

# ECONOMIC & CAPITAL MARKETS REVIEW

NEWMAN DIGNAN & SHEERAR, INC.

## ALL CLEAR? ... NOT YET

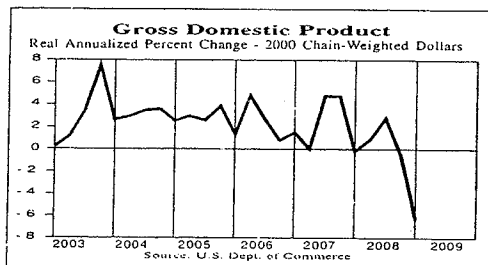
1<sup>st</sup> Quarter  
2009

### ECONOMY & MARKETS

Is the worst of the recession behind us? Maybe, but we suspect that the economy will get worse before it gets better. As to the market – we believe that the markets have most likely put in their lows. However, the road ahead is anything but smooth.

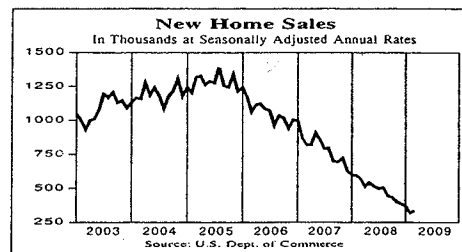
After a miserable January and February, March provided the markets with a bit of hope. After being at 13-year lows through March 3<sup>rd</sup>, the DJIA had its best month in six years and finished the 1<sup>st</sup> quarter down 13.3% - thanks to a nearly 8% gain in March. It was the DJIA's sixth straight quarterly loss and the worst 1<sup>st</sup> quarter loss since 1939. For the same period, the S&P 500 dropped 11.7%. The NASDAQ fared a bit better as it declined by "only" 3.7% for the quarter. Market woes did not spare international markets as the EAFE index dropped 14.6% for quarter. Bonds held their own as the Lehman Brothers Aggregate Bond Index moved slightly higher by 0.12%.

No doubt, the economy struggled during the 1<sup>st</sup> quarter. Banks wilted under the strain of toxic assets, credit remained tight, foreclosures moved higher and unemployment continued its ascent towards ten percent. Earnings will continue to be weak, and GDP growth for the 1<sup>st</sup> quarter should show a contraction of roughly 6% or so (see chart below). Remember that GDP declined by 6.2% in the 4<sup>th</sup> quarter of 2008. We expect 2<sup>nd</sup> quarter GDP to be negative by 3% or so followed by slightly positive GDP growth in the 3<sup>rd</sup> and 4<sup>th</sup> quarters.



Green shoots  
are  
emerging...

New and existing home sales have been terrible (see chart below). However, there appear to be some glimmers of hope as February new home sales showed a nearly 5% gain while existing home sales jumped over 5%. Surprisingly, average home prices actually increased in January by 1.3%.



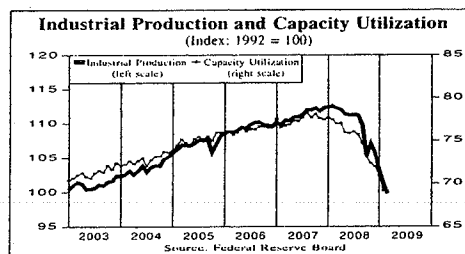
The National Association of Realtors' home affordability index is now at its most favorable reading since 1971, but we all know that it will probably become "more affordable" over the months ahead. Of course, there is likely more pain ahead for housing as cash strapped home owners struggle to meet monthly mortgage payments (not to mention the upcoming added supply and price pressures from banks liquidating homes acquired through bankruptcies). Commercial real estate has yet to find a bottom – witness the sale of the John Hancock building in Boston for \$661 million (after being bought 3 years earlier for \$1.3 Bn).

Despite the gloomy mood and economic environment, some economic green shoots are emerging (green shoots being the term used by Secretary Geithner to highlight positive economic signs). In addition to housing data mentioned above, durable goods orders for February increased 3.4% (versus a negative expectation) while retail sales were also better than expected. So as miserable as things are – and they are – it appears that the second derivative is improving, i.e., the rate of change is getting better and signs point to data being not as bad as expected. We are encouraged by these signs, but the "all clear" signal can't be

issued yet. The good news is that we are getting closer to the end of this nasty recession.

