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

Odysseus and the Sirens

4th Quarter 2014

ECONOMY & MARKETS

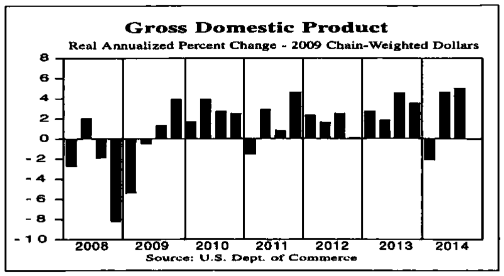
Resist the call of the Sirens! We are reminded of Book XII in Homer's ***Odyssey*** whereby Odysseus orders his sailors to tie him to the mast of the ship as they pass by the Sirens. Odysseus has his sailors fill their ears with beeswax to avoid hearing the melodious and seductive songs of the Sirens. Hearing the songs of the Sirens would surely lead the sailors to their death like many before them. Odysseus begs his sailors to untie him once he hears the irresistible call of the Sirens (promising to reveal the future), but his sailors tie him even tighter. It is said that the Sirens were so distressed that Odysseus heard their song and resisted that the Sirens threw themselves into the sea and drowned.

Investors today must resist the calls of the fast money crowd promising out-sized returns with little or no risk. Time honored techniques like diversification and patience seem to have fallen out of favor (how quickly we forget the pain of the past …). We suggest that investors tune-out the all-too-enticing talking heads, and stick with their game plan. Be careful of consensus as crowded expectations are reason enough to pause.

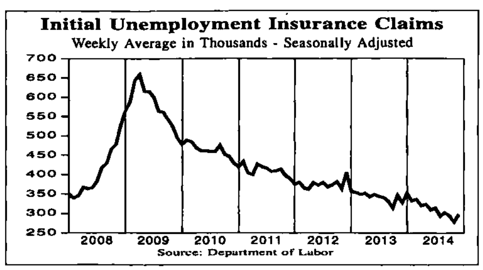
A Tale of Two Cities…

The fourth quarter of 2014 defined what generally happened in the markets for the entire year – US markets were higher while international markets struggled *(A Tale of Two Cities ...)*. For the quarter, the **DJIA** advanced 4.6% while the **S&P** moved higher by 4.4%. The **NASDAQ** surged 5.4% for the quarter. International markets continued their divergence from domestic markets as the **EAFE** Index declined 3.9% for the quarter. Bond returns were better-than-expected as the Barclay's Aggregate **Bond Index** gained 1.8% for the quarter.

For the year, the **DJIA** was up 7.5% while the **S&P 500** closed higher by 11.4%. The volatile **NASDAQ** raced ahead by 13.4%. International markets posted less-than-stellar returns as the **EAFE** index (developed markets) lost 7.4% for the year while emerging markets were lower by 4.6%. Bonds finished the year higher, much to most analysts' surprise, as the Barclay's Aggregate **Bond Index** gained 6.0% for 2014. Of note - an overriding consensus at the end of 2013 called for bonds to struggle in 2014 (ND&S was in that camp as well).

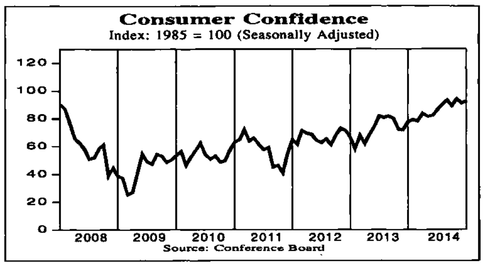


Domestic economic news continues to improve. **GDP growth** *(see chart above)* of 5% in the 3rd quarter was encouraging, and we suspect 2014 will finish with around 2.8% growth (Q4/Q4). 2015 GDP growth (domestic and global) should clock-in about 3% or so. Lower **jobless claims** *(see chart below)* are certainly encouraging, but we are reminded of the lowest labor participation rate (62.7%) since 1978. A smaller work force presents a drag on growth. Significantly lower oil prices, a nice tailwind for consumers, is reflected in subdued **inflation** (despite the Fed's easy money policies) and robust **consumer spending**. **Corporate balance sheets** remain strong while **durable goods orders** appear reasonable.



