ECONOMIC & CAPITAL
MARKETS REVIEW
NEWMAN DIGNAN & SHEERAR, INC.
Newman Dignan & Sheerar
INVESTMENT ADVISORS

Camelot?

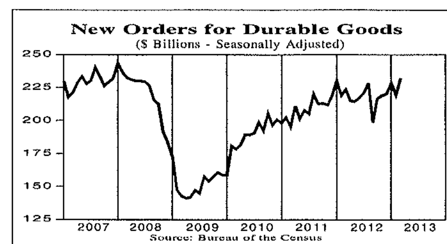
1st Quarter 2013

ECONOMY & MARKETS

Everything seems to be coming up roses ... housing is improving, consumer confidence is fairly resilient, durable goods orders are strong, employment is getting better and the markets are all higher. All of this good news is thanks to our modern-day King Arthur - Ben Bernanke. But alas, Camelot is really a mythical place, and perhaps we really aren't in Camelot (*it certainly doesn't feel that way!*). Nonetheless, despite a spend-thrift Fed, a hapless Congress and clueless European Central Bank investors are marching-on in their own Arthurian world. Perhaps when it is all said and done, generations to come will look back and say – *"Don't let it be forgot, that once there was a spot, for one brief shining moment, that was known as Camelot"* that is, until they discover that our myopic fiscal and monetary actions contributed to their suffering. Wake-up Washington ... the stakes are high!

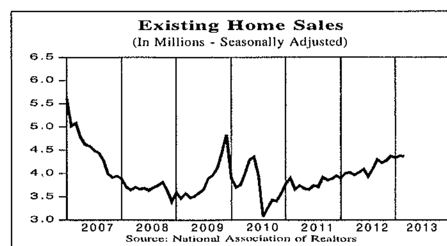
Despite myriad challenges from around the world, U.S. investors just experienced the best first quarter for stocks since 1998. For the first quarter of 2013, the **DJIA** moved higher by 11.3% while the **S&P** jumped 10.0%. The **NASDAQ** finished ahead by 8.2%. International markets struggled a bit, but closed higher as the **EAFE** Index advanced by 4.4% for the quarter. Bond returns were slightly negative (yes, it can happen ...) as the Barclay's Aggregate **Bond Index** finished down - 0.12% for the quarter.

Bull vs. Bear: one seems right and the other is making money. Given the mess in Europe and a dysfunctional Congress in the U.S. it would seem prudent to be a bit bearish. Yet, the U.S. economy continues to show signs of resilience. Among the improving signs are: improved **industrial production**, better-than-expected **retail sales**, falling **jobless claims,** moderate **inflation** *(so far)*, solid **productivity** numbers, strong **auto sales**, high **rail car loads**, improving existing **home sales**, declining mortgage **delinquency rates,** and resilient **durable goods orders** *(see chart below)*.



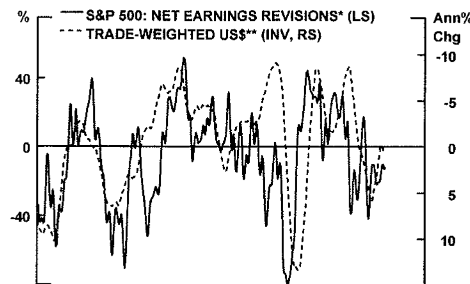
The resilience of durable goods orders during such uncertain times indicates that the economy is improving. High orders are consistent with business confidence in that businesses are seeking productivity-boosting investments that should lead to future earnings growth. Improving durable goods have been a reliable indicator for the broad market.

We have long contended that an improving housing market is critical for a sustainable pick-up in economic growth. **Existing home sales** *(see chart below)* are up 10% versus a year ago due to an improving labor market and extremely low mortgage rates. Home prices are up nicely – according to the Case-Shiller index, home prices are up 6.8% from a year ago. Prices should keep rising as well – relative to rents and replacement costs, housing is about 10% below fair value.



