Perspectives

A Quarterly Newsletter for Clients of Parsons Capital Management

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by John Mullen and Ruth Mullen

PARSONS
Capital Management, Inc.

www.parsonscapital.com

Corporate Headquarters
10 Weybosset Street, Suite 1000
Providence, RI 02903-2808
Phone 401.521.2440
Fax 401.521.4870
Toll-Free 888.521.2440

Florida Office
11450 SE Dixie Highway, Suite 205
Hobe Sound, FL 33455
Phone 561.868.2440

What began as a market wobble in the first quarter turned into a full rout and bear market in the second as the S&P 500 dropped by more than 15% in a quarter for just the ninth time since the end of World War II. There was seemingly no investable asset class immune to the weakness as equities across the globe were hit hard, bonds posted another quarter of negative returns, crypto plunged and even many commodities pulled back as recession fears took hold. The second quarter also saw 90% of the trading days post an intraday move of at least 1% in the S&P 500, the most volatile reading since 2009. At the root of much of the weakness was inflation that continued to march higher, and the fear that in an effort to tamp out inflation the Fed would push the US into recession. With inflation running hot and central banks around the globe tightening in response, the more speculative areas of the market were hit hardest. Growth stocks witnessed a bear market just in the second quarter; when combined with losses from the first three months of the year, the index has a negative return of nearly -30% at the midpoint of 2022. Value stocks were relative stars by comparison, falling just -12% in the quarter and about -13% for the year. Small and midcap stocks also lagged their larger peers but nowhere was the damage as severe as in the crypto space. Long touted as a safe haven or inflation hedge, it proved to be neither as crypto currencies were trounced in the quarter. The flagship Bitcoin lost over half its value.

Data as of June 30, 2022	June '22	Qtr. 2 '22	YTD '22
S&P 500	-8.25%	-16.10%	-19.96%
MSCI AC World Index (incl. US)	-8.39%	-15.53%	-19.97%
MSCI EAFE (Europe, Asia, Far East)	-9.26%	-14.29%	-19.25%
MSCI EM (Emerging Markets)	-6.56%	-11.34%	-17.47%
Russell Largecap	-8.37%	-16.67%	-20.95%
Russell Largecap Growth	-7.92%	--20.92%	-28.07%
Russell Largecap Value	-8.73%	--12.21%	-12.85%
Russell Midcap	-9.98%	-16.85%	-21.57%
Russell Smallcap	-8.22%	-17.19%	-23.43%
Bitcoin	-37.12%	-56.01%	-56.75%

Data provided by Tamarac Inc.

Fixed Income Markets

The fixed income market logged a second consecutive quarter of negative returns with the return dispersion looking very similar to the first quarter. Once again, bonds of nearly any maturity posted negative returns. The lone exception was the Bloomberg 2-4 Year Municipal index, with a positive total return of just 0.11%. As was the case in the first three months of the year, weakness only amplified with maturity: the Bloomberg US Credit 1-5 Year index posted a -1.75% total quarterly return versus the long bond index at -12.59%.

