Perspectives

A Quarterly Newsletter for Clients of Parsons Capital Management

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by John Mullen and Ruth Mullen

The weakness of the first quarter, when the S&P 500 closed lower in February and March, has become a distant memory. Building on the momentum coming out of the second quarter, the S&P 500 hit a new closing high on August 24th, surpassing the one set on January 26th. The rally in large cap stocks continued unabated through September, a month that has registered positive returns in only a third of the years since the 1960's. Small cap stocks were unable to escape the September doldrums and, after pacing their large cap peers for much of the year, wound up lagging badly in the quarter. Like the second quarter, both growth and value stocks "worked" as they moved higher together, though growth continued to widen the performance gap compared to value. Dollar strength, slowing growth and trade related fears all conspired to hold down international indices: developed international returns were muted, and emerging markets were outright negative once again. China, down over 24%, sank firmly into the grip of a bear market. The continuing performance divergence between small caps and emerging markets has reached nearly historic proportions.

Data as of Sept. 30, 2018	Sept. '18	Qtr. 3 '18	YTD '18
S&P 500	0.57%	7.71%	10.56%
MSCI AC World Index (incl. US)	0.48%	4.40%	4.26%
MSCI EAFE (Europe, Asia, Far East)	0.91%	1.42%	-0.98%
MSCI EM (Emerging Markets)	-0.50%	-0.95%	-7.39%
Russell Large cap	0.38%	7.42%	10.49%
Russell Large cap Growth	0.56%	9.17%	17.08%
Russell Large cap Value	0.20%	5.71%	3.92%
Russell Midcap	-0.64%	5.00%	7.46%
Russell Small cap	-2.41%	3.58%	11.51%

Data compiled from Tamarac Inc.

Fixed Income Markets

After moving broadly in line, and lower, with each other during the first two quarters of the year, fixed income indices began to separate in the third quarter. The Bloomberg Barclays Global Aggregate index was negative again in the quarter, pushing its year to date return to -2.37%. The US Aggregate broke its slump with a positive 0.02% return in the quarter, but remained down -1.60% for the full year. While the overall US Aggregate was positive for the quarter, there were many divergent pieces. Municipals posted a return of -0.15% while corporate credit rose 0.89% and high yield led the way up 2.40%. 1-3 year Treasuries managed a gain of 0.19% while all other maturities fell, with the worst performance occurring in the longest maturities.

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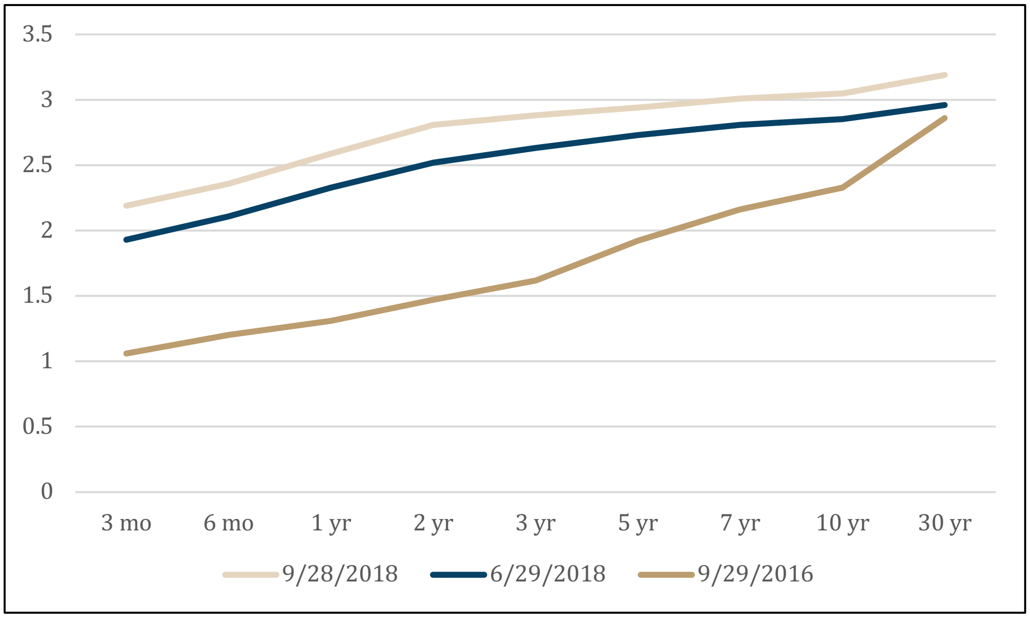
US Treasury Yields

Rising likelihood curve could invert…

The slope of the yield curve remained similar to the one in 2Q 2018, while moving higher in rates overall. Short rates kept creeping up as the Federal Reserve continued to raise rates. Investors' questions about future growth, the possibility of the Fed overshooting in this tightening cycle and low sovereign interest rates abroad all held long term rates in check, keeping the slope of the curve relatively flat. At the September meeting, the Fed stated their intention to raise rates once more this year and three times in 2019, and they removed their reference to being accommodative. Without a rising growth and inflation expectation, the likelihood increases that four more hikes could cause the curve to invert.

Slope remains flat while rates move higher…



Commodities

Commodity prices reversed course in the third quarter, showing broad based weakness throughout the index.

Few safe spaces in commodities…

Oil prices were lower in the quarter, but the commodity staged an impressive rally over the final six weeks in climbing 12.5% from its August 15th low. Gasoline and natural gas prices decoupled from the price of oil and were among the few commodities to post a gain in the quarter, up 6% and 3% respectively.

Metals, both precious and industrial, were weak in the quarter. Agricultural products were also mostly lower with soybeans being a frequent target for retaliatory tarrifs.

