Perspectives

A Quarterly Newsletter for Clients of Parsons Capital Management

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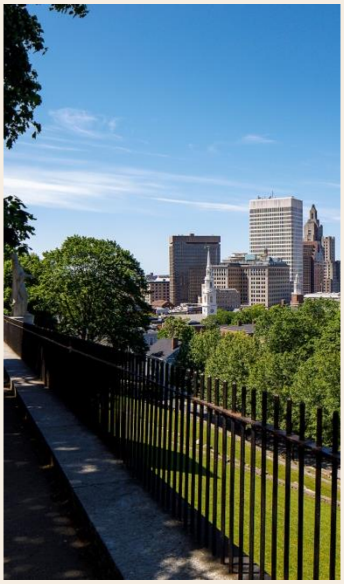

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There was reason to cheer as markets notched another all-time high on the first day of trading in 2022. Hope that the bull market might continue quickly gave way to reality as mounting issues emerged, resulting in a rapid drawdown that ultimately saw the S&P 500 decline -13%. Deep oversold conditions combined with a flush in investor sentiment allowed the market to form a bottom to bounce from, ultimately climbing 11% over the final weeks of the quarter. Growth stocks led the way higher during the March rally, but the damage done earlier in the year still left the growth focused index down -9.04% for the quarter. While value stocks did not quite keep pace in the final rally, their superior performance earlier in the year allowed for significant outperformance for the quarter, declining only -0.74%. Perhaps most striking in the quarter was the complete inability of bonds to hedge investors' stock positions. In fact, for many investors bonds were their worst performer, leaving the typical 60/40 portfolio down -5.5% in the quarter. Broadly speaking, international markets fared no better with the EAFE index down nearly -6% and Emerging Markets down almost -7%. The greatest weakness was seen from countries more intimately tied to the full global economy (i.e. Germany and China). The safe haven trade internationally was in commodity exporting countries like Canada, Mexico, Brazil and Australia.

Data as of March 31, 2022	March '22	Qtr. 1 '22	YTD '22
S&P 500	3.71%	-4.60%	-4.60%
MSCI AC World Index (incl. US)	2.22%	-5.26%	-5.26%
MSCI EAFE (Europe, Asia, Far East)	0.76%	-5.79%	-5.79%
MSCI EM (Emerging Markets)	-2.22%	-6.92%	-6.92%
Russell Largecap	3.37%	-5.14%	-5.14%
Russell Largecap Growth	3.91%	-9.04%	-9.04%
Russell Largecap Value	2.93%	-0.74%	-0.74%
Russell Midcap	2.56%	-5.68%	-5.68%
Russell Smallcap	1.25%	-7.53%	-7.53%
Bitcoin	5.39%	-3.74%	-3.74%

Data provided by Tamarac Inc.

Fixed Income Markets

There was simply no place to hide in the fixed income market as the Fed fully gave up any pretext that inflation might be transitory and diminish on its own. This resulted in increasingly hawkish language and action from the Fed. The fixed income rout was truly global with the Bloomberg Global Aggregate returning -6.16% for the quarter and the Bloomberg US Aggregate -5.93%. The sell-off accelerated as the quarter went on, with these two indices returning -3.05% and -2.78% in March alone. The longer out an investor went with maturities, the worse they fared. The Bloomberg US Treasury 1-3 year index returned -2.51% while the 20year+ index came in at -11.01%. High yield was a relative winner, returning -0.93% in March and -4.51% for the quarter.