But, alas, if the economy doesn't get better on its own then the government will ensure that it does. Now that consumers are beginning to actually save (the savings rate is now at its highest level in many years) it is time for the government to pick-up the slack. The Federal Reserve has essentially moved short rates to nearly zero, while Congress has created a massive stimulus package (\$1 trillion plus) that should accelerate the recovery. The latest life-line/acronym thrown-out by the government is the PPIP ... add that to the TARP and TALF (see page three for more info), and you're looking at budget deficits as far as the eye can see. With the printing presses running non-stop and short rates near zero, consumers will eventually be dealing with higher inflation (but not quite yet).

Capacity utilization continues to decline (see chart below). This should keep a lid on inflation for the time being as companies have cut expenditures and jobs. Of course, as demand eventually comes back, businesses will be in decent shape to benefit.



## OUTLOOK

Despite the current negativity bubble (as we discussed in our last newsletter), investors will likely be rewarded over the next few years and longer. The 10-year rolling period ending in 2008 saw negative returns for the stock market. This is only the third time in history that the markets have been negative over a 10-year period (the other 10-year periods that were negative ended in the years 1937 and 1938). *The markets may not necessarily revert back to their long-term mean returns, but it is quite probable that we will see reasonable returns for the next 10-year period* (although very few investors believe that this is possible). Jeremy Grantham from GMO in Boston sees U.S. high quality equities returning 10.4% for the next 10

years ... his last ten-year projection was spot on. Now for what we see over the next quarter or so...

*We expect to see some profit taking from the recent rally. Companies will most likely report horrible first quarter earnings, and we wouldn't be surprised if they talk-down the year ahead. Besides, we have yet to hear the results of the government's stress test for banks. It is quite possible that the results will be less-than-cheery. This may create an opportunity to put some money to work in equities over the early to mid-summer period. By then, the economy should be displaying some encouraging signs.*

It is very difficult to look through the current doom and gloom to find bargains, but that is what we are doing. We expect to add to existing positions and to establish new equity positions over the months ahead. Large cash positions and underweighted equity positions allow investors to dollar-cost average into quality names. Companies with good cash flows and solid balance sheets should do well going forward. We will attempt to dip our toes in the water to buy some beaten-up equities with good long-term potential – many good companies have been unduly punished in this broad-based market sell-off. Small-cap stocks traditionally do well coming out of recessions, and we will be adding selectively to this group. International equities have struggled lately, but we see some glimmers of hope in both developed and emerging markets. Alternative assets will continue to provide diversification and reduced volatility to portfolios.

Bond returns for the next 12 months or so will likely be marginal. Bond prices should come down as rates revert to more normalized levels. Treasuries may begin to underperform the overall bond market. Corporate bonds appear to offer reasonable returns. High yield bonds look attractive as the spread to underlying treasuries is around 1700 basis points. Overall, keep average maturities short-term.

*These markets are very difficult to time. As always, review your portfolios and asset allocation to ensure that they reflect your risk tolerance and long-term goals and objectives.*

Happy Spring.

Consumers  
are actually  
saving...

Companies  
are well  
positioned

## Alphabet Soup

The collapse of the "shadow" banking system over the last ~18 months has increased the desire for a rapid recovery in the traditional banking system. The following government sponsored programs are designed to further this effort:

**TARP**, or Troubled Asset Relief Program is designed to purchase assets and equity from financial institutions. It is the largest [initially ~\$700B] of the 2008 measures designed to address the mortgage mess. The original scheme was abandoned within a month of its introduction, although ~\$350B was used to inject equity directly into important financial firms. The unsolved problem of troubled assets led to:

**TALF**, or Term Asset-Backed-Securities Loan Facility is designed to support the issuance of asset-backed-securities collateralized by student, auto, credit and SBA loans. The Fed will lend up to ~\$1 trillion [originally \$200 billion].

**PPIP**, or Public-Private Investment Partnership is the most recent program. It is intended to improve bank liquidity and produce higher prices for some of the bank's questionable assets. This complex process for attracting more asset bids is designed to significantly increase the market value of the bank's housing related assets.