Commodity	Qtr. 3 '18	Year to Date '18
CRB (Commodity Research Bureau) Index	-2.10%	1.26%
Oil (West Texas Intermediate)	-1.27%	21.06%
Gold	-4.78%	-8.79%

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Economic Overview

US economy firmly decoupled…

The third quarter saw a continuation of the divergence theme that emerged during the second quarter. The US economy powered ahead, seemingly unfazed by the swirling trade turmoil that conspired to slow growth in many other countries. The fuel for domestic strength is stimulus in the form of tax cuts and increased government spending. Such moves are unprecedented at this late point in a business cycle, but with inflation pressures still tame, policy makers and many analysts suggest that this unusual condition could prolong the expansionary phase of the cycle.

The tax cuts enacted in December of last year look to be having a positive impact for both corporations and individuals. Corporations are using the windfall to make capital expenditures, buy back stock, and in some cases increase worker pay. Increased take home pay is allowing individuals to spend more while at the same time boost their savings rate.

Tax cuts working through the economy, housing weak…

If there is a weak link in the domestic economy it is housing. Outside of a slight tick up in July, approved permits to build new housing units have fallen each month since March. Housing starts have also been lower than expected in recent months. While the direct impact of home construction/remodeling on the economy is rather small, at 3.5% of GDP, housing activity has a large multiplier effect making the health of the industry important to the overall economy.

Trade tensions lessen in North America…

Turning to North America, it was a drawn out process but an agreement was finally reached between the US, Mexico and Canada on a renegotiated NAFTA, called USCMA. While the new agreement does not contain any earth shattering changes when compared to NAFTA, it does take a major trade risk off the table and draws the three economies closer. Perhaps most important: USCMA provides a united front against China as the US continues to try to change that country's economic behavior.

Outside of North America, the economic situation is more precarious. The JP Morgan Global manufacturing PMI (Purchasing Managers Index) reading fell -.4 in September to 52.2 – still in expansion territory but continuing an uninterrupted downtrend that began in December 2017.

Global outlook remains murky…

In Europe, as the quarter ended, fears of political instability reemerged in Italy. The new EU skeptic governing body put forward a budget that projected a deficit exceeding the allowable level for next year, before coming back into compliance in later years. This occurred at the same time the ECB signaled their intent to begin winding down their own QE program at the end of this year.

At the same time Italy seemed headed for a confrontation with the EU, negotiations between the UK and EU over Brexit dragged on with no clear progress. As the potential for a hard Brexit looked to be rising, business sentiment and activity in the UK saw another move lower.

Turmoil built in emerging economies. Turkey spiraled into hyperinflation and economic chaos. Argentina was forced to enter an IMF bailout program as their economy seized up. In a bright spot, South Korea's economy began to rebound as military and trade issues lessened.

The continued escalation in US trade tensions led Chinese policy makers to provide stimulus of their own. During the quarter the government lowered interest rates, announced plans for individual tax cuts, increased lending and lowered tariffs on non-US goods. The last time the Chinese government provided a similar level of stimulus to their economy, it led to a global capex boom and an increase in global growth. If trade tensions were to de-escalate the same virtuous cycle could play out again.

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Investment Implications

Market losing a key support?...

The hallmark of this unloved ten-year bull run has been a market that has continually climbed a proverbial wall of worry. A primary support throughout the advance has been the exceedingly accommodative Federal Reserve, spanning the tenure of two separate chairs. Born of necessity in the wake of the 2008-9 financial crisis and continuing throughout the expansion it ushered in, this support is now being withdrawn. A new reality for the market appears to be dawning.

Negative market reaction to Chairman Powell…

The Fed under Chairman Powell is, by his own words, going to be less detailed in their communication. In the nine instances when Chairman Powell has spoken publicly, the market has fallen five times as he has taken a more hawkish stance than what was expected. Currently, the Fed seems focused on tightening financial conditions to ward off an overheated economy which will ultimately put downward pressure on the Price/Earnings multiple. The removal of Fed accommodation is likely to also lead to higher market volatility, another headwind to P/E's.

P/E contraction offsetting EPS gains…

Already this year the forward P/E multiple has fallen by roughly 1.5 points, but the market is still up thanks to strong earnings growth. Looking forward, a return to the long term median forward P/E without a corresponding rise in expected EPS (earnings per share) would leave the market 8% below where it ended in September.

Adding to the anxiety of the market is the notion that we're at peak margins and that the 20%+ EPS growth this year is being fueled entirely by tax cuts and buybacks. While margins aren't likely to widen a great deal from here, they typically do not start to deteriorate until the average hourly earnings (AHE) growth rate moves above 4%. With AHE currently at less than 3%, it is unlikely wages will start to eat away at margins in the near term. Tax cuts have certainly aided earnings growth this year, but stripping out the effect of the cuts would still leave gains in the low double digits.

Politics to business cycle to margins, lots to worry about…

As if the shifting dynamics of the Fed weren't enough, markets are also grappling with the uncertainty brought about by the impending mid-term elections. Current odds favor Democrats taking control of the House while Republicans are expected to maintain their advantage in the Senate, and possibly pick up a seat or two. Such a scenario would be market friendly, since it would allow for the administration to continue its deregulation push while a divided Congress would result in a legislative status quo for the next two years. The market negative outcome would be for Democrats to take control of both houses of Congress. In that event, the deregulation push would be put on hold, and likely reversed. It could also allow President Trump to implement his more restrictive trade policies, as Democrats are traditionally supportive of tariffs.

Bond prices will adjust down as coupon rates increase. Ultimately, once a threshold has been reached and in certain circumstances along the way, bonds may be more attractive for purchase than they have been in years.

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