Perspectives

A Quarterly Newsletter for Clients of Parsons Capital Management

Quarter 3, 2021

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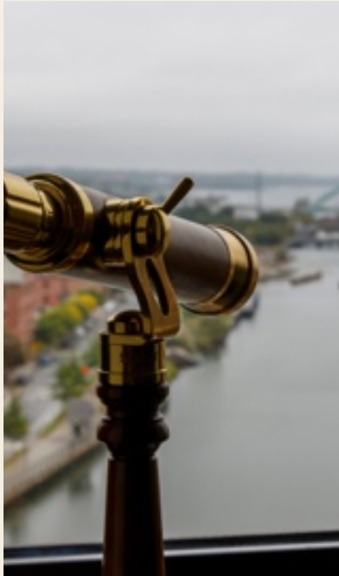

A strong second quarter earnings season through July and August was enough to help investors look past mounting concerns. All that changed as the calendar flipped to September and the issues facing the market became too great to ignore. The final month of the quarter saw yields jump higher, questions arise around the investability of China, inflation continue to run hot, supply chain bottlenecks remain unresolved, partisan and intra-party fighting bring legislation to a halt, a hawkish move by the Fed and signs of a slowing economy. Little wonder there was a September swoon. The performance of equities also shifted, resembling what was seen in the first months of the year. As rates rose, cyclical/value stocks had a relative advantage while growth issues saw their relative performance dinged. Outsized gains in July and August still left growth equities ahead of their value peers for the quarter, but the September shift in performance was pronounced. International equities also largely followed US stocks lower in the final month, and for the quarter the S&P 500 easily bested the EAFE and EM indices. Emerging markets were weighed down in particular from the weakness in China, where solvency questions surrounding a major real estate development company led to a spike in mentions of "Lehman Brothers" to end the quarter.

Data as of Sept. 30, 2021	Sept. '21	Qtr. 3 '21	YTD '21
S&P 500	-4.65%	0.58%	15.92%
MSCI AC World Index (incl. US)	-4.09%	-0.95%	11.49%
MSCI EAFE (Europe, Asia, Far East)	-2.83%	-0.35%	8.79%
MSCI EM (Emerging Markets)	-3.94%	-7.97%	-0.99%
Russell Largecap	-4.59%	0.20%	15.19%
Russell Largecap Growth	-5.60%	1.16%	14.29%
Russell Largecap Value	-3.48%	-0.78%	16.14%
Russell Midcap	-4.12%	-0.92%	15.17%
Russell Smallcap	-2.95%	-4.36%	12.41%

Data provided by Tamarac Inc.

Fixed Income Markets

Nearly every corner of the fixed income market posted a negative return in the month of September, with the US Aggregate and Global Aggregate indices -0.87% and -1.52% respectively. The only index with a positive return for the month was the Bank of America High Yield index, up 0.03%. The greatest weakness in the final month of the quarter was found in the longest duration areas of the market, as evidenced by the US Government Long index returning -2.85% compared to the Intermediate Index -0.57%. Like stocks, the returns seen in September were nearly a mirror image of what had worked in the first two months of the quarter. The strong performance in July and August left long bonds with a positive return of 0.46% for the quarter, though still -7.40% for the year.