↓ Oil + Gas a big plus

Consumer confidence *(see chart below)* is rising nicely – thanks to lower unemployment and lower oil and gas prices. Hourly wage rates are somewhat stagnant, and will likely limit consumption (the consumer is roughly 70% of U.S. GDP). The good news is that consumption is growing, but it is still less than its long-term rate of growth. An aging work force will ultimately lead to higher wage growth.



A few unintended consequences of a higher US dollar (up 15% from April lows) are beginning to emerge. The **December ISM manufacturing index** fell to 55.5 from 58.7 (weakest since June) … remember that roughly 45% of S&P 500 earnings come from overseas (US multi-nationals will feel some pain). Geopolitical tensions remain a wildcard, and will serve as a headwind to equity markets.

OUTLOOK

6-8% returns ...

↑ volatility

Bottom Line – We are reminded of Casey Stengel's quote – *"Never make predictions, especially about the future,"* but here we go - we expect the markets to finish the year 6% to 8% higher or so. Unlike in 2014, we see 2015 experiencing more volatility in both equities and fixed income. An interesting tidbit is that the split between up and down days in the S&P 500 over the past 50 years is 53% up and 47% down. A few good years in the stock market tend to resurrect a ***"recency-bias"*** whereby investors convince themselves that what happened recently will necessarily recur in the near future. We urge investors not to be lulled into complacency. A correction in the markets is long overdue … we have gone 1,185 calendar days without a 10% or greater drop in the S&P 500 (4th longest stretch in the last 50 years).

Market valuations have certainly increased over the past year, but current valuations are more-or-less in-line with historical averages. With 2015 consensus earnings estimates for the S&P 500 around $127 or so, the market is selling at 16x forward earnings. Interestingly, according to the Leuthold Group, the median stock in the S&P 500 trades around 21x earnings (~25% higher than the cap-weighted P/E ratio) … things are not always what they appear to be. Markets can certainly go higher from here (and they likely will), but higher valuations provide less room for disappointments. The U.S. economy will likely generate GDP growth around 3.0% … not bad, but what about the rest of the world? Asia should see reasonable GDP growth (big beneficiary of lower oil prices) while Europe will likely struggle to show positive GDP growth for 2015.

Bond prices should generally be flat to slightly lower in 2015, and investors should expect to collect their coupon. We anticipate keeping average durations in the short-to-intermediate range … we are not willing to take on much interest rate risk given the likelihood of higher rates. We are, however, willing to take on more credit risk as corporate balance sheets are reasonably strong. *Mortgage-backed debt, less-than-investment grade debt* and *emerging market debt* ought to provide reasonable returns for fixed income investors.

Small and mid-cap equities still add value to an overall asset allocation strategy, but we remain underweight as valuations appear fully priced. We are sanguine on *international equities* – both *developed* and *developing,* and we anticipate adding to positions in 2015 given attractive valuations and yields. Again, we believe that *large-cap companies with higher quality attributes* should continue to provide better-than-market returns (valuations are a bit stretched, but they provide predictable growth and dividends). We like companies with excellent dividend growth potential *(not necessarily just high dividend yields). Commodities* offer investors some protection from potential inflation and dollar weakness, but those scenarios do not seem likely for the next six months or so. *Alternative assets* will continue to provide good risk-management for portfolios ... particularly in an environment of increased volatility.

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

Tax Update for 2015

Income tax brackets for 2015 appear below:

<u>Marrieds</u>: If taxable income is	**The tax is**
Not more than $18,450	10% of taxable income
Over $18,450 but not more than $74,900	$1,845.00 + 15% of excess over $18,450
Over $74,900 but not more than $151,200	$10,312.50 + 25% of excess over $74,900
Over $151,200 but not more than $230,450	$29,387.50 + 28% of excess over $151,200
Over $230,450 but not more than $411,500	$51,577.50 + 33% of excess over $230,450
Over $411,500 but not more than $464,850	$111,324.00 + 35% of excess over $411,500
Over $464,850	$129,996.50 + 39.6% of excess over $464,850

<u>Singles</u>: If taxable income is	**The tax is**
Not more than $9,225	10% of taxable income
Over $9,225 but not more than $37,450	$922.50 + 15% of excess over $9,225
Over $37,450 but not more than $90,750	$5,156.25 + 25% of excess over $37,450
Over $90,750 but not more than $189,300	$18,481.25 + 28% of excess over $90,750
Over $189,300 but not more than $411,500	$46,075.25 + 33% of excess over $189,300
Over $411,500 but not more than $413,200	$119,401.25 + 35% of excess over $411,500
Over $413,200	$119,996.25 + 39.6% of excess over $413,200

