



ECONOMIC & CAPITAL MARKETS REVIEW

NEWMAN DIGNAN & SHEERAR, INC.

Sisyphus Revisited

ECONOMY & MARKETS

Ay caramba! What a crazy second quarter. Investors are beginning to feel like Sisyphus ... the markets work their way higher only to be pushed back down again (*and the cycle seems to continue*). Well, the S&P 500 is essentially where it stood in 2001 so its time to give Sisyphus some help. But where will it come from?

Following a decent start to the year, markets rolled-over in the 2nd quarter. The European debt crisis seemed to be the catalyst for the market correction (which was a bit overdue, in retrospect). But is what we're experiencing just another correction? *We see the recent sell-off as a correction (painful as it has been) in a slow and grinding recovery.*

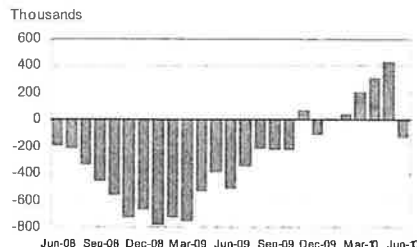
For the second quarter of 2010, the DJIA moved lower by 10.4% while the S&P sold-off by 12.2%. The NASDAQ was similarly weak as it gave back 10.2% for the quarter. International markets were even weaker as EAFE Index moved lower by 14.9% for the quarter. Bond returns were better-than-expected as the Barclay's Aggregate Bond Index moved ahead by 3.5% for the quarter.

Year-to-date performance numbers for equities have all turned negative thanks to a dismal second quarter. The DJIA is off 6.3% for 2010 while the S&P 500 is down by 7.6%. The NASDAQ is lower by 7.0% ... decently better than EAFE's 14.7% drop for 2010. Bonds (*much to everyone's surprise*) are up 5.3% for the year. How long can rates stay this low?

Perhaps the markets are due for an oversold bounce ... we wouldn't be surprised at all if we see a relief rally sometime soon. However, some real challenges remain for our economy and our markets. Chief among them are *unemployment, housing, consumer confidence, volatility and lack of clarity with regulatory reform.*

Let's start with the pernicious employment picture (*see chart below*).

Chart 2. Nonfarm payroll employment over-the-month change, seasonally adjusted, June 2008 - June 2010



It is quite obvious that naggingly high **unemployment** will be a detriment to future growth. *Unemployment at 9.5% is simply too high after so much stimulus was supposedly injected into our economy.* Where did it all go? The unemployment rate dropped last month (from 9.7% to 9.5%) simply because the number of people counted in the labor force dropped (if you haven't looked for work in 4 weeks you are not counted in the labor force ... a bogus statistical faux pas). May's private job-creation number was 33,000 ... add that to June's number of 83,000 and you get a whopping 116,000 jobs (not even enough to keep up with population growth). A **bright spot** in recent releases is that the average work week and hourly earnings increased slightly. Large companies certainly have the cash on-hand to hire workers, but they are being a bit cautious as the economic and political landscape is anything but clear.

Housing provides a similar challenge to growth going forward. Housing starts tumbled 10% in May to a 593,000 unit annual rate - a much bigger drop than expectations of a decline of 637,000. This was the biggest drop since March 2009. Furthermore, building permits dropped 5.9% - down for the second month in a row and below expectations of a 3.3% rise. Perhaps housing is off simply because of the expiration of the housing credit; however, we will be watching these trends quite closely.

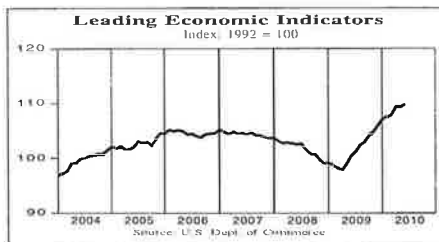
2nd Quarter
2010

Oversold
bounce
coming
↘

Consumer confidence could use a bit of perking-up. The chart below highlights that the Consumer Confidence Index turned sharply lower in June (down 9.8 points to 52.9 from 62.7 in May) ... after three straight months of increases. Consumer Confidence is very important as the consumer represents nearly 70% of GDP.



