Diversification pays off

2nd QUARTER 2015 SCOREBOARD

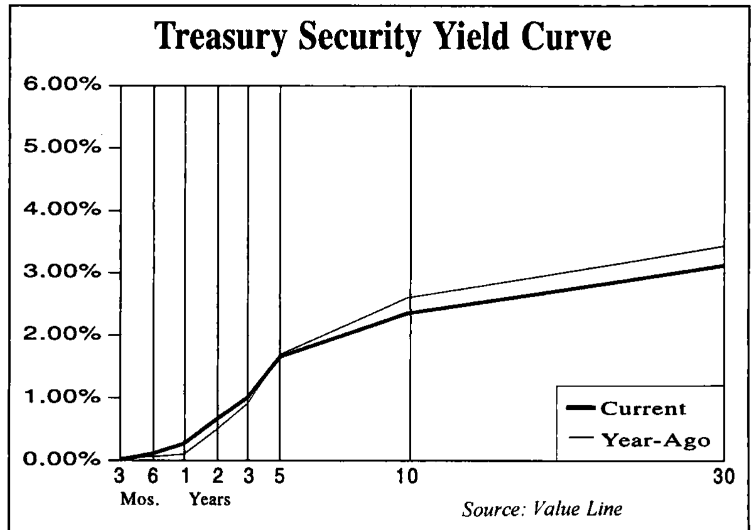
Index	Close	2nd Quarter % Change	Year-to-Date % Change
DJIA	17619.5	-0.9	-1.1
S&P 500	2063.1	-0.2	0.2
NASDAQ	4986.9	1.8	5.3
Nikkei	20235.7	5.4	16.0
MSCI EAFE	1842.5	-0.4	3.8

3 Month T-Bill	0.02%	Fed Funds Rate	0 - 0.25%
5 Year T-Note	1.63%	Prime Rate	3.25%
10 Year T-Note	2.35%	Gold	$1171.50
30 Year T-Note	3.11%	Oil	$59.47

Index returns are price only

Oil is over 10% in 2015 following 2014's 45% drop... a nice tailwind.

Yields move higher into year-end



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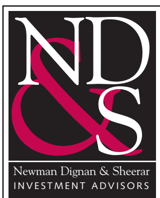


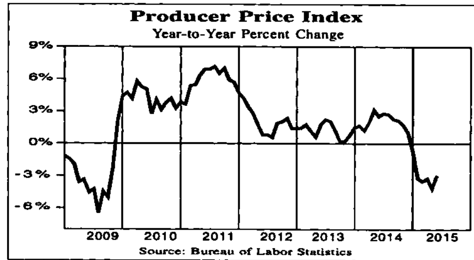
NEWMAN DIGNAN & SHEERAR, INC.

Registered Investment Advisors

56 Exchange Terrace, Suite 200 • Providence, RI 02903 • 401.351.4010 • Fax 401.351.4011

Good News ↳

the labor market. Continued job growth will likely lead to stronger wage growth … year-on-year rates of growth for both **average hourly earnings** (~2.0%) and the **employment cost index** (~2.6%) portend potentially better consumption and growth. A few clouds remain in the labor market - the U6 unemployment rate *(includes discouraged workers)* is still over 10%, and it suggests that a number of part-time workers would prefer full-time jobs. Nonetheless, the jobs data are encouraging.



↑ Disposable Income ↳

The **Producer Price Index** *(see above)* indicates that input costs for companies are still quite reasonable and that inflation does not appear on our doorstep. We know, however, that inflation will eventually greet us as inflation is *"always and everywhere a monetary phenomenon"* as Milton Friedman posited. For now, businesses and consumers can enjoy the low input costs that are helping to sustain profit margins and disposable income.

Buckle-up …

As the improving economic foundation is being set, we are quite aware that strong winds will blow. The **strong headwinds** will likely come from the following places: slowing growth in China, fallout and possible contagion from a Grexit, higher-than-average valuations, an inflection point in Fed policy and actions, changing demographics (low population growth and a growing age group 65 and over), low global growth expectations (IMF and Fed have lowered 2015 growth expectations recently), rising geopolitical and terrorism risk, and tail risks that we can't even see today … *buckle-up.*

Greece will likely reach a deal with its creditors, but it will be nothing more than "Extend and Pretend." Investors will cheer the initial news, but we will all once again suffer from headline news fatigue as the rally fades. Whatever reforms are implemented in Greece will most likely not be sustainable, but the effort must be made.

