A Quarterly Newsletter for Clients of Parsons Capital Management

Perspectives

Quarter 1, 2016

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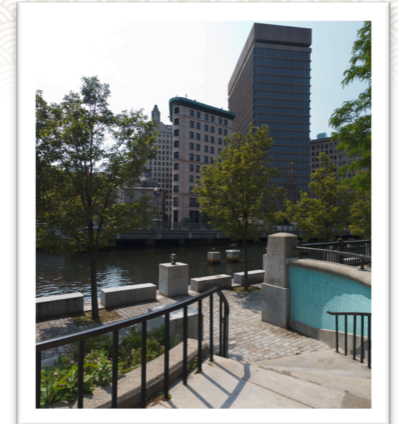

QUARTER 1, 2016

by John Mullen and Ruth Mullen

If investors simply looked at market levels on December 31st and March 31st, they might conclude that the first three months of 2016 were relatively mundane. In reality, an 11% decline in the S&P500 over the first five weeks, accompanied by near-daily headlines trumpeting the historically poor start, gave way to a furious 13% rally beginning February 12th. After a multi-year run of underperformance not seen since the height of the Tech Bubble, value stocks outpaced their growth counterparts. Internationally, emerging markets bucked the trend of the last three years to outperform developed markets, (including the US) as Japan and many European indices posted negative returns.

Data as of March 31, 2016	March '16	Qtr. 1 '16	YTD '16
S&P 500	6.78%	1.35%	1.35%
MSCI AC World Index (incl. US)	7.48%	0.38%	0.38%
MSCI EAFE (Europe, Asia, Far East)	6.59%	-2.88%	-2.88%
MSCI EM (Emerging Markets)	13.26%	5.75%	5.75%
Russell Largecap	6.97%	1.17%	1.17%
Russell Largecap Growth	6.74%	0.74%	0.74%
Russell Largecap Value	7.20%	1.64%	1.64%
Russell Midcap	8.19%	2.24%	2.24%
Russell Smallcap	7.98%	-1.52%	-1.52%

FIXED INCOME MARKETS

Returns in the fixed income markets mirrored the risk on rally in the equity markets over the second half of the quarter. High yield bonds rebounded strongly after falling -1.6% in January to finish the quarter with a positive 3.25% return, besting the 3.03% return for the overall bond market as measured by the Barclays Aggregate. Municipal bonds, having outperformed the Aggregate handily the last two years, got off to a slower start in 2016 returning 1.67%. Long term bonds, the second worst performer last year only to high yield, were the star in the quarter with a 7.30% gain.

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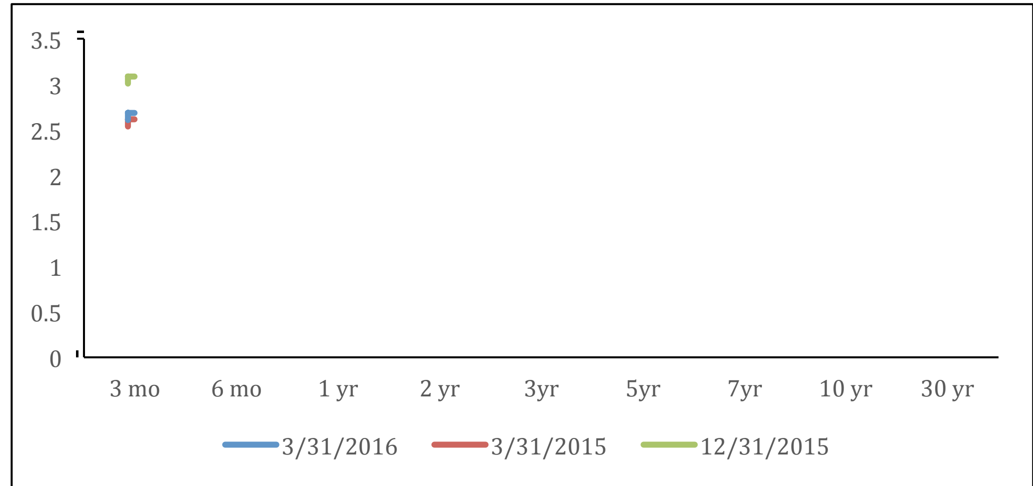
US TREASURY YIELDS

Excluding the 3-month Treasury, yields all along the curve fell during the quarter. The two year Treasury yield fell 33 basis points to 0.72% as the Federal Reserve moderated their earlier call for four rate hikes in 2016. At the same time, 10-year yields were down half a percentage point to 1.77% due to the economic growth outlook being called into question. With the 10-year falling faster than the 2-year, the curve flattened and the spread of 1.05% ended the quarter steeper than its low of 0.99% on February 11th as the growth scare abated.

The yield curve steepened as the equity market rallied…



COMMODITIES

The widest measure of commodity prices, the CRB Index, began 2016 in much the same way it finished 2015 with a decline of -3%. The performance of the Index constituents, however, indicated that the world economy may be stabilizing.

CRB weakness fails to tell the whole story…

Gold was, by far, the biggest gainer in the quarter. The yellow metal, which had already risen 5%, took off when the Bank of Japan surprised markets in announcing their move to negative interest rates. Speculation that the Fed would be forced to follow sent demand soaring.

Central bank interventions send demand for gold soaring…

Oil, as measured by West Texas Intermediate, began the year with a 30%+ drop in price before bottoming on February 11th. Talk of an agreement between OPEC and Russia to freeze output helped establish a price floor from which oil rallied as economic indicators from around the world began to surprise to the upside.

Other economically sensitive commodities, like silver and copper, also registered gains for the quarter and were among the first to turn. In contrast, a mild winter pushed natural gas prices down 19% and agricultural goods broadly fell. These were enough to turn the CRB negative.

