Newman Dignan & Sheerar
INVESTMENT ADVISORS

ECONOMIC & CAPITAL
MARKETS REVIEW
NEWMAN DIGNAN & SHEERAR, INC.

TRANSITORY

2nd Quarter 2011

ECONOMY & MARKETS

Federal Reserve Chairman Ben Bernanke remarked recently that the current soft economic news was likely transitory. We agree; however, the path to stronger economic data will be rough and bumpy … high unemployment, sluggish economic growth and a global debt crisis will make sure of that.

Markets corrected roughly 7%, peak-to-trough, over the course of the 2nd quarter – just as we predicted in our last newsletter. With economic and geopolitical challenges popping-up every day, it was no surprise that the markets corrected over the quarter. A rally during the last few days of June masked what was really a volatile quarter for the markets. The quarter was similar to last year's 2nd quarter (a peak-to-trough 17% correction) when we titled our newsletter *Sisyphus Revisited.*

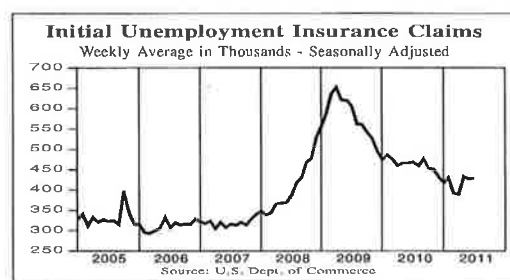
A choppy quarter...

For the second quarter, the DJIA moved higher by 1.4% while the S&P inched ahead by just 0.1%. The NASDAQ was down slightly by 0.3% for the quarter. International markets moved higher as the EAFE Index advanced by 1.6% for the quarter. Bond returns were better-than-expected as the Barclay's Aggregate Bond Index gained 2.3% for the quarter.

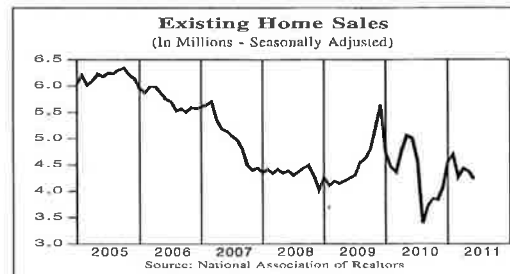
Year-to-date performance numbers for equities are quite reasonable given the economic and political backdrops. For the year-to-date period, the DJIA is up 8.6% while the S&P 500 is ahead by 6.0%. The NASDAQ is still ahead by 4.6%, and the EAFE index is ahead by 5% (in-line with the S&P 500). Bonds *(much to everyone's surprise)* are up 2.7% for the year through June.

transitory?

So perhaps the current soft patch is indeed transitory. No doubt, many of the issues that hampered the economy in the first half of the year will likely subside – namely, *higher gas prices*, the *Japan disaster* and *poor weather*. However, the major headwinds that seem to be limiting growth will take a good amount of time to subside. Chief among the economic headwinds are *unemployment*, *looming debt problems* and *housing woes*. Despite the administration's best efforts (not so shovel-ready projects, etc…) to get people back to work, **unemployment** remains too high at 9.1% *(see chart below).*



Housing remains in the doldrums *(see chart below)*. Perhaps the inventory is finally getting worked-off, but a lot of foreclosed and bank-owned homes have yet to even hit the markets. Fortunately, new housing starts are anemic, and this should help in the clearing process. One positive outcome of the housing crisis is that new homes are fairly cheap. New homeowners are spending less on mortgage payments than did the previous generation. An interesting metric called the financial obligations ratio (consumer financial payments/obligations to income) is at its lowest level (16.4%) since 1994. We see housing bumping along the bottom for the remainder of 2011.



The **Greek and European Sovereign debt crises** continue to rattle investors (and rightfully so). Greece passed an austerity package that will buy them some time (and

loans from the EU and the IMF), but the day of reckoning will come sooner or later. The short-term funding solutions weigh on growth prospects, and it will be very difficult for Greece to fund its debt and pension obligations while trying to grow its economy. Ultimately, we see the large European banks restructuring their loans to Greece. Of course, the United States has its own problems when it comes to debt *(see article on next page)*.