China, the world's second largest economy, is clearly slowing down. China is transitioning from an export-led economy to a consumption-based economy, and the transition will not be without its hiccups.

OUTLOOK

Bottom Line –A relatively flat first half to the year for the markets will likely be followed by a summer sell-off before moving higher into year-end.

Market valuations are higher-than-average as the S&P 500 is trading at 17.5X 2015 estimated earnings of $118 *(which may prove too high)* … slightly above the 20-year average of 16.7X. No doubt, low inflation and low interest rates help to mitigate today's valuation levels. Higher valuations, however, will temper future gains … history is quite clear *(see next page).*

Bond prices should move a bit lower over the next quarter as bonds react to the ongoing rate-hike chatter. Of course, geopolitical challenges could temporarily move bond prices higher and yields lower on a flight-to-safety. We anticipate keeping average durations in the short-to-intermediate range.

We remain constructive on equities even as the risk-reward calculus for equities is diminishing a bit. *Small and mid-cap equities* still add value to an overall asset allocation strategy, and the stronger US dollar will play to their strength. We continue to be sanguine on *international equities* – both *developed* and *developing,* as their valuations remain relatively attractive (despite Greece and China). Large-cap domestic equities - *particularly those with higher quality attributes and increasing dividends* - remain overweight in portfolios. Our growth bias continues to play-out as global GDP growth remains fairly anemic. *Commodities* remain out-of-favor. *Alternative assets* should continue to provide good risk-management for portfolios – particularly during times of volatility *(which seem to be here).*

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

Navigating the Unknown

We live in a world of unknowns. As professional investment advisors, we work closely with our clients to navigate a world of unknowns. One of the biggest unknowns facing the baby-boomer generation today is longevity. If you are 65 and married today, there is 47% chance that at least one spouse will live to age 90.

Mean Reversion

Another unknown facing investors today is correctly forecasting future investment returns. The legendary economist John Kenneth Galbraith said, *"We have two classes of forecasters, those who don't know, and those who don't know they don't know."* With that said, investing requires us to position portfolios with an uncertain future. There are an infinite number of scenarios that could play out over the next 6 months, never mind the longer-term. Fortunately, we have a lot of history to guide us. With the unprecedented 30 plus year bull market in bonds nearing an end and the current elevated U.S. equity valuations in equities here in the U.S., we believe it's **highly probable** that returns over the next 7 – 10 years will be below their long-term averages. Mean reversion is alive and well … you can always count on it over the long term.

Valuations are very helpful when forecasting long-term returns. On a price to earnings ratio (P/E) for the S&P 500, the geometric average is 14.5X going back to 1900, and it now stands at 20X. Since Greenspan's arrival at the Federal Reserve in 1987 and his introduction of accommodative monetary policies, the average as been 23.4X (the new normal?). Profit margins for the S&P 500 are already near post WWII cyclical highs so future equity performance will be driven mostly by revenue growth and then by margin expansion.

Despite the current headlines about Greece's enormous problems and China's stock market volatility and valuation, market research suggests that international equities will likely be the best asset class over the next 7 – 10 years (not shown below are expected returns from emerging markets which appear to have the highest forecasted returns). US outperformance relative to the MSCI EAFE is at an extreme, and the performance gap will almost certainly narrow. It is obvious from the chart below (and history) that equities will most likely continue to provide investors with the best return, albeit at levels lower than the most recent past.

What others are saying…

Educated Guesses

Firm	Outlook	U.S. Equity	Developed	U.S. Bonds	Cash
GMO, LLC*	7 years	-0.1%	1.5%	1.1%	1.7%
William Blair**	8 years	4.9%	8.2%	3.1%	2.8%
MS & Co.***	10 year	6.1%	n/a	3.1%	n/a
Charles Schwab****	20 years	6.3%	6.1%	3.3%	1.8%
JP Morgan*****	10-15 years	6.5%	6.8%	4.0%	2.0%

Source:
* GMO, 7-Year Outlook, May 31, 2015
** William Blair, Dynamic Allocation Strategies Team, May 31, 2015
*** Morgan Stanley & Co., On the Markets, December 2014
**** Charles Schwab Investment Advisory, April 24, 2015
***** JP Morgan, Long Term Capital Market Return Assumptions, January 2015

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

Newman Dignan & Sheerar
INVESTMENT ADVISORS

Curb Your Enthusiasm (?)