Improving economic picture behind the jump in oil, copper…

Commodity	Qtr. 1 '16	
CRB (Commodity Research Bureau) Index	-3.19%	-3.19%
Oil (West Texas Intermediate)	3.12%	3.12%
Gold	16.40%	16.40%

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ECONOMIC OVERVIEW

US: The first weeks of 2016 brought a torrent of disappointing economic results and weak projections. Among them:

- Productivity for the 4Q of 2015 fell 2.2% while labor costs rose 3.3%.
- Optimism among small business fell in January and February.
- Indices measuring manufacturing and service output also fell in the first two months while retail sales came in lower than expected.
- AutoNation predicted car sales for the year below Wall St. estimates.

2016 began with disappointment…

Recession fears emerged amidst headlines blaring that markets were off to their worst start ever. Indicators of economic health, like the price of oil and inflation expectations, continued to drop - feeding the recession narrative. As February gave way to March, a new picture started to take shape, one that indicated the US economy was much the same as it has been throughout this recovery; anemic but still growing.

Solid job market a bedrock for US economy, consumers…

While national monthly economic indicators remained weak, the more timely regional surveys started to increase pointing to an economy gaining momentum as the quarter went on. Job growth remained robust, averaging 209,000 jobs created per month, while the labor force participation rate increased each month. House prices continued to increase, but affordability remained high thanks to mortgage rates under 4% while the growth in average hourly earnings ticked up to 2.3%. All this helps explain the 2.2 point jump in the March consumer confidence survey to 96.2.

Slow and steady…

Looking forward, the US economy seems likely to continue the low growth path it has been on over the past few years. Tax and spending legislation passed last year should add 0.6% to GDP this year. States not heavily reliant on oil production (the majority) are expecting another year of solid gains in tax revenue, further lessening austerity at the local level. Orders for manufacturing equipment are turning up, albeit from a low base.

Europe: While the economic prospects are, on the whole, positive for the US, Europe is being buffeted by headwinds on multiple fronts:

- Terrorist attacks, besides the horrific human toll, have had a profound impact on planned travel to Europe with hotel vacancy rates over 60% in Brussels.
- The refugee crisis continues to stress the budgets of many EU countries.
- The euro is increasing in value, constraining exports.
- The outcome of a vote in the UK on whether to remain in the EU is creating uncertainty, and likely holding back the economy there.
- Negative interest rates are hurting bank profitability and curbing lending.

Multiple pressures facing Europe…

The situation is not all dire, however. EU unemployment has fallen nearly a full percentage point from last year to 10.3%. Manufacturing activity picked up in March after declining the previous two months, while various sentiment surveys also turned up. Overall, the picture in Europe is similar to the US, but with lower growth and more potential hurdles. At the same time, in contrast to the US, the ECB continues in their attempts to stimulate the economy.

Japan backsliding while China looks to be stabilizing…

Asia: A surprise move to negative rates may have backfired on the Japanese central bank. Since the announcement, the Yen has gained in value while the corporate inflation outlook has deteriorated, pointing to lower expected growth going forward.

In China, the central bank spent much of the first 5 weeks of the year doing everything in its power to reverse the slide in the yuan. In addition, the government continued to introduce targeted programs to support economic growth. As March ended, both efforts showed signs of success with the yuan well off its January lows and signs of improvement in the manufacturing and services industries.

INVESTMENT IMPLICATIONS

The dramatic surge in February and March begs the question: can it continue?

Janet and the Fed supporting market sentiment…

Both worldwide central bank action and macroeconomic factors are important supports for a continuing return to risk assets. Fed Chair Janet Yellen helped to usher in the quarter-end rally with her Congressional testimony February 10-11. She emphasized concerns about the strength of the dollar, rising borrowing costs, market volatility, and weakness in China's economy and currency. Since all of these are de facto tightening monetary conditions, the immediate need for the Fed to raise rates has lessened. Suddenly, the fear that had driven stock prices down turned to enthusiasm for risk.

Worldwide easing efforts starting to bear fruit…

Outside the US, the effects of the easing cycle that began roughly 1½ years ago are now showing up in world economies, especially those of emerging countries. Currencies of countries sensitive to world growth are rising, an important leading indicator. This development calms fears that the US is the only world economy which is expanding and that weakness in our trading partners will pull us into recession.

The 50% increase in the price of oil has reduced worries of major financial disturbances from its collapse. Reduction in fear usually evolves into embracing of risk. The oil price improvement has also helped economies which are dependent on energy exports, which in turn should support global growth.

The US dollar is now down relative to world currencies year to date. Interestingly, for 40 years the direction of the dollar has been the mirror image of world GDP growth. A continued downtrend would then argue for rising worldwide GDP.

Earnings key to market returns going forward…

Against a decidedly improving if uneven global backdrop, we see three areas of potential concern.

1. Stock prices are rising but earnings aren't. With the market ending the quarter trading at >17x projected earnings for 2016, earnings growth will be paramount to returns going forward. The weakening dollar coupled with growth both domestically and abroad, should they continue, will help both revenue and earnings, particularly those of multinational companies.

Number of hikes remain a wild card while election uncertainty to remain an overhang through fall…

2. The Fed raises rates. This does not always result in market setbacks, especially when rates are raised in times of economic strength, but at some point rates will be normalized and the reaction could go either way.
3. The November election will remain a headwind for the market, especially with this year's uncertainties and stark choices. Going back to 1933, the performance of the S&P in an open Presidential election year, +1%, is markedly weaker than non-Presidential election years or Presidential re-election years, both +9% on average.

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