

## A PUZZLEMENT

3<sup>rd</sup> Quarter  
2009

### ECONOMY & MARKETS

Why has the market rallied so strongly? As Yul Brenner said in **The King and I** "It is a puzzlement". Judging by the generous gains in the 3<sup>rd</sup> quarter (*thank you very much*) one would think that everything is just fine and that we've been given the all clear signal. Not so fast.

After a strong 2<sup>nd</sup> quarter, the markets continued their move higher during the 3<sup>rd</sup> quarter. The 3<sup>rd</sup> quarter was the best quarterly gain for the markets since 1998. For the quarter, the DJIA moved higher by 15.8% while the S&P moved ahead by a solid 15.6%. The NASDAQ had very strong gains as it recorded a 20% quarterly gain. International markets recovered a lot of ground as the EAFE Index finished ahead 18.8% for the quarter. Bonds were steady as the Barclay's Aggregate Bond Index moved by 1.8% ... not surprising was the fact that U.S. government bonds were generally negative for the quarter as bond investors moved to corporate bonds for higher yields.

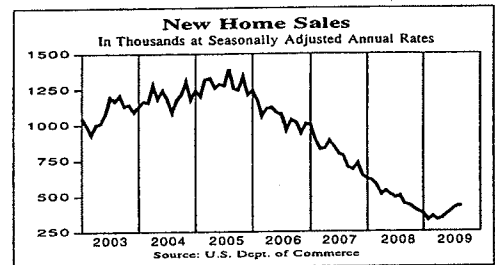
Year-to-date numbers are looking better thanks to a continued rebound off of the lows of early March. The DJIA is up 13.5% for 2009 while the S&P 500 is positive by 19.2%. The NASDAQ is now higher by 36.1% while the EAFE has surged ahead and is up 25.5% for the year-to-date period. The overall bond market is up 5.7% for 2009. Perhaps the markets have moved a bit too far off of the March low, but it is a welcomed relief for investors.

*Bull vs. Bear: one seems right and the other is making money.* Given the economic backdrop and headwinds that exist today it would seem prudent to be a bit bearish. However, the markets are telling us something different. Apparently, negative sentiment combined with a massive amount of money on the sidelines (over \$3 trillion) and a lack of good alternatives leads to positive price action in equities. We, of course, are happy to see such price action, but we're cognizant of the fact that sooner or later

the fundamentals will have to catch up to the market ... or else.

The government is pulling out all stops in its effort to stimulate economic growth. Is it working, and is it sustainable? Some of the stimulus is working, but time will tell whether or not it is sustainable. Cash for clunkers and housing tax credits have certainly bumped-up demand for autos and housing. *However, we're not convinced that such programs have any long-term multiplier effect.* Perhaps they just borrow from future growth. Nonetheless, an argument can be made that some sort of stimulus was necessary in order to jump-start the economy (*we just wish that it had been more stimulative and less political*).

The chart below highlights the short-term effects of the \$8,000 housing tax credit.

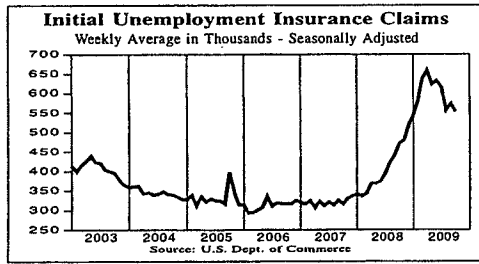


New home sales have bounced off very depressed levels, but is the bounce sustainable? Affordability remains near all-time highs, inventories are falling and price declines are moderating ... all good. However, one has to question whether or not the *shadow inventory* (houses that will be sold but are not on the market yet due to poor market conditions) will delay a housing recovery. Besides, a *cash-strapped consumer* who is either unemployed or afraid of losing his job may be a bit reluctant to purchase a home in this environment. It is critical that our economy function without massive government stimulus, yet it is clear that the stimulus will have to be withdrawn on a timely and systematic basis to avoid being either too inflationary or too deflationary.

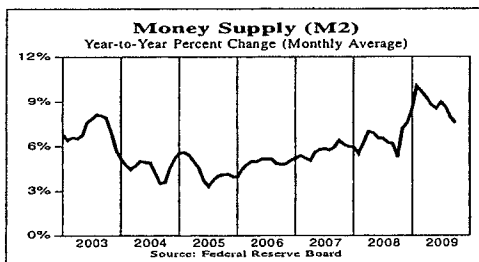
Markets  
climb a  
Wall of  
Worry  
Z

Govt. "stimulus" leads to higher taxes... guaranteed.

