Perspectives

A Quarterly Newsletter for Clients of Parsons Capital Management

Quarter 2, 2018

by John Mullen and Ruth Mullen

The second quarter got off to a most inauspicious start when, on the first trading day of April, the S&P 500 closed below its 200-day moving average for the first time in 442 trading days, the 6th longest streak in history. Domestic markets then rebounded to post gains in each month of the quarter, ending positive for the year. Even with the rebound, large cap stocks were stuck in a trading range as the opposing forces of a strong US economy and heightened trade tensions worked against each other. The biggest beneficiary of the strong domestic economy argument were small cap stocks, which easily outpaced their large and midcap peers by an even wider margin than what was seen in the first quarter. Growth stocks continued their dominance over value that began in early 2017. Fears of slowing global growth, potential for a trade war and the strains of a rising dollar all favored the relatively lower risk of US equities vs. foreign. Emerging economy markets were especially hard hit because they are more likely to feel the stress of an appreciating dollar and are generally more reliant on exports.

Data as of June 30, 2018	June '18	Qtr. 2 '18	YTD '18
S&P 500	0.62%	3.43%	2.65%
MSCI AC World Index (incl. US) GR	-0.50%	0.72%	-0.13%
MSCI EAFE (Europe, Asia, Far East) GR	-1.19%	-0.97%	-2.37%
MSCI EM (Emerging Markets) GR	-4.09%	-7.86%	-6.51%
Russell Largecap	0.65%	3.57%	2.86%
Russell Largecap Growth	0.96%	5.76%	7.25%
Russell Largecap Value	0.25%	1.17%	-1.69%
Russell Midcap	0.69%	2.82%	2.35%
Russell Smallcap	0.72%	7.75%	7.66%

Data compiled from Tamarac Inc.

Fixed Income Markets

Broad measures of the taxable fixed income markets saw another quarter of net losses (i.e. diminished market values exceeded income earned). Underneath the aggregate averages, differences emerged. US bond returns were less negative than those for foreign credit. Within the US, short term bonds were actually positive for the quarter, while intermediate and longer issues were down, pushing year to date returns further into negative territory. Spreads between US government and corporate issues widened slightly. Longer dated corporate bonds logged the most negative returns, continuing their poor performance from the first quarter to bring their year to date return to -6.38%. Domestic municipal bonds had a relatively strong quarterly showing, posting positive returns across all maturities. In an indication that the US economy remains robust and domestic credit concerns are low, high yield bonds had a positive 1% return during the second quarter - ending up 0.07% for the first half.

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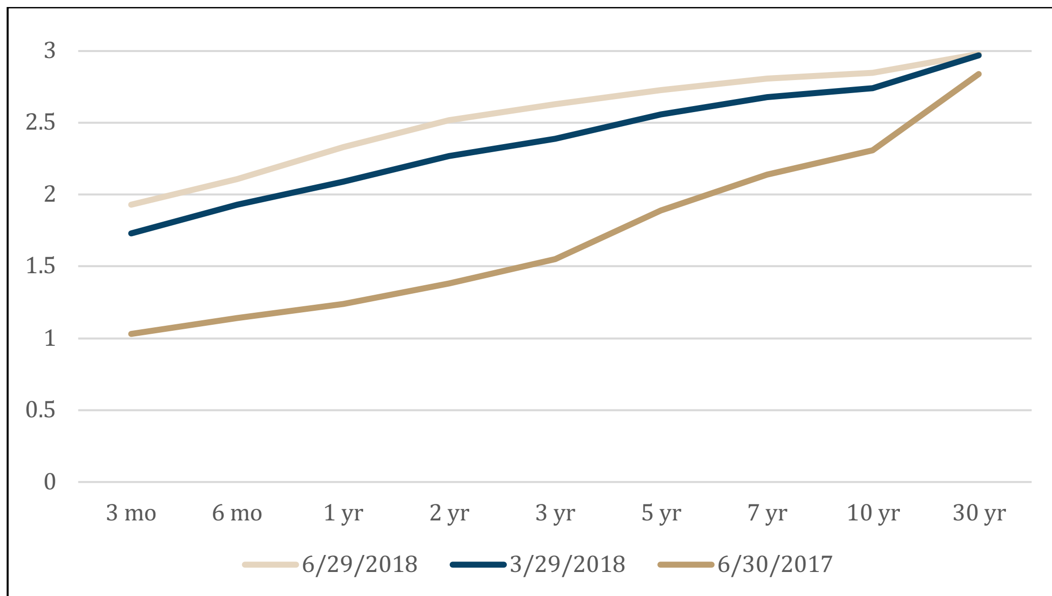
US Treasury Yields