Troubles in Europe and elsewhere have been taken in stride by investors; however, the problems are real. Contagion from Cyprus and the Italian elections seem to be contained (at least for now), but the ukase handed down from the EU to Cyprus is quite troubling – *see article on page 3.*

Outside of geopolitical issues like Europe and North Korea, investors should be concerned about a few other things - peaking profit margins, firming of the U.S. dollar, and a declining labor participation rate (among other things …). Profit margins are likely to narrow for U.S. companies as the output gap closes and labor costs continue their march higher. A flight-to-safety scenario has pushed the U.S. dollar higher, and history has taught us that net earnings revisions have a close inverse correlation with the dollar *(see chart below).* March's ugly employment report (the smallest payroll gain in nine months) included the lowest labor participation rate since May 1979. Perhaps the March report was a one-off, but we need more workers … 290,000 fewer people were counted as unemployed because they stopped actively looking for work!



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OUTLOOK

Great start 2-7

Bottom Line – The year is off to a great start, but we expect some bumps in the road over the next few months. GDP growth for the 1st quarter should come in just over 3%, but we expect roughly 1.5% growth in the 2nd quarter due to the impact of sequester-related cuts.

Investors seem to be *Waiting for Godot* – the market correction that just doesn't seem to come. According to C.B. Worth at Oppenheimer, the market has gone over 100 trading sessions (five months in a row) without a 5% selloff. The last selloff began September 14th and ended on November 16th for a loss of 8.9% … so we are overdue for a correction! The good news is that corrections/pullbacks are quite normal, and investors should not deviate from their long-term strategy.

Pullbacks are normal...

The S&P 500 reached a new high on the last trading day of the quarter. Today's market is certainly better positioned than during previous highs in the markets. For instance, the S&P 500 had trailing 4 quarter operating earnings of $53.92 and an operating P/E ratio of 28.3X during the peak of 3/24/00 while the current trailing 4 quarter operating earnings is $96.83 with the market trading at an operating P/E ratio of 16.2X. Dividend yields and cash-on-hand are roughly double what they were during the peak of 3/24/00.

Bond prices should generally move lower over the course of the year. U.S. Treasuries will be challenged as investors sell bonds and re-allocate to other fixed income instruments and higher dividend-paying equities. 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*, *slightly 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 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 over the next few quarters. Large-cap domestic equities - *particularly those with higher quality attributes* - are beginning to play a more significant role in market leadership, and we expect that role to continue for several years. We favor value stocks over growth stocks, and we expect that to continue for 2013. We continue to like companies with excellent dividend growth potential *(not necessarily just high dividend yields). Commodities* offer investors some protection from potential inflation and dollar weakness although we are somewhat hesitant to add to existing positions until signs of economic growth improve. *Alternative assets* should continue to provide good risk-management for portfolios.

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

Cyprus: Just another can to kick down the road?

In many ways, the answer is yes. After some trial balloons were unsuccessfully launched, a compromise austerity plan has received preliminary approval. Spending cuts, tax increases, a higher retirement age, and bank restructurings are among the measures required by the EU and the IMF.

Madness →

Fortunately, the initial proposal to tax all Cypriot bank depositors was rejected. To tax insured deposits would have produced a serious erosion of the rule of law. Of course, these are tough terms for large depositors, who will loose from 60% to 80% of their deposits. They will undoubtedly look for other tax havens, including Malta, Switzerland, Luxembourg, the Cayman Islands and many other locations around the world.

However, the bank closures and the imposition of capital controls will, along with the 60% to 80% haircut suffered by large depositors, drag the economy into recession. The bailout package assumes a 3% GDP decline, but the recent and ongoing chaos could easily produce a 5% to 10% decline. Further changes are still possible as the memorandum winds its way through euro-zone parliaments.

