Perspectives

A Quarterly Newsletter for Clients of Parsons Capital Management

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by John Mullen and Ruth Mullen

The market managed to build on the strongest first half year since 1997 to post a modest +1.7% gain, but underlying that gain was a quarter of turmoil. Stocks raced out of the gate in July to set new all-time highs for the S&P 500. August witnessed a reversal in fortune, with renewed trade concerns weighing on market sentiment. As tensions eased and the Fed cut in September, stocks managed to stage a rebound to end the quarter in the black. What was notable about the September rebound was a change in leadership. Value stocks, long a laggard in the 10-year bull market, led the market higher in the final month of the quarter with energy stocks the best performer. Even with the rebound, though, value stocks still finished behind their growth peers for the quarter. In other leadership changes during September, small cap and international outperformed. The strong month was not enough to lift either group into positive territory for the quarter, though, as the deteriorating global growth outlook weighed more heavily on them than on larger cap domestic equities.

Data as of Sept. 30, 2019	Sept. '19	Qtr. 3 '19	YTD '19
S&P 500	1.87%	1.70%	20.55%
MSCI AC World Index (incl. US)	2.15%	0.10%	16.71%
MSCI EAFE (Europe, Asia, Far East)	2.92%	-1.00%	13.35%
MSCI EM (Emerging Markets)	1.94%	-4.11%	6.22%
Russell Largecap	1.73%	1.43%	20.54%
Russell Largecap Growth	0.01%	1.49%	23.30%
Russell Largecap Value	3.57%	1.36%	17.81%
Russell Midcap	1.97%	0.48%	21.93%
Russell Smallcap	2.08%	-2.46%	14.12%

Data compiled by Tamarac Inc.

Fixed Income Markets

While equity markets were marked by fresh all-time highs and volatility, fixed income markets were setting records of their own. The month of August saw yields fall across the curve on the back of multiple geopolitical concerns and dour growth figures. During this descent in yields, the 30-year US Treasury fell below 2% for the first time in history. The US Aggregate bond index returned a respectful +2.27% total return in the quarter, but the real gains were seen in the long end of the curve. 20+ year US Treasuries returned +8.15% in the quarter and now stand at +20.20% for the year while intermediate bonds were +1.70% and +8.46% for the same periods. While high yield bonds lagged in the quarter with the Bloomberg Barclays US High Yield Composite up +1.33%, they were the only fixed income segment to post positive returns for September. Municipal bonds, as measured by the Bloomberg Barclays Municipal Index, posted a gain of +1.6% in September, and unlike the corporate sector high yield, munis' return for the quarter was positive at +2.8%.

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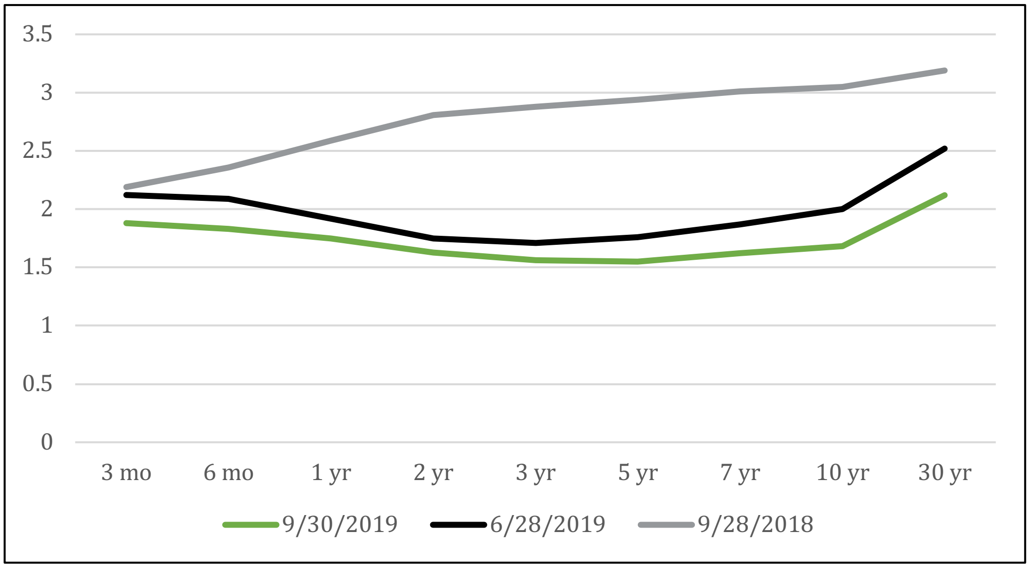
Perspectives

Global easing cycle creating more negative yielding debt…

Yield curve remains inverted…

US Treasury Yields

While the yield curve remained inverted in the quarter, the Fed Funds rate cut at the September meeting helped to lessen the U shape somewhat. While the Fed eased in the third quarter, it was not the only central bank to do so which helps explain the move lower across the curve. In Europe the ECB cut their official rate further into negative territory and restarted their Quantitative Easing program. The actions of the ECB combined with the Bank of Japan's continued easing bias resulted in over $15 trillion in negative yielding sovereign debt at the end of the quarter, compared to just $6 trillion a year ago. With such a backdrop, it will be difficult for domestic rates in the mid to longer end of the curve to move much higher.



Attack in Saudi Arabia not enough to revive oil prices…

Copper cracks as growth weakens…

Commodities

After slipping slightly lower in the second quarter, commodities continued to lose ground in the third, led lower by weakness in the price of oil.

The attack on Saudi oil facilities in late September sent oil prices higher by 15% the following day. The gains proved to be short lived, as the Saudi government assured markets they would be able to quickly bring production back online and governments around the world promised releases from oil reserves.

