we can make progress within the current governmental infrastructures of the developed world, we could grow our way out of the debt overhang. Therefore, risks and rewards are elevated.

Taxable bonds: The end of the Fed's quantitative easing (QE2) program in June did not usher in a spike in interest rates, a relief to bond markets. Credit conditions have tightened, however, due to renewed concerns about debt contagion from Europe. Liquidity in the global bond market has receded, which adds risk to the investing environment. Increasing uncertainty even more are the protracted US debt ceiling negotiations and talk of downgrades and defaults – factors which would create chaos and spiking interest rates.

Municipal bonds: We may witness localized defaults or restructurings as the debt cycle unwinds. Close attention to individual bonds continues to be necessary.

Parsons Capital Management

10 Weybosset Street, Suite 1000

(401)521-2440 *(888)521-2440* *www.parsonscapital.com*