The above list of programs is not comprehensive, and lists intentions but not necessarily actions. One way to measure the government's efforts is to note that the Fed had expanded its balance sheet to \$2.253 trillion by mid-December. This measure of government involvement then shrunk to \$1.87 trillion by 3/11/09, but is now above \$2 trillion [as of 3/25]. Announced securities purchases should boost the balance sheet to ~\$3.5 trillion in the coming weeks [months?] and then to over \$4 trillion due to **TALF**. If the **PPIP** effectively gets off the ground, the balance sheet could eventually expand to over \$5 trillion.

This enormous expansion raises lots of longer-term questions, including moral hazard and future inflation rates. Stay tuned.

### A Trillion Here ... A Trillion There

Pretty soon it adds up to real money. With all the spending coming out of Washington, we thought that it would be a good idea to understand what a trillion dollars really looks like. Let's see, does a trillion have nine zeros, twelve zeros or eighteen zeros? Well, believe it or not, the answer could be either twelve or eighteen zeros. However, today's common method includes twelve zeros. Here's what it looks like:

**\$1,000,000,000,000**

Now that's a lot of zeros! The fiscal year 2010 federal budget is projected to be \$3.5 trillion. Worse yet, that's a big legacy for our children and grandchildren to inherit.

### Treasury Guarantee Program Extended

Good news. The U.S. Treasury recently announced that it extended its money market guarantee program through September 18, 2009. The program had been scheduled to expire on April 30<sup>th</sup>.

...it all  
better work!

Good  
news  
→

Things improve from here

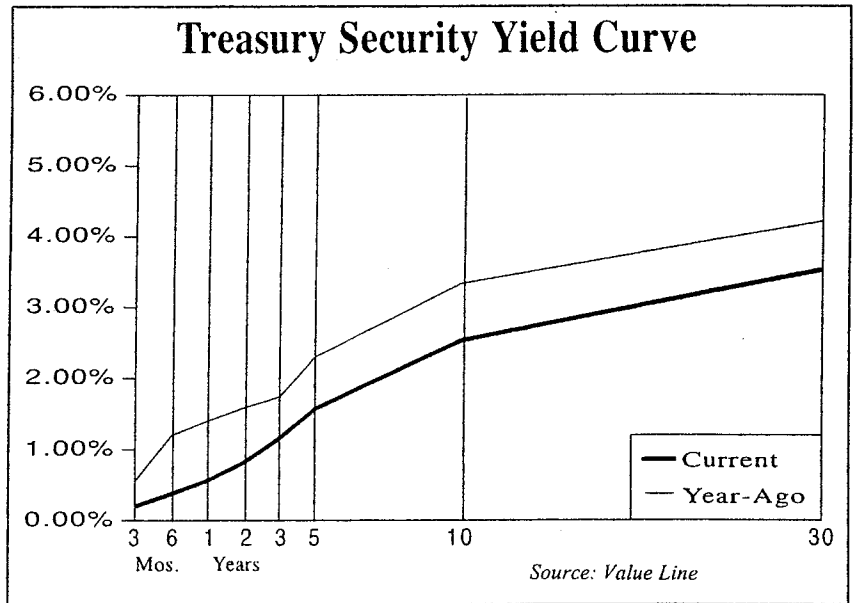
### 1<sup>st</sup> QUARTER 2009 SCOREBOARD

Index	Close	1 <sup>st</sup> Quarter % Change	Year-to-Date % Change
DJIA	7608.9	- 13.3	- 13.3
S&P 500	797.9	- 11.7	- 11.7
NASDAQ	1528.6	- 3.1	- 3.1
Nikkei	8109.5	- 8.5	- 8.5
MSCI EAFE	1056.2	- 14.6	- 14.6
3 Month T-Bill	0.21%	Fed Funds Rate	0 - 0.25%
5 Year T-Note	1.66%	Prime Rate	3.25%
10 Year T-Note	2.68%	Gold	\$922.60
30 Year T-Note	3.54%	Oil	\$49.66

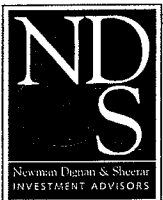
Oil is up 11% year-to-date, but still down from the \$147 peak.

It's a great time to re-finance debt

We see rates moving slowly higher



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