

# PERSPECTIVES

## Quarter 4 2011

What a year! Stocks gyrated daily/weekly/monthly between the risk-on and the risk-off trade. S&P stock prices spanned a 20% trading range from the high of 1363 reached on April 29 to the low of 1099 touched on October 3, ending 2011 virtually flat with the beginning of the year excluding dividends. High frequency traders betting on momentum factors crowded out traditional fundamental investors. US markets handily outperformed the rest of the world, especially Europe and the emerging countries.

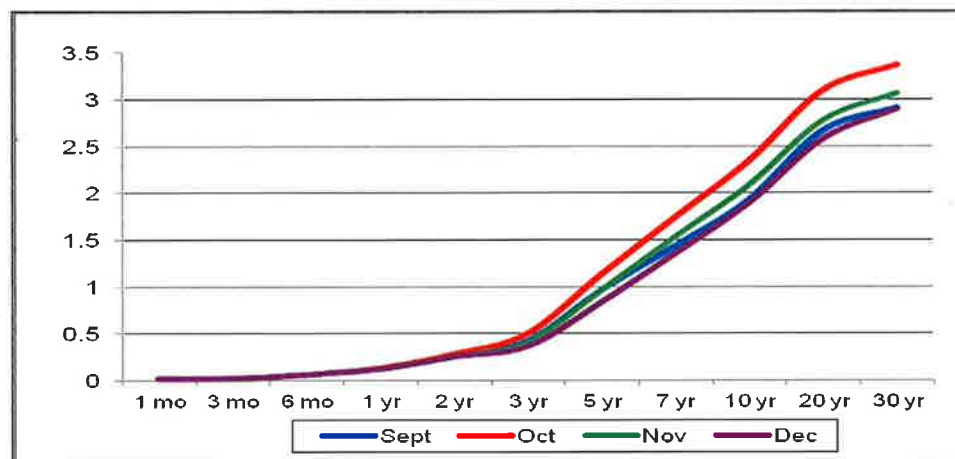
Data as of December 30, 2011	Qtr. 4		
	Dec '11	Qtr. 4'11	YTD '11
S&P 500	1.02%	11.80%	2.11%
MSCI AC World Index (incl. US)	-0.17%	7.11%	-7.61%
MSCI EAFE (Europe, Asia, Far East)	-1.03%	2.86%	-14.82%
MSCI EM (Emerging Markets)	-1.29%	4.08%	-20.41%
Russell Largecap	0.84%	11.84%	1.50%
Russell Largecap Growth	-0.32%	10.61%	2.64%
Russell Largecap Value	2.02%	13.11%	0.39%
Russell Midcap	-0.12%	12.31%	-1.55%
Russell Smallcap	0.66%	15.47%	-4.18%

### Fixed Income Markets

Bonds continued to outperform stocks in an unprecedented run – not only for the year but, as in 2010, for the ten year period ending December 31. Investors fleeing the stock market accepted miniscule yields yet demand pushed up prices. Treasuries returned + 9.81% in 2011; the BC Aggregate bond index, which includes corporates, posted +7.84%; and high yield came in at +4.98%. Municipals were the strongest at +10.70%, as prior fears of municipal bankruptcies gave way to sheltering income from taxes.

## US Treasury Yields

An important change occurred in 2011 regarding what influences the yield curve. The Federal Reserve effectively succeeded in managing longer term rates through policy communication when they stated that economic conditions were likely to warrant very low short-term rates at least through 2013. This and subsequent statements removed the risk premium from owning longer bonds, thereby pushing yields down.



## Commodities

Oil prices had plummeted in the third quarter, pricing in concerns about a global recession that didn't materialize. They reversed course in the fourth quarter as economic indicators, especially in the US, improved. Adding to upward momentum were renewed tensions in Iran and Nigeria. Continued production disappointments from Iraq fueled supply concerns. Broader commodity prices rose slightly in the quarter but still fell for the year on fears of falling Chinese demand and an unwinding of speculation.

Commodity	Qtr. 4 '11	Year to Date '11
Oil	29.00%	7.95%
CRB (broad index)	2.62%	-8.54%
Gold	-5.16%	10.54%

Selling pressure pushed down gold prices despite currency instability. Hedge funds were liquidating, and the Chicago Mercantile Exchange raised margin requirements – forcing some speculation out of that market.

