A Quarterly Newsletter for Clients of Parsons Capital Management

Perspectives

Quarter 1, 2014

PARSONS
Capital Management, Inc.

CELEBRATING 20 YEARS AND $1 BILLION IN ASSETS UNDER MANAGEMENT.

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QUARTER 1, 2014

by Ruth Mullen and John Mullen

In a choppy first quarter, most averages eked out modest gains. Favorable corporate earnings results vied with geopolitical concerns for investors' attention. Developed country markets, especially the US, handily outperformed emerging markets as the 1970's term "stagflation" (stagnant economy with inflationary pressures) was resurrected to apply to slowing growth coupled with rising interest rates in developing economies. Within the S&P 500, a rotation away from the highfliers of 2013 into more value-oriented stocks was evident.

Data as of March 31, 2014	Mar'14	Qtr. 1 '14	YTD 14
S&P 500	0.84%	1.81%	1.81%
MSCI AC World Index (incl. US)	0.50%	1.21%	1.21%
MSCI EAFE (Europe, Asia, Far East)	-0.57%	0.77%	0.77%
MSCI EM (Emerging Markets)	3.09%	-0.37%	-0.37%
Russell Largecap	0.64%	2.05%	2.05%
Russell Largecap Growth	-1.01%	1.12%	1.12%
Russell Largecap Value	2.39%	3.02%	3.02%
Russell Midcap	-0.27%	3.53%	3.53%
Russell Smallcap	-0.68%	1.12%	1.12%

FIXED INCOME MARKETS

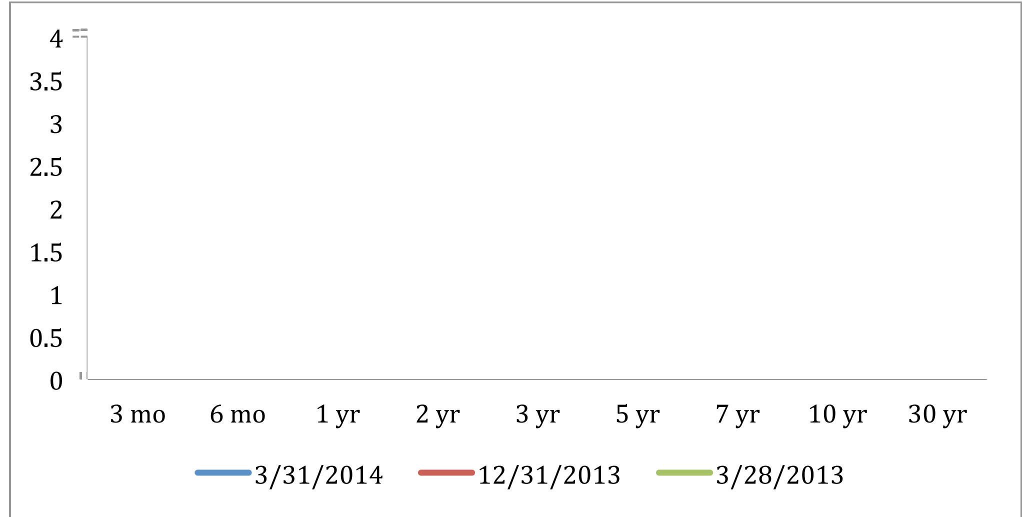
Bonds registered positive returns (lower yields, higher prices) in the quarter, +1.86% as measured by Barclays' Aggregate index, reversing the declines of 2013. Last year's concerns that Fed tapering of bond purchases would lead to higher long term rates was replaced by new worries about Russia's annexation of Crimea as well as the economic health of China and other emerging markets. Risk aversion drove money into longer maturities. Corporate and high-yield bonds performed well (+3%), as spreads between their yields and Treasuries contracted. Propelled by limited new supply and improving fiscal health, municipals generated strong returns (+3.3%).

Perspectives

US TREASURY YIELDS

On March 19, new Fed Chair Janet Yellen said that the central bank's stimulus program could end in the Fall of 2014 and benchmark rates could rise six months later. In response, short term yields increased. Long terms yields fell in relief about long term inflation laced with concerns about slowing global growth.

Long dated yields declined as inflation expectations fell…



COMMODITIES

After dropping more than 20% over the prior three years, commodity prices rose broadly in the quarter. Notable exceptions were basic metals such as copper, and gasoline which fell -3.4%.

Oil prices dropped in January but increased in February and March resulting from cold weather demand and new pipeline capacity from the Midwest to the Gulf coast. Releases from the Strategic Petroleum Reserve helped moderate oil prices. Natural gas rose only +2.84% ($0.12) for the quarter but repeatedly spiked over $7 (an 80% move) during the cold snaps in January and February. Food prices jumped, paced by soybeans, corn, and wheat.

Following three years of declines, commodities rallied to start the year…

Looking ahead, the US Energy Information Administration's annual report predicts that oil and gas production increases will exceed worldwide demand in 2014 and 2015, which should limit further price increases.

Supply and demand fundamentals should keep oil prices in check…

Commodity	Qtr. 1 14	Year to Date 14
CRB (broad index)	8.74%	8.74%
Oil (West Texas Intermediate)	3.21%	3.21%
Gold	7.51%	7.51%

Gold followed a precipitous drop in 2013 with a snapback rally, +11% through March 17, mostly due to worries over Russia and the Ukraine. Gains were sliced after Fed Chair Yellen's remarks on policy.