Yields move higher, but curve continues to flatten…

Yields ended June higher across the board when compared the beginning of the quarter and the same period last year. The shorter end of the curve continued to be pushed higher by the Federal Reserve as they hiked the Fed Funds rate. A combination of ongoing intervention by international central banks to hold down rates in their countries and some doubts about the growth and inflation outlook in the US conspired to limit the move higher in longer rates, resulting in further curve flattening. At 30 basis points, the difference between the 10-year and 2-year rate is the narrowest it has been since 2007.



Commodities

Energy prices rallied…

Crop and timber prices whipsawed by tariffs…

Broadly, commodity prices rose during the quarter as shown by the 3.05% advance in the CRB index. Looking closer, however, uncovered vastly different fortunes for the underlying products.

Oil prices raced higher on the expectation that already tight supply would become a larger issue following the US pulling out of the Iran nuclear deal. Continued production issues in Venezuela and Libya also contributed to the tightening supply outlook.

Crop prices bore the brunt of expected tariff retaliation, with the prices for corn and soybeans falling -4% and -16%, respectively. Timber, another tariff battleground, saw further price gains in the quarter to end up 22% for the year.

Commodity	Qtr. 2 '18	Year to Date '18
CRB (Commodity Research Bureau) Index	3.05%	4.25%
Oil (West Texas Intermediate)	14.27%	22.61%
Gold	-5.41%	-4.21%

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Economic Overview

World growth decoupling…

World economies continued to feel pressure in the first quarter, leading to a further decoupling in growth outlooks. Nowhere was this more evident than the deterioration in the manufacturing PMI (Purchasing Managers Index). At the end of 2017, 83% of countries surveyed had an m-PMI moving higher and none were below 50 (a level that delineates between expansion and contraction). By the end of June, 81% of global m-PMIs were moving lower and five countries had a reading below 50. The decline in manufacturing activity is likely largely driven by trade/tariff fears.

US economy remains insulated, jobs a bright spot…

The US economy has shown surprising strength in the face of mounting headwinds. In June, the US added a better than expected 213,000 jobs, although the unemployment rate actually moved higher as the improving economy drew more people back into the workforce. Even with the higher workforce participation, there were still more job openings than people looking for work at the end of the quarter - something that had never before happened. With such strong labor figures, it would be expected to see labor costs shooting higher; yet wage growth remains tame at just 2.7%. A likely contributor to this anomaly is the growing percentage of millennials in the workforce replacing older, higher salaried employees at a lower entry cost.

Rising oil prices are also no longer the large threat to the domestic economy they once were. Thanks to significantly increased domestic production and consumers spending less on fuel in general, higher oil prices are now a net wash for GDP growth.

Tax reform impacting spending…

The tax reform package passed last December has begun to show up in corporate actions. Companies are making capital expenditures, as evidenced by the 21% jump in corporate capex in the first quarter (the best rate in seven years) and the strength in goods producing jobs seen in the latest employment reports.

The domestic economy also evidenced a boost from higher government spending, both at the federal and state levels. Improving tax receipts encouraged states across the country to increase spending. Nowhere is this clearer than in California (which would be the world's 5th largest economy if it were its own country) where spending has increased by 9%.

