ND&S Newman Dignan & Sheerar INVESTMENT ADVISORS

ECONOMIC & CAPITAL MARKETS REVIEW

NEWMAN DIGNAN & SHEERAR, INC.

The New Gulag

3rd Quarter 2014

ECONOMY & MARKETS

In light of Vladmir Putin's sabre rattling in the Ukraine and the ever-changing geopolitical landscape, we thought it appropriate to continue our literary theme – this time with a Russian tilt. Aleksandr Solzhenitsyn's 1973 epic novel – *The Gulag Archipeligo* – highlights the plight (imprisonment, brutalization and murder) of millions of innocent Soviet citizens in forced labor camps (the Soviet Union's own holocaust) mostly during Stalin's rule from 1929 to 1953. Solzhenitsyn maintains that the camps were derived from the ideology behind the Bolshevik revolution's "spiritual baseness," and that the government at the time should "let the people breathe, let them think and develop!"

What does this have to do with investing and the world today? One could argue that the never-ending, incessant noise of tensions around the world is nothing new. From a behavioral finance standpoint, perhaps the noise holds investors captive in their own gulags.

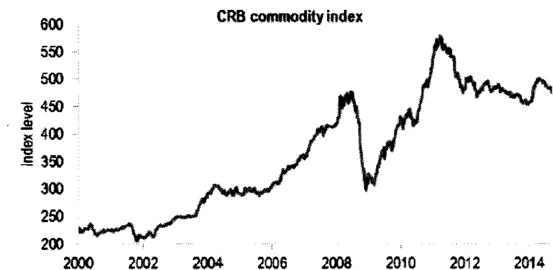
Despite some volatility over the summer months, equity investors were generally not harmed during the third quarter. For the third quarter of 2014, the **DJIA** moved higher by 1.3% while the **S&P** inched higher by 0.6%. The **NASDAQ** finished ahead by 1.9%. International markets gave back earlier gains as the **EAFE** Index declined 6.4% for the quarter. Bond investors saw only minor swings in rates during the quarter as fears of the end of quantitative easing were offset by a flight-to-safety into U.S. treasuries. Bond returns were up modestly as the Barclay's Aggregate **Bond Index** finished higher by 0.17% for the quarter.

For the year-to-date period, the DJIA is up 2.8% while the S&P 500 is ahead by 6.7%. The NASDAQ is higher 7.6%, and the EAFE index is down 3.6%. Bonds have held their own this year as the Barclay's Aggregate Bond Index is ahead by 4.1% for the year through September.

Behind all the geopolitical noise around the world, the U.S. economy continues to plod along. Some of the positive signs pointing to economic progress include: improving **leading economic indicators** *(see chart below)*, healthy **durable goods**, early signs of improving **capital expenditures**, recovering **housing prices**, improving **retail sales**, encouraging **industrial production**, good **manufacturing activity**, and low **interest rates** and **inflation**.

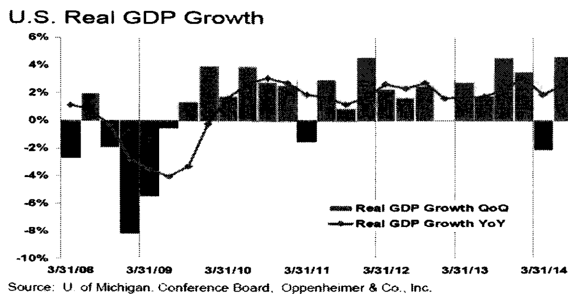
Missing from the above lists of positives is **housing**. The U.S. housing recovery is still on track, but the recent data are mixed. Overwhelming student debt, delayed marriages and tepid wage growth have served to put a damper on the housing recovery. Let's hope the slowdown is just temporary and not secular.

Commodity prices *(see chart below)* have mostly moved lower over the past two years. Lower commodity prices (particularly oil/gas) provide a tailwind to consumers and most businesses as input costs and expenses go lower. Retail sales and corporate profit margins should benefit.



Source: Bloomberg

Reasonable GDP 2→



Source: U. of Michigan, Conference Board, Oppenheimer & Co., Inc.

2nd quarter revised GDP growth was a very healthy 4.6% *(see chart above)*. We suspect that real growth in the second half of this year will be roughly 3% … not great, but certainly not recessionary and better than most of the world. Personal consumption expenditures will be important going forward, and we expect them to improve as employment gets better (should offset strong dollar impact).

