

THE LOST DECADE

4th Quarter
2009

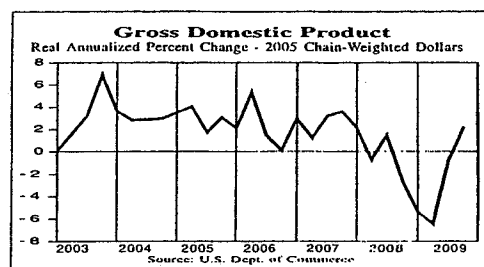
ECONOMY & MARKETS

Good riddance to the first decade of the 21st century – *The Lost Decade*. It is quite rare that equity markets experience negative returns over a ten year period, yet the last decade is one such exception. On the other hand, bonds have generally outperformed equities for the past decade ... we do not see that pattern as sustainable. The 10-year change in the S&P 500 is negative 24.1% while the NASDAQ is off by a staggering 44.2%. Bonds (as measured by the 10-year Treasury total return index) are up by 85% for the decade. Even when you include dividends, the 2000s have the distinction of being the only decade in 90 years to post a decline; even the 1930s posted a positive cumulative gain of 10%. We expect the next 10 years to treat equity investors much more kindly. Well, at least the decade ended on a positive note.

2009 was certainly not void of any drama, but the end result was quite gratifying ... particularly after one of the worst years on record in 2008. For the year, the DJIA moved higher by 18.8% while the S&P moved ahead by a solid 23.5%. The NASDAQ had very strong gains as it recorded a 43.9% yearly gain. International markets bounded back nicely as the EAFE Index finished ahead 27.7% for the year. Bonds were fairly steady as the Barclay's Aggregate Bond Index moved ahead by 5.9% ... not surprising was the fact that U.S. government bonds were generally negative for the year as bond investors moved to corporate bonds for higher yields.

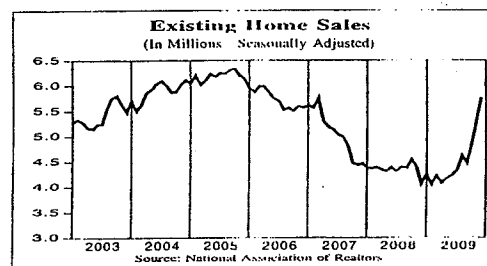
For the 4th quarter, the markets continued their move higher along with the improving economy. The DJIA moved ahead by 7.4% while the S&P 500 advanced 5.5% for the quarter. The NASDAQ jumped 6.9% while international markets eeked out a 1.8% gain. Bonds increased slightly as the Barclays Aggregate Bond Index inched higher by 0.21%.

Now let's take a look at current economic and market conditions. As we mentioned on several occasions last year, it would seem prudent to be a bit bearish given the economic backdrop and headwinds that exist today. However, the markets are continuing to tell us something different. Early last year we were fond of saying that things were getting less worse. Now we are able to say, without reservation, that things are getting slowly better.



GDP growth (see chart above) appears to be improving quite nicely (albeit off of very depressed levels). The recent release of the Chicago purchasing managers index at roughly 60.0 portends a fairly robust level of GDP growth in the 1st quarter of 2010 (maybe we'll even see positive job growth soon ... miracle of miracles).

Another notable improvement is illustrated in **existing home sales** (see chart below) and in housing prices.



The housing market seems to have stabilized as home prices have risen for 5 consecutive months. Perhaps the good news in housing is a bit ephemeral as the first-time home buyers credit may have artificially boosted sales (along with a bit of bottom fishing). New home sales

But all is not lost...

are lower, but that's a good thing as we need to work through a bloated inventory of existing homes. Oh, did we mention the negative potential impact of the shadow inventory? But, we suppose "It's always something" as Rosanne Rosanna Danna used to say.

Although housing is improving, we feel that it is important to keep an eye on some behind the scenes items - like *delinquencies and foreclosures*. Fannie Mae recently reported that serious delinquencies (>90 days) rose to nearly 5%. Furthermore, foreclosure activity does not seem to be moderating. Speaking of Fannie Mae (and Freddie Mac), did anyone notice the nice \$4-6 million bonuses awarded to the CEOs? It is interesting to note that the bonuses were all cash and no stock. Where's the pay czar? Makes us say hmmm...

Unemployment and its likely nagging effect on consumer spending will continue to weigh on the markets. Recent data seem to suggest that unemployment levels will improve, but are businesses willing to hire? No doubt, we expect a pick-up in the economy and in consumer spending, but we remain somewhat suspect as to the sustainability of any rebound. We're willing to be surprised.

Lastly, what happens when the government's massive (\$787 + billion) stimulus money runs out? We're not convinced that the stimulus money has been as "stimulative" as it should have been. States will be forced to make tough choices as they deal with declining tax revenues and higher social welfare demands. Perhaps the next round of stimulus spending (rumors are that only 30% or so of the money has actually been spent) will provide some lasting benefits. Keynesians unite ... this is your time.

OUTLOOK

Bottom Line - We believe that the S&P 500 will close in the 1215 - 1275 range for 2010. This implies a gain in the high single-digit range for equities. Bond returns will likely be challenged in 2010 with returns in the very low single-digits. We do not expect a double-dip recession in 2010.

4th quarter GDP should come in around 4 - 5%, and continue in the 3 - 4% range through mid-

year. GDP will most likely weaken during the second half of 2010 as fiscal stimulus is phased out and unemployment rates struggle to come down. As a result, cyclical names ought to do well during the first half of the year before giving way to more defensive, higher dividend-paying equities. Gold and commodities probably have room to run higher although we expect a fair amount of volatility.