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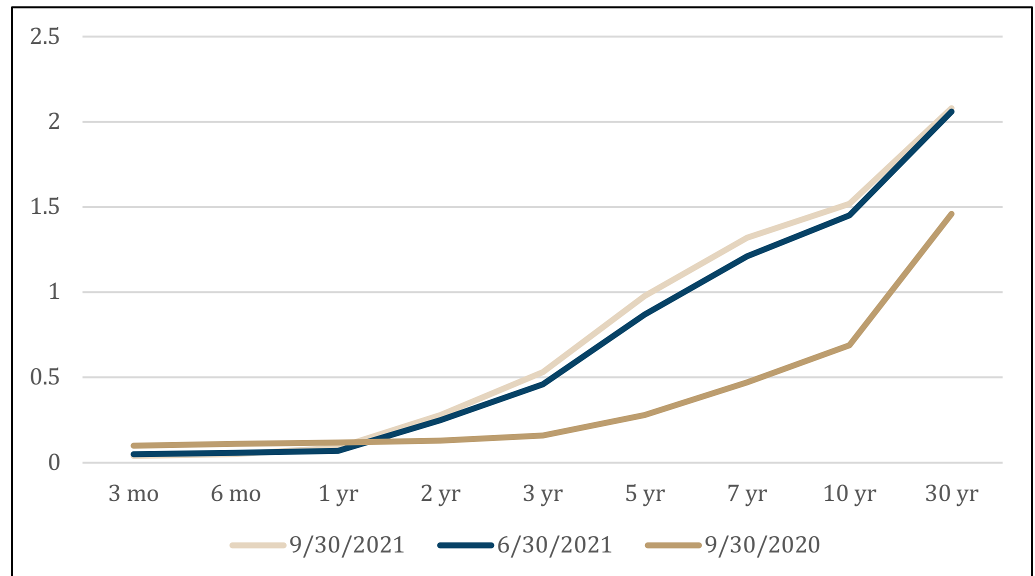
US Treasury Yields

Signs of investor concern over a policy mistake…

Perhaps the most notable aspect for Treasury yields in the third quarter was this: at the end of September, yields on one-month Treasuries (0.07%) were higher than those going out to six months (0.05%). This premium on the shortest-term Treasuries reflects market concern surrounding the debt ceiling negotiations underway in Washington and the risk of a political miscalculation. The last time the debt ceiling came close to being breached, a similar move higher in short term interest rates occurred before finally settling lower once an accord was reached.

Rates drifting higher…



Commodities

While the broad commodities index enjoyed a strong quarter, gains were focused in a narrow segment.

Energy rallies, other commodities muted…

All things energy continued to march higher in the third quarter with natural gas the standout, surging 61%. Adding onto gains earlier in the year, natural gas prices have now risen 131% in 2021. Oil and gasoline saw more muted gains of roughly 2% in the quarter, but both commodities are up over 50% for the year.

Performance elsewhere was more mixed. Gold drifted lower after enjoying a small spike in the second quarter. Copper flashed a clear warning signal on economic growth as the price of the industrial metal fell -5% from the end of June through September. Silver, after brief flirtation with meme-mania, stood out for all the wrong reasons, ending the quarter down -17%.

Commodity	Qtr. 3 '21	Year to Date '21
CRB (broad index)	7.29%	36.47%
Oil	2.31%	55.57%
Gold	-0.88%	-7.28%

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Perspectives

Economic Overview

Synchronized growth gives way to Stagflation…

At the start of 2021, forecasters were expecting explosive global growth as Covid was tamed and economies around the globe reopened. While the first quarter certainly delivered, cracks began to form in the second quarter. By the time September came to an end, it seemed clear that the growth outlook had peaked. Mentions of stagflation (slow/no growth, high inflation) became common.

Economy unexpectedly slowing at a rapid pace…

In a sign of how quickly growth cooled, on September 9th the Economic Surprise Index (a measure of reported economic indicators coming in better or worse than expected) hit its lowest level since May of 2020. To be clear, this does not mean the economy is on the verge of a recession - simply that it has slowed much faster than nearly anyone anticipated. The culprits are clear; a mini Covid surge through the summer driven by the Delta variant and uneven vaccine rollouts (both domestically and internationally) as well as global supply chains still being challenged following a near complete shutdown last year.

A mixed bag in the jobs report…

Perhaps no one economic reading more clearly captured the bifurcated nature of the US economy than the September employment report. After a few months of (relatively) restrained growth, there was heightened expectation going into September with the official estimate of a 500,000 gain and whisper numbers much higher. Forecasters were banking on a return to school, further vaccination progress and the end of enhanced unemployment benefits to drive people back into the workforce. The initial reading came in at 194,000 jobs added and 183,000 fewer participants in the workforce (leading to a small drop in the unemployment rate). While the headline number was clearly a miss, some of the below the line items gave reason for optimism:

- The previous two months' jobs numbers were revised up 169,000
- The number of hours worked were up a strong 0.8%
- Wages per hour rose 0.6%

Elsewhere, manufacturing continued to be a bright spot in the economy as manufacturers across the spectrum continued to struggle to meet strong demand. The ISM Manufacturing PMI rose in September to 61.1, a 1.2 point improvement from August, and well ahead of expectations of 59.6. Here again, there is good news and bad news. The new orders component of the index was very strong at 66.7, showing good momentum. However, the prices paid index hit 81.2, up nearly two points from August, as wide-ranging shortages led to a continued rise in input prices.