Given the major headwinds noted above, it is little wonder that **consumer confidence** *(see above)* is low and moving lower. Stubbornly high unemployment and continued housing woes weigh heavily on consumer confidence and spending. The cycle continues ... business confidence will stay subdued until they're certain that demand will be there. S&P 500 companies are sitting on nearly $1 trillion of idle cash (60% or so being in the US). An improving business environment would go a long way towards businesses investing more and hiring more. The government needs to move from rhetoric to action and allow US businesses to compete more effectively and fairly on a global scale.

Earnings, **interest rates** and **valuations** are still quite reasonable. The S&P 500 should earn roughly $94 or $95 per share in 2011, and that puts the market multiple at roughly 14 times earnings. US corporations continue to have strong balance sheets. We see M&A activity increasing along with increased share buybacks and dividend increases ... all good things for equity investors.

S+P 500 @ 14 X ... pretty reasonable.

Manufacturing in the US has been remarkably resilient. June's Chicago Business Barometer (formerly known as Chicago PMI) rose to a stronger-than-expected 61.1 from 56.6 in May. Some slowdowns were noted in the index (backlogs lower), but new orders surged. The June US factory PMI was also better-than-expected.

OUTLOOK

Bottom Line – We expect continued choppiness in the markets over the next few months as investors digest a plethora of economic and political data ... a muddle-through environment. Sell-offs (and the concomitant economic and political challenges) will likely rattle investor confidence. We believe that sell-offs of five percent or more should be used as opportunities to add to positions, where appropriate. We continue to see the markets finishing the year higher from today's levels. 2nd quarter GDP will be somewhat disappointing at 2.0%-2.5%. The good news is that we expect GDP growth to be around 3% for the final six months of 2011 – reflecting moderating oil prices and the easing of supply-chain disruptions in Japan. The Fed will keep rates low for the remainder of the year.

Bond prices should generally move lower over the course of the quarter. U.S. Treasuries remain challenged, but will be a safe-haven during times of turmoil in the world. We anticipate keeping average durations in the short-to-intermediate range. We are, however, willing to take on more credit risk as corporate balance sheets are improving nicely. A mix of *floating rate funds*, *mortgage-backed debt*, and *emerging market debt* ought to provide reasonable risk-adjusted returns for fixed income investors.

Small and mid-cap equities seem extended, but we see active managers adding value. *Developed international equities* and *emerging market equities* still add value to investors. We continue to like *large-cap companies with higher quality attributes (particularly those with nice yields). Commodities* offer investors some protection from potential inflation and dollar weakness, but we suspect that they will be quite volatile over the next few quarters. *Alternative assets* provide good risk-management for portfolios.

The "noise" of the markets will continue ... investors should stay diversified and in-line with their longer-term objectives and risk tolerance. ***Happy Summer!***

$14.3 trillion!

The Looming Debt Ceiling Crisis

The Federal Government's credit card is maxing out, so its "debt ceiling" [currently $14.3 trillion] must be raised. This is usually a proforma exercise done late on a Friday afternoon, but the last election has emboldened the new House Republicans [who now have a majority] to demand spending cuts. The government's current spending is 25% of GDP [$14.7 Billion last year], while tax revenues are less than 20% of GDP.

The current administration claims that the best way to stimulate the economy is for the federal government to ramp up its spending. The result is an incredible annual spending deficit with little sustained impact on economic growth. Gross debt has increased by $500B+ annually since 2003, with increases of $1 trillion in F2008, $1.9T in 2009 and $1.7T in 2010. As a result government indebtedness is now 96% of GDP [using 2010 numbers], the 12th highest in the world, and bumping up against the debt ceiling.

Inside the beltway, every issue has a political angle, and the debt issue is no exception. Its immediacy [the deadline is ~Aug. 2] makes it the perfect vehicle for attracting attention. The administration wants to make sure that the debt increase bill allows it to continue to tax and spend ["enhance revenues" and "invest"]. The newly empowered opposition is determined [at least for the moment] to increase the debt limit only if spending is cut.

