A Quarterly Newsletter for Clients of Parsons Capital Management

Perspectives

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QUARTER 1, 2017

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The S&P 500 followed up its strong fourth quarter rally by posting the best start to a year since 2013, and third best since 2000. While the broad market showed a continuation of the rally that began in October 2016, the components of the rally changed dramatically. Questions surrounding the economic outlook led to growth stocks outperforming their value counterparts by more than 5 percentage points in a reversal of fortune from last year. Perhaps reflecting some doubt regarding proposed policy initiatives intended to help domestic companies, mid and small cap stocks lagged large cap. International markets, buoyed by softer rhetoric from the White House and an improving growth outlook, shook off their fourth quarter malaise to lead the way higher.

Data as of March 31, 2017	March '17	Qtr. 1 '17	YTD '17
S&P 500	0.12%	6.07%	6.07%
MSCI AC World Index (incl. US)	1.29%	7.05%	7.05%
MSCI EAFE (Europe, Asia, Far East)	2.87%	7.39%	7.39%
MSCI EM (Emerging Markets)	2.55%	11.49%	11.49%
Russell Largecap	0.06%	6.02%	6.02%
Russell Largecap Growth	1.16%	8.91%	8.91%
Russell Largecap Value	-1.02%	3.27%	3.27%
Russell Midcap	-0.16%	5.15%	5.15%
Russell Smallcap	0.13%	2.47%	2.47%

FIXED INCOME MARKETS

Much like the equity markets, emerging market bonds were the best performer - returning 3.28% for the quarter versus 0.82% for the total US bond market. High yield bonds spent the first two months of the year in the top spot before a -0.21% return for March dropped the group to second with a gain of 2.71%. Domestically, short maturity bonds were relative losers compared to longer dated issues as the Fed rate hike pushed up short rates and growth concerns drove demand to the long end. Municipal bonds shook off chatter that their preferential tax treatment could be in question in any tax reform and returned 1.58%.

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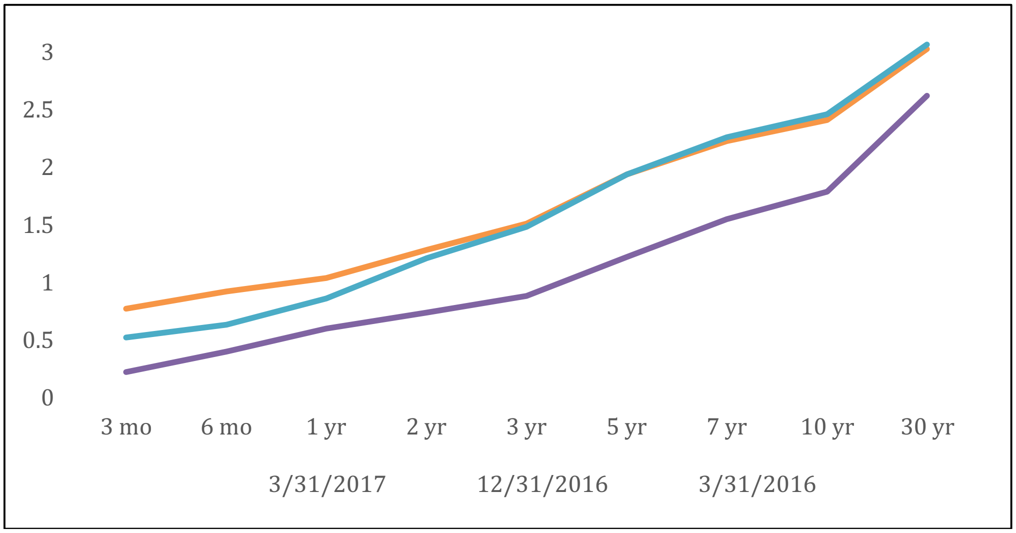
US TREASURY YIELDS

As the chart below shows, yields across the curve moved up significantly from one year earlier. The move up along the curve was not uniform, however, with the spread between 2 year and 10 year rates widening from 1.05% in 2016 to 1.13% at the end of the quarter. When comparing the curve to where it started the year, the effect of the Fed rate hike announced March 15th can clearly be seen with a move up in the short maturities. The slight decline in longer dated issues was a result of the growth outlook for the US economy coming into question as the quarter unfolded.

Yields move higher from year ago, but curve flattens during the quarter…



COMMODITIES

A weakening dollar may have given a boost to the relative return performance of international stocks and bonds, but it was not enough to prop up the commodity sector where energy prices weighed heavily.

Fossil fuel weakness drags down CRB…

Oil was still up for the year as recently as March 1st before a three week correction dropped the price per barrel 12%. The correction began on concerns that the production cuts announced by OPEC were not going to be enough to balance the oil market and that US production would step in to more than fill any gap. WTI staged a 6% rally over the closing 4 days of the quarter as signs began to emerge indicating a tighter market.

Prices on precious metals were a bright spot for commodities with both gold and silver (+11%) up for the quarter. Not to be outdone, many of the industrial metals including copper (+6%), aluminum (+13%), platinum (+5%), lead (+16%) and zinc (+8%) ended the quarter higher – an indicator that global growth may be firmer than feared.

Precious and industrial metals buck commodity weakness…

Commodity	Qtr. 1 '17	Year to Date '17
CRB (Commodity Research Bureau) Index	-3.29%	-3.29%
Oil (West Texas Intermediate)	-5.81%	-5.81%
Gold	8.64%	8.64%

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ECONOMIC OVERVIEW

During the first quarter, the global growth outlook began to shift. For the past two years, the US has been the engine of growth for the world while the Eurozone countries dealt with internal structural issues, China slowed due to government efforts addressing overcapacity, and various emerging markets were laid low by the commodities bust. As the quarter came to an end, global growth increasingly looked to be syncing up.