Manufacturing shines, but supply chains remain a pain point…

Shipping and logistics data made it clear that global supply chains will not be cleaned up in the near term. In the past 18 months, the cost to send a 40-foot container from Shanghai to LA has risen from roughly $2,000 to almost $20,000. At the same time costs are rising, it is taking longer to get shipments through. On an average day before Covid, there would be one ship anchored outside the Port of LA waiting to unload. On September 19th, the high number was 73.

Globally, the economic picture resembled what unfolded in the US. Inflation in the Euro Zone registered 3.4%, a 13 year high. Surging Covid cases in Singapore resulted in a return of work-from-home orders. Supply chain struggles dented growth in the UK. Euro area PMIs softened from their summer highs on the back of bottlenecks and inflation but remained elevated.

No economy was more newsworthy in the quarter than China. Freight traffic continued to drift lower (a trend that began in March). Signs that the property bubble has started to deflate could be seen with Evergrande (the country's second largest property developer) missing debt payments. Finally, forced rolling blackouts and strict Covid lockdowns combined to drive down economic output.

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Investment Implications

Equities indices highly sensitive to interest rate moves…

Markets are more dominated now by tech and other high P/E growth stocks than at any point since 1995-2000, and these stocks like low interest rates. That makes indices more responsive to rate movements, which has clearly been on display throughout the year. When long-term rates rose at the start of the year and then again in September, cyclical stocks outperformed growth. In between, rates fell and growth again asserted leadership. September 30th marked the 40th anniversary of a very long trend downward in interest rates: the 10-year Treasury peaked at 15.84% in September 1981 and stood at 1.52% on September 30, 2021. With the price/earnings multiple already stretched, the S&P500 index could struggle with a sustained move higher in rates from here.

Uncertainties coming from multiple fronts…

Throughout the quarter, investors were forced to deal with multiple uncertainties coming from nearly every imaginable source. The Federal Reserve, somewhat surprisingly, took a slight hawkish turn at their latest meeting and indicated their preference was to start tapering bond purchases beginning at their November meeting.

At the same time, Progressives in the Democratic party seem to be taking a page from the Tea Party Republicans in 2011, using their votes in a slim majority to hold out for their preferred policies. In 2011, the Tea Party withheld votes needed to raise the debt ceiling, ultimately leading to a last-minute compromise after exacting some concessions from President Obama. Now, Progressives are withholding votes on a bipartisan "hard" infrastructure deal until their preferred "soft" deal is approved in the Senate. At the same time, the debt ceiling again needs to be raised and the government funded to avoid a default and shutdown, respectively. As the quarter came to a close, legislation was passed to avert a shutdown, but Republicans were still withholding their needed support to raise the debt ceiling.

Investor sentiment turns bearish…

At the same time the Fed is making a hawkish pivot and the political sausage making is on display for all to see, investors are also dealing with a slowing domestic and international economy, inflation not seen in a generation, Covid variants and a government-led crackdown in China that has left its market uninvestable in some minds. Last quarter's Perspectives noted that investor exuberance (an important contrary indicator) was an increasing concern, with bullish responses to the American Association of Individual Investors survey reaching 48.6%. In the face of multiple and increasing uncertainties, that is one factor that turned positive as September drew to a close. The final AAII reading of the quarter registered 28.1% of respondents bullish versus 40.7% bearish, compared to 38% and 30.5% historically.

Using history as a guidepost…

To divine where markets might be headed, it can be helpful to seek out historical comparisons. What is playing out now closely resembles what occurred in 2012 and 2013 when politicians fought over government funding and the debt ceiling, and the Fed was preparing to taper bond purchases. In both periods, market volatility was heightened with swift and steep drawdowns that ultimately resolved higher as the political brinksmanship caved to common sense.

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