Perspectives

A Quarterly Newsletter for Clients of Parsons Capital Management

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QUARTER 4, 2012

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Uncertainty about the elections and US fiscal policy after 2012 produced volatility and mixed fourth quarter results in US stock markets. A year-end "relief" rally in anticipation of a deal capped an unexpectedly strong year for all markets. In general, cyclical sectors outperformed defensive and higher risk was rewarded commensurately. Europe was the strongest region in international and Asia the strongest in emerging, as China roared back late in the quarter after lagging most of the year.

Data as of December 31, 2012	Dec '12	Qtr. 4 '12	YTD '12
S&P 500	0.91%	-0.38%	16.00%
MSCI AC World Index (incl. US)	1.93%	2.63%	16.54%
MSCI EAFE (Europe, Asia, Far East)	3.21%	6.60%	17.90%
MSCI EM (Emerging Markets)	4.90%	5.61%	18.63%
Russell Largecap	1.04%	0.12%	16.42%
Russell Largecap Growth	-0.03%	-1.32%	15.26%
Russell Largecap Value	2.07%	1.52%	17.51%
Russell Midcap	2.25%	2.88%	17.28%
Russell Smallcap	3.56%	1.85%	16.35%

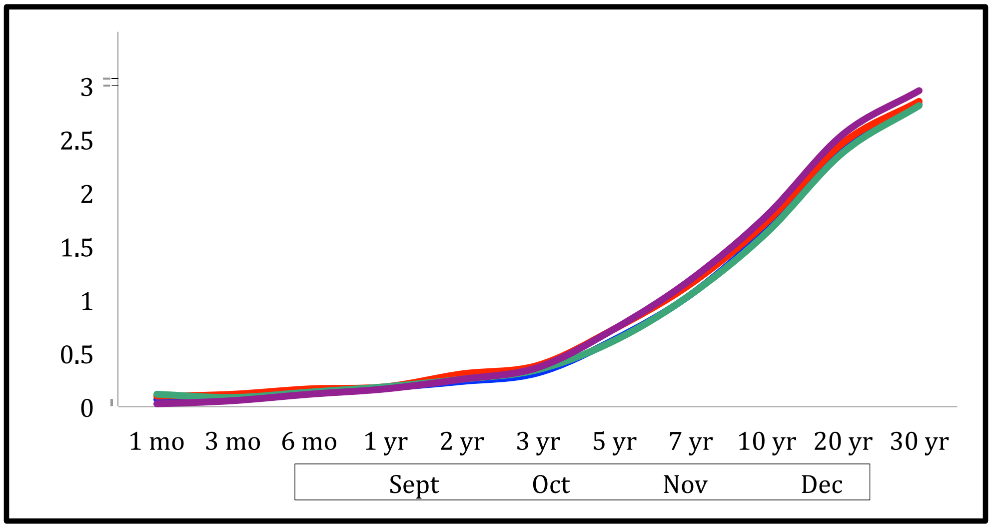
FIXED INCOME MARKETS

Risk was the hallmark of the fourth quarter in the bond markets. Money moved out of the 10 year Treasury, producing a quarterly return of -0.1% and reducing the year's total return to +2%. Both short and long Treasuries were the weakest performers of 2012. Corporate bonds did slightly better as the yield spread to Treasuries tightened, posting a +4.22% annual return. High yield again stood out at +3.3% for the quarter and +15.8% for the year, comparable to stock returns. The lower the quality, the better the return. Municipals endured a sell-off in December in reaction to talk of eliminating the tax exemption, but posted solid results for the year at +6.78%.

US TREASURY YIELDS

Yield curve
steepened in the end of the year…

The all-important 10 year Treasury yield fell from 1.83% in late October to 1.58% in mid November (nearly 14%) amid the pre-election stock market jitters. It then rose again to end the year at 1.78%, almost where it started the year at 1.89%. Similarly, the 30 year Treasury began the year with a yield of 2.89% and ended at 2.95%, with volatility throughout. The two year began and ended at 0.25%.



COMMODITIES

Inflation subdued
in the face of increased QE…

It is unusual to see commodity prices falling when the Federal Reserve is exercising quantitative easing, but that is what happened in the fourth quarter and the year. The recession in Europe and the slowing of Chinese growth reduced both regions' appetites for raw materials at the same time as the market was well supplied via production increases in Saudi Arabia, Iraq, and the US. Unleaded gas fell in the fourth quarter as sharply as it rose in the third – over 20% - ending the year not far from where it began, up +4.91%.

Commodity	Qtr. 4 '12	Year to Date '12
Oil	-0.01%	-10.82%
CRB (broad index)	-6.42%	5.86%
Gold	-4.62%	-5.85%

Gold fell in US dollars but not in other currencies, a factor of the weaker dollar. Some of the tailwinds for gold faded from prior years such as signs of inflation and concerns about a currency collapse. Gold often moves inversely with stocks, which was the case in 2012.

ECONOMIC OVERVIEW

Economies and markets move in trends and cycles. Several trend reversals, some shorter and some longer in duration, began to take shape in 2012. The theme running throughout was one of pent-up demand beginning to translate into consumption against an improving fiscal backdrop.

Policy uncertainty
constraining consumption, but housing an economic bright spot…

Capital Expenditures: As business confidence fell in 2012, companies cut back on capital spending rather than initiate mass layoffs. As a result, at year end the average age of durable goods was at the highest level since the 1960's. Durable goods consumption as a percent of GDP was well below its historical average, 17% vs. 21%.

