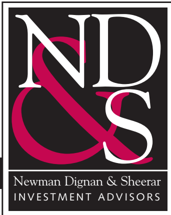


ECONOMIC & CAPITAL
MARKETS REVIEW

NEWMAN DIGNAN & SHEERAR, INC.

The Emperor Has New Clothes (?)

2nd Quarter 2014

ECONOMY & MARKETS

"But he hasn't got anything on," a little child said.

"Did you ever see such innocent prattle?" said its father. One person whispered to another what the child had said, "He hasn't anything on. A child says he hasn't anything on."

"But he hasn't got anything on!" the whole town cried out at last.

The Emperor shivered, for he suspected they were right. But he thought, "This procession has got to go on." So he walked more proudly than ever, as his noblemen held high the train that wasn't there at all.

Hans Christian Andersen, "The Emperor's New Clothes"

Hans Christian Andersen's 1837 Danish fairy tale - *The Emperor's New Clothes* – is the story of an emperor who is swindled by two weavers who promise to make the emperor a new suit of clothes that are invisible to anyone who is "hopelessly stupid." Of course, "the emperor's new clothes" has become an idiom about logical fallacies *(among other things)*.

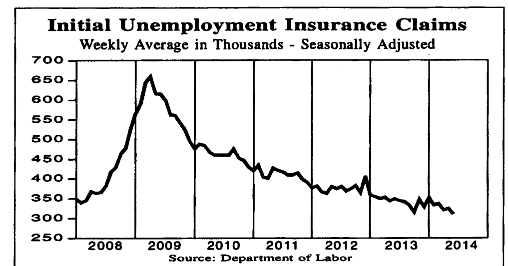
One could argue *(and some do)* that the weavers are the Fed and that the emperor is the markets. As the Fed and other central banks around the world continue to pump up their balance sheets one has to wonder when the party will end. Markets are marching higher as they adhere to the old adage – *Don't Fight the Fed*. When will someone finally yell out "but he hasn't got anything on"? Perhaps the markets are simply validating Adam Smith's invisible hand and the self-interested behavior of investors *(in maximizing their own needs, investors maximize the collective good…)*. However, one must not dismiss Keynes' theory of herd behavior that often leads to unsustainable outcomes. For now, few investors seem to realize that the emperor's clothes are at least a bit tattered. Let's hope some trustworthy weavers come along soon. Maybe, just maybe, we'll see some coherent fiscal policies that support the slowly expanding economy *(don't hold your breath)*.

Don't Fight the Fed

Despite the markets being propped-up by the Fed, equity and bond investors were rewarded during the second quarter. For the second quarter of 2014, the **DJIA** moved higher by 2.2% while the **S&P** jumped 4.7%. The **NASDAQ** finished ahead by 5.0%. International markets broke out of their slump as the **EAFE** Index climbed 2.9% for the quarter. Bond investors were rewarded as the Barclay's Aggregate **Bond Index** finished ahead by 2.0% for the quarter thanks to geopolitical uncertainty.

Equities finished the first-half of 2014 on a high note. For the year-to-date period, the DJIA is up 1.5% while the S&P 500 is ahead by 6.1%. The NASDAQ is ahead by 5.5%, and the EAFE index is higher by 2.95%. Bonds continue to confound investors as the Barclay's Aggregate Bond Index is up by 3.9% for the year through June *(who would have thought?)*.

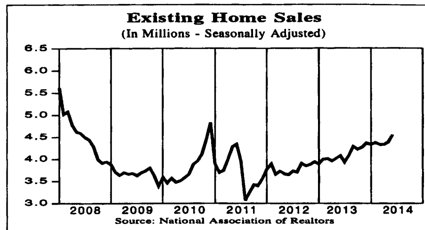
No doubt, a few encouraging economic reports *(at least on the surface)* seem to be indicating a slowly expanding economy. Among the positives lately are: declining **unemployment** *(see below)*, improving **consumer confidence**, strong **auto sales**, decent existing and new **home sales** *(although teetering a bit)*, and improving **manufacturing**.

