Perspectives

A Quarterly Newsletter for Clients of Parsons Capital Management

Quarter 4, 2021

by John Mullen and Ruth Mullen

A weak start to December gave way to a Santa Claus rally to close out a year that began on an inauspicious note. After a negative -1.1% return in January, the direction turned up and hardly looked back. There were only two more down months in 2021 and just a single drawdown of 5% or more: -5.2% from September 2nd to October 4th. With the nearly +29% advance for the year, the S&P500 has now returned a total of +90.13% over the past three years—the best three-year run since 1999. Energy was the year's best-performing sector at +53.3%, followed by REITS at +46.2% and financials +35%. A huge rally from value in the final weeks of the year was not enough to fully close the relative performance gap to growth. Looking further down the capitalization scale, small and midcap equities lagged their larger peers in the quarter and for the year. Abroad, developed market equities rose in the quarter but were unable to match the advance seen domestically. Emerging market equities eked out a gain in December but were still negative over the final quarter, and for the year. Brazil, China and Hong Kong were all particularly weak. Even after a precipitous December decline, Bitcoin still managed to post eye-popping gains for the year on the back of a large advance in earlier quarters.

Data as of Dec 31, 2021	Dec '21	Qtr. 4 '21	YTD '21
S&P 500	4.48%	11.03%	28.70%
MSCI AC World Index (incl. US)	4.03%	6.77%	19.04%
MSCI EAFE (Europe, Asia, Far East)	5.13%	2.74%	11.78%
MSCI EM (Emerging Markets)	1.92%	-1.24%	-2.22%
Russell Largecap	4.05%	9.78%	26.46%
Russell Largecap Growth	2.11%	11.64%	27.59%
Russell Largecap Value	6.31%	7.77%	25.16%
Russell Midcap	4.08%	6.44%	22.59%
Russell Smallcap	2.23%	2.14%	14.82%
Bitcoin	-16.67%	-0.89%	62.34%

Data provided by Tamarac Inc.

Fixed Income Markets

US fixed income, as measured by the Bloomberg US Aggregate index, posted a negative return of -1.54% for the year, with an essentially flat return over the final three months. Fueling this negative total return was a rise in interest rates, which pushed prices down more than the interest paid. While the Agg itself posted flat returns for the quarter, various segments of the index diverged significantly. In a reversal from what has been witnessed for much of the year, the greatest weakness was found in the short and intermediate corners of the market, returning -0.68% and -0.55% respectively. Long credit actually posted a positive return of 1.52% for the quarter. However, in a sign of how weak long credit had been through the first three quarters of the year, it still ended 2021 with the worst return of the three indices at -1.18%.

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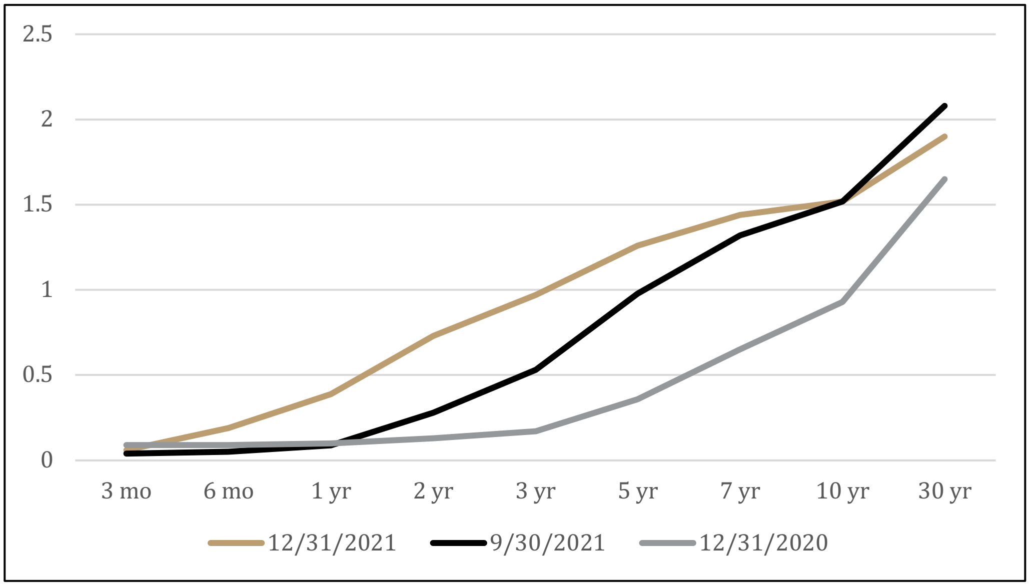
US Treasury Yields

