PARSONS CAPITAL MANAGEMENT, INC.
A tradition in money management

PERSPECTIVES

Quarter 3 2011

During the third quarter, volatility reached truly abnormal levels. Beginning in August, the Dow Jones index has averaged 1.69% in daily price swings, twice the average since 2000. There were 3 days in August when the intraday change exceeded 4%. The 4% level had been breached in two previous troubled markets: 26 days in 1931 and 22 days in 2008.
Flight from risk also defined third quarter activity, as smaller capitalization stocks and emerging markets fell more than larger cap US stocks.

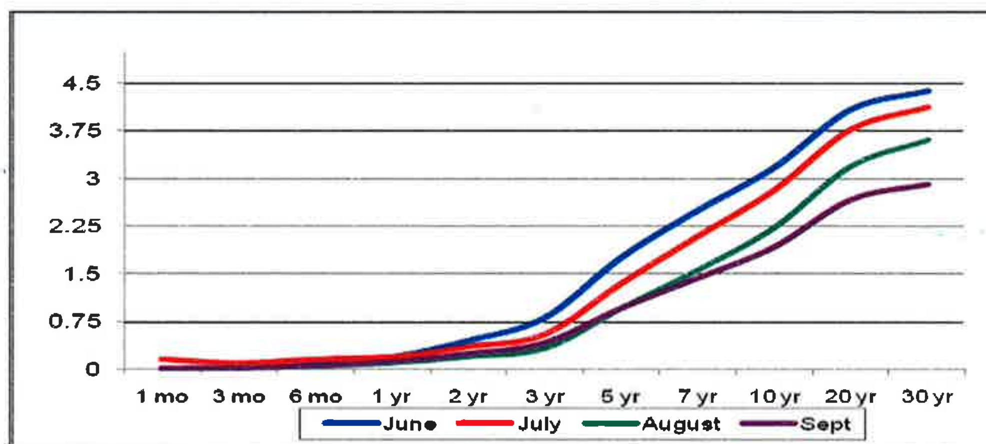
	Qtr. 3		
Data as of September 30, 2011	**Sept '11**	**Qtr. 3'11**	**YTD '11**
S&P 500	-7.03%	-13.86%	-8.68%
MSCI AC World Index (incl. US)	-8.85%	-17.06%	-13.75%
MSCI EAFE (Europe, Asia, Far East)	-9.50%	-18.97%	-14.63%
MSCI EM (Emerging Markets)	-14.56%	-22.46%	-21.66%
Russell Largecap	-7.46%	-14.68%	-9.25%
Russell Largecap Growth	-7.37%	-13.14%	-7.20%
Russell Largecap Value	-7.56%	-16.20%	-11.24%
Russell Midcap	-9.63%	-18.90%	-12.34%
Russell Smallcap	-11.21%	-21.87%	-17.02%

Fixed Income Markets

Once again, all categories of bonds outperformed stocks in the third quarter amid a flight to safety. The extent of the fear trade was evidenced in Treasuries posting the strongest returns of all bond categories despite already miniscule rates: +6.48% total return vs. +3.82% for the broad bond market and the first negative return for high yield in 2 years, -6.01%. Municipals continued their rally, logging +3.8% for the quarter.

US Treasury Yields

Fear of a recession and concern about the evolving credit crisis in Europe brought domestic and international investors into short, intermediate, and longer dated Treasuries, flattening the yield curve throughout the quarter. Sellers of stocks, commodities, euros, and high yield bonds all sought the perceived safety of US-backed obligations.



Commodities

Volatility and negative returns were not confined to stock markets. Oil erased its year-to-date gain to fall into a double digit decline, as did the CRB measure of a broad basket of commodities. The fear of inflation resulting from massive world-wide stimulus was replaced by the fear of world-wide recession brought on by reduced consumption and restrictive government policies (for differing reasons) from developed countries to China.

Commodity	Qtr. 3 '11	Year to Date '11
Oil	-15.74%	-12.35%
CRB (broad index)	-11.50%	-10.50%
Gold	9.23%	14.08%

Gold bucked the trend of other commodities and the stock market, recording all-time highs - another hallmark of fear-based investing.

Economic Overview

Political events dominated economics in headline news, depressing consumer and business confidence even though actual non-financial business activity and consumer behavior were positive.