Impressive synchronized global growth…

The global composite Purchasing Managers' Index (PMI) rose 0.4 to 53.8 in March, thanks to a jump in services while the manufacturing PMI held at its best level in seven years. The strength was broad based with 87% of countries showing a PMI in expansion territory (any reading above 50) while 80% had a PMI higher than the previous year. Continued future expansion was suggested by the new orders index, a leading indicator, reaching 54.2 - its best level since January 2014. The OECD Composite Leading Indicator also edged up in its most recent report to 100.04 marking the 11th straight month of increases. Global trade grew 3.4% in the three months ending in January (latest available data) marking the quickest pace of growth in six years. January also marked the fourth month of higher global industrial production.

European economies shaking off populist fear post strong growth…

Drilling down, developed markets logged their 4th year of higher PMIs than emerging markets, even with emerging market PMIs rising to their highest level since mid-2014. Paced by Sweden, Switzerland, the Netherlands and Germany, developed Europe stood out in their global peer group. The U.K. PMI, perhaps due to BREXIT reverberations, was lower for the third month in a row but still healthy at 54.2.

Global growth helping to lift emerging markets…

In the wake of the commodities bust, many emerging markets were forced to significantly tighten their belts but now show signs of stabilizing. India looks to be recovering from their demonetization last year, registering a third month of improving PMIs in March. Chinese industrial profits for the first two months of the year rose 30% compared to last year as government efforts to reign in overcapacity begin to bear fruit. Mexico was another standout among emerging markets as their market rallied 16%, helped by a 10.7% gain in the peso.

Domestically, economic measures showed a more uneven picture. Since the election, there has been a growing divide between "soft" (survey) data and "hard" (output) data, with the former much stronger than the latter. The most recent data sets help to close the gap somewhat but still indicate an economy of cross currents resulting in a steady, if not spectacular growth rate:

A mixed bag of results for US economy, but growth remains positive…

- US PMI fell for the second month to 53.3
- US rail carloads and intermodal traffic rose 3.5% from 1Q 2016
- February job openings rose more than expected to 5.743 million
- March consumer confidence much better than expected, rising to 125.6 best since 2000
- Small business optimism fell slightly to 104.7 in March, still well above historical average of 98
- State tax surveys broadly weakened, lower sales tax the primary culprit
- Retail sales softer than expected, may in part be due to unusually long delay in federal tax refunds this year
- Auto sales fell to a 16.2 million annual pace in March vs. the 17-17.5 million range for much of the past year
- Banks indicate they are tightening lending standards as loan growth is slowing and auto delinquency rates are increasing
- The economy added an average of 178,000 jobs per month in the quarter vs. 163,000 average the past six months

If the historical relationship held, the current percentage of small businesses expecting higher sales would indicate US GDP growth of 5%. Data doesn't support a rate that strong, but such optimism helps to explain this year's turnaround in capital expenditures and manufacturing, two long-dormant sectors.

INVESTMENT IMPLICATIONS

Strong, synchronized global growth should reduce the odds of a worldwide recession. There are, however, possible canaries in the coal mine. With so many measures of growth hitting multi-year highs, there is increasingly little room for improvement. For example, the Citigroup Economic Surprise Index, while still positive and at an elevated level, has fallen from its peak recently.

Can data get better in the face of rising rates…

At the same time economic surprises look to be topping out, global short rates have hooked up as central banks around the world remove stimulus. The last two uptrends were followed by the Eurozone recession in 2010 and the global slowdown in 2013/14 respectively (though the world economy is stronger now than in either of those instances).

A shift in market leadership…

Domestic markets may have enjoyed one of their best starts in years, one punctuated by 109 trading days without a 1% move down in the S&P, but the strong first quarter rally was decidedly of a risk off nature. Healthcare stocks, which had been the second worst performing group in the fourth quarter, were the third best to begin the year helped by the failure to repeal the ACA. Financial, energy and industrial stocks all led the way higher following the election but found themselves in the bottom tier of sectors as the Trump trade came into question. Sensing that growth prospects abroad may be superior, the stock of companies with a higher percentage of revenue generated overseas outperformed their domestically focused peers. This kind of rapid sector rotation resulting from quickly changing events and perceptions will probably continue.

Trump agenda getting bogged down…

This shift in leadership occurred as concerns began to mount regarding the ability of the new administration to enact their pro-growth policies. Following the failure of Republicans to pass their health care agenda, there is waning confidence they will be able to push through tax reform or an infrastructure package of meaningful size. Reduced confidence can reduce price earnings (P/E) ratios.

On the other hand, earnings season is just getting under way, and expectations are for as much as a 10% year over year increase. That would prop up the "e" part of the P/E equation.

A change in regulations on banks has the potential to unlock $150-200 billion in capital…

Also offsetting legislative difficulties are some of the executive orders rolling back regulations and potentially freeing up capital for investment.

Even as markets have moved higher, there are few signs of exuberance that would serve as a warning of a major market top. Investors Intelligence survey showed 30% of investors identified themselves as bullish at the end of March compared to 50% at the start of the year. While margin debt reached a new all-time high in dollar terms, at 2.5% of market value it was the same level it's been since 2013.

Lack of catalyst has market churning…

With indices not showing the classic signs of a major top coupled with increasing uncertainty for the direction of political policy, markets are stuck in a trading range. Growth, both domestic and abroad, will be essential to US equities continuing their nearly eight year bull market. An economic slowdown, a policy misstep from either the Fed or the administration impacting confidence or an inflation spike eroding the P/E multiple would each prove to be a significant headwind.

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