Is there any goods news out there? Of course, but the overwhelming negative sentiment and parade of Cassandras seem to be drowning out any rays of sunshine. Both **Leading Economic Indicators** (see chart below) and **Durable Goods Orders** support an economic recovery. The LEI suggests that a double-dip in the near-term is unlikely. Meanwhile, negative sentiment is building up and expectations for a recovery have been reduced ... all necessary to put in a bottom. Lastly, **rail-car loadings** (a favorite economic indicator of Warren Buffett) for the past two months are up over 14% ... certainly a good sign.



OUTLOOK

Bottom Line – We need to lower our year-end targets based on recent disappointing economic data. We see the S&P 500 closing 2010 in the 1100 - 1150 range (perhaps a bit higher). Bond returns will likely be in the 3-4% range for the year.

We expect 2nd quarter GDP to come in around 3.5%. 2nd quarter earnings should be up nicely, but companies will likely temper guidance based on an overall lack of clarity. The markets seem to have discounted a slowing economy, but corporate guidance will be critical to investor confidence going forward.

We mentioned in our last newsletter that the markets would correct when we least expected it. Well, the correction came, and it wasn't pretty. Interestingly, the correction didn't seem to occur commensurate with an overriding level of bullishness. Nonetheless, the markets are rarely black and white. The recent cover of Bloomberg Businessweek displaying a big bear letting out a "GRRRRR!" may be a good contrary indicator ... perhaps all of the negative sentiment is a necessary reagent to the market stabilizing.

Bond prices moved higher and yields moved lower as the European debt crisis shifted money into U.S. Treasuries and embarrassed most interest rate forecasters. Rates ought to slowly trickle higher, but it is possible that they stay low for an extended period of time should the economy continue to sputter and deflation fears take hold. The Fed has reiterated that it expects to keep short-term rates "exceptionally low" for an "extended period." However, their recent statement was unequivocally more dovish. The Fed characterized the economic recovery as "proceeding" as opposed to "continuing to strengthen" in their earlier statement.

Small and mid-cap equities still add to value to an overall asset allocation strategy. We are slightly underweighting *developed international equities* while adding to *emerging market equities*. We continue to believe that *large-cap companies with higher quality attributes* should begin to play a more significant role in market leadership as the year progresses. *Commodities*, as we stated in our last newsletter, should come under pressure as global economic growth moderates. *Alternative assets* have proven their worth over this past correction ... we believe they continue to add value to portfolios.

Yes, the recession is over, but the recovery will be slow and bumpy. Despite the staccato pace of trading and the supposed end of long-term investing, we continue to focus on long-term goals and objectives. Investors will be well served by remaining diversified, keeping risk levels in check and reviewing their asset allocation.

Happy Summer!

GRRRR!

There are a few good signs →

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BRAZIL

Good things are happening in Brazil, and we're hoping to cash in on their success. As we mention on the previous page of this newsletter, we are underweighting developed international markets and beginning to add more exposure to Brazil and other emerging markets. Brazil is the fifth largest nation in the world, yet it is not considered a "developed" nation as it is part of the international emerging market index.

Brazil has a lot to offer investors – it is the leading exporter of iron ore, coffee, soy, orange juice, beef, chicken, sugar and ethanol. Unlike the United States, Brazil runs a budget surplus. Seventy-three percent of the energy in Brazil comes from hydroelectric power. Brazil also has one of the top ten oil reserves in the world. In addition to their strong economic fundamentals, Brazil will be hosting the 2014 World Cup and the 2016 Olympics. We expect a good amount of investment to go into infrastructure and other projects over the next few years to get ready for these major events. A good way to take advantage of expected spending is to invest in any number of ETFs that give investors exposure to Brazilian companies. We particularly like the Market Vectors Small-Cap Brazil Fund (BRF) ... a pure-play on the potential growth in Brazil. Like most emerging market investments, expect volatility.

“TO ROTH OR NOT TO ROTH”

With the elimination of the income limits to convert traditional individual retirement accounts to Roth IRA's, many people are considering full or partial conversions.