2nd Quarter 2015

ECONOMY & MARKETS

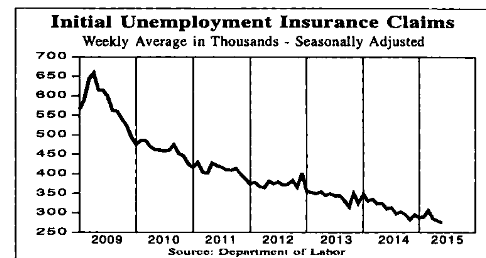
The title of Larry David's hit comedy series – *Curb Your Enthusiasm* – seems to capture today's market sentiment. Investors have benefited from a six year run-up in stock prices off the 2009 market bottom, but we suspect that we may be in for a *temporary* set-back in the markets. Temporary is the operative word as markets will no doubt continue to provide investors with decent returns … just like they always have.

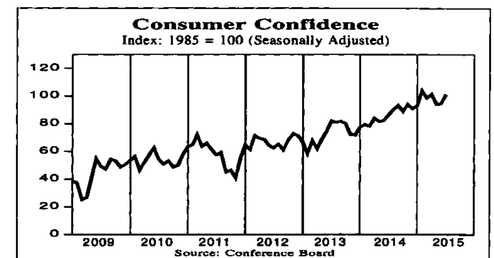
Will the 'final' farewell tour for the Grateful Dead signal the end of the bull market? We think not, but investors may be in for a sideways to down market for the next quarter or so. Investors will likely see a bit of red in the markets, but perhaps it will be just a *"Touch of Grey"* – the Grateful Dead's only top 10 hit. According to BTN Research, the summer months of June – August have produced an average loss of 0.3% for the S&P500 for the past twenty-five years. Current economic conditions, despite Greece and China, are too good to suggest a major move down.

For the second quarter of 2015, the **DJIA** moved lower by 0.9% while the **S&P** inched down by just 0.2%. The **NASDAQ** finished ahead by 1.8%. International markets gave back a bit as the **EAFE** Index dropped 0.4% for the quarter. Bond investors saw their first quarterly drop since 2013 as the Barclay's Aggregate **Bond Index** finished lower by 1.7% thanks to jitters about a likely change in Fed policy in the quarters ahead.

U.S. equities finished the first-half of 2015 essentially flat. For the year-to-date period, the **DJIA** is down 1.1% while the **S&P 500** is ahead by 0.2%. The **NASDAQ** is ahead by 5.3%, and the **EAFE** index is higher by 3.8% as lower valuations overseas are beginning to attract investors. Bonds are basically flat as the Barclay's Aggregate **Bond Index** is negative by 0.1% for the year through June *(yes, bonds can and will lose money…)*.

It appears that a broadening economic foundation is being set. Quite a few encouraging signs have been surfacing in the economy over the past few months *(but will they stick?)*. Among the positives lately are: strong **job growth** and declining **unemployment** *(see below)*, sustained **low energy prices**, moderate **wage gains**, increasing **household net worth**, declining **foreclosures**, rising **equity values** in homes, improving **manufacturing** data (15% of GDP), strong **auto sales**, decent **retail sales**, and improving **leading economic indicators**. Of course, all of this has led to improving **consumer confidence** – June's index rose to 101.4, up nicely from May's 94.6 level *(see below)*.





We have mentioned many times that in order to get sustained economic growth we need to see better labor market conditions *(not just smoke and mirrors)* … well that is beginning to happen. June's **unemployment rate** fell to 5.3%, the lowest since April 2008. The unemployment rate is moving ever closer to the Fed's long-run estimate of full employment (5.0% - 5.2%). U.S. employers added 223,000 jobs in June, and the number of **job openings** (JOLTS data) stand close to 5.4 million, the highest in over a decade … all decent signs for