A Quarterly Newsletter for Clients of Parsons Capital Management

Quarter 2, 2012

Perspectives

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QUARTER 2, 2012

by Ruth K. Mullen and John H. Mullen

The mad dash between "risk on" and "risk off" continued to play out daily, weekly and monthly during the second quarter, with "risk off" winning. By being down less, US markets again outperformed the rest of the world; large cap led all other capitalizations; value beat growth. Within the S&P500, defensive sectors outstripped cyclical sectors. High frequency traders' influence was felt throughout the quarter, evidenced by momentum factors trumping valuation in stock picking, and dispersion of performance (the range between relative returns) being extreme across styles, sectors and individual stocks.

Ruth and John Mullen
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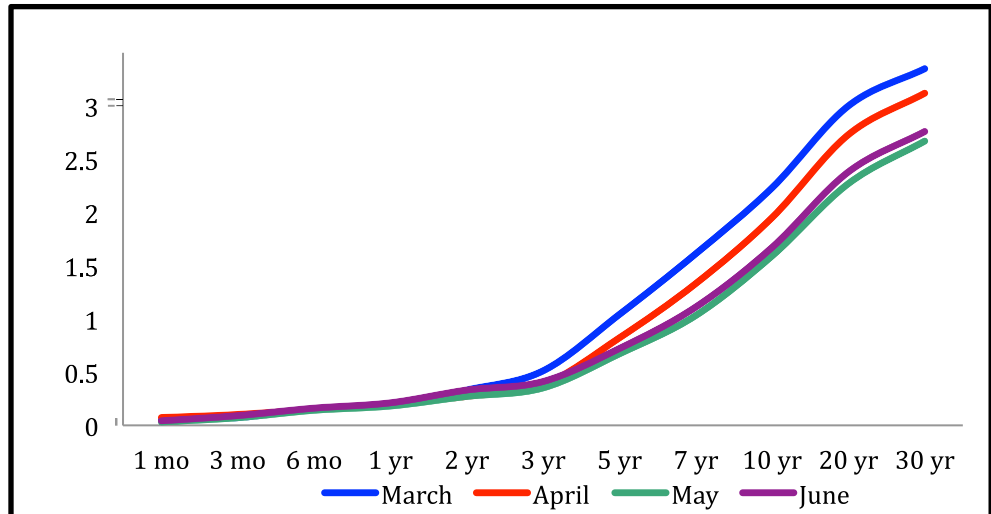
Data as of June 30, 2012	June '12	Qtr. 2 '12	YTD '12
S&P 500	4.12%	-2.75%	9.49%
MSCI AC World Index (incl. US)	5.15%	-4.86%	6.29%
MSCI EAFE (Europe, Asia, Far East)	7.05%	-6.85%	3.38%
MSCI EM (Emerging Markets)	3.91%	-8.77%	4.12%
Russell Largecap	3.83%	-3.12%	9.38%
Russell Largecap Growth	2.72%	-4.02%	10.08%
Russell Largecap Value	4.96%	-2.20%	8.68%
Russell Midcap	2.81%	-4.40%	7.97%
Russell Smallcap	4.99%	-3.47%	8.53%

FIXED INCOME MARKETS

The money that raced out of bond markets in the first quarter returned in the second quarter, looking for safety and principal preservation. All fixed income sectors were positive for the quarter, paced by long Treasuries. In traders' minds, the safer the better - investment grade bonds returned more than high yield, a sure sign of risk aversion. Municipals continued to perform well due to increasing improvement in state finances and expectations of higher taxes ahead.

US TREASURY YIELDS

Interest rates fell and the yield curve flattened, especially at the long end. Treasury yields are again at historically low levels despite the global financial system being awash in cash from continued easing, especially by the central banks of developed countries. Interestingly, short term sovereign yields in Switzerland and Germany actually turned negative in May and June – i.e. bondholders were willing to pay those governments interest rather than collect it – an extreme sign of risk aversion.



COMMODITIES

Oil slumped dramatically in the face of a potential worldwide economic slowdown. The national average of gasoline at the pump declined -22% to $2.59, while natural gas reversed course and gained 40% (Henry Hub spot) during the quarter. Natural gas is being used more widely as fuel in the transportation, industrial, and utility industries while domestic production has been declining; the reaction to this imbalance may initiate a sustained upward price move. Gold erased most of its first quarter price gain amid the cross-currents of purchasing by central banks and other accumulators concerned about currency instability vs. likely forced selling in the futures markets.

The CRB (Commodity Research Bureau) broad index declined, but the underlying statistics tell two different stories. Commodities used in worldwide industrial production such as oil, aluminum, copper and precious metals fell due to the perceived threat of slowing global growth. In contrast, commodities tied to world population growth and consummables such as wheat, corn, soybeans, pork, coffee, sugar, and orange juice all rose.