The benefit of converting allows the owner of the Roth IRA, as well as the future beneficiaries, to never pay income tax on the income, growth or distributions. The cost of the conversion, however, is that the distribution from the traditional IRA to fund the Roth is considered taxable income. There is a special rule for 2010 conversions that allows taxpayers to defer 50% of the converted amount to 2011 taxable income and the balance in 2012.

The IRS also allows taxpayers to "recharacterize" or unwind a Roth conversion until the due date of the taxpayer's tax return for that year. This provides a maximum window of 21 ½ months. If the value of the Roth conversion declines, a taxpayer can reverse the transaction back to the traditional IRA and not pay a tax. You can then reconvert later and pay less tax.

Remember that any distribution from a traditional IRA is realized as taxable income even if it is used to pay taxes on a Roth IRA conversion. Therefore, it is to the taxpayer's benefit to pay the tax on the conversion from non-retirement assets. Many clients, after reviewing the amount of tax on a conversion, decide not to convert. The additional taxable income generated can place them in a higher bracket and possibly cause them to pay taxes on social security benefits.

To convert or not to convert should be carefully reviewed with your tax advisor or preparer. You should also have more than enough "free-cash" from non-retirement accounts to pay for the tax. There is no doubt that the Roth IRA conversion can be beneficial for future retirement needs and for the next generation. Tax-free compounding is a powerful investment strategy.

Regardless of whether or not one converts, please make sure to verify that your beneficiary designations for all of your retirement accounts are exactly what you want.

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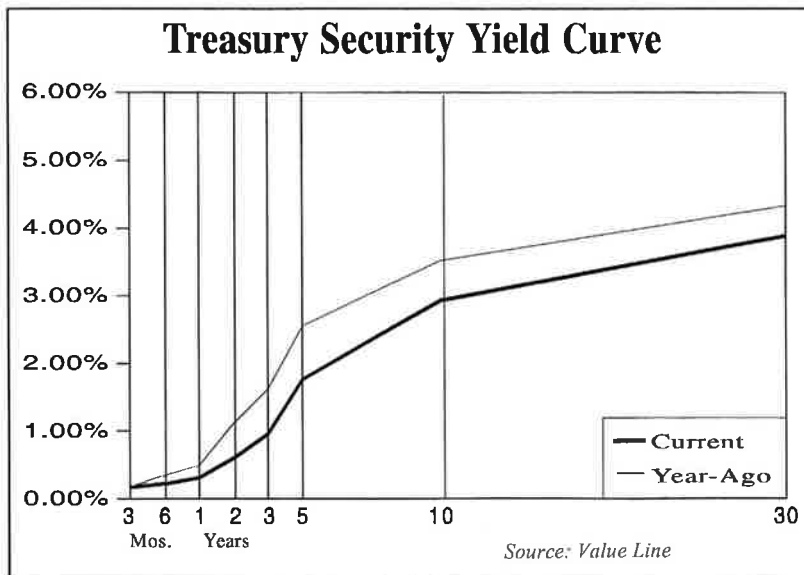
2nd QUARTER 2010 SCOREBOARD

Index	Close	2 nd Quarter % Change	Year-to-Date % Change
DJIA	9774.0	- 10.4	- 6.3
S&P 500	1030.7	- 12.2	- 7.6
NASDAQ	2109.2	- 10.2	- 7.0
Nikkei	9382.6	- 15.4	- 11.0
MSCI EAFE	1348.1	- 14.9	- 14.7
3 Month T-Bill	0.16%	Fed Funds Rate	0 - 0.25%
5 Year T-Note	1.77%	Prime Rate	3.25%
10 Year T-Note	2.93%	Gold	\$1245.50
30 Year T-Note	3.91%	Oil	\$75.63

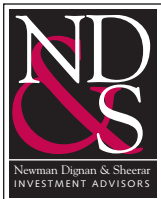
Gold is up
13.7% in
2010

Oil down nearly
5% in 2010

10-year
treasury
below
3%



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NEWMAN DIGNAN & SHEERAR, INC.

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30 Exchange Terrace • Providence, RI 02903 • 401.351.4010 • Fax 401.351.4011