Sentiment ignored the noise…

The slew of negative headlines has also seemed to have little to no impact on the outlook of small businesses or consumers, with sentiment indicators for both remaining near all-time highs.

Even with so many positives, there are still warning signs. Subprime auto loan delinquency rates are at their highest since 1996. The June composite PMI also ticked lower to 56.2, though remained at a strong level.

Globally the picture is more muddled, with emerging markets feeling the brunt of the growing headwinds. Four of the five countries (Brazil, Russia, Turkey, South Korea and Denmark) showing a contraction in their m-PMIs are emerging economies. With their reliance on trade, emerging economies are often the first to feel the effect of a higher US dollar and any slowdown in global activity. In this way, they operate as canaries in a coalmine.

Global outlook less rosy, EMs taking the brunt…

In China, the government showed signs of supporting their economy to help offset any damage done by US tariffs. Even before the imposition of tariffs, exports to the US had weakened. The Chinese government has cut reserve requirements for banks, allowing them to lend more money, and has also lowered or eliminated tariffs on imports from many smaller trading partners.

In what was generally a weak quarter for the Eurozone, June provided some possible green shoots. French business sentiment and EZ investor expectations both broke downtrends to move higher. The most recent readings for industrial production in Spain moved higher, as did manufacturing orders in Germany. This all helped lead to a tick higher in the composite PMI for the EZ to 54.9, though it still remained below its expansion high.

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Investment Implications

Earnings up, multiples contracting…

The first half of 2018 has been a frustrating one for investors; what worked in the previous year has largely underperformed through the first six months. On the back of a very strong first quarter, in which a nearly 25% jump in earnings per share was highlighted by 81% of companies beating already high expectations, the outlook for the second quarter reporting period improved. While earnings have shot higher, the market has failed to make major gains due to the fact that, for the first time since 2011, the forward price to earnings (P/E) ratio is meaningfully contracting. In fact, since the peak in the S&P 500 forward P/E in December 2017, Information Technology is the only GICS sector to not see a contraction in its multiple.

Era of extraordinary measures officially at an end…

The P/E ratio is a measure of what investors are willing to pay for expected earnings, and when uncertainty creeps up or the outlook falters, P/Es will typically move lower. A near constant source of certainty throughout this nine-year bull market has been the Federal Reserve and their ultra-accommodative policies. With the end of QE and the beginning of rate normalization, the Fed has already moved to take away the punch bowl. In a May speech, NY Fed Governor Williams noted the era of forward guidance and market handholding was likely coming to an end as economic conditions continued to normalize. For the first time since the Global Financial Crisis, US markets are looking at a potential future without a firm underpinning from the Fed.

Disappointing economic data, primarily abroad, and heightened threats to global trade further eroded the investment outlook. Cyclical stocks like financials, which at one point in June were down for 13 consecutive trading days, and industrials bore the brunt of the shift in sentiment.

Cyclicals lose ground as growth outlook deteriorates…

With corporate earnings highly likely to remain robust through the rest of the year, the key to the market's performance will be what might change investors' outlook and allow P/Es to expand.

Already there is some evidence that the economic picture is beginning to brighten with the global economic surprise index turning up, although still in negative territory. Any hint of a thaw in trade tensions has also served to boost the market. The just completed Mexican election may be the opening to resolve the long running NAFTA dispute. The outlook with Europe, and especially China, is currently dourer without an obvious path to de-escalation.

Doesn't take much good news to move markets…

Certainty regarding our own political outlook would also be a boon to the market. Historically, US markets tend to trade in a range below recent highs through the first many months in an off presidential election year. It is only once the election outlook begins to become clear that markets turn up and rally into the year end. The first half market moves have been in keeping with this precedent.

Not the typical backdrop to end a bull market…

The last time investors pulled out money at the same rate as the just completed quarter was the third quarter of 2016. That was just before the market began a 5 quarter, 25% rally. The current market environment of fragile sentiment, ominous news headlines and fearful trading is not how a bull market typically dies.

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