ECONOMIC OVERVIEW

The US economy ended the first quarter of 2014 on a stronger note:

- January-March payroll employment grew by 533,000 jobs, and unemployment ended the quarter at 6.7%.
- The federal budget deficit fell below 3% of GDP in March for the first time since the second quarter of 2008. Tax revenues reached 17.1% of GDP, slightly above the long term (since 1960) average. Spending declined to 20% of GDP, higher than its long term average of 19.3% but down 4% from 2010. Put another way, current fiscal year tax receipts were up +10% from the same period last year and spending was down -3.4%. Revenues were helped by job creation and consequent payroll withholdings as well as tax increases and capital gains. Defense spending was constricted by sequestration; health care spending (especially Medicare) increased less than actuarial projections.

Increased employment and higher tax rates led to a surge in government revenue…

- Preliminary first quarter trade data points to a reduction in that deficit as well. Usually, trade deficits increase during economic expansions, as consumers demand more imports – especially energy. In this expansion, energy imports are decreasing due to rising domestic production; in addition, OPEC imports have fallen to 45% of the total while non-OPEC imports (mostly Canada and Mexico) have risen to 55%. Roughly 1/3 of the improvement in the trade deficit is due to petroleum.

Domestic energy trends helping to reduce deficits…

- The manufacturing workweek reached 40.9 hours on average in March, the highest since the 1950's. This helps explain the increase in consumer disposable income and also portends continued hiring increases.
- The American Bankers' Association consumer loan delinquency rate has plunged from a peak of 3.4% in late 2009 to 1.59% at the end of 2013, by far the lowest rate in over 35 years.
- After two months of weather-reduced demand, vehicle sales jumped 6.9% month over month in March, to 16.3 million annualized, and auto executives predicted further gains in April. Retail sales surged 1.1% in March, on top of prior month gains.
- Higher home prices (+13% year over year) and rising wages drove an increase in consumer confidence in the first quarter, but it was bifurcated. Confidence increased in households earning $50,000-$75,000 and $125,000 and over, but fell in households earning $15,000-$25,000.

Increased consumer confidence not universal…

- The NFIB Small Business Optimism index rebounded in March +3.2 points to 94.2, up from 87.8 at year end 2012.

Signs that the expansion is sustainable:

- The engine of growth is the private sector, and headwinds from government contraction have probably turned neutral. Since 2010, government workers' wages have increased just 1.5%, while private wages have increased 19.7%. Private sector GDP has increased an average 5.1% over the last 3 years, while government fiscal spending has been a drag on overall GDP growth.
- Inflation remains low, and low inflation recoveries tend to last longer - 33 quarters on average. This one is 19 quarters in duration so far.

Private sector growing faster than the public sector while inflation remains tame…

- The economic impacts of the manufacturing and energy renaissances are broadening.
- The Eurozone recovery appears to be stabilizing.

Trouble spots to be watched are student loans, gasoline prices, the China slowdown, US Federal Reserve monetary policy, and Russia's actions with its neighbors.

INVESTMENT IMPLICATIONS

Is the five year bull market sustainable? History can only provide reference material, since the current environment is never the same; however, being aware of what markets have done in past contexts helps to assign odds to what may happen going forward and to position portfolios accordingly.

Unusually long time without a significant correction…

There hasn't been a 15% correction for over two years, the longest stretch since the previous bull market ended in 2007. This rally has outlasted the historical average of other bull markets going back to 1928, with higher returns. However, the preceding bear market of 2008-2009 was much steeper than average, so "round trip" gains measured from the beginning of the bear through the current bull are still below average at 20%. Past bull markets that survived to a 6th year have accumulated much larger gains.

Since the 1970's, every correction was spurred by either Fed tightening, higher oil prices, or a significant global financial crisis.

Fed pledges to remain accommodative even while reducing QE…

- Fed tightening: the unprecedented stimulus of the last 6 years is waning in effectiveness. Arguably it needs to be tapered now that the private sector recovery appears solid, in order to begin to address the imbalances that have resulted and avoid even bigger problems in the future. That recognition, on top of the careful Fed communication campaign preparing investors, has resulted in an orderly readjustment in the bond market so far. Any misstep along the way could produce varying degrees of distress in bonds or stocks or both, as we saw with some of our new Fed Chair Yellen's recent remarks.
- The outlook for oil prices has a definite downward bias from a supply/demand viewpoint - good for stocks, bonds, and corporate profits. Russia's activities present short term risks. Usually, geopolitical flare-ups are buying opportunities; however, one issue to keep in mind with Russia is that Europe is its largest trading partner, and an economic meltdown in Russia could destabilize the fragile recovery in Europe, producing more widespread consequences.
- Financial conditions in Asia have deteriorated. The re-tooling of China's economy from investment to consumption is ushering in a period of slower growth and deleveraging, which could get disorderly. Japan's tax hike raises concerns about a demand shock in an important economy.

Stocks levered to US economy outperforming YTD…

And of course, the risks we can't see are always there. These cross currents will undoubtedly add to volatility, but the strength of the mid-cycle low inflation US economic expansion provides a supportive backdrop for US equities. The first quarter negative return of the Dow Jones Industrial Average, which is comprised of mostly giant multi-national companies deriving significant earnings from abroad, vs. the S&P 500 positive return, indicates a move of investment dollars toward US-centric companies rather than out of the market.

Putting all of this together, the current turmoil in the US market looks to us more like a rotation in an ongoing bull than the start of another bear.

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