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 (large-cap equities with good dividends). *Can we pull-back from here?* Absolutely, but it is likely that sell-offs will be used as buying opportunities. We continue to believe that investors will be modestly rewarded over the next few years with relatively low inflation and moderate growth.

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

Corporate and international bonds continue to look reasonable. U.S. treasuries are overvalued, and will most likely trade lower as the new year progresses. Should economic growth stagnate then yields could move temporarily lower. We say temporarily since an enormous amount of fiscal and monetary stimulus will ultimately lead to higher rates. TIPS appear to be fairly valued, at best.

The recession is essentially over, but our optimism is guarded as risks remain. Unemployment rates need to decline so that consumers feel more confident. Housing is recovering, but it will probably be a drain on economic growth for the next year or so ... the massive real estate bubble and credit bubble will take time to unwind. No doubt 2010 will contain surprises. As such, we will continue to be vigilant about your exposure to risk.

Happy New Year!

Get people
back to
work!

Guarded
Optimism

Obama vs. Monetarists

Spend,
spend,
spend...

The Obama administration's economic plan is based on *Keynesian economics*, which argues that aggressive fiscal policy will stimulate an economy out of recession. *John Maynard Keynes* championed this theory of economics in the 1930's. Although massive incremental government spending will produce a temporary boost to economic activity, it usually produces excessive inflation as an unwanted side effect. The counter theory that most macroeconomists agree with is *monetarism*, which simply states that to maintain stable growth the money supply must be better managed. The founder of monetarism was *Milton Friedman*. He concluded that fiscal stimulus "hampered recovery from the contraction, prolonged and added to unemployment and set the stage for ever more intrusive and costly government." President Obama's \$800 billion spending "*stimulus*" is a questionable policy, where politicians demand a quick fix for the economy while ignoring long-run, responsible fiscal reforms. As Harvard University's Robert Barro noted in disapproval of the stimulus plan, even though we have an economic crisis, it does "not invalidate everything we have learned about macroeconomics since 1936."

Tax Considerations

No income
limit...

For 2010, the *maximum annual contribution to 401(k)s, 403(b)s and 457s* is \$16,500. The catch-up contribution for people 50 and over is \$5,500. *Traditional and Roth IRAs* can receive contributions up to \$5,000 with an additional \$1,000 for those 50 and older. The *income limit for Roth IRA* contributions begins to phase-out at \$167,000 for married couples and \$105,000 for singles. The biggest change is the elimination of the income limit for IRA conversions to Roth IRAs. We recommend that clients review this opportunity with their tax advisors.

Estate and generation skipping tax changes for 2010 are significant. *For 2010 only, both the federal estate tax and the generation skipping tax are repealed entirely.* The *annual gift tax exclusion* is still \$13,000. The *top gift tax rate* in effect for 2010 is 35%. Assets included in estates will no longer receive a "stepped up" tax basis, subjecting them to potential capital gains.

We expect Congress to pass substantial changes to the existing estate tax within the next few months. Again, any major strategies to take advantage of these tax law changes should be reviewed with your tax advisor or legal counsel.

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Nice Rebound
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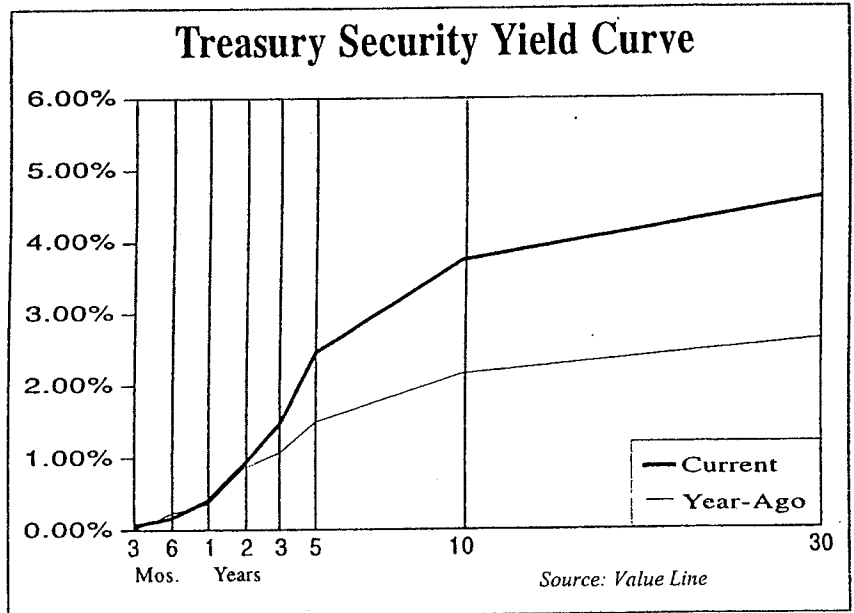
4th QUARTER 2009 SCOREBOARD

Index	Close	4 th Quarter % Change	2009 % Change
DJIA	10428.1	+ 7.4	+ 18.8
S&P 500	1115.1	+ 5.5	+ 23.5
NASDAQ	2269.1	+ 6.9	+ 43.9
Nikkei	10546.4	+ 4.1	+ 19.0
MSCI EAFE	1580.8	+ 1.8	+ 27.7
3 Month T-Bill	0.06%	Fed Funds Rate	0 - 0.25%
5 Year T-Note	2.69%	Prime Rate	3.25%
10 Year T-Note	3.84%	Gold	\$1095.20
30 Year T-Note	4.63%	Oil	\$79.36

Gold up 23.9% for 2009.

Oil up 77.9% in 2009.

The next move by the Fed is higher
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We at Newman Dignan & Sheerar, Inc. wish to extend to our clients and friends our best wishes for a happy, healthy and prosperous New Year.

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