A Quarterly Newsletter for Clients of Parsons Capital Management

Perspectives

Quarter 4, 2014

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The fourth quarter was marked by impressive performance from the US markets, highlighting a year in which the S&P 500 recorded 53 new all-time closing highs. The strong fourth quarter showing by US smallcap stocks allowed them to end the year with a positive return, though still far behind their large and midcap peers. International stocks, both developed and emerging, continued lagging in the quarter despite a 37% rise by the Shanghai A Shares Index, widening the 2014 gap between US performance and the rest of the world.

Data as of Dec. 31, 2014	Dec. '14	Qtr. 4 '14	YTD '14
S&P 500	-0.25%	4.93%	13.69%
MSCI AC World Index (incl. US)	-1.57%	1.12%	5.50%
MSCI EAFE (Europe, Asia, Far East)	-3.44%	-3.53%	-4.48%
MSCI EM (Emerging Markets)	-4.56%	-4.44%	-1.82%
Russell Largecap	-0.23%	4.88%	13.24%
Russell Largecap Growth	-1.04%	4.78%	13.05%
Russell Largecap Value	0.61%	4.98%	13.45%
Russell Midcap	0.21%	5.94%	13.22%
Russell Smallcap	2.85%	9.73%	4.89%

FIXED INCOME MARKETS

After punishing investors in the prior year, the bond market enjoyed strong 2014 performance. The best returns came from bonds that suffered the most in 2013, and long term bonds surprised nearly everyone with significant outperformance vs. shorter maturities and even vs. stocks. The US 30 year Treasury index returned +22.66% for the year, while 1-3 year Treasuries eked out a small gain of 0.62%. High yield bonds suffered in comparison due in part to weakness from the energy sector, turning negative at -1.06% in the quarter and just +2.50% for the year. In stark contrast year over year, municipal bond funds saw net inflows of $21 billion in 2014 vs. redemptions totaling $63 billion in 2013; the broad municipal index earned +9.05%.

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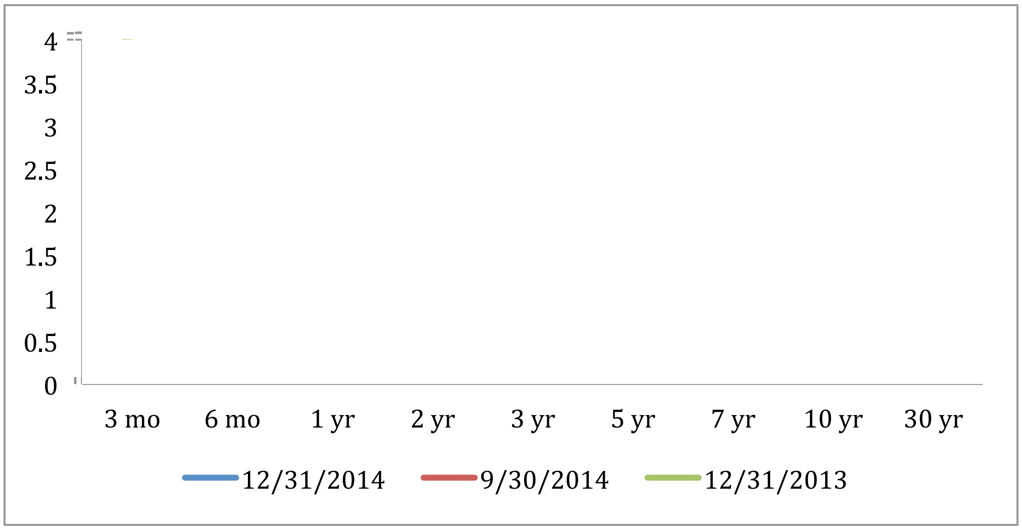
US TREASURY YIELDS

Long bonds catch a bid and the curve flattens, even as the Fed ends QE…

The flattening of the yield curve gained momentum in the fourth quarter. By the end of the year, the yield on the US 10-year Treasury had declined 87 basis points to 2.17%, and the 30-year ended 2014 with a yield of 2.75%, a drop of 121 basis points. This drop in yields occurred even as the US Fed ended their purchase of Treasuries under the most recent QE program and economic growth surprised to the upside, pointing to continued demand from foreign investors.



COMMODITIES

OPEC holds production steady as oil gets pummeled…

The selloff that began for commodities in the third quarter showed no sign of easing in the fourth. Falling demand in China and other emerging economies put downward pressure on prices. Saudi Arabia surprised the market by declining to act as the swing producer of oil, deciding to defend their market share instead of the price of oil. The inaction of OPEC, a departure from past practices, accelerated the drop in prices. At the same time as US domestic output increased, production unexpectedly rebounded in war torn areas like Iraq and Libya, adding to the world supply glut. In concert with oil, gasoline in the US fell 41.65% in the quarter, ending the year down 44.15%.

The price of natural gas also fell during the quarter, down 27.79%, on relatively mild weather and continued strong production domestically. Natural gas ended the year at $2.91, down more than 31% over 12 months.

Gold a relative winner in the commodity space…

With inflation continuing to slow and the rise in the dollar, gold remained unappealing, ending the year with a slight negative return.