Rate hike cycle becomes consensus…

As seen in the chart below, rates under 10 years moved higher throughout the quarter, while rates beyond 10 years fell slightly. The rise in rates from the shortest end of the curve out to 10 years was in reaction to the Fed, which leaned increasingly hawkish throughout the final three months of the year. An escalation of tapering and calls for coming rate hikes in the face of inflation that clearly was not transitory created a repricing in Treasuries. The drop seen in longer-term rates could be taken as a sign that market participants are wary of economic growth in coming years.

Rates much higher than year ago…



Data from US Treasury

Commodities

Energy prices finally paused their furious rally, which began last year. For the quarter, oil prices barely budged while gasoline futures edged up +2% and natural gas prices tumbled by -36%. The backwardation in oil markets, where futures prices are lower than current market prices, points to a continued tight supply and demand picture.

Oil takes a pause, food and metals higher…

Much of the overall quarterly increase in the CRB index came from the food sector. Notably rising prices were seen in staples such as soybeans, wheat and meat—many increasing double digits as the year ended.

Gold managed to stage a rally in the closing months of 2021, perhaps finally helped higher by increasingly entrenched inflation. Other metals did well in the quarter as well, with silver higher by 7% and copper rallying 9% after stumbling in the third quarter.

Commodity	Qtr. 4 '21	Year to Date '21
CRB (broad index)	1.52%	38.55%
Oil	0.15%	55.80%
Gold	4.11%	-3.47%

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Economic Overview

Reactions to Covid varying by country…

An uneven global economic recovery continued in the final quarter of the year as countries responded to rising Covid cases in divergent manners. Domestically, a clear emphasis emerged to enhance precautions but focus on keeping the economy open. On the other end of the spectrum, China continued its zero-tolerance Covid policy, locking down cities and provinces containing millions of citizens for as few as 20 new cases.

US economy picking up steam after summer slowdown…

Domestically, after a soft patch in the middle of the year that saw growth decelerate markedly from the second quarter to the third (from +6.6% to +2.1%), the economy looks to have reaccelerated in the final three months of the year. Many headwinds remain, however.

While the ISM* Manufacturing PMI** (at 58.7) and the ISM Services PMI (at 62) surveys both slipped in December, they remained firmly in expansion territory. Readings at these levels would historically indicate GDP growth of 4.5%. Perhaps most encouragingly, the inventory subindex of the Manufacturing PMI improved significantly from the first half of the year, giving an early sign that supply chains may be healing.

Employment constraints still evident helping to fuel inflation…

Employment continued to be a headwind in both the Manufacturing and Services surveys. Employment constraints can be seen in other metrics, such as over 10 million job openings in the JOLTS survey and a labor force participation rate (at 61.9%) down nearly 2 percentage points from pre-Covid levels. Total employment is still below pre-pandemic levels by 3.9 million people. The National Federation of Independent Business (NFIB) small business survey also showed this dichotomy as the overall survey improved in December, but labor supply remained the primary strain on operations.

Inflation readings also point to an economy that is not functioning properly. After years of running below 2%, inflation is now hitting levels not seen in decades. The latest print for December, at 7%, was the highest reading since 1982. Initial, and ongoing, lockdowns have seriously strained supply chains globally, creating bottlenecks like those seen in the ports of California where dozens of ships remained parked waiting to be unloaded. Inflation and bottlenecks go hand in hand as long as demand continues at current levels. Fear of specific shortages feeds on itself, as demand increases for goods in short supply.