## **Economic Overview**

2011 was the second year in a row in which the economy muddled through despite daunting macroeconomic and geopolitical disruptions: a major nuclear accident in Japan; a mid-year stall in US economic activity; a significant slowdown in China together with whiffs of inflation; the toppling of several long term political leaders in various countries; an almost calamitous financial meltdown in Europe, threatening the common currency; unprecedented credit downgrades of government debt; and strident, divisive, ineffectual US politics.

### **International**

*ECB cuts rate to 1%...*

A most significant event was that Mario Draghi succeeded Jean-Claude Trichet as President of the ECB, Europe's equivalent of the Federal Reserve. Draghi ushered in a dramatically different approach: accommodative monetary policy and a harmonious working relationship with the power structure of Merkel, Sarkozy, and Lagarde (the latter also a new and enlightened leader of the International Monetary Fund). Draghi provided liquidity to credit markets starving for it, buying time for banks and governments to potentially work through serious funding issues.

### **Domestic**

*US GDP 1.3% in 2Q, 1.8% in 3Q, expected 4Q GDP >3%...*

The engines of US growth are traditionally consumer spending (still 71% of the economy), industrial production/transportation, and housing. They take turns leading economic activity through its cycles of expansion and contraction. Signs of stability in housing and strength elsewhere abounded in the last third of 2011, signaling an expansion built on stimulus which could become self-sustaining if not derailed:

*Unemployment claims break out below 400,000...*

- Consumer confidence, consumer spending, and consumer installment debt all increased month over month and year over year. In November (latest available), consumer credit jumped by \$20.4 billion, the most since November 2001. At the same time, chargeoffs and reserves for bad debt were at record lows, indicating that debt is within responsible limits. The savings rate stood at 3.5%, supporting that thesis.
- Railcar shipments reversed year-ago trends, up +2.2% for the full year paced by crude oil and petroleum product shipments + 11.1%. The US has steadily increased its domestic oil production, lessening dependence on foreign oil from a high of 60% of consumption in 2005 to 40% in 2011.
- Various surveys of business sectors all point to future increases in activity: construction equipment dealers, truckers, NFIB small business, the "Big 3" US auto manufacturers, retailers, homebuilders, and the U. of Michigan's jobs survey.

US labor costs have become more competitive internationally, especially when productivity is factored in. This, together with the cheap dollar, low cost of natural gas, and relatively well developed infrastructure are causing the US to emerge as a top global competitor for production and manufacturing.

## **Investment Implications**

**Stocks:** After years of stocks underperforming bonds, with S&P profits rising for 16 consecutive quarters to double where they were in early 2009, and buoyed by global accommodative monetary policy, the case for stocks continues to improve. Public company executives are getting the message that historically, more than 50% of the total return from common stocks has been in the form of dividends; the year end dividend yield on the S&P 500 was 2.12%, up 89% from 1.12% at its trough in 2000. An obvious question is: which is a better investment, 100 year Mexican sovereign debt at 6% or a large cap US stock yielding 4% or more with the expectation of dividend increases?

Valuations are clearly being constrained by geopolitical uncertainty, and investors have been spooked by volatility. As companies continue to show that they can increase business despite all of these worries, the climate should become more inviting for investors to reconsider stocks.

If employment improves in 2012 as we expect, our portfolios will move toward a more cyclical vs. defensive posture – emphasizing sectors and companies leveraged to expansion. All companies are being reviewed for exposure to Europe as a negative factor. We favor US companies over all others due to our rising competitiveness.

**Taxable bonds:** Looking forward, bond investors risk earning negative real (i.e. inflation-adjusted) returns in sovereign debt, especially in the US. Based on historical correlations with stocks, US Treasury bond interest rates should be 1% higher than they are. 2010-2011's massive movement of small investors from stocks and money markets into bond funds could be marking a trough in rates.

**Municipal bonds:** Our position remains generally defensive in this asset class as rates continue to fall, making the risk/reward tradeoff less attractive. We are, however, finding selective individual offerings of interest.

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