Commodity	Qtr. 4 '14	Year to Date '14
CRB (broad index)	-17.44%	-17.92%
Oil (West Texas Intermediate)	-37.89%	-45.87%
Gold	-1.42%	-0.19%

ECONOMIC OVERVIEW

The fourth quarter was again marked by a US economy that powered higher despite weakness in much of the rest of the world. Leading economic indicators rose, indicating continued growth ahead. With a relatively closed economy, as evidenced by exports comprising less than 15% of GDP, America is less reliant on world growth than many other countries. Consider that in the quarter:

Strength in the American economy broad based…

- US Manufacturing PMI in December was 55.5 (anything over 50 indicates expansion) while the International reading was 52.3.
- 252,000 jobs were added in December. The US has added at least 200,000 jobs for 11 months, the longest such streak since 1994.
- US labor productivity rose, offsetting wage increases to keep unit labor costs steady compared to many international markets where ULC's are on the rise.
- US third quarter GDP was revised up to +5% while Japan and the UK both lowered their GDP numbers.
- The US Fed ended their QE program and turned an eye towards eventually raising rates; in contrast, the European Central Bank laid the groundwork for embarking on their own QE, Japan expanded theirs, and countries from China to Romania moved to ease.

America reemerging as the driver of global growth…

- Foreign related capital expenditures have been weak, but US focused capex remains in a strong uptrend and is now 13.4% above its prior peak in 2009.
- There is the very real potential that US real GDP grows at a faster rate than Emerging Market GDP, which last occurred in 1999.

While the US economy significantly outpaced the rest of the world, the quarter still provided a mixed bag of data points that show steady but not breakneck growth:

Two steps forward, one step back…

- New house sales fell in November and were revised down in October. Mortgage rates under 4% have little effect when new house prices continue their upward trajectory, hurting affordability.
- While the manufacturing PMI (measuring growth in the manufacturing sector) remained high in December, it was still down from 58.1 in November with other regional surveys pointing to a slowdown in growth.
- Though oil related capex and employment are a small percentage of the overall economy, they have been sources of strength during the recovery. To sustain momentum, other sectors will need to participate.
- Restrained spending coupled with higher taxes and economic growth shrank the Federal deficit to 2.8% of GDP.

The present situation continues to look bright for the US consumer. Inflation remains low and stable. Savings from the recent drop in energy prices is estimated to be the equivalent of a $200 billion tax cut. Consumers are also enjoying an improving income picture with real disposable personal income growing at an average rate of 2.5% since 2013 compared to only 2.1% going back to 2010. Such gains are likely to persist into the New Year with 24 states raising their minimum wage.

US consumers enjoying multiple tailwinds while the picture is much bleaker for many international countries…

Meanwhile, unemployment sits at 11.5% in the Eurozone, with 23.7% of their youth without a job, inflation already negative and wages growing at just 1.4%. In Russia, weak oil prices and international sanctions have combined to send the Ruble down 42% in the last months of the year, forcing their central bank to raise rates even as growth slows to almost zero. China has resorted to targeted easing to minimize the impact of slower government investment and a deflating credit bubble.

INVESTMENT IMPLICATIONS

Outside of two minor selloffs in February and October, 2014 churned out one new all-time closing high after another. In contrast to 2013, growth in corporate earnings provided the impetus for the bulk of the gains. P/E expansion and dividends did the rest. Looking forward to 2015, however, there are ample reasons for caution:

Another record year for the S&P, though gains look harder to come by going forward…

- 2014 ended with the S&P sporting a forward P/E ratio of 16.7, leaving little room for P/E expansion to drive returns.
- Earnings per share in the S&P are currently projected to increase 8% in 2015, but the expected weak earnings for energy related companies make this a difficult number to reach.
- Dividend growth in the S&P is expected to decelerate over the next year, growing at 8.3% versus 10.3% in the past year. At the same time, share buybacks are unlikely to match their 27% growth in the past 12 months.

Declining oil will aid the US but will wreak havoc on many oil exporting countries…

- The lagged effect of the decline in oil prices will be more keenly felt in 2015, with consumers enjoying the aforementioned tax cut equivalent to $200 billion thanks to lower energy costs. At the same time, energy related capex is scheduled to fall $100 billion, negating some of that gain.
- With Russia all but certain to fall into a deep recession this year and countries like Brazil, Spain, France and Japan all flirting with negative growth, there is potential for social unrest.
- Volatility is returning to the market following the end of US QE, with 17 prince swings of +/- 1% of the S&P in the last 3 months of the year compared to just 21 in the first 9 months.

End of QE and precipitous drop in oil prices indicate increased volatility ahead…

Even with these various headwinds, there are reasons to remain constructive regarding the US market:

- Many of the difficult choices facing other countries (shoring up banks, consumer deleveraging, reducing government deficits) have already been addressed in the US.
- Corporations and consumers are increasingly confident, pointing to an economic recovery that is becoming self-sustaining.
- US dollar strength will continue to help dampen inflation at home, aiding consumer purchasing power as the labor market continues to strengthen.

While not perfect, the outlook for the US is better than most…

- Though the S&P looks close to fully valued on a price-to-earnings basis, it compares favorably to many international markets where the P/E ratio is higher or expected earnings/economic growth are lower, and to the bond market where valuation continues to look stretched.

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