A spending mismatch…

Based on data from the US Bureau of Economic Analysis, the long-term trend in activity would expect US consumers to be spending roughly $5.2 trillion on goods and $8.8 trillion on services on an annual rate. Instead, the latest figures have consumers spending $5.6 trillion on goods and $8.4 trillion on services, though the gap to trend has been closing. With too many dollars chasing too few goods, further exacerbated by constrained supply chains, higher inflation may become embedded.

Global economies in tenuous position…

Looking globally, the story is similar to that of the US. Throughout Europe and Asia, both developed and emerging markets saw their December manufacturing surveys in expansion territory, with only Mexico, Brazil and Thailand below 50. Also like the US, most surveys softened from their November readings though still came in above expectations.

The primary concern for global economies revolves around new restrictions being put in place in an attempt to combat surging Covid cases brought on by the Omicron variant. In Germany, the IFO Business Climate and Business Expectation surveys have both fallen below 100 and the Bundesbank recently warned that the economy there may actually shrink in the quarter due to new restrictions. With growth already tenuous, it would not take much for these economies to shrink; however, such contractions should be short lived as restrictions are removed.

*Institute of Supply Management **Purchasing Managers' Index: indicators of national levels of economic activity derived from monthly polling of private sector companies. Above 50 indicates expansion.

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Investment Implications

Two very different market backdrops…

The investing landscape for 2022 is very different from this time last year. Then, inflation and interest rates were low, the Fed was accommodative, hopes of eradicating Covid-19 were based on increasing vaccination rates and fiscal stimulus was pouring into the economy. As a matter of fact, federal spending reached 30% of GDP in fiscal 2021, 8.5% higher than the long-term average and the highest since World War II.

Higher volatility seems certain…

This year, inflation is at 7%; interest rates are rising; the Fed has indicated that there will be rate hikes this year at the same time they reduce Quantitative Easing, both of which are tightening measures; and federal spending is set to take a steep dive as short-term stimulus measures fall off and the Build Back Better plan looks dead in the water. As icing on the cake, we have an off presidential election year, which since1930 has tended to be highly volatile ending in negative returns roughly 50% of the time.

Some positive offsets to looming headwinds…

However, there are mitigating factors: States' financial positions are healthier than they have been in decades and state-level spending is expected to pick up some of the slack from the reduction at the federal level. Tax revenues, especially capital gains, are expected to be the highest in 20 years at over 21% of GDP—resulting in a significant reduction of the federal deficit. Companies' earnings and forward-looking statements are on balance strong. Higher inflation can actually boost earnings growth. The dollar often peaks as the Fed begins to change course, which is a tailwind for the earnings of multinational companies. Consumers' savings rates as well as spending are healthy. The possibility of Covid becoming endemic has been introduced. There are early signs that at least some of the supply chain bottlenecks may be easing. And the corollary to the prospect of negative returns in off presidential election years is that once the election is over, the market tends to turn up; the one-year return historically since 1962 has been an average of +31%.

The long-term view from here is that the imbalances that have been present in economic policy since 2008, designed to combat first the Great Recession and more recently the Covid era, should begin to be unwound this year. That's a structural positive, as the former trajectory was unsustainable and invited increasing speculation.

Finally a lasting shift in leadership may be taking hold…

After outsized stock market returns in the last three years, we may see a pause as the economy transitions to a healthier path. There is still a lot of cash on the sidelines that has been finding its way into the market when corrections happen. Some portion of the recent inflation readings is in fact transitory.

Underneath the averages, the rotation away from growth and lofty valuations looks like a trend taking hold after many false starts in the last two years. This kind of market favors stock picking over index investing. It will be important to focus on quality in company strategy, management and earnings. Because of the speed at which market prices move, we remain confident that the best strategy is to stay invested instead of trying to time ups and downs.

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