A Quarterly Newsletter for Clients of Parsons Capital Management

Perspectives

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QUARTER 3, 2016

by John Mullen and Ruth Mullen

The third quarter was marked by strong returns, internal turmoil and changes in many longstanding relationships between asset classes. Markets shook off the shock of Brexit and turned in the best performance of the year. Emerging markets, which stumbled in the second quarter, easily outperformed the developed world with Chinese equities leading the charge up 14%. Markets in Europe rebounded as the worst fears regarding Brexit fallout failed to materialize and the ECB expanded its easing program. Equities in the US exhibited their own tilt towards risk with small and midcap stocks both outperforming larger peers. While most equity markets demonstrated a decidedly risk-on preference, the performance of growth stocks when compared to value signaled a more apprehensive outlook.

Data as of September 30, 2016	Sept. '16	Qtr. 3 '16	YTD '16
S&P 500	0.02%	3.85 %	7.84%
MSCI AC World Index (incl. US)	0.66%	5.43%	7.09%
MSCI EAFE (Europe, Asia, Far East)	1.27%	6.50%	2.20%
MSCI EM (Emerging Markets)	1.32%	9.15%	16.36%
Russell Largecap	0.08%	4.03%	7.92%
Russell Largecap Growth	0.37%	4.58%	6.00%
Russell Largecap Value	-0.21%	3.48%	10.00%
Russell Midcap	0.20%	4.52%	10.26%
Russell Smallcap	1.11%	9.05%	11.46%

FIXED INCOME MARKETS

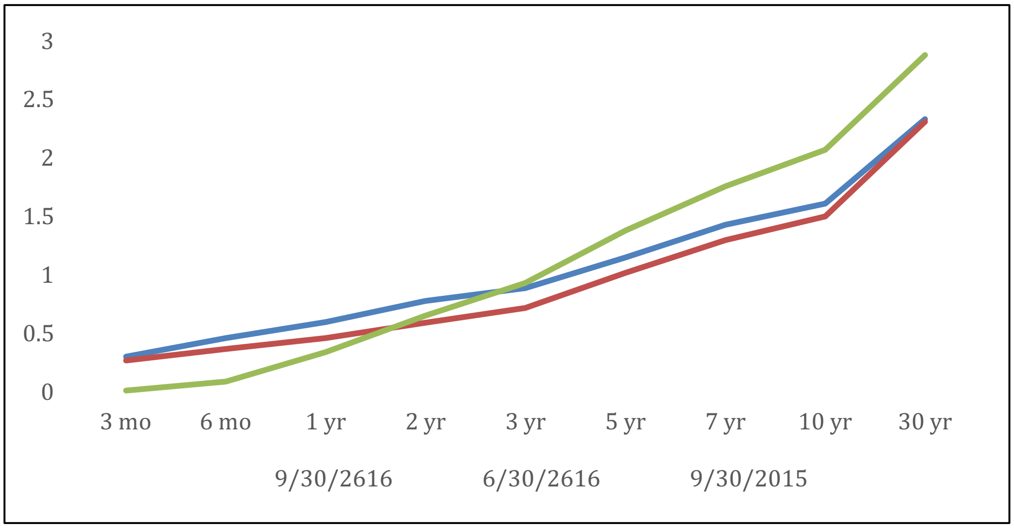
The appetite for risk was not confined to stock markets. Speculative sections of the fixed income market, where bonds are more actively traded, added to previous gains to post year to date returns more normally seen in good years for stocks. Through September 30, long US Treasuries were up +15.74%; high yield +15.32%, and foreign bonds outperformed domestic, paced by emerging markets. Municipals and short term bonds logged slight negatives for the quarter, leading to more muted year to date returns of +4.01% and +1.33% respectively.