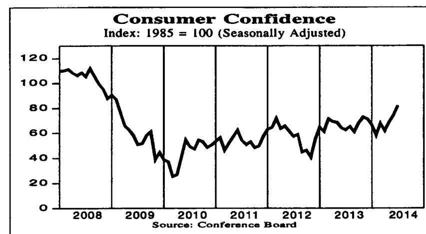


June's unemployment rate fell unexpectedly to 6.1% versus an expected rate of 6.3%. Good news, more people are working. But wait, nearly 40% of those unemployed are millennials, and the labor force participation rate is at a 30-year low. The U6 unemployment rate *(includes discouraged workers)* is still over

12%. Maybe that is why it still doesn't feel like a recovery. In order to get sustained economic growth we need to see better labor market conditions *(not just smoke and mirrors)*.

Existing home sales *(see below)* appear to be improving. Low rates, improving consumer confidence *(see below)* and employment gains are all contributing to a better housing environment.





What could go wrong? The Bank for International Settlements recently warned that global stock markets seem to be detached from underlying economic conditions. The BIS argued that markets may be unprepared for an eventual rate rise. Add to that rising geopolitical tensions, and on could certainly see some bumps in the road … *buckle-up*.

... bumps in the road

OUTLOOK

Bottom Line –A good first half of the year for the markets will likely be followed by a summer sell-off before moving higher into year-end. Uncertainty surrounding Fed actions (*and government inactions*) along with headwinds from Iraq and Ukraine will contribute to increased volatility for the next few months. Barring any acute global blowups, we suspect that the markets finish the year plus or minus 3% from where they stand today.

+/- 3%

Market valuations appear fairly valued as the S&P 500 is trading at 16.6X 2014 estimated earnings … roughly in-line with the 20-year average of 16.7X. The trailing 12 months multiple appears a bit rich at 18.0X, but earnings estimates have been increasing steadily. The Equity Risk Premium stood at 6.0% at the end of June - above its 4.9% long-term average *(indicating equities are more attractive than bonds)*.

After a dismal 1st quarter GDP of minus 2.9% *(weather-related)*, consensus expectations for 2nd quarter GDP indicate a decent 3% growth rate. Improvements in unemployment, housing and manufacturing should support a broadening out of the economy.

Bond prices should move a bit lower over the next quarter as bonds react to the end of Fed tapering and the beginning of rate-hike chatter. Of course, geopolitical challenges could temporarily move bond prices higher and yields lower. We anticipate keeping average durations in the short-to-intermediate range. We remain willing to take on more credit risk as the economy and corporate balance sheets improve.

We remain constructive on equities even as the risk-reward calculus for equities is diminishing a bit. Heck, even Bill Gross expects stocks to return 4-5% over the next 5 years. *Small and mid-cap equities* still add value to an overall asset allocation strategy, but we remain underweight the group as valuations appear fairly priced – at best. We are sanguine on *international equities* – both *developed* and *developing,* as evidenced by our adding to these groups over the past quarter. Valuations for international equities remain relatively attractive. Large-cap domestic equities - *particularly those with higher quality attributes and increasing dividends* - are playing a more significant role in market leadership, and we expect that role to continue *(considering low rates and demographic trends)*. Our value bias has helped portfolios recently, but growth stocks have corrected such that we are somewhat ambivalent to the value versus growth debate. *Commodities* offer investors some protection from potential inflation and dollar weakness. We are beginning to see some nascent signs of inflation. *Alternative assets* should continue to provide good risk-management for portfolios – particularly during times of volatility (which *will* come).

We suggest that investors maintain a fully diversified portfolio consistent with one's longer-term objectives and risk tolerance.

Happy Summer!

We Welcome Erik Manchester to ND&S

We would like to welcome Erik Manchester to ND&S as an Investment Counselor. Prior to joining ND&S, he was a Financial Advisor with Morgan Stanley Wealth Management in Providence, RI for over three years. At Morgan Stanley, Erik managed investment portfolios for high net-worth individuals, family trusts, endowments and retirement plans. Erik is currently enrolled in the College of Financial Planning, and is a candidate for the Certified Financial Planner CFP® designation. Prior to entering the financial services industry, Erik worked as an Account Manager overseeing worldwide accounts for a specialized manufacturing company in North Kingstown, RI serving the offshore and military industries. Erik is a graduate of the College of Business at Florida State University, and received a Bachelor of Science degree in Finance. He currently serves as President of Ocean State Toastmasters in Warwick, RI. Erik is an avid golfer and member of Potowomut Golf Club where he is co-chair of their Membership Committee. Erik resides in the Edgewood section of Cranston.

