Perspectives

A Quarterly Newsletter for Clients of Parsons Capital Management

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by John Mullen and Ruth Mullen

The momentum of the first quarter carried over into the second, with the S&P 500 returning 3.9% in April. As optimism over a potential trade deal with China gave way to fears of increased tariffs and a further ratcheting up of the trade war, the market cracked - falling -6.6% in May. A pledge to return to the bargaining table plus indications that the Fed was preparing to cut rates then managed to turn the market around. When the dust settled, the S&P recorded its best June since 1955 and the market saw the best first half returns in 22 years. Leadership seesawed throughout the quarter. In April and June, when trade tensions eased and the consequent expectations for global growth improved, value outperformed growth and smaller capitalization stocks did as well as or better than large cap. Overall, however, investors continued to seek relative safety in US large cap companies with reliable growth prospects. Trade issues continued to have an outsized effect on both developed and emerging international stocks, as those economies are more dependent on international trade than the US.

Data as of June 30, 2019	June '19	Qtr. 2 '19	YTD '19
S&P 500	7.05%	4.30%	18.54%
MSCI AC World Index (incl. US)	6.59%	3.80%	16.60%
MSCI EAFE (Europe, Asia, Far East)	5.97%	3.97%	14.49%
MSCI EM (Emerging Markets)	6.32%	0.74%	10.76%
Russell 1000	7.02%	4.25%	18.84%
Russell 1000 Growth	6.87%	4.64%	21.49%
Russell 1000 Value	7.18%	3.84%	16.23%
Russell Midcap	6.87%	4.13%	21.35%
Russell 2000	7.07%	2.10%	16.99%

Data compiled from Tamarac Inc.

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Fixed Income Markets

Once again it paid to be long in the quarter as money continued to flow into fixed income unabated. The US Aggregate Bond Index returned 3.08% for the quarter to bring its year-to-date performance to 6.11%. Corporate credit again outperformed the aggregate with a return of 4.27% for the quarter after posting 4.87% in the first quarter. While all maturities had a positive return in the quarter, the best returns were seen in longer duration. The Bloomberg Barclays US Government Long bond index returned 6% (10.92% YTD) and the US Credit Long index 7.02% (15.43% YTD) as a lower growth outlook combined with falling rates abroad to bring down domestic US yields. Municipal bonds were relative laggards in the quarter, returning only 2.14% though still posting a strong 5.09% return for the first half. High yield also trailed, up only 2.5%, falling along with stocks in May before rebounding in June.

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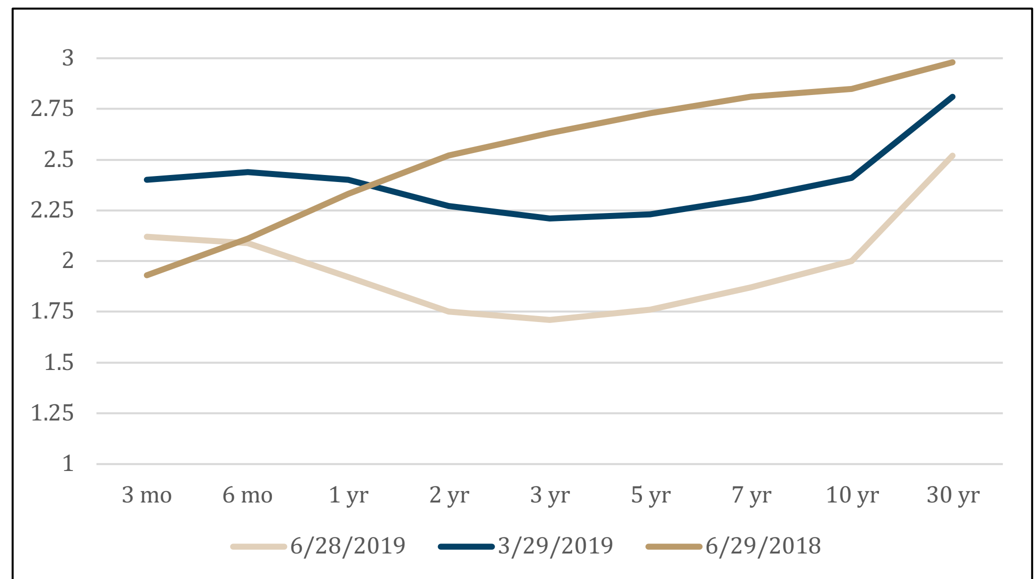
US Treasury Yields

Low/negative global yields limiting how far Fed can go…

The slight U-shape nature of the yield curve first seen towards the end of 2018 became more pronounced throughout the second quarter. The curve also moved lower across maturities as the outlooks for inflation and growth both fell and investors increasingly factored in a Federal Reserve that would have to begin cutting rates in the second half of the year. The Fed was the first central bank to begin to normalize rates in this economic expansion, but may have found a limit to how far out of line with other central banks it can get. At the end of the quarter, the Fed Funds rate of 2.5% was 0.75% above the next closest (Canada at 1.75%). Considering that the world is mired in low growth and $13 trillion in negative yielding debt, there is tremendous global pressure keeping domestic rates low.

U-shaped yield curve moves lower in the quarter…



Commodities

Energy complex pushing commodities lower…

The performance in the commodity space was practically a mirror image of the first quarter, leaving the CRB Index down slightly for the three months ending in June.

Nowhere was the weakness more pronounced than in energy, the largest component of the CRB. Oil prices actually managed to post gains in both April and June but an overall $10 price drop left WTI in the red for the quarter. In sympathy, gasoline prices fell -7% and natural gas prices were -13% lower.

After falling in the first quarter, agricultural products gained in the second quarter, led higher by corn (+24%) and wheat (+15%).

