A Quarterly Newsletter for Clients of Parsons Capital Management

Perspectives

Quarter 2, 2016

PARSONS
Capital Management, Inc.

Corporate Headquarters
10 Weybosset Street
Suite 1000
Providence, RI 02903-2808
Phone 401.521.2440
Fax 401.521.4870
Toll-Free 888.521.2440

Florida Office
11450 SE Dixie Highway
Suite 205
Hobe Sound, FL 33455
Phone 561.868.2440

QUARTER 2, 2016

by John Mullen and Ruth Mullen

Improving global growth indicators lifted stocks for much of the quarter, until uncertainty reintroduced volatility during the last weeks of June. Buoyed by a dovish Fed domestically and polls indicating that the U.K. would vote to remain in the EU, investors grew increasingly comfortable with risk as reflected in the outperformance of value versus growth stocks, smaller cap stocks and emerging market indices. A surprise victory for Brexit sent stocks tumbling, especially in Europe, and safe haven assets soared for two days in late June, but a quick rebound brought most indices outside of Europe to positive returns by month end.

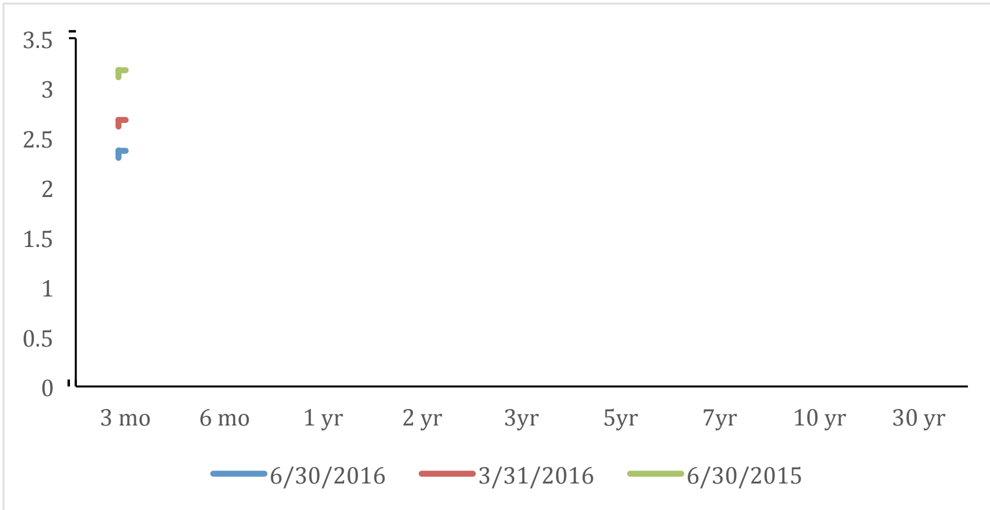
Data as of June 30, 2016	June '16	Qtr. 2 '16	YTD '16
S&P 500	0.26%	2.46%	3.84%
MSCI AC World Index (incl. US)	-0.55%	1.19%	1.58%
MSCI EAFE (Europe, Asia, Far East)	-3.32%	-1.19%	-4.04%
MSCI EM (Emerging Markets)	4.10%	0.80%	6.60%
Russell Largecap	0.23%	2.54%	3.74%
Russell Largecap Growth	-0.39%	0.61%	1.36%
Russell Largecap Value	0.86%	4.58%	6.30%
Russell Midcap	0.46%	3.18%	5.50%
Russell Smallcap	-0.06%	3.79%	2.22%

FIXED INCOME MARKETS

The unexpected win by the leave camp in the Brexit vote drove a flight to safety in the closing week of June. Even as stocks managed to rebound, the fixed income markets held up indicating that there remains a great deal of uncertainty on the path forward for the U.K. and the EU. Long dated US Treasuries were the biggest beneficiary of the market turmoil, returning 6.42% in just the month of June and 6.76% for the quarter. For the first six months, US government and investment grade bonds maturing in 20+ years have returned 14.33% - handily outperforming stocks. Improving economic prospects allowed high yield bonds to narrow the performance gap from the first quarter, with a return of 4.77% versus 4.09% for investment grade.

