Perspectives

A Quarterly Newsletter for Clients of Parsons Capital Management

Quarter 4, 2022

by John Mullen and Ruth Mullen

A fourth quarter rally ultimately ended in a December swoon for domestic markets, capping off the worst year for stocks since 2008. Bitcoin again stood out for all the wrong reasons with another quarterly decline bringing the full-year rout to -65%. Value stocks continued to outpace growth, decisively breaking a multi-year pattern of underperformance. Of particular note, growth stocks were unable to regain leadership in the fourth quarter when longer-dated interest rates fell, inflation looked to have peaked and the US Dollar declined. This environment is usually supportive for growth stocks. Another multi-year trend reversed in 2022 with the superior performance of international stocks vs. the US. Leadership changes often emerge from volatility. Growth has outperformed value for 15 years; the prior cycle was 15 years. US beating international this cycle has lasted 12 years vs. an average of eight years since 1975. There have been several false starts with these potential leadership changes in the last 18 months; this one may be real.

Data as of December 31, 2022	Dec '22	Qtr. 4 '22	YTD '22
S&P 500	-5.76%	7.56%	-18.11%
MSCI AC World Index (incl. U.S.)	-3.90%	9.88%	-17.96%
MSCI EAFE (Europe, Asia, Far East)	0.11%	17.40%	-14.01%
MSCI EM (Emerging Markets)	-1.35%	9.79%	-19.74%
Russell Large Cap	-5.82%	7.24%	-19.13%
Russell Large Cap Growth	-7.66%	2.20%	-29.13%
Russell Large Cap Value	-4.03%	12.42%	-7.53%
Russell Mid Cap	-5.41%	9.18%	-17.32%
Russell Small Cap	-6.49%	6.23%	-20.43%
Bitcoin	-3.75%	-15.03%	-65.37%

Data provided by Tamarac Inc.

Fixed Income Markets

Bonds broke their multi-quarter streak of negative total returns with the US Aggregate Index ultimately posting a positive total return of 1.87% in the final quarter of 2022, although the return for the year stayed negative. Municipal bonds were strong across the board in the quarter with positive total returns in each maturity segment and returns improving as maturities moved out further into the future. Annual returns were still negative at -8.5%. In a reversal from earlier quarters, US Treasury returns were strongest in the middle part of the curve (3-7 years) while the longest-dated Treasuries had a negative total return. For the full year, the Bloomberg US Treasury 20+ Year Index returned -31.09%, which was only slightly better than the -33% return witnessed by the NASDAQ Index in 2022. Lastly, taking the top of the podium for the quarter were high yield bonds with a total return of 4.17%, barely besting the 4.10% return from the Municipal Index. For the year, the Bloomberg US High Yield Composite returned -11.19% compared to the US Aggregate's -13.01%.

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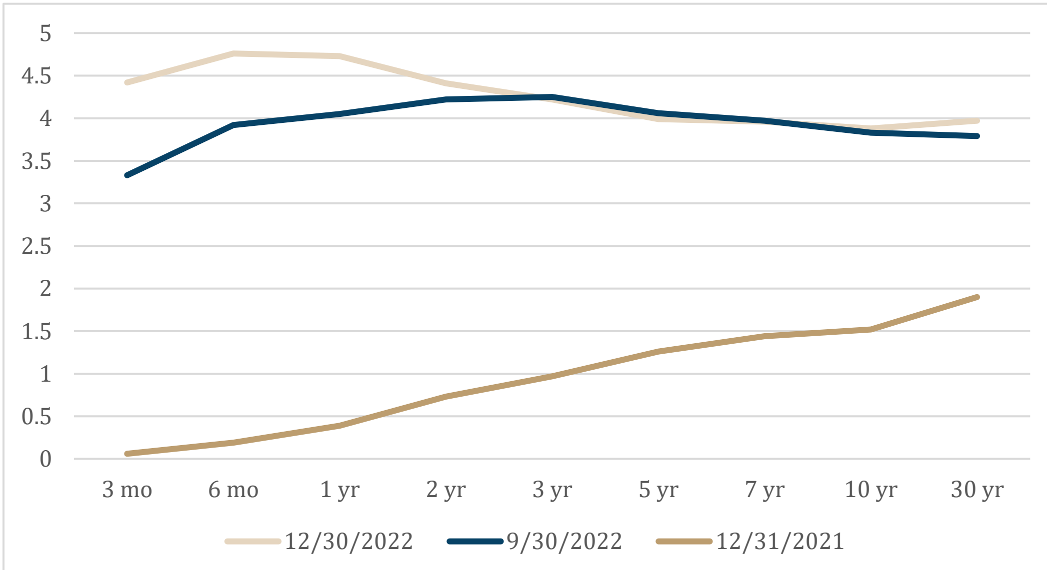
US Treasury Yields