Gold rallies on increasing uncertainty…

Gold surged as political and monetary uncertainty led investors to seek a safe haven asset.

Commodity	Qtr. 2 '19	Year to Date '19
CRB (Commodity Research Bureau) Index	-0.89%	7.88%
Oil	-3.31%	28.90%
Gold	9.03%	10.28%

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Economic Overview

Economic recovery matches longest on record…

The end of the second quarter also marked the 10th year of this current economic expansion, tying for the longest on record. While the length of the recovery is notable, what stands out even more is the relatively subdued growth it has generated. In the last 10 year expansion (1991-2001), total payrolls expanded 23%, real GDP rose 43% and the S&P 500 returned 417%. For the current expansion, those numbers are 17%, 25% and 338% respectively. Very rarely in this recovery has the economy managed to fire on all cylinders, leading to the moderate level of growth, and the second quarter was no exception.

Domestic economy shifting back to low growth…

The domestic economy is increasingly becoming bifurcated, with the consumer and service segments largely tuning out the noise and manufacturing feeling the bite of tariffs.

- Following a weak payroll report in May (+75,000), June roared back with a gain of 224,000
- In the same June report, average hourly earnings grew by over 3% year to year, and the unemployment rate bumped up as more people reentered the workforce (helping to cap inflation pressure)
- Consumer confidence, as measured by the Conference Board, did slip in the latest reading but remained elevated at 121.5
- The June services PMI (Purchasing Managers Index) moved up from May's reading and remained in expansion territory at 51.5

Employment/services strong, manufacturing weak…

Manufacturing activity in the second quarter was notably weak. For example, manufacturing in New York State fell by the most on record in June. In the run-up to the first round of tariff increases, companies over ordered supplies and are now working off those elevated inventories, hurting demand. At the same time the issues forcing Boeing to cut production are impacting a wide range of capital expenditure numbers, due to their large supply network. Finally, with the economic uncertainty index at its highest level since the vote for Brexit three years ago, corporations are putting expansion plans on hold until there is more clarity on the trade front.

Economic uncertainty rising…

Internationally, the economic story is similar. With resilient labor markets and weak manufacturing, the combined results are not as strong as the US. The comparative weakness in foreign countries is due to multiple factors but is primarily attributable to the outsized role consumers play here and the relatively self-contained nature of the US economy (i.e. not as reliant on international trade for growth as Europe and Asia).

International economies remain largely weaker than US…

The Eurozone manufacturing PMI fell by -0.1 points in June to a reading of 47.6, the fifth month in a row below 50 (indicating contraction). Weakness was especially pronounced in Germany, the growth engine for Europe, with a PMI reading of 45. With its economy largely export oriented, German growth is likely to struggle until global growth recovers. In the UK, Brexit drama seems to finally be taking a bite with their PMI down -1.5 points to 48 on weakening domestic demand.

In Asia the growth outlook is also deteriorating. Chinese policy makers continued to ease in an effort to support growth in the face of tariffs. PMI readings stabilized in June, albeit below 50, and the LEI (Leading Economic Indicators) actually improved in May. At the same time, Japan and South Korea are engaged in their own trade battle while both of their PMI readings sit under 50. India was a notable outlier with a PMI of 52.1, the 23rd consecutive month of expansion.

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Investment Implications

10 year bull market remains unloved…

The ongoing bull market, now over ten years old, is often referred to as the most unloved bull market of all time. When one considers the seemingly unending stream of uncertainty that investors have been confronted with since 2009, it is no wonder people are having issues fully embracing the historic run.

A long list of issues investors have been confronted with…

In the earlier years, investors had to deal with concerns over a wave of foreclosures hitting the market. Then there were municipal bond default fears, a banking crisis in Europe, worries about Quantitative Easing leading to hyper-inflation, multiple China slowdowns, numerous Greek bailouts and fears over the dissolution of the EU, the Fiscal Cliff in the US, Brexit, expansion of regulations at an unprecedented rate, the Fed attempting to normalize policy, and finally, policy making via Twitter.

The continued onslaught of negative headlines served to dent the market at times but ultimately the direction remained up as domestic equities were supported by a solid, if unspectacular, economy. With domestic growth looking as if it is falling back towards the slow/muddle-through that has characterized much of the ten year expansion, volatility is likely to remain elevated.

One constant has been continued growth from US economy…

Here again in 2019, markets are getting whipsawed as central bankers around the globe ease policy in the face of slowing growth, exacerbated by tariffs and trade wars. In response, global bond yields and inflation expectations are moving lower, putting a premium on growth companies and dividend payers. In June, the Fed made clear that they were no longer merely on hold with rate hikes, but were now moving toward easing as soon as July.

With negative yielding debt few options for investment…

With roughly $13 trillion in negative yielding debt worldwide (comprised of government and corporate issues), a Fed likely to cut rates at least two times and the yield on the S&P 500 nearly matching the yield on 10 year Treasuries, TINA (There Is No Alternative) investing seems to have returned. At the same time, corporations are continuing to reward shareholders by buying back stock and boosting their dividends (+9% year over year in the second quarter), helping to keep stock returns attractive relative to other asset classes.

Fear of mistakes have added to worries investors have been forced to contend with…

It has been said that bull markets do not die of old age but are killed by a recession or policy mistake. Early in the year, it seemed as if the Fed had made such a mistake with their final rate hike in 2018, pushing US short rates far beyond those of other developed economies. With their June pivot to an easing stance, that mistake may have been rectified. There is an ongoing undercurrent of concern and uncertainty regarding the possibility of an executive branch policy error, but so far such errors have been walked back or never moved beyond threats, which ironically has added to the Wall of Worry without destroying the bull market. While the market is not cheap at 17 times next year's expected earnings, it is also not wildly expensive given the massive amount of global liquidity and wealth creation looking for a place to invest.

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