US TREASURY YIELDS

The effect of the Fed rate hike from last December can clearly be seen when comparing the short end of the curve at the end of June to a year ago. The cause for the drop in longer rates is not as straightforward. Nearly the entire decline in long rates occurred in the aftermath of the Brexit vote, indicating a flight to safety and concerns over future growth. As stocks rebounded, Treasury yields remained pinned instead of rising, a factor of declining yields abroad. Indeed, in a world where government bond yields for Germany and Japan are negative 10 and 20 years out, respectively, demand remains high for US Treasuries despite historically low yields.



Curve flattened as Brexit drove demand for safe-haven assets…

COMMODITIES

After declining in each of the past three years, commodity prices as measured by the CRB Index surged higher by 13% in the quarter, led by oil and natural gas. What makes this advance all the more notable is that it occurred even with the dollar appreciating, bucking a multi-year trend.

Oil prices higher as supply/demand comes into balance…

Oil, which had begun to rally in the first quarter, continued higher and ended June 84% above its February lows. Oil prices were supported by unplanned outages in Canada, Nigeria and Venezuela, while production in the US continued to slide lower. At the same time, world demand for oil has remained strong. All this has contributed to supply and demand coming into balance much sooner than had been forecasted.

Dr. Copper giving upbeat assessment of global growth…

The rally in gold and silver that began with the introduction of negative rates by the Bank of Japan continued in the second quarter. Additional easing measures from the central banks of Switzerland, Japan and the EU pushed yields further into negative territory, increasing the appeal of the metals.

Copper, long heralded as a barometer for the strength of the global economy, rallied strongly in June and is now up nearly 3% year to date.

CRB bucking 3 year down trend…

Commodity	Qtr. 2 '16	Year to Date '16
CRB (Commodity Research Bureau) Index	13.01%	9.48%
Oil (West Texas Intermediate)	26.06%	30.48%
Gold	6.88%	24.56%

ECONOMIC OVERVIEW

US: The quarter began with heightened concern regarding the economy after an initial estimate for GDP growth of only 0.5%. The April data did little to assuage these concerns with retail sales, housing and employment numbers all indicating an economy that was not accelerating. As April turned to May, the data began to improve along numerous fronts:

US economy shaking off 1Q doldrums…

- Mortgage applications for purchase posted strong gains in May and June
- Industrial production in May (latest available), though down 1.4% from 2015, came in better than expected
- Consumer spending rose 1% from April to May, the largest one month gain in nearly 7 years
- Consumer confidence jumped nearly 6 points to 98 in the June survey helped by a 2.8% gain in wages & gas prices 27% lower than last year
- Initial jobless claims remained near historic lows
- Oil and gas rigs increased 15 from their May low of 434
- Bank loans increased 7.4% year over year in June

Consumers feeling better and spending more…

Perhaps no single data point did as much to change the narrative on the strength of the US economy than the June jobs report. After disappointing reports in April and May, in which the job gains were less than expected and the participation rate declined, June was a blowout. The US added 287,000 jobs in June, 112,000 more than had been expected. Even more encouraging, the participation rate saw a huge jump from 62.2% in May to 62.9% in June as citizens reentered the workforce, encouraged by their prospect of getting a job.

Auto sales showing some cracks…

Not everything improved in the quarter, however. Auto sales increasingly looked to have peaked with the 3 month average in June at 17.1 million versus 18.1 million in December. This slowdown has happened even as outstanding auto loans topped $1 trillion for the first time ever. At the same time, the wider manufacturing sector is still being held back as customers work off higher than desired inventory levels.