Housing: Pre-bubble, housing starts were running 1.5 million annually. They climbed to a high of 2.3 million in 2006, plummeted to a low of 400,000 in 2008, and have been inching higher since, crossing 800,000 in 2012.

Demographic Demand: the echo boomers are beginning to form households, although their spending power is constrained by the explosion in student loans, which now average $24,301 per borrower.

Improving employment
leading to fiscally healthier states…

Employment: Unemployment decreased from 8.3% in January to 7.8% in December. This statistic should continue falling even at lower job creation rates due to a demographic decline in the working age population. In the fourth quarter, the median duration of unemployment continued its downward trajectory; average hours worked increased +1.5%; private payrolls increased an average of +180,000 per month.

State and Local Government Spending has been a drag on GDP since 2009 as municipalities cut to balance their budgets. At the end of 2012, it crossed into positive territory. Even California projected a surplus in its next fiscal year.

Energy independence
and manufacturing renaissance two key themes for the US…

Energy Independence: The International Energy Administration projects that expanded extraction methods and the effect of already mandated fuel economy standards will combine to make the US energy independent and a larger producer of oil than Saudi Arabia by 2020. In 2012, power generation by natural gas in the US equaled coal-fired at 32% each. Historically, coal accounted for 50% and gas for 20%.

Domestic Manufacturing: The drumbeat of US companies planning to repatriate jobs for productivity and quality reasons continued, with Google, Apple, GE, Ford and Caterpillar leading the pack. Boston Consulting Group forecasted that by 2015, the US will have a production cost advantage of 5-25% over Germany, Japan, and the UK. The cost gap with China will fall to 7% (from 12% in 2010).

China
reaccelerating as Europe avoids a crisis…

China appears to have turned the corner to emerge from the recent tightening/ slowdown cycle. Exports rose +14.1% year over year in December to a record high, paced by a big rebound to Europe.

Europe: Mario Draghi and the leadership in Europe have successfully negotiated the immediate crises in the peripheral countries and preserved the euro at least for the time being. As evidence of this, Spanish long term interest rates ended the year at 5.34% (down from a high of 6.81%), Italian at 4.54% (high 7.06%) and Greek at 13.33% (high 29.24%). The Ireland turnaround was punctuated with their successful access of the public debt markets without central bank support.

US: The overriding domestic economic concern, namely the widening budget deficit, experienced what could prove to be a cyclical improvement which will make the structural problem easier to solve. Tax revenues grew 10% year over year in the second half of 2012 (before the tax increases), and federal spending grew less than GDP. Taken together, the budget deficit as a percent of GDP at year end 2012 was 6.7%, down from 8.2% a year earlier.

INVESTMENT IMPLICATIONS

Cliff averted
but more needs to be done…

Government balance sheets
expanding as the personal and corporate sectors heal…

Bond valuations
becoming stretched…

Stocks: The fiscal cliff may have turned into a slope with the New Year deal, but the ugly deficit debate looms. The last debate in the summer of 2011, which set up the current situation, resulted in S&P downgrading US Treasury debt from AAA to AA+ on August 5. During the period of the debate and downgrade, the S&P 500 dropped 18.8% from July 7 through October 3. S&P and Fitch have already indicated that they will downgrade again in the absence of comprehensive budget reform to get the US off the current path of unsustainable deficit spending. Given the tenor of the cliff negotiations and the entrenched positions of the two sides, at this point such an outcome looks more likely than true reform – warranting caution in the first quarter. Offsetting the fiscal risk is continued monetary policy support from the Bernanke Fed which is expected to continue under Janet Yellen after his tenure ends in 2014. In addition and mostly due to Central Bank support around the world, the global recovery is taking root as an expansion. Debt has been the largest worldwide economic restriction since the credit crisis began in 2007, but huge strides have been made in corporate and personal deleveraging (apart from the student loan bubble mentioned above, which will eventually require adjustment). Debt has essentially been moved to the sovereign level where it theoretically can be managed by policy and economic growth. Absent significant policy mistakes, we may be moving closer to the end of the long bear market which arguably began in 2000.

Corporate Bonds: The risk/reward balance in the bond market has shifted decisively toward risk. This is nowhere more true than in high yield, where Fed policy has driven yield-seeking investors who are historically more risk averse than is this asset class. While the projected default rate of 2% is much lower than the historical average of 4.8%, and the spread vs. Treasuries is still around 4%, the absolute yield is the lowest ever recorded. If overall interest rates rise with an improving economy, inflation, or a reallocation by investors out of bonds into better performing stocks, the risk is much higher than the current interest rate of 6%.

Municipal Bonds: The Obama administration's fiscal 2013 budget proposal capped tax preference items at 28% and did not exclude muni interest. Recent reports from the GAO and the National Taxpayer Advocate have both made forceful arguments for simplifying the tax code, partly by eliminating deductions including municipal interest. These developments have pushed down muni prices. An outright elimination of the exemption is unlikely in that it would throw state and local finances into a tailspin; more likely is a modification. Meanwhile, the new uppermost tax bracket of 39.6% and the Medicare Net Investment Income Tax of 3.8% make municipal interest more valuable for higher earners, ensuring some level of demand and supporting prices.

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