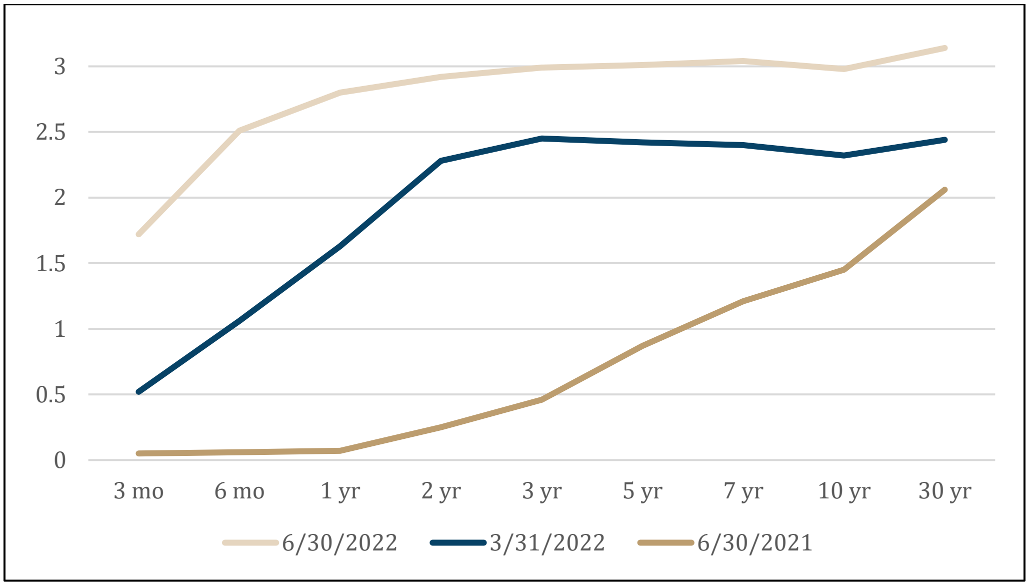
Perspectives

US Treasury Yields

Fed surprised with 75bp hike…

On June 15th, the Fed somewhat surprised markets by raising their benchmark rate by 0.75%, which was the largest hike since 1994. The third hike of the nascent tightening cycle brought the Fed Funds Rate to 1.5%-1-75%. In the same meeting, the Fed stated that they expected to end the year with a rate of 3.5% - meaning multiple hikes of at least half a point currently remain in the pipeline. The more aggressive posture from the Fed was necessitated by inflation numbers that continued to run hot and were increasingly broadening out. The current slope, shown below, indicates little room for policy error going forward.

Yield curve flattening…



Data from the Federal Reserve

Commodities

Performance in the commodities space was nearly a mirror image of what was witnessed in the first quarter of the year. Whereas the first three months saw nearly every commodity post gains, the second quarter was marked by widespread weakness with only gasoline and oil ending the quarter higher. The broad-based declines were enough to pull the CRB index into negative territory for the first time since the first quarter of 2020.

CRB win streak snapped at eight quarters…

Perhaps nowhere was price volatility more pronounced than with natural gas, which dropped 50% in the three weeks from June 6 through the end of the quarter. Indicating how far the commodity had run up, that drop still resulted in just a -4% decline overall for the quarter.

In a sign of recession fears taking hold, copper prices dropped -22%.

Commodity	Qtr. 2 '22	Year to Date '22
CRB (broad index)	-1.10%	25.73%
Oil	5.46%	40.62%
Gold	-7.51%	-1.16%

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Economic Overview

Recession increasingly on investors minds…

The final first quarter GDP reading came in at -1.6%, which was slightly worse than the initial estimate. The question on many minds is: Will a recession follow? The Atlanta Fed GDPNow forecast steadily deteriorated throughout the second quarter to end with a projection of -2.1%, which would result in two consecutive quarters of GDP contraction—the baseline for recession.

Jobs market has weakened, but remains solid…

While the rule of thumb is two quarters of GDP contraction equates to a recession, the reality is a bit more nuanced. Here the picture becomes less clear whether the US economy is actually in a recession. While GDP declined in the first quarter, Gross Domestic Income (an alternative measure of GDP) rose at a 2.1% annualized rate. Further, manufacturing production is up at a 6.6% annualized rate through the first five months of the year, nonfarm payrolls have been growing at an average of 488,000 per month in 2022 and personal spending continues to grow. Weekly jobless claims also remain low at 231,000 to end June, though there has been a steady uptick from the low point of 166,000 back in the middle of March.

Consumers down on the economy, corporate outlook less dour…

Economic surveys also present an inconclusive picture of the current state of the domestic economy. The University of Michigan Consumer Sentiment survey plunged nearly -15% in the month of June to a reading of 50, an all-time low for a survey that goes back to the 1940s. Respondents' optimism regarding continued wage gains was more than offset by concerns revolving around inflation and the overall economic outlook for the year ahead.

While the consumer survey showed a dour outlook, the corporate surveys pointed to a mixed environment. The June manufacturing Purchasing Managers Index (PMI) survey conducted by the Institute for Supply Management (ISM) remained in expansion territory at 53, although that was down -3.1 points from the May reading. Looking at the components of the survey, the New Orders Index (a leading indicator) slipped into contraction, falling -5.9 points month over month to 49.2. On a positive note, pricing pressures eased. Turning to the service side of the economy, the ISM Service PMI for June came in at 55.9, slipping -0.6 points from the previous month. Unlike the manufacturing survey, New Orders remained firmly in expansion territory at 55.6, though it was a -2 point drop from May.

