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

Paradise Regained ... *sort of*

2nd Quarter 2013

ECONOMY & MARKETS

John Milton's epic poems – *Paradise Lost* and *Paradise Regained* – remind us of our constant search for paradise … perhaps the Federal Reserve is unsure of what to do next in order to preserve paradise. Listening to the Fed is sort of like listening to Alice's Caterpillar in *Alice in Wonderland* who is sitting in the tree and pointing in both directions.

Paradise Lost - Fed Chairman Bernanke indicated on June 20th that the Fed would consider tapering their $85 billion-per-month bond buying program should the economy continue to improve and unemployment move lower. The markets, as usual, overreacted to the Fed's announcement (thinking, somehow that tapering is the same as policy tightening/raising rates … *it is not*). Bonds sold-off massively as the 10 year yield rose 100bp while equities retreated on fears that the Fed would soon take away the punch bowl.

Paradise Regained - Ben Bernanke and the Fed to the rescue again. Members of the Federal Open Market Committee have been tripping over themselves recently to "clarify" comments made several weeks ago by Ben Bernanke that led to the market's Taper Tantrum. Believing that the punch bowl is being re-filled, investors pushed the markets higher and put off fears of any day of reckoning.

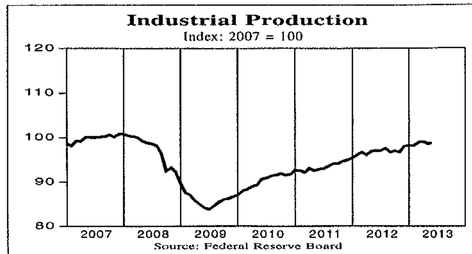
Despite some volatility, equity investors were rewarded during the second quarter. For the second quarter of 2013, the **DJIA** moved higher by 2.9% while the **S&P** jumped 2.9% as well. The **NASDAQ** finished ahead by 4.5%. International markets continued to struggle as the **EAFE** Index declined 2.1% for the quarter. Bond investors were not so fortunate during the quarter. Bond returns were negative (two quarters in a row) as the Barclay's Aggregate **Bond Index** finished down – 2.3% for the quarter thanks to Fed-induced uncertainty.

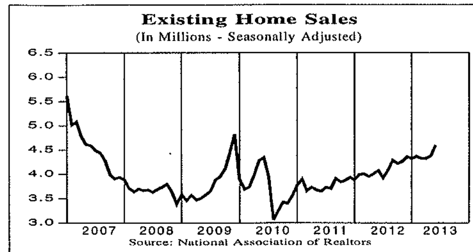
Equities just finished their best first-half performance in over 10 years … not bad considering the economic and political backdrops. For the year-to-date period, the DJIA is up 15.2% while the S&P 500 is ahead by 13.8%. The NASDAQ is still ahead by 13.4%, and the EAFE index is ahead by 4.1%. Bonds continue to struggle as the Barclays' Aggregate Bond Index is lower by 2.4% for the year through June.

Some argue that the Fed's backpedalling is essentially saying that the economy can't stand on its own. *We disagree*. Sooner or later, investors will have to get used to the fact that the Fed can't lower rates and/or stimulate growth forever. We are constantly reminded that the markets seem to have no memory from day-to-day … why was anybody surprised that tapering would eventually end? Fed Vice Chairman Dudley reiterated that quantitative easing tapering "may be appropriate later in 2013" with a completion "around mid-2014." He later went on to say that "accommodation would continue after the trim to QE" and that the fed funds rate would not rise until 2015. The Fed sees potential in the economy, but they certainly do not see rampant growth and/or inflation. *We agree*.

Auto sales *(see chart below)* point to a resilient consumer. Auto sales, like many other economic indicators, are simply moving back to pre-recession levels so it is unlikely that the economy is overheating (we see no signs of that).

Industrial Production and Existing Home Sales *(see charts below)* are also pointing to an improving economy.





Slowing manufacturing and political instability continue to be headwinds for the markets going forward. Portugal, Egypt, Iran, North Korea and many other countries will continue to challenge economic and political stability around the world. Bad news is good news … challenges to economic growth will likely keep central banks around the world in an accommodating mood.

OUTLOOK

Bottom Line –A very 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 the Middle East and China will contribute to increased volatility for the next few months. We plan to add to positions on any material weakness in the markets.

Market valuations are still reasonable although not as cheap as they were over the past few years. The S&P 500 is trading at 14.7X 2013 estimated earnings of $109. The Shiller P/E ratio would argue that the markets are overvalued, but that ratio measures average earnings over the past 10 years (which included unusually low earnings during the recession and financial crisis). Somewhat concerning is the fact that GDP estimates have been revised lower over the past few weeks. First quarter GDP was revised down to 1.8% from 2.4% while 2013 GDP estimates seem to be holding steady at around 2% … not good, but not recessionary and certainly not inflationary.

Bond prices should move a bit higher over the next quarter as bonds recover from their recent Fed-induced sell-off. We expect to reduce fixed income positions should we see the 10-year treasury yield recover to 2.0% to 2.25%. 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 over the next few years. We are willing to take on more credit risk as the economy and corporate balance sheets slowly improve. *Floating rate funds*, *mortgage-backed debt*, *and slightly less-than-investment grade debt* ought to provide reasonable returns for fixed income investors. We expect emerging market debt to recover from its recent back-up.