US TREASURY YIELDS

BoJ actions felt around the world…

With all of the world's major central banks maintaining, or even expanding, their accommodative stance in the quarter, the yield curve did not change much at either end when compared to the end of June. Short yields in the US had moved up through July and August in anticipation of a potential hike by the Fed at their September meeting but fell back towards June levels when the decision to hold was announced. 10 and 30 year yields had risen higher throughout the quarter but the decision by the Bank of Japan at their September 29th meeting to explicitly target 0% for their 10 year yield brought rates around the world back near their June levels.

Higher inflation outlook pushed up intermediate term yields in the US…



COMMODITIES

Commodity prices, after posting impressive returns for the first six months of the year, reversed lower during the third quarter. Agricultural prices were the primary reason for the decline in the CRB with particular weakness seen in corn, wheat and soybeans. Lumber was a notable exception, rallying +10%, as home construction remained solid in the quarter.

Agriculture weakness weighed down broader commodity index…

Oil weakened significantly to start the quarter, down -12% by the start of August, as concerns mounted over the potential for new supply to come online and signs of slowing economic growth. As inventory data came out pointing to a much tighter spread between supply and demand, oil prices rebounded. After abandoning production quotas nearly two years ago, which sent oil prices tumbling, OPEC announced at the end of September that member countries had reach consensus on production limits going forward, further boosting prices.

Flat oil prices kept gasoline and natural gas prices in check…

Gold was unable to build on the price gains seen in the first half of the year. Gold had rallied when central banks embraced negative rates as an easing tool, but the third quarter saw an increasing uneasiness by policy makers to further expand this program.

Commodity	Qtr. 3 '16	Year to Date '16
CRB (Commodity Research Bureau) Index	-3.17%	6.01%
Oil (West Texas Intermediate)	-0.18%	30.23%
Gold	-0.27%	24.23%

ECONOMIC OVERVIEW

US: Lackluster growth in the first half of the year was followed by some signs of renewed if uneven expansion during the third quarter. This follows the pattern seen for most of the seven year recovery since 2009.

Workers pay accelerated in tight labor market…

The pace of job gains slowed to an average of 190,000 per month in the quarter compared to 203,000 per month over the past twelve. At the same time, layoffs remained low with the four week average for jobless claims ending the quarter at 253,500. For perspective, the last time there was a reading this low was November 1973 when the job market was half the size of today. Even though the pace of job gains slowed, workers' compensation rose – finally moving above the rate of 2% annualized which had persisted since 2009. Average hourly earnings began to accelerate with the tightening labor market and various initiatives to raise minimum wages starting in late 2015, and have been above that 2% mark in each of the past 14 months. September reached a new recovery high at +2.65%.

US consumers optimistic but spending shifts to online and experiences hurting retail…

Muted inflation, with food prices down in each month this year when compared to last year and energy prices still contained, combined with growing compensation to improve consumer confidence which rose to a new recovery high of 104.1 in September. Unlike years past, consumers are not rushing out to spend their money. Retail sales continued to disappoint and auto sales, while down only slightly from September of last year, required the highest average incentive payments since December of 2008.

Brexit fallout contained, so far…

UK: Perhaps the forecasters got too far ahead of themselves following Brexit. To be sure, growth had been weakening leading up to the vote as shown by the Economic Surprise Index turning down in March. Following the vote, expectations continued to deteriorate, but results began to surprise on the upside. The quick formation of a new government was key in supporting the economy as austerity measures were relaxed. The government also began to outline when Brexit could be triggered, releasing pent up corporate spending. Finally, the significant weakness in the pound - down -13% compared to the dollar since Brexit - proved to be a strong support for exports.

No hard landing in China, but growth still fueled by "old" economy…

China: While significant problems remain, domestic growth accelerated, reducing fears of a near term hard landing. The most recent statistics for electricity usage, retail sales, industrial production and government spending all came in stronger than expected. The government continued to target certain areas of the economy to support growth while still trying to wind down excesses. To this end, September auto sales jumped nearly 27% compared to last year aided by a tax cut. At the same time, new policies were put forth to restrict banks' ability to rollover loans to so-called "zombie" firms – a move to reduce some of China's over capacity. Exports, on the other hand, were surprisingly weak – down -10% year over year. This reflects slow global growth and could add complications to trade and currency issues.