OUTLOOK

Bottom Line – A decent year-to-date period for the markets will likely be followed by a month or so of increased volatility. We would not be surprised to see market averages lower by 5% or so before recovering most, if not all, of those losses by year-end. Uncertainty surrounding the Middle East (ISIS, Syria, Iraq, Iran, Afghanistan, etc...), Hong Kong (civil unrest), Russia (sanctions, Ukraine, etc…), Ebola, and a host of other issues will likely provide enough drama to finally send the markets lower. The markets have gone quite some time without a material correction, and we suspect that a correction is overdue. But remember, market corrections are normal.

Corrections are normal...

Market valuations have certainly risen, but they are roughly in-line with historical averages. The S&P 500 is trading at 17.0X 2014 estimated earnings of $116. Low inflation and low interest rates will allow valuations to creep higher before they become a concern. Risk management becomes even more critical as markets move higher, and proper asset allocation and portfolio diversification will help investors to weather most storms.

Bond prices should move lower over the next quarter as bond yields resume their march higher prompted by the end of quantitative easing and the anticipation of the Fed raising interest rates sometime in 2015. We are currently underweight most fixed income targets as we believe the U.S. is near the end of a 30-year bull market in bonds. Of course, extremely low rates overseas will attract capital to the U.S. and may keep interest rates lower for a longer period of time than most investors expect. Who would have thought that the German 10-year Bund would yield 0.89% versus the U.S. 10-year Treasury yield of 2.51% (let alone the Italian 10-year yielding 0.20% *less* than the U.S. 10-year)? We anticipate keeping average durations in the short-to-intermediate range. *Floating rate funds, mortgage-backed debt, and slightly less-than-investment grade debt* ought to provide reasonable returns for fixed income investors. Strategic bond funds should outperform the overall bond benchmark as rates begin to slowly trend higher.

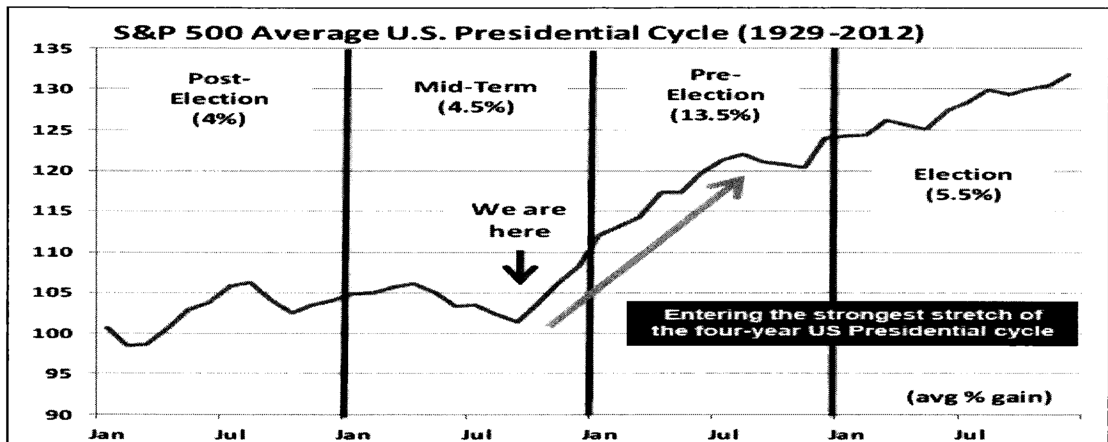
Small and mid-cap equities still add value to an overall asset allocation strategy, but we remain underweight the group as valuations appear fairly priced – at best. Although the Russell 2000 (small-cap proxy) is down 5.3% in 2014 we see more downside ahead. We are sanguine on *international equities* – both *developed* and *developing.* Valuations for international equities remain attractive (although a strong dollar and continued geopolitical uncertainty create headwinds in the short-term). Large-cap domestic equities - *particularly those with higher quality attributes and increasing dividends* - will continue to play a significant role in market leadership.

Commodities may offer investors some protection from potential inflation and dollar weakness although current deflationary signs are weighing on the group (cheaper goods equals good news for consumers and businesses). We started a small position in this space recently, and it appears that our timing was a bit too early. *Alternative assets* should continue to provide good risk-management for portfolios. We were pleased to see alternatives perform relatively well during the market's recent sell-offs.

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

The Presidential Cycle – *Time Is On Our (My) Side*

Yes it is, yes it is … or so goes the song made famous by the Rolling Stones. A review of the Presidential Cycle *(see chart below)* points to good times ahead for investors.



