A Quarterly Newsletter for Clients of Parsons Capital Management

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Perspectives

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QUARTER 3, 2013

by Ruth Mullen and John Mullen

Despite slowing world growth, increasing concern over geopolitical hotspots like Syria and Iran, uncertainty about Fed policy, profit warnings from bellwethers WalMart and Cisco, and the specter at quarter's end of a government shutdown, stocks recorded strong performance. For the first time in over 2 years, non-US returns eclipsed the S&P 500. The thesis that Europe has seen the worst of its widespread recessionary conditions encouraged investors. Domestically, growth and smaller cap stocks outpaced value and larger cap shares. Technology turned from a laggard to a leader.

Data as of Sept. 30, 2013	Sept. 13	Qtr. 3 13	YTD 13
S&P 500	3.14%	5.24%	19.79%
MSCI AC World Index (incl. US)	5.04%	8.29%	17.81%
MSCI EAFE (Europe, Asia, Far East)	7.42%	11.62%	16.59%
MSCI EM (Emerging Markets)	6.53%	5.90%	-4.05%
Russell Largecap	3.72%	6.35%	21.30%
Russell Largecap Growth	4.66%	8.48%	21.75%
Russell Largecap Value	2.76%	4.23%	20.68%
Russell Midcap	4.58%	7.70%	24.34%
Russell Smallcap	6.38%	10.21%	27.69%

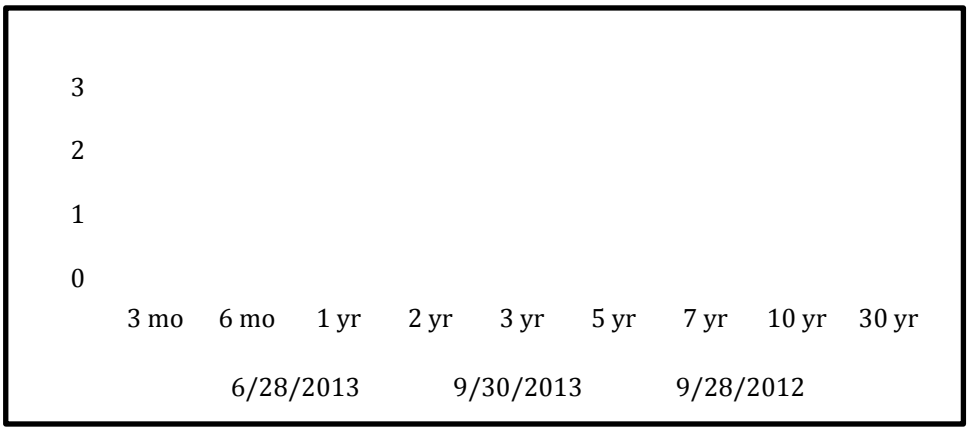
FIXED INCOME MARKETS

After a huge outflow of $60 billion from bond funds in the month of June, the exodus continued through the third quarter – exceeding $58 billion. Most of that money apparently transferred into money market funds. Even so, bond prices rebounded from the drubbing of May-June. The BC US Aggregate bond fund index gained +0.57%, but the year to date return was still -1.89%. Municipals fared the worst of all bonds in the quarter, down -0.19% and down -2.87% year to date, even with September being up +2.15% (the best monthly showing since January 2012). High yield was the only bond category holding onto positive returns for the year at 3.73%.

US TREASURY YIELDS

During September, the yield on the 10-year Treasury touched 3%, its highest closing level since 7/21/11 and up an astounding 80% from the low of 1.66% just 5 months earlier on May 2. The ascendancy of Lawrence Summers as President Obama's choice to replace Fed Chair Bernanke spooked the bond market, already jittery about imminent Fed tapering. When the Fed surprisingly postponed tapering at its September 18 meeting, rates turned down again. An additional relief rally after Summers withdrew his name brought the 10 year to end the quarter at 2.64% vs. 2.52% on June 30.Within a multi-year historical context, yields are normalizing rather than exploding upward: even with the sudden increase since May, the September 30 yield is 50.75% below its June 2007 high of 5.30%.Veterans may remember 10 year yields of 14% in 1983.

Treasury yield curve steepens…



COMMODITIES

Even before the chemical weapons incident in Syria on August 21 spurred increases in oil spot prices, market fundamentals had already been moving Brent prices higher. Increasing global refinery demand coupled with record levels of unexpected crude outages, notably in Iraq and Libya, affected the supply/demand equation.

Improved global growth helped commodities rally…

Broad commodity prices (led by cocoa, sugar, silver, gold, copper, and feeder cattle) pared their first half losses, as supply/demand metrics and the weakening dollar had a firming effect. Gasoline was up slightly in the quarter but still down 5.19% year to date, buoying consumer spending potential.

Commodity	Qtr. 3 13	Year to Date 13
Oil	5.98%	11.45%
CRB (broad index)	3.59%	-3.21%
Gold	11.28%	-20.19%

Gold staged a dramatic rally, especially after the Fed's turnaround on tapering, yet it was still down for the year.