Much more aggressive tightening cycle than what was anticipated…

The Fed continued raising rates in the fourth quarter, taking the Fed Funds rate to a range of 4.25%-4.5% with a 50-basis-point increase in their final meeting of the year. For comparison, the Fed began the year expecting to take the FFR from a range of 0%-0.25% to 0.75%-1%. Perhaps in a nod to the fact they began the year behind the inflationary eight-ball, the Fed maintained their relatively hawkish stance in their final minutes, hinting not just at further hikes to come in 2023 but a willingness to hold rates until clear signs emerge that inflation has been tamed rather than pivot to easing.

Treasury yield curve has now been inverted for more than 100 days…



Data from US Treasury

Commodities

Commodities up, but energy taking a back seat…

Commodities, as broadly measured by the CRB Index, snapped back in the final quarter of the year after falling in the third quarter. Unlike most recent quarters, the energy complex was not the driving force behind total performance.

Oil, represented by the West Texas Intermediate contract, posted a minor gain after plunging nearly -25% in the quarter prior. Gasoline futures were flat for the quarter and, while up 10% for the year, were down -42% from their summer high. As it became clear that Europe was not facing an impending energy crisis, natural gas steadily declined, dropping -34% in the quarter and ending the year off -54% from the high.

Metals were a standout in the quarter with a strong rally from gold nearly erasing the declines seen through the first three quarters of the year. Copper was even stronger, up 12% for the quarter, though ended the year down -15%.

Commodity	Qtr. 4 '22	Year to Date '22
CRB (broad index)	4.58%	21.98%
Oil	0.97%	6.71%
Gold	9.85%	-0.13%

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Economic Overview

While there are mounting signals that inflation has peaked globally, the absolute level remains too high—forcing central banks to continue to hike rates even in the face of slowing economies.

Inflation tamer, but still a problem…

In the US, the Personal Consumption Expenditure (PCE) price index moderated to 5.5% in November, which was down from a 6.1% reading in October and a high of 7% in June. This is important; the PCE measure is the Fed's preferred reading for inflation. The slowdown in inflation is notable as it gives the Fed clearance to moderate their rate hikes, a welcome development as more signs emerge pointing to a slowing domestic economy.

More signs of domestic trends weakening…

In December the ISM Services PMI (Purchasing Managers Index, a measure of economic activity) for the US fell to 49.6, a notable miss from the expected reading of 55 and a large drop from November's reading of 56.5. This marked the first contractionary reading for the survey since May of 2020 at the height of the Covid lockdowns. The Manufacturing PMI logged its second consecutive month in contraction, also missing expectations with a reading of 48.4.

Beneath the headlines, both surveys showed a marked decline in the new orders component, pointing to weakening demand. On an encouraging note, however, both surveys saw a drop in pricing pressure pointing to a potential further easing of inflation and margin compression. As if the signals weren't mixed enough, the manufacturing survey showed strength in the jobs component as labor hoarding continued, while the services index employment dropped nearly 2 points to 49.8.

Labor market remains strong, propping up the economy…

Looking at the jobs market, broadly, there is still work to be done before the Fed is likely comfortable that inflation has been tamed. The final jobs report of the year showed employers added 223,000 jobs in December, pushing the unemployment rate down to 3.5% even as the participation rate notched an increase. A potential positive was wage growth, which came in softer than expected, up 4.6% year over year. It appears that a higher percentage of jobs gained have been part-time. A slower rate of wage growth reduces the chances for a wage-price inflation spiral taking hold.