Commodity	Qtr. 2 '12	Year to Date '12
Crude Oil (WTI)	-19.26%	-17.48%
Gold	-3.84%	1.82%
CRB (broad index)	-7.86%	-9.26%

Perspectives

ECONOMIC OVERVIEW

International

Fiscal uncertainty in Europe…

Europe continued to buffet markets, as the high stakes negotiations between debtor and creditor member nations played out in public and private. France's leadership changed, which left German Chancellor Angela Merkel the lead stalwart on economic austerity. The debtors outnumber the creditors and want what the creditors have; the creditors have leverage and do not want to absorb huge losses from the debtors; yet all sides appear to agree that the EU must be preserved – at least for now. Greece managed to form a government and remain in the EU.

The quarter ended with a euphoric lift in stocks, +2.5% on June 29, in response to an agreement among EU leadership on a broad outline addressing three pressing issues: recapitalizing Eurozone banks, separating bank debt from sovereign debt, and moving toward cross-border banking and supervisory union. The reality of forming such a union is mind-boggling in its complexity, but the rhetoric calmed markets, and Spain – much more important economically than Greece – avoided a government bailout by the terms of this agreement.

Growth concerns in China…

China's economic indicators began falling early in the quarter and more strongly toward the end, adding to global woes. Europe is China's largest trading partner, and a Eurozone recession could be protracted depending on what the ultimate governing fiscal policy is.

Domestic

Europe's recession began showing up in quarterly earnings estimates and company guidance among exporters. 20% of S&P500 earnings are derived from Europe.

Weakening US economy…

The promising signs of recovery turning into expansion which appeared in the first quarter quickly gave way to a drumbeat of disappointments:

- Initial unemployment claims inched back to just under 400,000 per week from closer to 350,000 earlier in the year
- Widespread weakness showed up in durable goods orders, which posted the first decline since the previous recession
- Regional business surveys fell in all five regions of the country except Dallas
- Consumer sentiment hit the lowest level this year
- Consumer spending fell in May, the first decline since November 2011

On a macro level, the looming "fiscal cliff", a term introduced by Fed Chairman Bernanke, became more widely recognized. The term refers to the confluence of four already mandated events:

Potential contraction from austerity…

- the expiration of the Bush tax cuts (therefore a significant increase in tax on income, dividends, capital gains and estates) on 12/31/12
- additional taxes and surtaxes to fund the Affordable Care Act, beginning in 2013
- the expiration of fiscal stimulus measures, notably the payroll tax and extended unemployment benefits, on 12/31/12
- spending cuts scheduled to be triggered automatically in January 2013 as a result of the failure of the deficit reduction super committee negotiations last year

Estimates of the total dollar impact from these events run from $300 billion to $600 billion. If they hit all at once, they can be expected to cause a 4-5% contraction in the economy which is running at a pace of around 2% growth, sending the US into recessionary territory.

INVESTMENT IMPLICATIONS

With so many global struggles in the spotlight, no wonder the market succumbed to profit-taking in the second quarter. In these times of dramatic volatility, it is perhaps surprising that the quarterly correction was as small as it was and that June was actually positive. Valuation and sentiment are keys to that and could provide clues to the second half. On valuation, stock prices are already constrained by uncertainty. Sentiment refers to a bullish or bearish tone to the market, and although that seems to change almost daily, the prevailing backdrop is that declining inflation pressure allows more central bank easing in Europe, China and the US in order to avoid serious recession. Low interest rates and massive liquidity tend to put a floor under valuation.

Commodities also point to some positive implications. Lower energy and fuel costs can boost consumer firepower in the second half. Consumer spending at 71% of the domestic economy is the single largest factor in GDP growth and the ultimate end point of most industrial production. And in industries where energy costs are a component of the profit margin, this is a positive development. In contrast, certain food companies and others negatively affected by grain costs will suffer.

As we move into the second half of the year, the looming domestic “fiscal cliff” should take center stage in the investment arena, probably ushering in more volatility. Pundits are busy handicapping possible policy outcomes which range from “punt” to “grand bargain”, with most concluding that at some point something will be done. The logic is that now that the economic effects have been quantified, it is too destructive to allow the cliff to happen.

Philosophical differences constraining actions in DC…

Due to the philosophical chasm between Republicans and Democrats regarding the scope and size of federal government, the outcome of the elections could produce directional change, but those same deep differences will make any resolution to the structural problems difficult at best. In short, there are few if any reliable signposts, which brings us back to individual company evaluation. Large cap stocks tend to do best when uncertainty reigns, and the prospects for the US still appear to outstrip those of everywhere else in the world.

High frequency traders moving the market…

The noise in the stock (and to some extent the bond) markets from high frequency traders rapidly moving between risk on and risk off in reaction to world events and to price momentum – jumping on price trends to capitalize on small changes but doing so in huge volume – is forcing fundamental valuation to take a back seat. The ensuing gyrations have driven away smaller “retail” investors, and it is difficult to imagine that they will return until the situation changes. The SEC is examining high frequency trading tactics and the possibility of preferential treatment being given to large traders by research houses. Transparency on these issues would be welcome. Meanwhile, volatility creates opportunity for the patient investor as there is a value/price equation for everything…and this market is requiring tremendous patience.

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