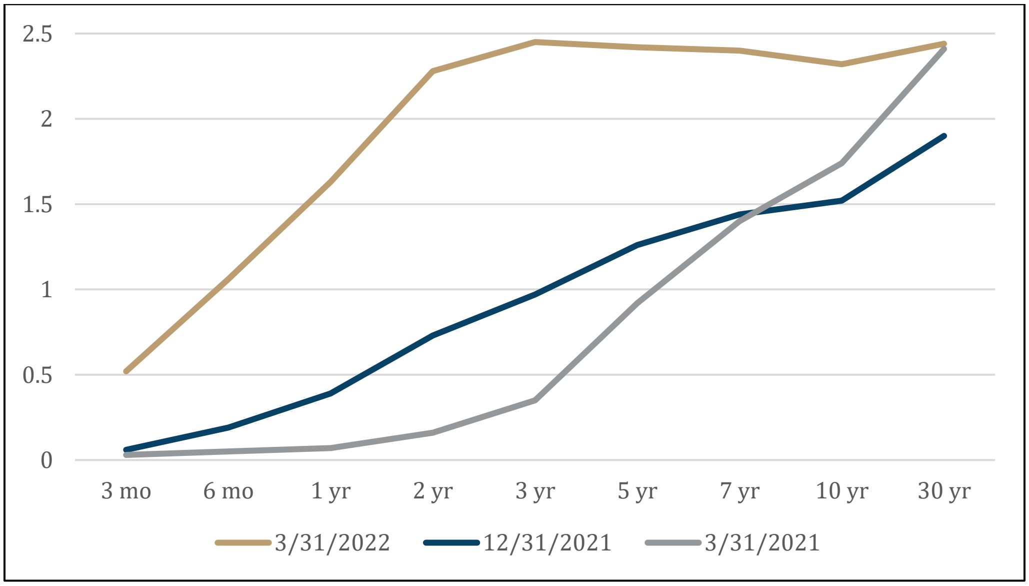
Fed begins to tighten…

Yield curve inverts at quarter end…

Commodities rip higher in 1Q…

US Treasury Yields

What a difference three months makes. Increasingly hawkish commentary from a Federal Reserve known for its dovish tendencies finally caught the attention of bond investors. To fully drive home the point, the Fed raised rates by 25 basis points at their March meeting and signaled a willingness to hike by 50 in future meetings if and as needed. Rates across the curve moved higher, both in the quarter and when compared to a year ago. Shorter-term rates rose more significantly than intermediate and long rates, causing the curve to largely flatten beyond two years. At quarter end, the curve inverted between 3 and10 years, spurring talk of recession possibilities.



Data from the Federal Reserve

Commodities

The broad measure of commodity prices, as shown by the Commodity Research Bureau (CRB), showed a massive quarterly jump in prices. The gains in commodities were widespread, from energy to food to metals.

Oil prices, which began the year in an uptrend, rose further when the invasion of Ukraine raised the potential for further supply disruptions. The rise in oil drove gasoline (+43%), natural gas (+51%) and heating oil (+58%) all higher.

Looking at commodities more broadly, silver and copper both saw notable gains of +8% and +6% respectively. Gold's nearly +7% advance was, perhaps, somewhat tempered by a strong US dollar.

In the food sector, corn (+26%) and wheat (+30%) both shot higher. Lumber, last year's commodity darling, was one of the few to fall in the quarter, dropping nearly -16%.

Commodity	Qtr. 1 '22	Year to Date '22
CRB (broad index)	27.12%	27.12%
Oil	33.33%	33.33%
Gold	6.86%	6.86%

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Economic Overview

Renewed Covid cases, entrenched inflation and Russia's invasion of Ukraine combined to throw the global economy into turmoil in the quarter.

Global economic upheaval…

The data in the US was contradictory, with strong labor markets juxtaposed against recession warning signs:

The March jobs report showed an economy at full employment, with 431,000 jobs added and the unemployment rate falling to a new pandemic-era low of 3.6%. The tight labor market resulted in a gain of 0.4% in average hourly earnings month over month (5.6% year over year) with strong wage gains helping to pull participants back into the job market. At the same time, companies seemed unwilling to part with employees, with the last report in the quarter showing just 187,000 new unemployment claims, the lowest since 1969.

Labor market robust, but signs of recession…

While the employment picture is quite strong, the outlook among individuals and businesses is decidedly less so. The NFIB Small Business Optimism Index fell by -1.4 points to 93.2 in March, marking its third consecutive month below the 48-year average of 98. Consumers seemed to feel no better: the University of Michigan consumer sentiment survey fell to 59.4 in March, the lowest reading since August of 2011. In both surveys, inflation was the primary culprit for the depressed outlook. Perhaps most alarmingly the year-ahead consumer inflation expectation index registered its highest reading since November of 1981 at 5.4%, perhaps influenced by the March seasonally adjusted CPI coming in at +8.5% and Producer Prices +11.2% year over year, the latter being the highest jump ever.

Consumers feeling the pain of inflation…

Bottlenecks starting to ease…

The ISM Purchasing Managers Index (PMI) for the US manufacturing and service sectors also offered a muddled message. The Manufacturing PMI remained firmly in expansion territory at 57.1, but that is a decline of -1.8 points from the six-month average. The New Orders and Backlog components both fell, pointing to a softening of demand but also some relief in delivery bottlenecks. The Services PMI managed to rebound +1.8 points to 58.3 following a steady decline from the November 2021 high-water mark of 68.4. Here too there was evidence of a pickup in supplier deliveries, indicating a possible peak bottleneck point has been reached.