At the end of the day, the debt ceiling will be increased and some spending will be cut, but realize that talk of "default" and $1 trillion in cuts are hyperbole. Not raising the debt ceiling would require setting spending priorities, which politicians are loath to do. Also, spending cuts will be spread over 10 or more years, possibly back-end loaded.

Turn-off CNBC *... and enjoy the summer!*

blah, blah, blah...

The talking heads are at it again ... "the sky is falling, the sky is falling! No, forget about that ... you should be fully invested to take advantage of today's powerful rally. Wait a minute ... I mean get out of the markets today and get in after tomorrow's massive sell-off. Hold on ... Friday's unemployment report will likely set the tone for the rest of the year so we advise investors to be fully hedged until the news is out". Wow, that's more than anyone can absorb while remaining sane and somewhat stress-free.

Our advice – turn-off CNBC and all the talking heads. The markets will have issues to deal with (good and bad), but we prefer not to be drawn into the emotional hype proffered by the media. Besides, they're wrong most of the time anyways.

History has shown that investors are better served by following long-term investment plans than by making investment decisions based on the day-to-day noise of the markets. Many studies have illustrated that individual investor returns are substantially less than average mutual fund or market returns – the primary reason being that investors often act emotionally at market extremes ... wanting to sell at market bottoms and wanting to buy at market tops.

So enjoy the summer and all of the gifts that it provides, and maybe start watching the history channel or the food channel – you'll be less stressed!

A volatile quarter →

2nd QUARTER 2011 SCOREBOARD

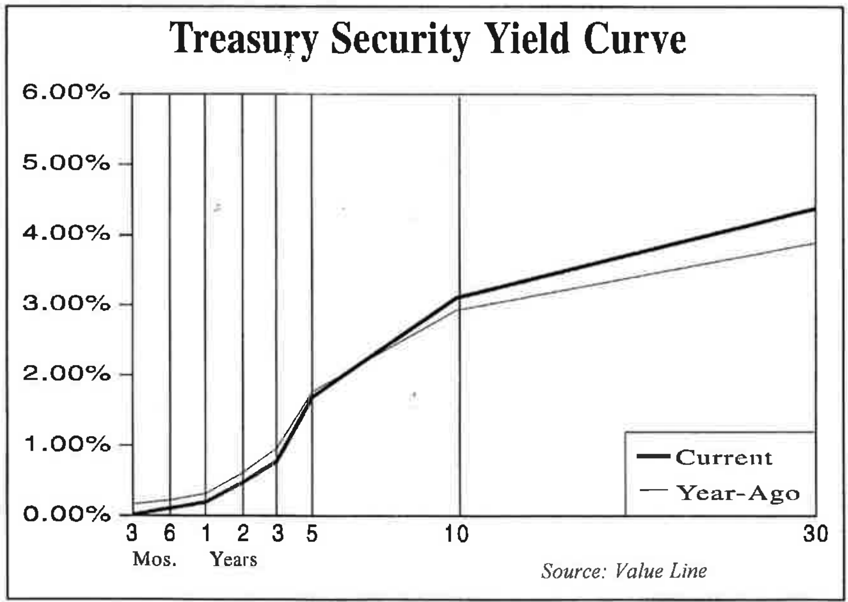
Index	Close	2nd Quarter % Change	Year-to-Date % Change
DJIA	12414.3	0.8	7.2
S&P 500	1320.6	- 0.4	5.0
NASDAQ	2773.5	- 0.3	4.5
Nikkei	9816.1	0.6	- 4.0
MSCI EAFE	1708.1	0.3	3.0

3 Month T-Bill	0.03%	Fed Funds Rate	0 - 0.25%
5 Year T-Note	1.77%	Prime Rate	3.25%
10 Year T-Note	3.16%	Gold	$1502.30
30 Year T-Note	4.38%	Oil	$95.42

Gold is higher by 5.7% in 2011.

Oil is up 4% in 2011.

Interest rates are modestly lower so far in 2011



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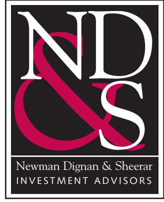

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