Rhode Island Estate Tax – *an update*

Recently, the Rhode Island General Assembly approved an $8.7 billion budget for fiscal year 2015. The law includes tax changes that could affect many of our clients.

Effective Jan 1, 2015

The Rhode Island Estate Tax exemption has been increased from $921,655 to $1.5 million for those dying on or after January 1, 2015. This change also eliminates the so called "cliff tax" which would tax estates valued over the exemption amount back to dollar one. Now any estate less than $1.5 million will not be subject to estate tax. The unlimited marital deduction remains in effect. There is no Rhode Island estate tax or federal estate tax for estates passing to a surviving spouse. There is also an inflation adjustment to increase the exemption beginning in January 1, 2016.

Inflation – *some nascent signs*

Milton Friedman taught us that inflation is "always and everywhere a monetary phenomenon". We are taking Friedman's comments seriously since the Monetary Base has quintupled from $800 billion to $4 trillion since the start of quantitative easing in late 2008.

Inflationary trends in the United States and the Eurozone have been declining for the past few years. Fears of deflation have allowed central banks around the world to keep monetary policies very accommodative. The Fed just agreed at their June meeting to end their recent $85 billion bond-buying program by October. As this chapter of quantitative easing comes to a close in the United States, we suspect that inflation may turn higher. May's Consumer Price Index (CPI) report showed that core inflation (minus food and energy stripped out due to their volatility) rose 0.3%, the most since August 2011. The overall CPI rose 2.1% from a year earlier. The increase in the index reflected higher prices on groceries, gasoline, rent, medical care and other consumer items.

...nascent signs...

So the Fed must be worried since May's 2.1% rate is greater than the Fed's 2% target (for price stability and economic growth)? Well, sort of, but they use a different measure of inflation. The Fed prefers to use the Personal Consumption Expenditure Index (PCE). The PCE is taken from the personal consumption expenditures component of GDP. The PCE index typically shows less inflation than does the CPI, but even the PCE is showing some nascent signs of inflation.

Investors cannot fully immunize their portfolios against inflation, but a few things have tended to perform well in moderately inflationary environments – commodities, real estate, equities, and inflation-protected bonds. Cash and long-term bonds suffer due to loss of purchasing power.

Reasonable gains

2nd QUARTER 2014 SCOREBOARD

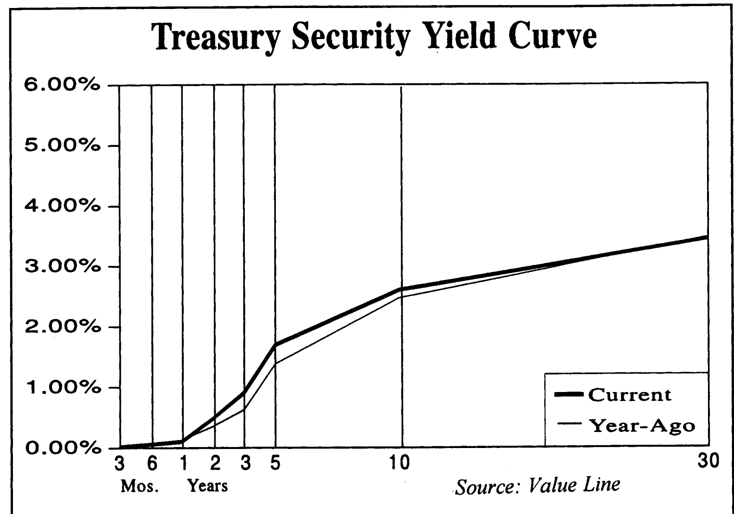
Index	Close	2nd Quarter % Change	Year-to-Date % Change
DJIA	16826.6	2.2	1.5
S&P 500	1960.2	4.7	6.1
NASDAQ	4408.2	5.0	5.5
Nikkei	15162.1	2.3	-6.9
MSCI EAFE	1972.1	3.0	3.0

3 Month T-Bill	0.03%	Fed Funds Rate	0 - 0.25%
5 Year T-Note	1.64%	Prime Rate	3.25%
10 Year T-Note	2.54%	Gold	$1321.80
30 Year T-Note	3.36%	Oil	$105.37

Index returns are price only

Oil is up 6.8% year-to-date

When will rates finally move higher?



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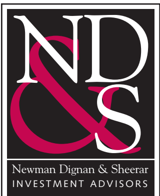

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