Cyprus is a reminder that the Euro project is far from complete. The character of the EU is on display, for better or worse. Each member state is responsible for its national debts. Yet the common currency makes it impossible for a profligate country to use devaluation to reduce its debt burden. Greece, for example, is in its 6th year of recession.

Effectively, the Cypriot tax haven is closing, an untidy exit from the Eurozone has been prevented [or merely postponed?] and the banking systems in Europe and the U.S. have been strengthened.

On to the next crisis!

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The Shrinking Stock Market

Good for investors →

The stock market is shrinking. Large publically traded companies have been buying back their own stock at record levels. In February alone, 86 companies in the S&P 500 authorized $94.3 billion in new stock buy-backs. Of course, mergers have contributed to the shrinking supply of stocks as well. On the other hand, the IPO market continues to be anemic while more companies are delisting than ever before. As measured by the Wilshire 5000 index (the broadest index for the U.S. equity market named after the nearly 5000 stocks it contained in 1974), there were just 3,687 stocks last year. In 2011 there were 4,008 stocks listed – that's down from 6,639 stocks in 2010. Thanks to cheap credit, many companies like Dell, US Airways, Office Max, Best Buy and Heinz have been lured by investors to go private.

What does the shrinkage of outstanding shares of stock mean? For us, it reiterates the attractive valuation of companies, yet it also spells a slowing economy and unwillingness by companies to expand and grow. Above all, less supply of attractive stocks should mean higher prices especially as the rotation from cash/money market funds to stocks continues to increase. Eventually a rotation from bonds to stocks will provide further fuel to the stock market. We look forward to investing in solid companies that have cash to invest for growth and enough cash left over to increase their dividends.

Record Highs

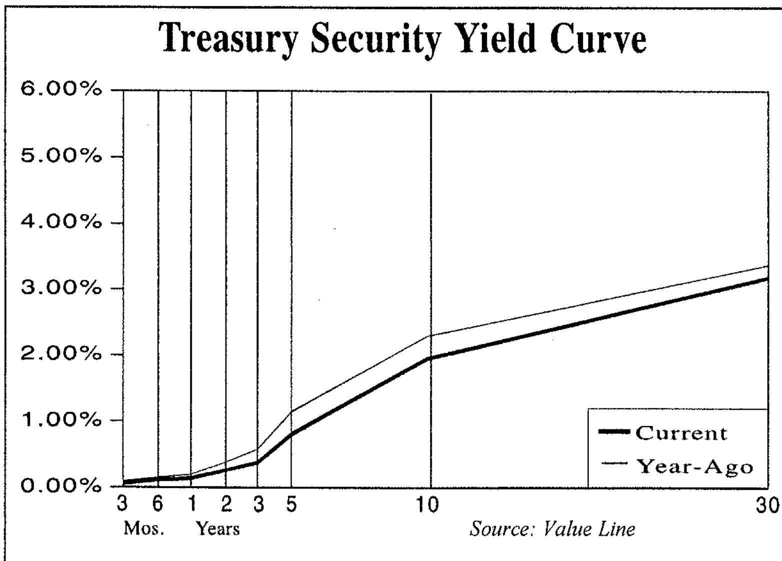
1st QUARTER 2013 SCOREBOARD

Index	Close	1st Quarter % Change	Year-to-Date % Change
DJIA	14578.5	11.3	11.3
S&P 500	1569.2	10.0	10.0
NASDAQ	3267.5	8.2	8.2
Nikkei	12397.9	19.3	19.3
MSCI EAFE	1674.3	4.4	4.4

3 Month T-Bill	0.07%	Fed Funds Rate	0 - 0.25%
5 Year T-Note	0.76%	Prime Rate	3.25%
10 Year T-Note	1.85%	Gold	$1594.80
30 Year T-Note	3.10%	Oil	$97.23

Oil is up 5.9% so far in 2013. We see prices moderating...

Anemic yields



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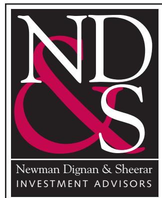

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