The two PMI surveys discussed above would typically indicate an economy growing at roughly 2.4%. Another data point, the Atlanta Fed GDPNow tracking estimate, has first quarter growth pegged at 1.5%. Both indicate a deceleration from the initial reopening boom yet point to an economic slowdown without a recession.

Global economy no more sound than US…

Globally, the economic picture can best be described as uneven. Countries heavily reliant on commodity production and exports are witnessing strong trends while goods producing/consuming countries are seeing deterioration. These different outlooks are resulting in divergent central bank actions as well.

China, long a primary engine for global growth, continues to be whipsawed by Covid and the government's "zero-Covid" approach. In March both China surveys, the CFLP (China Federation of Logistics and Purchasing) and Caixin, fell into contraction territory at 49.5 and 48.1 respectively. This economic weakness and Covid impacts have resulted in the Peoples Bank of China embarking on a series of easing measures.

In Germany, the powerhouse of the European economy, the economic picture is bleak. Heavily reliant on other countries (primarily Russia) for energy imports, the current commodity cycle has an outsized influence. The ZEW economic survey plunged nearly 94 points for the biggest drop in the history of the survey. The IFO survey fell nearly 8 points, led by a 13.3-point drop in the expectations component. This was even greater than what was witnessed at the outset of Covid (-11.8 points in March 2020). Wholesale prices surged +22.6% year over year in March. It looks increasingly likely that Germany has entered a recession.

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Investment Implications

Robust list of worries confronting investors…

The list of concerns facing investors at the end of the quarter is long and complex. From the invasion of Ukraine by Russia and the resulting commodity surge, to a US Avian Flu outbreak, inflation protests in other countries, supply chain bottlenecks and shocks, China's Covid lockdowns coupled with a property crisis, weakening consumer sentiment here and abroad, a likely recession unfolding in Europe and the North Koreans firing off rockets, there is a litany of issues for investors to concern themselves with. But rising above all, for domestic investors, is the path the Fed will ultimately choose in their attempt to stamp out inflation. All of this is taking place against the backdrop of the debut of the 2022 election season.

Fed finally tackling inflation…

The Fed has made it clear that they are firmly entrenched in a tightening cycle. After raising short-term interest rates 25 basis points in March (believed by many investors to be too little too late), their rhetoric continues to express a willingness if not an intention to continue. At the same time, the Fed will soon begin to actively shrink their balance sheet to further remove liquidity. Liquidity is nectar to the stock and bond markets, and both are nervous at this prospect.

Higher vol the norm in midterm years…

Midterm election years historically tend to see higher volatility. When combined with the issues laid out above, the first quarter certainly lived up to expectations. With an average daily move of +/- 1.11%, the first quarter of 2022 was the 26th most volatile going back to 1945 (305 quarters total). Continuing to use history as a guide, market performance tends to be choppy and trending down in these midterm election years until early fall. Once the election is decided, a relief rally typically plays out into year end and beyond.

With inflation high and the Fed intent on pushing interest rates higher, price earnings multiples on stocks are likely to continue to contract. In such a scenario, earnings growth will be of even higher importance than during the last two years. As first-quarter 2022 earnings announcements are about to get underway, the backdrop is full of cross currents and uncertainty. Overall, earnings are expected to be up +6%, a respectable number considering the high year over year growth witnessed in 2021. However, if we exclude energy companies, the expected growth rate for the remaining S&P 500 constituents would be only +1%. Further, eight of eleven sectors are forecast to have revenue growth higher than their earnings growth, pointing to mounting pressures on profit margins.

Markets navigating fraught macro conditions…

It has been decades since both stocks and bonds posted negative returns for any protracted period of time. With the Fed early in a tightening cycle that should last until inflation breaks, bonds will likely continue to struggle. Growth stocks, with high multiples applied to their earnings or revenue, also stand out as vulnerable to a hawkish Fed. Value stocks, which typically sport above-average dividend yields and lower valuations, were the relative standouts in the first quarter, and that is likely to continue until inflation is tamed.

In this environment, liquidity at the portfolio level, careful selection of securities, and inflation hedges will be of paramount importance.

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