<u>Household Heads</u>: If taxable income is	**The tax is**
Not more than $13,150	10% of taxable income
Over $13,150 but not more than $50,200	$1,315.00 +15% of excess over $13,150
Over $50,200 but not more than $129,600	$6,872.50 + 25% of excess over $50,200
Over $129,600 but not more than $209,850	$26,722.50 + 28% of excess over $129,600
Over $209,850 but not more than $411,500	$49,192.50 + 33% of excess over $209,850
Over $411,500 but not more than $439,000	$115,737.00 + 35% of excess over $411,500
Over $439,000	$125,362.00 + 39.6% of excess over $439,000

The ***federal estate and gift tax exemption*** for 2015 is $5,430,000 (the rate remains 40%). The ***Rhode Island estate tax*** threshold for 2015 increases to $1,500,000 (from $921,655 in 2014). The federal ***gift tax exclusion*** remains that same as last year at $14,000 per donee.

The ***maximum 401k, 403b and 457 plan contribution*** increases to $18,000 with a catch-up amount of $6,000 for those 50 and older. ***IRA and Roth IRA max contributions*** remain at $5,500 ($6,500 for those over age 50).

still favorable rates

Capital gains rates max out at 20% for filers in the top income bracket (add to that a 3.8% Medicare surtax). The 15% rate applies to filers below the top income rate except for fillers in the 10% or 15% income tax bracket where the rate remains 0%.

As always, we urge clients to review all tax related matters with their tax advisors.

Important Compliance Update

Pursuant to the ongoing written disclosure requirement placed upon registered investment advisers, we are required, on an annual basis, to make available to our clients our most recent written disclosure statement as set forth on our Form ADV Part 2A (our *"Brochure"*). As such, please contact ND&S should you wish to receive our most recent *Brochure*.

ND&S maintains a proxy voting policy that highlights our handling, research and voting of proxies. Please contact ND&S should you wish to receive a copy of our Proxy Policy. *As always, we ask that you also notify us of any significant changes to your financial situation.*

4th QUARTER 2014 SCOREBOARD

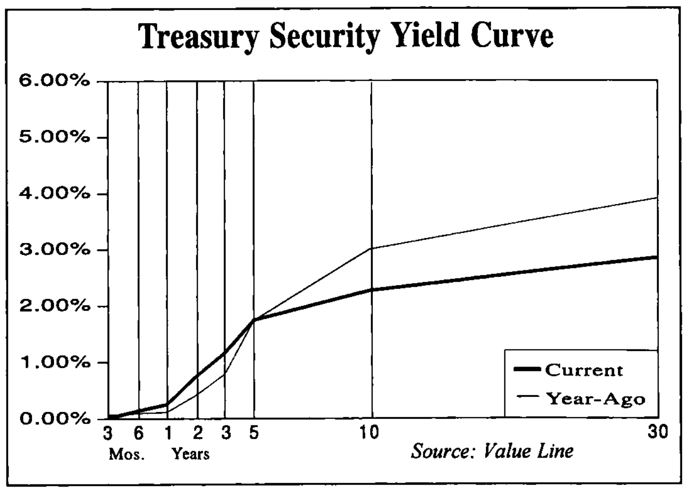
Index	Close	4TH Quarter % Change	2014 Yearly % Change
DJIA	17823.1	4.6	7.5
S&P 500	2058.9	4.4	11.4
NASDAQ	4736.1	5.4	13.4
Nikkei	17450.8	7.9	7.1
MSCI EAFE	1774.2	-3.9	-7.4

3 Month T-Bill	0.05%	Fed Funds Rate	0 - 0.25%
5 Year T-Note	1.66%	Prime Rate	3.25%
10 Year T-Note	2.17%	Gold	$1182.30
30 Year T-Note	2.75%	Oil	$53.75

Index returns are price only

Oil prices down 45% in 2014... a significant tailwind

Yields move lower before finishing the year slightly higher



ND&S wishes to extend to all of our clients and friends our best wishes for a happy, healthy and peaceful New Year!

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