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,* and we expect to add to currently-underweight positions during the next quarter. Valuations for international equities are quite attractive and have discounted the economic and geo-political headwinds that exist today. 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 for several years. We are somewhat ambivalent to the value versus growth debate although history shows that growth stocks tend to outperform value stocks as rates begin to move higher and the economy slowly recovers. *Commodities* may offer investors some protection from potential inflation and dollar weakness although we do not see those conditions prevailing today. *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-off.

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

Diversify and reduce risk…

The Case for Alternative Investments

Alternative Investments have a low correlation with equity markets; therefore they help in navigating volatile markets that have been stirred up by potential FED tapering, European sovereign-debt crises and a looming credit crunch. With higher volatility in the equity markets and historically low returns of fixed income assets, the traditional 60% equities/ 40% bonds investment strategy begins to face limitations in hedging against inflation and volatility.

Alternative investments, with their low correlation with equity markets, help to diversify portfolios and reduce risk. The term Alternative Investments (or just 'Alternatives') is an umbrella for various asset classes including:

- **Commodities**
(Energy Resources, Agricultural Products, Precious Metals, etc.)
- **Real Estate**
(Global commercial and residential housing markets, as well as mortgages.)
- **Private Equity**
(Privately held companies)
- **Strategies Employed by Hedge Funds**
(Strategies such as investing in currencies, exclusively shorting stocks, exploiting mispricing of stocks after corporate events, etc.)
- **Derivative Based**
(*Investments* like futures and options allow various strategies, includings convertible arbitrage, fixed income relative value, managed futures and market neutral strategies. These strategies often exploit a mispricing of derivative securities.)

When stock markets fall, an investment in alternatives will normally stay flat or even rise. Gold and other precious metals, which fall under 'commodities', for example, see their value mostly increase when stock prices decline and vice versa. Of course, there are always exceptions to what normally occurs.

Other strategies like investments in currencies, termed "Global Macro", often serve as an excellent hedge against inflation. For instance, if wages in developing countries continue to rise, the US will experience higher costs of imports. Investing in currencies of developing countries has proven successful in mitigating that risk.

Derivative-based securities provide a more complex alternative. Options, for instance, are contracts that allow the holder to buy or sell stocks (the underlying assets) in the future for a predetermined price. The value of an option changes not only with the price of the underlying asset, but it also naturally changes in value over time and with changing volatility in the stock market.

A word of warning …

Investments in Alternatives do not guarantee profits or complete protection against losses. However, alternatives do provide invaluable diversification in a portfolio. Because of that, we carefully select Alternative Investment Funds managed by leading institutions such as Goldman Sachs, AQR Capital Management, GMO and Ivy to diversify portfolios and reduce market risk.

2nd QUARTER 2013 SCOREBOARD

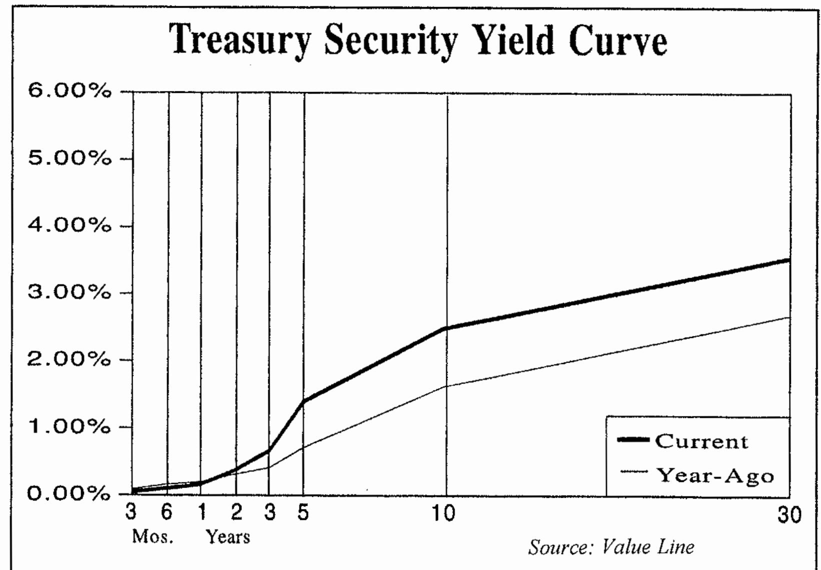
Index	Close	2nd Quarter % Change	Year-to-Date % Change
DJIA	14909.6	2.9	15.2
S&P 500	1606.3	2.9	13.8
NASDAQ	3403.2	4.5	13.4
Nikkei	13677.3	10.3	31.6
MSCI EAFE	1657.9	-1.0	4.1

3 Month T-Bill	0.03%	Fed Funds Rate	0 - 0.25%
5 Year T-Note	1.39%	Prime Rate	3.25%
10 Year T-Note	2.48%	Gold	$1223.80
30 Year T-Note	3.49%	Oil	$96.56

Record Highs (again)

Gold is down c27% in 2013 while oil is higher by 5%

Rates are moving higher



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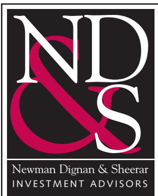

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