International

- Throughout the summer, European leaders seemed inattentive to the severity of the expanding debt crisis, specifically in terms of protecting Italy and Spain from Greek contagion. Germany's support of bailing out peripheral countries appeared to be eroding, potentially a threat to the common currency itself. Consideration of a US-style recapitalization of the large banks along with a managed default of Greek sovereign debt was lacking until the very end of the quarter, when a change in leadership at the IMF and at the EU Central Bank took place.
- China, which surpassed the US as Europe's largest trading partner during the third quarter, denied reports that it would support the Eurozone by buying large quantities of Italian debt. A real estate and lending bubble inside China, coupled with troubling inflation, prompted the government to tighten fiscal and monetary policy and bank lending. This development sparked fears of a "hard landing" for that globally important economy. China has domestic financial issues too, with purportedly sizeable deficits at their state and local government levels and rising nonperforming loans on their banks' balance sheets.

Domestic

Examples among many of continued good news on business activity and retail sales:

- Railcar shipments were heavy throughout the quarter, including Union Pacific's strongest weekly volume all year the week before Labor Day and shipments +8% annually for the third quarter.
- Real consumer spending, led by retail sales, increased 2% over the prior quarter, closing in on the early 2008 peak. Consumer financial obligations as a percent of disposable income have plunged from almost 19% to 16.1% in 3 years.

On the other hand, dismal federal budget and jobs data:

- The federal deficit hasn't budged from -$1.3 trillion (9.3% of GDP, higher in percentage terms than the projected 2012 Greek budget deficit), with no policy progress in sight.
- Private sector payrolls have averaged increases of 105,200 per month from May through September, down from 196,400 monthly from December 2010 through April. These are partially offset by government layoffs, which have averaged 17,500 since 2009. 200,000 net new jobs per month are necessary to reduce unemployment below 9.1%.

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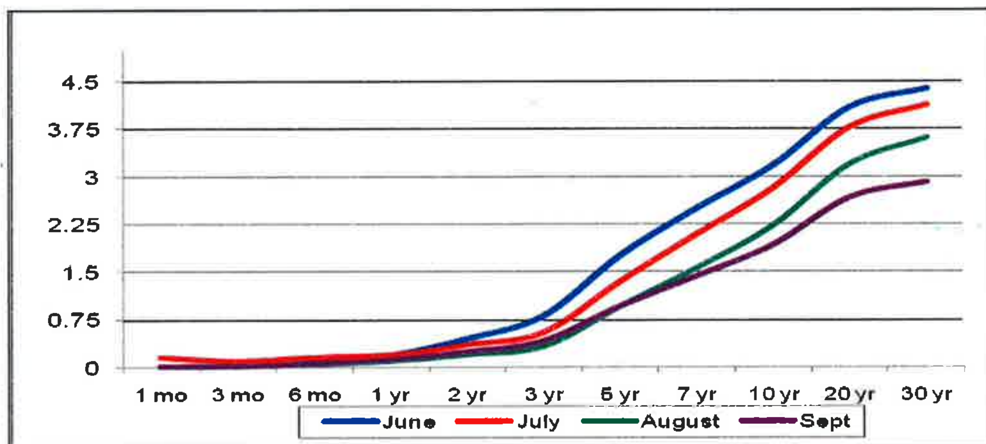

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Investment Implications

Stocks: When economics becomes political, markets and stocks become virtually impossible to handicap in terms of valuation. Increasingly this year, punctuated in the third quarter, emotion has trumped reasoned analysis. At 10.5 times forward earnings as of the end of September, nearly a 1/3 discount to the long term average of 15 times, the overall S&P price/earnings multiple seems compelling. Yet in another time of low confidence in Washington leadership, the end of the Carter presidency, that P/E fell to 6.8 (importantly, interest rates were much higher then).

Volatility can presage a further market decline or the transition from a bad period into a good one. The latter scenario is usually marked by heavy volume on up days as investors gain more confidence in the sustainability of the rally. The danger signal in the current volatility is that volume has been heavier on down days than it has been on up days, an indication that long term investors are exiting the market and leaving it to "hot money" participants like hedge funds and high frequency traders. In every month since the start of May, more money has left the US stock market than entered, to the tune of $93 billion total.

The risks in owning equities are real against the backdrop of potentially serious policy mistakes being implemented both domestically and abroad. These risks and the unknowns that accompany them must be balanced against the steady drumbeat of improving business and consumer statistics which has been building for months.

Taxable bonds: Interest rates continue to be low for new investment in quality bonds. The spreads are widening between Treasuries and lower quality bonds, dramatically so relative to high yield bonds. As it corrects, high yield is becoming an attractive asset class of its own.

Municipal bonds: With the rally in muni's, the risk/reward trade-off has become more negative. Even though states have led the federal government in downsizing their budgets and tax receipts have exceeded expectations, the looming cutbacks in federal support to states do not seem to have been factored into the market. We are defensive in that portion of our portfolios.

Parsons Capital Management

10 Weybosset Street, Suite 1000

(401)521-2440 (888)521-2440

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