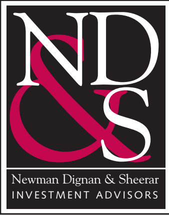


ECONOMIC & CAPITAL
MARKETS REVIEW
NEWMAN DIGNAN & SHEERAR, INC.

HARVARD BEATS YALE 29-29

2nd Quarter 2012

ECONOMY & MARKETS

The 2008 documentary by Kevin Rafferty highlights one of the most famous football games in Ivy League history. Harvard Stadium was the scene of the 1968 game between the two undefeated teams of Harvard and Yale. The heavily favored Yale team was ahead by 29-13 with just two minutes remaining. Somehow, Harvard scored 16 points in the final 42 seconds, and The Harvard Crimson declared victory with the headline – *"Harvard Beats Yale 29-29"*.

We suppose most investors can claim victory today *(why not, the politicians will!)* … even if it is just a moral victory like Harvard's in 1968. Given all of the headwinds and potential time bombs that investors face today, the markets continue to muddle along. We suspect that the next quarter will be more of the same with, perhaps, a bit more downside.

As we projected in our 1st quarter newsletter – *What, Me Worry?* – equity markets around the world pulled back in the 2nd quarter. For the quarter, the DJIA moved lower by 2.5% while the S&P gave back 3.3%. The NASDAQ declined by 5.1%. International markets sold-off more than domestic markets due to continuing concerns in Europe as the EAFE Index finished the 2nd quarter lower by 6.9%. Bond returns were positive due to a flight-to-safety out of equities over continuing European woes as the Barclay's Aggregate Bond Index rose 2.2% for the quarter.

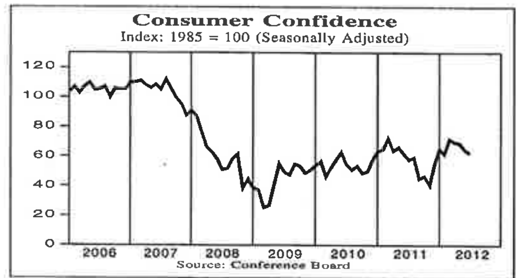
Year-to-date performance numbers for equities are quite reasonable given the economic and political backdrops. For the year-to-date period, the DJIA is up 5.4% while the S&P 500 is ahead by 8.3%. The NASDAQ is still ahead by 12.7%, and the EAFE index is ahead by 3.4%. Bonds continue their march higher as they are up 2.5% for the year through June.

anything but rosy →

Worldwide economic news over the quarter was anything but rosy. Of course, most of the discouraging economic news is emanating from Europe, but slowing growth in Europe and China is beginning to impact growth in the United States and in Emerging Markets.

European leaders continue to drag their feet as the banking and liquidity concerns in Europe fester. Despite some positive actions at the recent EU Summit in Brussels, a lot of challenges remain. Chief among the challenges are finding a solution to the sovereign debt crisis and then getting all 17 countries (in the eurozone) to agree on that solution. It seems unreasonable and politically untenable to assume a full fiscal union with shared responsibility; therefore, a break-up of the euro is not out of the question. In the meantime, the unemployment rate in the 17-nation eurozone rose to 11.1% in May (with Spain's rate being the highest at 24.6%).

News out of China points to slowing economic growth. China's economic growth in the 2nd quarter is expected to slow to 7.6% *(slowest pace since early 2009)* as factory output and retail sales weakened. We suspect that China will pull through with a soft landing as their central bank continues to lower interest rates and reserve requirements along with quickening stimulus spending on infrastructure.

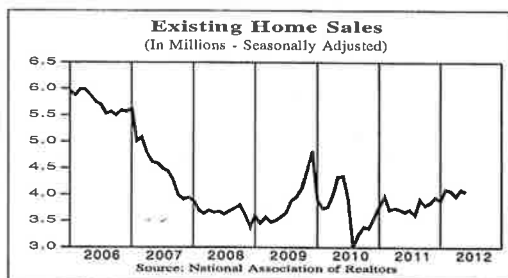


U.S. economic conditions are moderating at a quicker pace than expected, and it is not surprising to see consumer confidence numbers *(see chart above)* decline as a result. Payroll growth in the U.S. remains muted, and U.S. manufacturing data *(see chart on next page)* have taken a turn for the worse. The U.S. manufacturing sector contracted in June for the

first time since July 2009. The ISM manufacturing came in at 49.7 versus a consensus forecast of 52.0 and May's level of 53.5. June's reading was the lowest in nearly three years. We're sure that some politicians will put a good spin on recent economic news, but it is hard to sugar-coat the lousy manufacturing news.