Covid outbreak clearly impacting China…

From a high of 55 back in November of 2020, China's Caixin Manufacturing PMI has mostly steadily deteriorated, ending the year in contraction territory at 49. The punishing zero-Covid-related lockdowns clearly impacted the Chinese economy, hurting both consumption and production. With the December pivot by Chairman Xi to open up the economy, there is likely more near-term weakness as a populace that is under vaccinated and underexposed is suddenly confronted by a highly infectious strain of Covid. Seemingly in acknowledgement of this reality, Chinese central planners are already announcing a new wave of stimulus that should help to supercharge the economy there once Covid has burned through.

Japan still not blinking, yet…

The only major central bank that has yet to change course to address inflation is Japan. It is, perhaps, understandable that after fighting deflation for decades the BoJ would be hesitant to move off from an easing position; with inflation as measured by the CPI pushing towards 4%, though, even Japan may be forced to tighten in 2023.

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Investment Implications

Volatility reigned as leadership shifted…

As stated above, the volatility of 2022 ushered in what appears to be a cyclical reversal in at least two major long-term trends in the stock market when value bested growth and international outperformed the US. In the bond market, the 40-year decline in interest rates reversed abruptly into a rising rate environment, which also looks structural.

These trends are interrelated and portend a very different investing landscape than what we've experienced for decades. Gone are the easy monetary policies that lifted all boats. Gone also is "TINA": "there is no alternative" to stocks to generate returns. Bonds and fixed income instruments, even cash, now earn some income. In our opinion, even though inflation and interest rates seem to have peaked in 2022, inflation will be hard pressed to fall as low as the Fed's stated target of 2%, and higher interest rates are sticky.

Macro forces no longer the tailwind they once were…

Why is that so? The two macroeconomic forces of globalization and disinflation, which reigned more or less for decades, fostered increasingly easy money policies by central banks. These policies, which went into overdrive in the wake of the global financial crisis of 2008–09 (one could argue they also created it), flooded the financial world with cash, much of which worked its way into the stock and bond markets and fueled consumption of goods and, increasingly, services. Central banks could get away with it because globalization was such a strong disinflationary force: cheaper labor and sourcing continually pushed down the cost of goods and services, expanding profits while keeping prices low. With rates at or below zero, the value of potential future stock earnings continued to increase, fueling the performance of growth stocks.

These macro forces unraveled over the past year. Inflation returned with a vengeance and, unlike prior spikes since 2009, proved to be embedded and not transitory. Interest rates moved higher in response, and by the end of the year there was no negative yielding debt remaining in the world, compared to a peak of $18.4 trillion in such debt at the end of 2020. With globalization increasingly in reverse and certain hard-to-tame components of inflation (think rent and wages) looking sticky, it seems unlikely rates will return to the levels seen over the past 14 years.

Central banks tightening in the face of stubborn inflation…

The Fed and central banks worldwide (the lone exception being Japan) have been forced to suddenly pivot from fighting the threat of deflation to dealing with the reality of inflation. So far, the Fed's aggressive tightening has been less painful than it might have otherwise been due to the full-employment economy. The stubborn excess of jobs available vs. workers is forcing the Fed to go further than they might have hoped. They would have preferred to reduce that "jobs available" number without creating significantly higher unemployment, but that hasn't happened. Labor force participation is still lower than before the pandemic.

Volatility likely here to stay…

We expect the volatility that usually accompanies transitions to continue in 2023, yet we also think that 2022 will become the 16th of 16 off presidential election years where a stock market bottom area has been established, giving way to a new bull market. In other words, even though we may revisit the area of the October lows, further downside from there seems limited and upside potential is greater. Returns over time may be single digit, but positively biased.

In this new environment, balanced portfolios can work again—once interest rates settle. In general, companies that can self-fund while paying and growing a dividend should stand out. Industrials are a sector that should benefit (in the late '90s, before the growth super-cycle took hold, industrial stocks were a larger weight in the S&P 500 than tech stocks; today their weightings stand at 10% and 25%, respectively), while stocks keyed toward commodities, where a cycle of higher prices seems to be in the early stages; and certain healthcare and financial stocks should take leadership.

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