BoJ embarks on a new easing path while central bank balance sheets continue to expand…

Japan: In September, the Bank of Japan unveiled its latest policy to combat consistently low growth and inflation. First the BOJ announced that it will continue to expand its balance sheet, already at 86% of GDP versus the Fed at 24% of US GDP, until inflation reaches its 2% goal. The BOJ also targeted a maximum 10 year interest rate of 0%. The fact that the BOJ is committed to buying up government bonds until inflation reaches the target will allow the government to continue issuing debt to fund investments. This tactic contributes to the continuation of low global interest rates.

Rest of the world: While the Fed is debating when next to raise its short term lending rate, the rest of the world remains in an easing bias. In the quarter, global short rates declined to 1.62% as policy makers in several countries cut their rates in the face of contained inflation. Additionally, the BOJ, Bank of England and European Central Bank all continued to expand their balance sheets. In February 2015, these three central banks had combined balance sheets of $5 trillion. Since then, each has enacted or expanded easing programs, pushing their total to $8.2 trillion at the end of September.

Perspectives

INVESTMENT IMPLICATIONS

Next president will be faced with a fiscal drag starting 2017…

With the election now just weeks away, markets are increasingly reflecting what the policy landscape could look like under the winning candidate. The makeup of the House and Senate is also growing in importance in investors' perception. Starting with Kennedy, every new president has been able to pass a fiscal package early in the first term; therefore, we should expect something significant next year. The ability to pass a stimulus program then is meaningful, as the stimulus enacted this year will result in a drag of -0.5% of GDP in 2017.

As we see it, there are three plausible outcomes from this election: Clinton wins the White House while Democrats regain control of the Senate and Republicans hold the House; Clinton wins and Democrats take both the House and Senate: Trump wins and Republicans hold their majorities in both the House and Senate.

Most likely election outcome has historically been best setup for stocks…

The first scenario has historically been the best for stocks, with annualized returns averaging 9.3%. In this environment, Clinton would ultimately have to compromise with Republicans in order to pass anything of substance. Bipartisan efforts in the House have already made progress toward revamping the tax code, especially corporate taxation. A larger compromise closing the budget deficit would likely be positive for markets overall. Infrastructure, alternative energy, life science equipment stocks, and companies benefiting from increased lower income household consumption should fare better than pharmaceuticals, restaurants and retail, and traditional energy.

Democratic sweep could prove perilous for equity market…

If Democrats were to sweep, they would feel voters had given them a broad mandate to move forward with their platform. Markets would view this negatively, and this outcome is not currently priced in. Pharmaceutical and biotechnology stocks would find themselves under pressure on the expectation of government price controls. Even the managed care and hospital companies, long beneficiaries of Democratic legislation, could suffer as a move to a one payer system gains traction. Traditional energy and financial companies would also find this to be a difficult operating environment. The infrastructure package would likely be larger with Democrats in full control, so firms tied to government contracts would be relative winners. Railroads would benefit if fewer pipelines were built.

Little consensus between Republicans for best path forward…

If Trump were to win the presidency, the probability of Democrats taking the House and Senate is extremely low. Even with Republicans in control of the legislature, Trump would likely find it necessary to compromise with leadership since they have outlined divergent views on the best path forward. Traditional energy, big defense, and infrastructure companies would be beneficiaries of shared Republican objectives. Lower tax rates should spur investment, but larger deficits would hurt the market overall. While a President Trump may be forced to compromise on some issues, much of his trade policy can be enacted by presidential decree, putting multinational firms at risk. The risk could be larger if a trade war ensues or increased tariffs and trade barriers slow growth. Consumer consumption could fall with more expensive imported goods. Health insurance providers may also fare poorly due to reduced loss coverage as the Affordable Care Act is rolled back.

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