A Quarterly Newsletter for Clients of Parsons Capital Management

Perspectives

Quarter 4, 2013

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QUARTER 4, 2013

by Ruth Mullen and John Mullen

The fourth quarter capped a blowout year for US stocks, which outpaced all other countries in performance (expressed in US dollars). Investors shook off their macro concerns about Washington dysfunction, debt and deficits, unemployment, rising interest rates, and foreign tensions – climbing the proverbial “wall of worry” and pouring money into stocks mostly through mutual funds and exchange traded funds. IPO’s staged a comeback. Bullish sentiment reigned at year end, recording the highest reading since October 1997. Internationally, returns ranged from -2% in emerging markets to +25% in Europe.

Data as of Dec. 31, 2013	Dec. '13	Qtr. 4 '13	YTD 13
S&P 500	2.53%	10.51%	32.39%
MSCI AC World Index (incl. US)	1.76%	7.42%	23.44%
MSCI EAFE (Europe, Asia, Far East)	1.51%	5.75%	23.29%
MSCI EM (Emerging Markets)	-1.44%	1.86%	-2.27%
Russell Largecap	2.70%	10.23%	33.11%
Russell Largecap Growth	2.86%	10.44%	33.48%
Russell Largecap Value	2.53%	10.01%	32.53%
Russell Midcap	2.98%	8.39%	34.76%
Russell Smallcap	1.97%	8.72%	38.82%

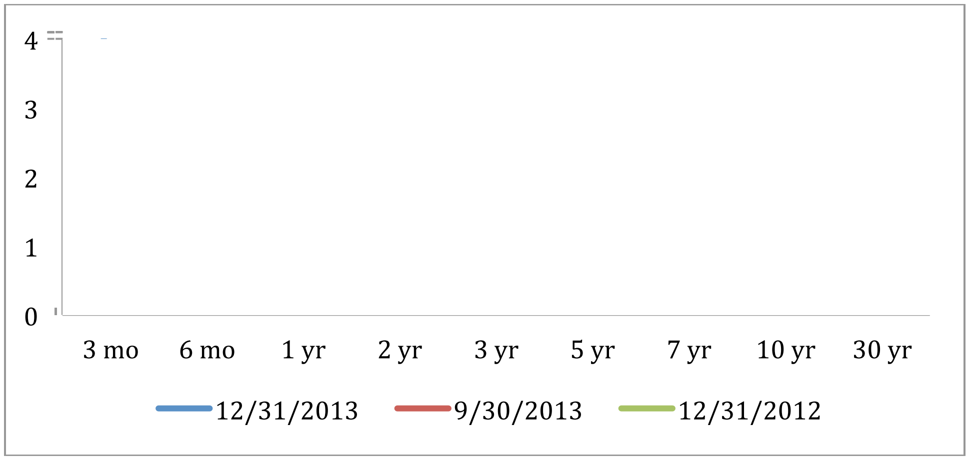
FIXED INCOME MARKETS

Bondholders endured the second worst year ever recorded by the BofA Merrill Broad Market Index (1994 being the worst). While most bond maturities of 5 years and under managed small positive returns, longer durations suffered; for example, US Treasuries 20 years and longer fell -13.88%. High yield gained +7.42%, further narrowing the spreads to investment grades. Municipals returned -2.55% overall. In the muni market too, longer durations were punished more than shorter, with -15% returns and lower seen in maturities over 15 years.

US TREASURY YIELDS

The Fed's conversation about tapering, which first rattled the Treasury market in May, created upward pressure on interest rates to varying degrees for the rest of the year. The 10 year Treasury began the year yielding 1.78% and ended yielding 3.04%, resulting in a -7.8% return for the year. Given that the short end of the curve is anchored by Fed monetary policy, the yield curve steepened dramatically.

With the Fed pegging short rates the yield curve steepened…



COMMODITIES

The growth in China's annual imports of commodities, especially crude oil, coal and soybeans, slowed markedly from 2012 as Beijing tightened credit to help shift its economy from being driven by exports and infrastructure spending to consumerism. This was the principal force behind commodities underperforming the S&P 500 for the third year in a row.

Strong US dollar and slowing Chinese demand led to lower commodity prices…

Commodity	Qtr. 4 13	
CRB (broad index)	-0.98%	-3.60%
Oil	-3.23%	9.64%
Gold	-8.92%	-27.81%

Gold continued its decline while diplomacy with Iran helped send oil lower…

The spectacular fall in the price of gold was exacerbated by investor outflows from global gold ETF's, forcing sales. Fund outflows in the US accelerated in December after the Fed's taper confirmation. In addition, the negative returns were magnified for US investors because of the strength of the dollar against other currencies.

Unusually cold weather in many parts of the US sparked a surge in the price of natural gas during the fourth quarter, +27%. The fuel, which is being used more widely as an alternative to oil, gained +35% for the year.

The national average price of gasoline at the pump rose +6.98% in the fourth quarter but was up only +0.33% for the year, an important factor in consumer disposable income.

ECONOMIC OVERVIEW

As 2013 progressed, a powerful feedback loop developed between positive economic events, many unanticipated, and wealth creation which once again brought to light the resilience of the US economy.