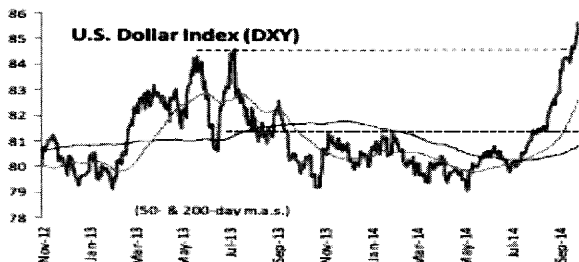
Source: Oppenheimer Asset Management, and Bloomberg
Note: These results cannot and should not be used as an indicator of future performance.

We like the odds…

The S&P 500 tends to do well in the fourth quarter of most years, and particularly in the fourth quarter of mid-term election years. Of course, as the chart illustrates, the best year of the cycle tends to be the third year with average gains of 13.5% (data from 1929 – 2012). But we all know better than just assuming what happened before will happen again. A strong case can be made that the markets are long overdue for a correction, and a nasty correction would likely alter the outcome for 2015. Perhaps the Presidential Cycle doesn't play out this time, but we like the odds.

The Ascent of the U.S. Dollar

The third quarter brought more volatility for equity investors, but a welcome improvement for most participants in the domestic economy. This was the result of the persistent ascent of the US dollar *[see chart below]*. The dollar, which fluctuated in a narrow [~200BP] range during the first half of this year, started a resilient advance on July 2nd. This ultimately resulted in a stellar 7.7% advance.



Source: Oppenheimer Asset Management and Bloomberg

The sources of the dollar's strength are many. They include decelerating/eroding European economies, the Japanese "stimulus" efforts [have they overdone yen debasement?], and the ongoing tapering of QE3 [it will be over in another month!]. The Fed's promised target date for QE3 ending is not slipping, as many of its previous end-of-monetary-ease dates did.

This is a core reason for the dollar's strength. Moreover, the Fed is now considering when to **raise** Fed Funds, which have been effectively zero [actually 0% to 1.25%] since 2008. A Fed funds increase will be the first since 2006.

Cheaper Gas

Dollar strength is making imports in general and commodities in particular [think gasoline, grains. gold] more affordable. US companies with predominately domestic customers will also benefit [foreign customers will be buying US goods with depreciating currencies … effectively a price increase]. It's time to dust off the family chariot and drive to your favorite retailer to purchase some fall finery. Enjoy.

3rd QUARTER 2014 SCOREBOARD

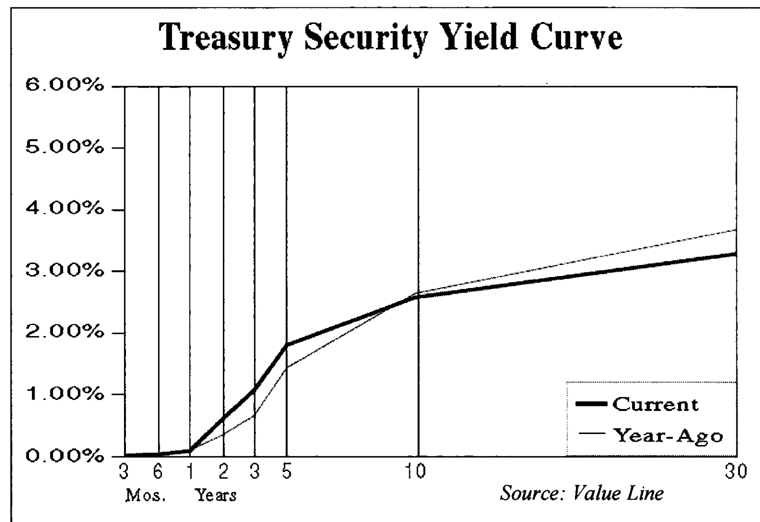
Index	Close	3rd Quarter % Change	Year-to-Date % Change
DJIA	17042.9	1.3	2.8
S&P 500	1972.3	0.6	6.7
NASDAQ	4493.4	1.9	7.6
Nikkei	16173.5	6.7	-0.7
MSCI EAFE	1846.1	-6.4	-3.6

3 Month T-Bill	0.02%	Fed Funds Rate	0 - 0.25%
5 Year T-Note	1.77%	Prime Rate	3.25%
10 Year T-Note	2.51%	Gold	$1210.50
30 Year T-Note	3.21%	Oil	$91.16

Index returns are price only

Oil prices dropped 14.9% during the 3rd quarter.

Rates are still trading in a tight range



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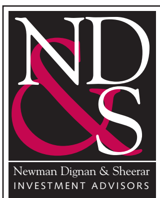

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