Besides, the government can't afford to keep funding programs given its large and unsustainable debt load.



The unemployment chart above highlights how consumption will likely be constrained over the next few quarters. Have the earnings that we've seen lately been mostly tied to inventory rebuilding? It's hard to tell, but it is tough to argue for a continued pick-up in consumer spending until housing and unemployment improve. The savings rate in the US has been rising steadily, and is estimated to be at 5-6%. This falls in line with Keynes' Paradox of Thrift ... just when you want the consumer to spend and stimulate the economy it is at the exact time that the consumer either doesn't want to or can't spend ... so he increases his savings rate. Add an increased savings rate to a decrease in money supply - M2 (see chart below) and bank lending and one can be convinced that the era of conspicuous consumption is fading. The consumer is key to our economic recovery ... let's hope that the collapse of credit doesn't derail our recovery.



The good news is that corporations are in relatively good shape with healthy balance sheets, lean inventories and a general lack of wage pressures. US companies have enormous capacity with utilization around 68%. Inflation and rates remain low while market valuations appear reasonable. With 2010 earnings estimates at \$75 - \$80, the current P/E is roughly 14X ... not bad considering such low interest rates and inflation. The Fed model implies fair value at 16X indicating that the markets may be a bit under-valued.

Still no velocity of money...

Good news...

The dollar's significant slide over the past year should slow down temporarily as growth resumes. No doubt, the dollar is still entrenched as the world's dominant reserve currency. Long-term, however, dollar weakness is probable unless Congress stops spending at today's unsustainable rate.

### OUTLOOK

3<sup>rd</sup> and 4<sup>th</sup> quarter GDP should come in around 3% or so ... not a bad recovery. We see the equity markets finishing the year higher from current levels. A still large amount of cash on the sidelines (with very little yield) will most likely find its way to equities. Bond fund inflows should stall as investors add to equity positions. We continue to believe that the lows experienced in March will prove to be the ultimate lows. Can we pull-back from here? Absolutely, but it is likely that sell-offs will be used as buying opportunities. The bearish arguments are quite compelling, but the price action and momentum (don't fight the Fed) seem to be dictating a continued move higher. We continue to believe that investors will be modestly rewarded over the next few years with relatively low inflation and slow growth.

Small-cap, emerging market and international equities look attractive. We also believe that large-cap companies with higher quality attributes should begin to play a more significant role in market leadership (unlike the most recent rally). Alternative investments appear to offer value on a risk-adjusted basis. Of course, we are always looking to add to groups that out-of-favor yet still have favorable fundamentals (beware the herd).

Corporate and international bonds continue to look reasonable. We see treasuries as overvalued, yet yields could stay low until economic growth and inflation resume sometime in mid-to-late 2010. TIPS appear to be fairly valued.

The recession is most likely over, but risks remain. Housing must improve and unemployment needs to come down before we see a sustainable recovery. We will continue to be vigilant about your exposure to risk.

Happy Fall.

## TAX PLANNING REMINDERS

**Required Minimum Distributions** As we mentioned in an earlier newsletter, *2009 Required Minimum Distributions (RMDs) are waived from retirement accounts (for tax year 2009 only)*. This affects individuals over age 70 ½ who are required to take an annual RMD and those required to take a distribution from an Inherited IRA. Also, if a beneficiary is receiving distributions over a 5-year period, he or she can waive the distribution for 2009, effectively taking distributions over a 6-year period.

**Dividends & Long-term Capital Gains** The current tax rate for an individual for both qualified dividends and long-term capital gains is 15% (short-term gains are taxed at one's marginal tax rate). After 2010 the qualified dividend tax rate will revert to each taxpayer's ordinary income tax rate while the long-term capital gains tax rate will revert back to 20%. *This explains our bias towards capturing dividends and long term gains prior to year-end.*

**The Roth Revolution** A Roth IRA is an extremely tax-efficient vehicle for the accumulation and transfer of wealth. Income-based restrictions have precluded high-income taxpayers from taking advantage of Roth IRAs. In 2010 and thereafter income limitations have been eliminated, thus creating an opportunity for IRA holders to convert to Roth IRAs.