Copper, long seen as an indicator of economic health, slipped lower by 5% in the quarter and turned negative for the year.

Gold was one of the few bright spots in the commodity sector, benefiting from the general flight to safety.

Commodity	Qtr. 3 '19	Year to Date '19
CRB (broad index)	-3.41%	4.19%
Oil	-7.06%	19.80%
Gold	3.97%	14.66%

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Economic Overview

Recession talk spiking…

The outlook for global economic growth dimmed during the third quarter, highlighted by a spike in recession fears in the US during the month of August. While talk of a recession seems premature at this point, growth has undoubtedly shifted lower as uncertainty takes hold across the globe.

Trade tensions hitting US growth as manufacturing slows…

Since the ratcheting up of trade tensions, the US economy has fared better than most and been able to largely shrug off the headwinds. During the third quarter, however, cracks began to appear:

- The September manufacturing ISM reading, a measure of general business activity in the manufacturing industry, slipped to 47.8 vs. 50.4 expected (below 50 indicates contraction).
- September service PMI (Purchasing Managers Index) at 50.9 stood near the lowest level in the past 3 years.

Consumer remains the workhorse of the domestic economy…

While there are clearly pockets of weakness in the domestic economy, there is still enough evidence to indicate muddle through growth is the most likely path forward:

- The manufacturing PMI (more domestically focused than ISM) rose to 51 in September, a 5-month high.
- The latest jobs numbers (136,000 jobs added in September, unemployment rate of 3.5% and average hourly earnings growth of 2.9%) were solid.
- Lower paid workers saw Average Hourly Earnings growth higher at 3.5%.
- On the back of strong labor markets, consumer confidence remained near the highest levels seen in the 10+ year recovery period.
- Lower interest rates spurred housing: new home sales grew 7.1% in August to a 713,000 annual rate (near a 12 year high).
- The consumer savings rate ticked higher to 8.1%.

The US economy is clearly slowing back towards the moderate rate of roughly 2% seen in the middle years of the expansion; however, with a strong consumer (68% of GDP) supported by a solid labor market, a recession is not the base case.

Central banks easing, but global economies still weakening…

This is not necessarily true in the rest of the world. The easing measures enacted by the ECB, Bank of Japan and People's Bank of China have been unable to offset the challenges presented by trade friction.

The September manufacturing PMI for the Euro Zone came in at 45.7, its eighth straight month under 50. Weakness has been especially pronounced in Germany, an economy highly sensitive to global trade. However, in a sign that the situation there might be stabilizing, German Industrial Production grew 0.3% month over month in September versus an expected contraction of 0.1%.

Maybe some early green shoots…

In Japan, Industrial Production fell by 1.2% month-over-month in August (latest available), worse than the outlook for a decline of just 0.5%. Offsetting the weak manufacturing number was growth in retail sales of 4.8% compared to expectations for just 2.4%. Helping to explain the strong retail sales numbers was employment growth of 1% year-over-year in September and an unemployment rate last seen in the 1980's.

In China, tariffs have unquestionably taken a bite out of the economy. Trade to the US has fallen nearly 10% and GDP growth for 2019 is expected to come in near the lowest rate since the Great Recession.

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Investment Implications

Uncertainty the new wall of worry…

The wall of worry which has been a constant companion of investors over the past ten years has recently given way to something new, perpetual uncertainty. Uncertainty first began to take hold in the fourth quarter of 2018, combining with a hawkish Federal Reserve to send markets plunging to end the year. 2019 has witnessed a rebound in stock prices as the worst case scenarios didn't play out and the Fed pivoted to take on an accommodative stance, but volatility has remained elevated.

Ample issues to concern investors…

In just the past quarter, investors have been forced to deal with renewed fears of escalation in the trade war with China, stress in the bond market, attacks on Saudi oil facilities, the never-ending Brexit saga and the specter of impeachment proceedings at home. Through all that the US economy has managed to hold up relatively well, buoyed by a strong consumer.

Markets sending investors conflicting signals…

The impact of uncertainty can be seen not just in the heightened volatility of markets but also in the performance of underlying assets. With domestic stocks making new all-time highs in July before ending the quarter just a few percentage points below those levels, one would be forgiven for thinking the economy must be robust and the outlook bright. Behind the move toward all-time highs are the types of stocks that powered the advance witnessed in September: value stocks. Long laggards in this 10-year bull run, their outperformance is notable in that value typically outperforms when growth is improving.

In the bond market, low Treasury yields are a clear sign that investors are cautious about the near term outlook. However, at the same time spreads between the yields of investment and non-investment grade bonds have tightened which typically is an indication of improving prospects.

4Q meltdown redux?...

With the heightened uncertainty and conflicting messages coming from markets, there is some concern we are going to witness a repeat of the fourth quarter of last year. There are important differences this time around. As mentioned above, the Fed has drastically shifted to an accommodative stance. At this point last year when the yield of the 10-year Treasury was 150 basis points higher than today, the Fed was hiking rates and "a long way from neutral". Contrast this with today, where the Fed is embarking on "insurance cuts" meant to prolong the expansion with the cover to do more thanks to low inflation.

The good and the bad of volatility…

With growth as low as it is, there is little room for error and any exogenous shock has an increased potential of ushering in a recession. But with central banks around the world engaged in a massive easing cycle and some early signs of growth potentially bottoming, a repeat of last year's meltdown seems unlikely. Volatility is likely to remain elevated until there is more clarity on important policy issues, most prominently trade, but in volatility there is often opportunity.

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