Some hope that peak inflation has been seen…

The latest jobs reports also offered mixed signals. As mentioned above, jobless claims remain low by historical standards but have been marching higher. Such moves are nearly always seen before a recession, but do not on their own always signal one is looming. The May JOLTS report showed 11.25 million job openings, a drop from the 11.68 million posted in April. While the number of openings is coming down, with only 5.45 million workers looking for jobs, the ratio of openings to workers remains elevated at nearly 2:1. This is notable as the Fed has explicitly stated they want to see job openings come down to help ease inflation.

On the inflation front, there was some potential good news in June. The Core PCE, the Fed's preferred measure of inflation, slowed for the third straight month in May to a reading of 4.69%. The May reading for personal income came in at +0.5% month over month, as expected, but spending grew at just 0.2% versus the expectation of 0.4%.

Globally the story is similar to what is being witnessed domestically. Inflation is entrenched and expanding, energy costs are exploding, PMIs are weaking (though generally still in expansion) and consumers are feeling the pinch. In reaction to the high inflation present around the globe, major central banks are raising rates in hopes of cooling their economies.

The notable exception to this global trend is China. While most countries are seeing their PMIs drop, China's manufacturing PMI rose 3.6 points to 51.7 in June. Instead of tightening, their central bank is easing to revive lending and stimulate an economy long battered by Covid shutdowns.

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Investment Implications

A resounding end to stock and bond bull markets…

No wonder investor sentiment has turned sour after the worst year-to-date performance of a classic 60% stocks/40% bond portfolio since the 1960s; to say that this has been a tough year for stocks and bonds is an understatement. After a 12-year bull market in stocks during which prices doubled, redoubled and more, as well as a 40-year bull market in bonds which saw interest rates fall from nearly 20% to almost zero, the landscape has changed. Much of the volatility seen in the first half of 2022 is a sign of investors recalibrating risk tolerance and where the opportunities will lie in this new environment. Many of these investors have a short time horizon, exacerbating the volatility.

There are a myriad of factors to worry about these days. For stock and bond investors, chief among them are inflation and the central bank actions to tame it, the odds of recession and Price/Earnings ratios and corporate earnings.

Race between inflation and consumer on who breaks first…

The Fed was late to recognize how serious and embedded inflation was, and they are playing catchup. Their job is complicated by the health of consumers' and businesses' balance sheets as well as the full-employment situation described in the pages above. Consumers' savings rates are falling, indicating that they are absorbing inflation so far by spending down savings. In a sense, it's a race to see how long that can last while the Fed continues tightening, which will help determine whether there is a real recession, how deep it will be and how long it will last.

There is no easy way to say that the Fed needs to engineer demand destruction in order to prevent inflation expectations taking hold the way they did in the 1970s. Their cushion is that 2:1 ratio of jobs available to job holders. A soft landing is possible if that gap can be narrowed without a significant increase in the unemployment rate.

A recession needed to help flush the system…

Recessions are part of the economic cycle, and one may be necessary as part of the formation of a strong bottom in stock prices from which we can sustainably move forward into the next expansion.

One interesting factor to consider in this respect is home values. Keep in mind that the latest official data show that about 53% of Americans own stocks directly or indirectly while 65% of Americans own a home, and for that bottom 50% the median value of net wealth was $10,000 and $89,000, respectively in the two assets. Needless to say, the bottom half represents many more consumers than the top 10%, If home values hold in better than stock values, and supply/demand suggests that may happen, the hit to consumer confidence may not be too harsh, and a recession not too deep.

A narrow path remains to a "soft-ish" landing…

Most of the correction in the stock market so far this year has been attributable to a contraction in the P/E multiple from over 20 times to 15.9 times currently. The "E"—earnings—looks vulnerable, however. Corporate reports and especially corporate guidance in the coming earnings season will be key.

At inflection points like this one, it is more important than ever to take the long view. Many stocks in the underlying indexes have already corrected more than 50%. This is a process of flushing out speculation and restoring a healthier market. Normalized interest rates will help savers. Cyclicality by definition means that this cycle will pass into the next bull market.

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