Roth IRAs are similar to traditional IRAs regarding contribution limits and tax deferred growth but there are fundamental differences between the two: *contributions to a Roth IRA are not tax deductible; distributions now and after death from a Roth IRA are NOT subject to income tax; there are no required minimum distributions (RMDs).*

We recommend clients consider establishing a Roth IRA for working children and grandchildren. Also, working with their tax advisor, clients should review the cost of converting all or part of an existing IRA into a Roth IRA. Individuals reaping the most advantages are those facing a higher tax rate in retirement. Don't forget – one must have sufficient non-IRA funds available to pay the additional tax on conversion. The upfront costs to convert to a Roth IRA are significant as the taxpayer will report the full amount converted as taxable income (subject to the tax rate of the year converted). However conversions done in 2010 may proportionally spread the taxable income into 2011 and 2012. Keep in mind that top marginal tax rate of 35% in 2010 will rise to 39.6% in 2011 and beyond.

### Managed Futures – Another Tool in Portfolio Management

One of the key tenets of *Modern Portfolio Theory* is that more efficient portfolios can be created by diversifying across asset classes with low correlations. Managed futures involve the investment in global futures and options markets. Managed futures can invest in over 150 different markets worldwide – stock indices, financial instruments, agricultural products, precious and industrial metals, currencies and energy products. Managed futures traders take advantage of price trends by purchasing futures positions in anticipation of a rising market or by selling futures positions if they anticipate a falling market. *A benefit of adding managed futures to a diversified portfolio is the potential to reduce volatility with the ability to enhance overall portfolio performance.* Managed futures have historically had a low to slightly-negative correlation to traditional investments like equities and bonds. We will be selectively adding managed futures strategies to client portfolios in order to take advantage of their many benefits.

Of course, while there is no guarantee that a managed futures strategy will be profitable and avoid losses, we believe that it can be a prudent addition to many portfolios.

Best quarterly gain since 1998 for the DJIA.

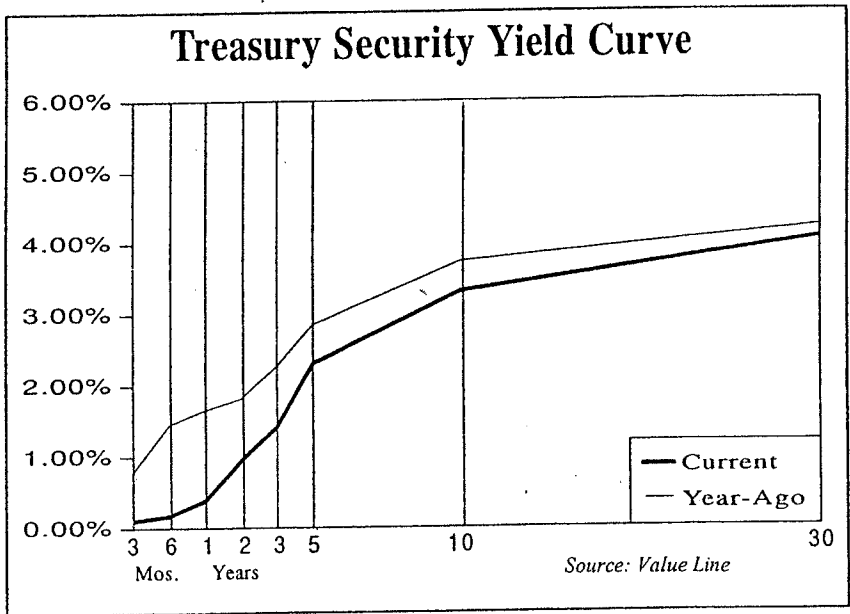
### 3<sup>rd</sup> QUARTER 2009 SCOREBOARD

Index	Close	3 <sup>rd</sup> Quarter % Change	Year-to-Date % Change
DJIA	9712.3	+ 15.8	+ 13.5
S&P 500	1057.1	+ 15.6	+ 19.3
NASDAQ	2122.4	+ 15.8	+ 36.1
Nikkei	10133.2	+ 1.8	+ 14.4
MSCI EAFE	1552.8	+ 18.8	+ 25.5
3 Month T-Bill	0.13%		
5 Year T-Note	2.32%		
10 Year T-Note	3.30%		
30 Year T-Note	4.04%		
Fed Funds Rate	0 - 0.25%		
Prime Rate	3.25%		
Gold	\$1008.00		
Oil	\$70.61		

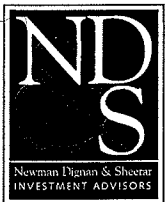
Gold is up over 14% this year... probably going higher.

Oil is up 58% in 2009.

How low can you go?  
Govt. bonds offer little yield.



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