bright spots →

A few bright spots exist in the U.S. – namely, housing *(see chart below)*, low interest rates, low inflation, strong corporate balance sheets and lower gas/oil prices. These bright spots will help to offset weaknesses mentioned above, but will they be enough? Nonetheless, an unemployment rate of 8.2% does not engender confidence among businesses and consumers. Leaders around the world need to wake up and stop kicking the can down the road! Given that we're in an election year in the U.S., we doubt any leaders will emerge who are willing to proffer solutions to difficult problems. Maybe next year …



OUTLOOK

range bound →

Bottom Line – We remain constructive on the markets, and suspect that the markets will be range-bound (1290-1430 for the S&P) in the short-term. Similar to last quarter, the markets will likely sell-off over the next few months on deteriorating fundamentals in Europe and China. We suspect, however, that any pullback in the markets will be fairly shallow as buyers come in to support the markets.

Valuations remain reasonable with the S&P 500 selling at roughly 13-14x estimated earnings *(which, of course, will be revised downwards as the year progresses)*. The equity risk premium remains elevated indicating that stocks are attractive relative to bonds. From a contrarian standpoint, equity and bond mutual fund flows may bode well for equities. For the quarter, investors yanked $44 billion from stock mutual funds and added $71 billion to bond funds.

Bond prices should generally move sideways over the quarter as conflicting economic data keep rates fairly range-bound. U.S. treasuries ought to remain challenged as investors sell treasuries and re-allocate to other fixed income instruments and higher dividend-paying equities. However, a flight-to-safety into treasuries could continue should European fiscal efforts fail. 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 improving nicely. *Floating rate funds*, *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 are now underweight the group as valuations are a bit stretched. We continue to be underweight *developed and emerging international equities* despite valuations in this space at a 30% discount to historical averages. Again, we believe that *large-cap domestic companies with higher quality attributes* are attractive. 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. *Alternative assets* will continue to provide good risk-management for portfolios.

Of course, markets can and will pullback on any given day, but a fully diversified portfolio consistent with one's longer-term objectives and risk tolerance is the best strategy to manage through the day-to-day noise and fears of the markets. *Il faut cultiver notre jardin!*

Happy Summer!

fear of contagion...

... a better proxy...

Why Greece Matters

Europe's dire fiscal and economic situation seems to have centered around Greece over the past few months. Greece's attempts to install austerity measures, necessary after many years of lax fiscal policies and profligacies, have been met with protesters and rioters in the streets of Athens. But isn't Greece just a small country? Why couldn't the European Union simply allow Greece to default on its debt, leave the Eurozone and go back to the drachma?

Money is flying out of Greek banks at a rate of nearly €600 million a day, and many Greek banks are substantially insolvent. So how are the banks meeting demands for withdrawals, and how does the ECB help prevent runs on banks? The ECB created a process called Emergency Lending Assistance (ELA). The ECB authorizes national central banks to make money available (through ELA) to banks with solvency issues. The rub is that the debt is now the responsibility of the national central bank and its government. Interestingly, the ECB does not disclose the amount of ELA money *(where's the transparency?)*. Greece (through the Greek Central Bank) essentially prints euros under the ELA (since the ECB won't loan them money without strict terms) to provide collateral to banks with solvency issues. ELA loans are guaranteed by the Greek Central Bank which in turn is guaranteed the Greek government which already can't pay its bills ...hmmm, makes you wonder. There is very little chance that Greece will be able to pay for the banking losses monetized through ELA. The ECB could vote to cut-off Greek ELA and force Greece's bank to shut down, but that is unlikely. That action could create a European-wide bank run if depositors in France, Spain, Italy, Portugal and Ireland fear that their money isn't safe (interestingly, the Eurozone does not have an FDIC equivalent to insure deposits).