Europe: Unlike the US, the quarter opened on a strong note for Europe with better than expected GDP growth of 2.1% for the EU. That strength largely continued throughout with improving readings for both the services and manufacturing Purchasing Managers Index. That was the good news. The surprise vote by the U.K. to leave the EU was an unexpected outcome and resulted in the outlook for Europe being ratcheted down, even more dramatically so for the U.K. The uncertainty had already begun to take a toll on the U.K. economy with growth slowing and consumer confidence turning down in the run-up to the June vote. The quarter ended with the central banks of Europe and the U.K. signaling plans for further easing measures.

Brexit fallout the great unknown…

Asia: The Bank of Japan continued its massive QE program and signaled a willingness to push the target interest rate further into negative territory to spur the economy. The BoJ was forced to expand its purchases from government bonds into domestic equities, becoming a top 10 shareholder in 90% of the Nikkei 225 constituents. While growth in Japan has remained stubbornly subdued, wage gains have accelerated recently - typically a precursor to a wider pickup in inflation.

Japan pushing policy hard, China trying to balance demands…

China seems to have found some success in the near term in their attempts to reform the economy while keeping growth at an acceptable level. In contrast to the first quarter, the relative stability in worldwide markets allowed the Chinese central bank to let the yuan drift lower without seeing a spike in capital outflows from the country. In reaction to surging home prices and signs of speculation, the central bank took steps to curb lending - a proactive move in an attempt to ward off a bubble. At the same time, the government announced a new round of stimulus in the form of a $450 billion monorail line.

INVESTMENT IMPLICATIONS

Brexit just the latest in a series of shocks…

Worst of post-Brexit fears yet to come true…

Bond and stock performance telling two different stories…

Presidential elections odds starting to show in stock performance…

A relief rally began at the end of June when investors' worst fears failed to materialize. Since March 2009, the market has climbed the proverbial "wall of worry" again and again as one serious issue after another has avoided disaster. Think of the US debt ceiling crisis, 2012 fiscal cliff, US government shutdown, sequestration, the Greek/EU crisis (parts 1 and 2), and the China growth scare – just to name a few. No wonder this bull market has been labeled as one of the most unloved in history.

This time, the Brexit vote sparked concerns about bank liquidity, the potential for other countries to leave the EU, currency chaos, and an economic slowdown. Liquidity was immediately addressed by central banks proactively injecting cash into the banking system and announcing the ability and willingness to do more – a very different response from 2008. In Spain, the pro-EU party registered an unexpectedly strong showing in the polls. A sense of EU solidarity rather than disintegration emerged. The pound sterling fell, but other currencies stabilized. The US Fed looked smart for not having raised rates, and the phrase "lower for longer" referring to interest rates took hold. Then, the icing on the economic cake came in the final days of June as various economic indicators in the US and China – even Japan – came in stronger than expected. The market likes the combination of improving growth with low interest rates.

How long can this aging bull last? The anomalous relationship between long term interest rates which continue to fall (usually a sign of weakness to come) even as the stock market rises sets a cautionary tone. For the moment, "lower for longer" continues to steer more cash into risk assets in the pursuit of higher returns. The significant increase in the price of oil – up over 80% from its cyclical low – has so far been a tailwind to stock prices by reducing the risk to companies and countries tied to its production. As the effects of this increase work their way through the system and into the CPI, however, inflation could return to uncomfortable levels and become a headwind.

With the US elections coming in November, we look to handicap the effects on industries and companies of Republican or Democrat victories at the presidential and Congressional levels. A Clinton win is positive for infrastructure spending and government contractors, and negative for managed care companies (the introduction of the public option) and pharmaceuticals (price controls). Big banks could come under more pressure, but a lot of bad news is already priced in there. Minimum wage increases are expected to hurt the retail and restaurant stocks. The other side of that coin is that increased consumer spending of wage hikes, if it materializes, should help revenues in targeted sectors. A Trump win is more difficult to quantify due to the fluidity and even lack of stated policy, though multinationals are at risk from a drastic shift in tax and trade agendas.

One thing we can expect is continued volatility resulting from the speed of events and movement of money in and out of markets. We prefer to own strong companies with the ability to manage through difficult times.

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