Economy

Taper announcement ultimately a positive for stocks…

The relief rally ignited by the Federal Reserve's September surprise that they would not yet begin to taper their bond purchases was undeterred by outgoing Chairman Bernanke's masterfully worded announcement on December 18: the Fed would reduce their monthly purchases from $85 billion to $75 billion in January if conditions were "broadly consistent" with the Fed's vision of a sustainable recovery. Hawkish news delivered with dovish language to investors who had been carefully prepared through public communications all year long sent the Dow Jones average up 290 points that day alone.

Signs of bipartisanship emerged while the deficit continued to improve faster than expected…

On December 26, President Obama signed the budget deal which, although not a grand bargain, at least set government funding levels for 2014 and 2015. A frustrating obstacle to the workings of government and the ability of the private sector to plan was removed. The next hurdle will be the debt ceiling which is set to be reached in February 2014.

The federal deficit, which touched $1.4 trillion and topped 10% of GDP in 2009, is projected to fall to 3% of GDP by the end of 2014. Spending is nearly unchanged since 2009, and receipts have grown mainly from increased tax payments due to the stimulus-induced recovery in general and the 2013 tax increases in particular. At the same time, interest rates which the government must pay on its debt service have remained low, and smaller deficits mean less issuance of new debt.

The trade deficit narrowed sharply in November (latest month available), hitting its lowest point since October 2009. The increase in exports was broad based, reflecting strength in domestic energy production as well as manufacturing and services. Energy imports continued to contract, and by the end of December the average 52 week surplus of exports over imports was 1.1 million barrels per day. Most of the foreign demand came from the US's NAFTA trading partners wanting our refined products.

US economy showing signs of strength…

After years of stagnation, ADP private nonfarm payroll employment was 238,000 in December, greater than estimates and the strongest since November 2012. All three months of the third quarter exceeded 200,000, indicating a positive trend.

All of this good news led forecasters to predict fourth quarter GDP growth of over 3%.

Markets

Multiples expanded as money flowed into stocks and out of bonds…

Total wealth in the S&P 500 grew to more than $4 trillion by the end of December. The rally attracted growing investment in stocks through mutual funds and exchange traded funds (ETFs) in a "great rotation" out of low yielding bonds. The combined inflows into equity funds reached a record $388 billion in the 12 months ended in November, partially sourced from $111 billion flowing out of bond funds from June to November. At the same time, corporations continued to buy back their own stocks. Increasing optimism about the economy and the market on top of the supply-constricting influence of buybacks drove price/earnings ratios up dramatically. 21% of the S&P 500's 32% return was from the P/E ratio increasing. Excitement was also generated by IPO's (initial public offerings) and other deals. Revenue from IPO's to investment banks increased 44% over 2012.

The stock market regained its predictive role as a leading economic indicator.

INVESTMENT IMPLICATIONS

The biggest question for 2014 is the sustainability of the rally. The odds favor yes, as the conditions underpinning the 2013 rally still exist. Last year, forward earnings rose 7%, the forward P/E ratio increased 21%, and the dividend added 2%. Earnings are on track to increase 5-7%, and another 1% in P/E expansion isn't an unreasonable expectation, given the low interest rate environment, the economic expansion seemingly underway, supportive monetary policy, neutral to positive fiscal context, sentiment, buybacks, and cash flows. Add another 2% for the dividend, and returns in the low double digits are possible (although not without volatility along the way).

Moderate growth with low inflation a positive backdrop for equities…

- Earnings: analysts are continuing to increase earnings estimates, and for the first time since 2009 revenue increases are becoming a factor.
- P/E ratio: The S&P 500 P/E ratio rose from 12.6 to 15.3 in 2013. We discuss here the many reasons why P/E's can expand further, but the biggest risk to that thesis is a rise in interest rates. Since 1871, the average P/E ratio has been 15.5; however, the average drops to 12.8 when long term rates are in a secular uptrend and rises to 17.5 when rates are trending down. An uptrend began in May 2013, so the direction and velocity of that trend bear close attention. Rising rates are often associated with inflation, which is virtually non-existent right now, muting the possible negative effect of a move up in rates. Any change in inflation expectations could be a game-changer.

Economic recovery becoming broader based…

- Economic expansion: The economy is gaining momentum and the recovery which began in 2012 with housing is broadening into more sectors. Falling commodity prices are putting more disposable income into consumers' pockets and lowering input costs for many companies.
- Supportive monetary and fiscal environments: The December Fed minutes reiterated the market-friendly position of the central bank, which brings to mind the adage "Don't fight the Fed." Federal and state austerity has been an economic headwind for three years; private GDP growth at over 3% has carried the ball for over a year. With the December federal budget agreement removing concern about further incremental fiscal tightening and most state budgets healthier than they have been in years, the headwind should turn neutral or even become a tailwind in 2014.

Fed continues to ease, but elevated bullish sentiment a concern…

- Sentiment: At over 4 to1, the bull/bear ratio could be cause for concern. However, the predictive value of this ratio is inconclusive when it exceeds 3.
- Buybacks: Corporations are stepping up their return of cash to shareholders through buybacks and dividends. Combined, they reached $207 billion in the third quarter of 2013, almost matching the previous record, and climbing due to record cash in their coffers.. Stock buybacks have exceeded stock issuance since 2010, reducing the total number of shares outstanding.

Companies continue to return cash to shareholders helping to attract the individual investor…

- Cash flows: The momentum of cash rotating from bonds and money markets to stocks appears to be increasing, with individual investors now joining in.

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