The fear of contagion is why Greece matters. Highly indebted governments and banks can survive for some time, but when confidence disappears (banks don't lend, businesses don't spend and consumers retrench) then a nasty crisis ensues *(sound familiar?)*. The time to act is now – the can has been kicked, and it will roll no more.

Economic Margin – Going Beyond Traditional Metrics

We at ND&S search for superior equity investments using a concept called "Economic Margin". It is a refinement of the traditional earnings growth approach, and is designed to identify companies which are growing in a sustainable way. Economic Margin correlates with Market Value/Invested Capital better than earnings growth correlates with price/earnings ratios. Knowing this, we can use expected Economic Margin [and EM improvement] to help select stocks that are more likely to outperform their peers, and to outperform the market.

Economic Margin is designed to be a better proxy for corporate profitability than is earnings. EM correctly adjusts for distortions in traditional accounting measures. It is calculated by starting with net income and then adjusting for accruals and non-operating charges, subtracting a capital charge and then dividing by the inflation-adjusted invested capital. EM helps to answer: What are the cash flows?, How much capital is required?, and What are the opportunity costs of capital?

Assessing a potential equity investment usually starts with an analysis of the company's historic Economic Margin generation, followed with forecasts of its future levels of economic performance. This is done in both absolute and relative terms [relative to the company's peer group]. Note that improving Economic Margin is especially propitious for future equity performance.

Please note that EM is only one of the many metrics that we review when analyzing a company. We also look at each company's historic record, its competitive position within each industry segment (we generally prefer companies that are number one or two in their key segments), its management quality, cash flow, earnings growth, dividend history, balance sheet and volatility.

2nd QUARTER 2012 SCOREBOARD

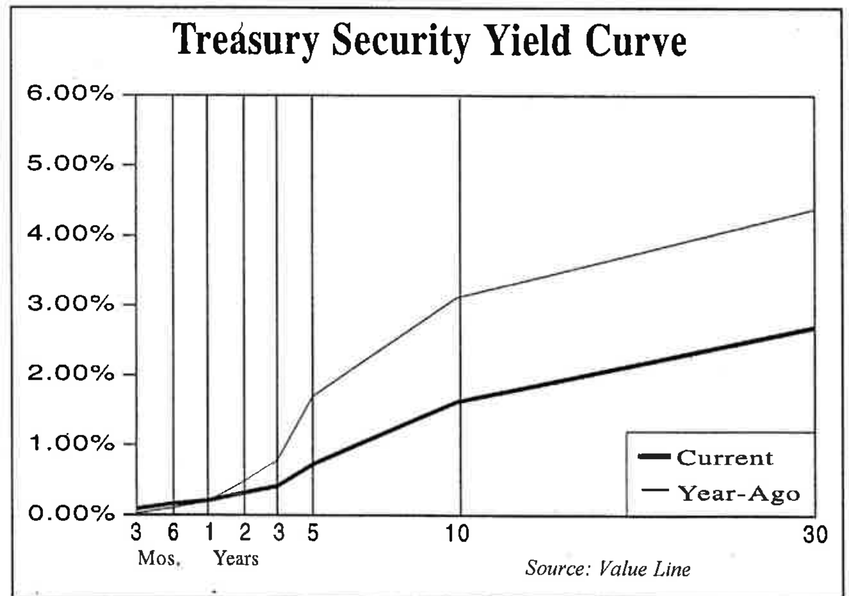
Index	Close	2nd Quarter % Change	Year-to-Date % Change
DJIA	12880.1	- 2.5	5.4
S&P 500	1362.2	- 3.3	8.3
NASDAQ	2935.1	- 5.1	12.7
Nikkei	9006.8	-11.0	6.5
MSCI EAFE	4768.4	- 6.9	3.4

3 Month T-Bill	0.09%	Fed Funds Rate	0 - 0.25%
5 Year T-Note	0.72%	Prime Rate	3.25%
10 Year T-Note	1.65%	Gold	$1603.50
30 Year T-Note	2.74%	Oil	$84.96

no surprise

Oil prices are down over 14% this year ... a big plus.

Flight-to-safety results



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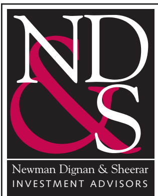

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