ECONOMIC OVERVIEW

Fed surprised the market with taper delay…

The biggest economic news of the quarter was the surprising Fed announcement on September 18 that they would not yet begin the tapering program to reduce their monthly $85 billion in bond purchases. Previous Fed announcements had prepared investors for that reduction, which was presumed to signal the beginning of the end of the current easing cycle. The Fed apparently remained unconvinced that the US economy could maintain sufficient momentum with a reduction in quantitative easing, citing a disappointing labor market and other soft data. Second quarter GDP growth came in at 2.5%, and the Fed lowered their 2013 forecast to 2-2.3% - well below the central bank's stated optimum level of 3.25%.

Yet most statistics pointed to an increasingly strong private sector economy:

More signs of continued, slow, economic growth in the US…

- Household net worth at $74.8 trillion at latest measurement on 6/30/13 was $6.7 trillion above its pre-recession level in 2007 and has risen 34.67% since the nadir on 6/1/09. The largest factors in the increase were equity and home prices.
- In July, the S&P Case-Shiller Home Prices Index posted its biggest advance since February 2006, +12.29% from July 2012.
- US auto sales were up an expected +9% in the quarter, continuing a steady advance since September 2009. The average age is still 11 years for US cars and 14 years for pick-up trucks. Vehicle production was down in the quarter but remains near the pre-recession high in 2007 and is expected to reaccelerate in the fourth quarter.
- The September ISM manufacturing index data came in at 56.20, 6% above its trailing 10 year average and its highest level in over a year. In less than 5 years, it has risen 70%.
- Initial jobless claims continued their descent, falling to 305,000 at quarter's end.
- Even with the unemployment rate at 7.4%, job openings as measured by the Bureau of Labor Statistics were most recently at 3.7 million, near a 4 year high.
- Consumer confidence and sentiment, however, declined to 5 month lows in September, probably due to Middle East tensions, gridlock in Washington DC, among the relentless drumbeat of negative news headlines.

The US energy production renaissance is increasing in momentum. US crude oil imports are currently near 15 year lows while exports of refined products are up over 500% since 2004. Current exports run 3.9 million barrels per day, the highest in history. September marked the first month in which the US produced more oil than it imported (7.8 million barrels per day vs. 7.6 million). The US is now the world's largest oil and gas producer, having overtaken Russia in September.

In Europe, improvements in both the composite Purchasing Managers' Index and retail sales suggest that the regional economy continues to recover, albeit it at a moderate pace.

Europe seems to have bottomed while China avoids a hard landing…

In China, early signs of more robust third quarter growth following a slowdown in the first half of 2013 appeared in the expansion of the services sector and higher exports, especially to the US. The expected growth rate of 7.5% (which is the government target rate and the latest forecast by the International Monetary Fund) would be the slowest pace of expansion in 23 years.

In Japan, the quarter showed a broad-based expansion in both services and manufacturing, signaling the ninth straight month of increasing private sector activity. An announced sales tax increase on top of anemic domestic demand may snap the streak.

INVESTMENT IMPLICATIONS

Federal dysfunction causing near-term uncertainty…

STOCKS: At quarter's end, the prospects of a government shutdown and debt default began to be priced into the market. What was unthinkable and is certainly unquantifiable became possible. There were two government shutdowns in 1995 (the first over Medicare premiums, the second over the budget), and counter-intuitively, the S&P 500 rose during both of them. Corrections immediately followed the end of both of them, quickly giving way to significant rallies. The market tends to pay more attention to monetary policy, the economic environment, and earnings. All of those are on balance positive, which should translate into buying opportunities embedded in any adverse reaction to Washington gridlock - as long as it doesn't last too long or affect debt payments.

Of much greater significance to long term investors is the unfolding US energy revolution. The economic reverberations are widespread:

Lower domestic energy costs a long-term advantage for the US…

- Downward pressure on energy prices, including natural gas and electricity, which in turn supports the domestic manufacturing renaissance and consumers' disposable income.
- Falling energy costs reduce inflation.
- The multiplier effect of energy job creation is measured at over 10:1.
- Spending on drilling equipment is the largest component of the recent increase in capital expenditures.
- Low natural gas prices and strong infrastructure within the US relative to other countries are attracting increasing foreign and domestic investment in plants, contractor jobs, and natural gas fueling stations. Boston Consulting Group estimates that international companies will invest at least $50 billion through the end of this decade on products that take advantage of low-price natural gas.
- Revenues in energy-producing states should increase, as will federal tax revenues.
- The reduction of energy imports lowers the trade deficit and alters the geopolitical balance of power.

Taken together, these factors suggest a much more supportive environment for equities than has been the case for many years.

Yellen Fed a positive for the bond market…

BONDS: The biggest influence on interest rates continues to be Fed policy. The presumptive next Fed Chair Janet Yellen is expected to steer a slow and deliberate pace of tapering, or reducing the amount of economic stimulus in the system. That is the best news possible for the bond market given that rates still must normalize upward from current historically low levels; the only question is the timet frame. This trend favors stocks over treasuries and corporates for total return until the rate normalization process is complete.

The rout in the municipal bond market since May has produced attractive buying opportunities amidst anomalous valuations: muni interest rates actually exceed taxable rates in some issues and maturities. The lack of new issuance, which should continue in the economic environment described above should help to offset the negative effects of rising rates and muni bond fund outflows.

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