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

Dante's Inferno

3rd Quarter 2013

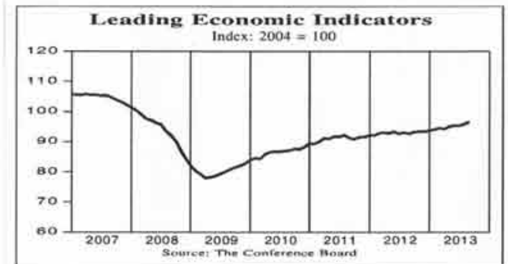
ECONOMY & MARKETS

Dante Alighieri's epic poem, The ***Divine Comedy***, is divided into three parts – *Inferno*, *Purgatorio* and *Paradiso*. Continuing our literary theme of recent newsletters, we thought it appropriate to title this quarter's newsletter - ***Dante's Inferno*** - given the utter and complete dysfunction of our government in Washington. Similar to Dante, many investors today feel "lost in the deep wood" as a result of the current budget battle and shutdown in Washington. Upon entering the gates of hell, Dante sees the quote "Abandon all hope, ye who enter here." *Despite the current pall cast over the markets and economy by the bickering politicians in Washington we are reminded not to lose hope at all.* The drama may continue for a bit, but the world will not end. As Winston Churchill famously quipped *"You can always count on Americans to do the right thing - after they've tried everything else."* Representative democracy is often a messy and ugly affair.

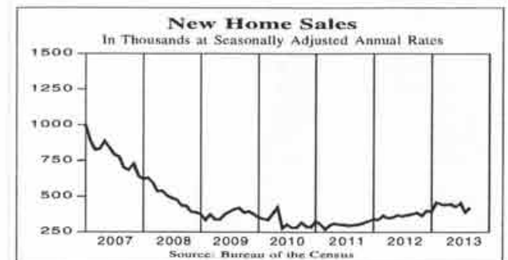
Despite some volatility over the summer months, equity investors were rewarded during the third quarter. For the third quarter of 2013, the **DJIA** moved higher by 2.1% while the **S&P** jumped 5.2%. The **NASDAQ** finished ahead by 11.2%. International markets bounced back nicely (reversion to the mean?) as the **EAFE** Index jumped 11.6% for the quarter. Bond investors saw large swings in rates during the quarter as fears of tapering by the Fed sent rates higher only to be knocked down again when the Fed decided not to taper in September. Bond returns were mostly positive as the Barclay's Aggregate **Bond Index** finished higher by 0.4% for the quarter.

For the year-to-date period, the DJIA is up 17.6% while the S&P 500 is ahead by 19.8%. The NASDAQ is higher 26.1% (time for a correction?), and the EAFE index is ahead by 16.1%. Bonds have made up a little bit of ground lately, but the Barclay's Aggregate Bond Index declined by 1.9% for the year through September.

Behind all the noise out of Washington is an economy that is slowly plodding along and getting better. Some of the positive signs pointing to economic progress include: improving **leading economic indicators** *(see chart below)*, improving **housing starts** and **existing home sales**, recovering **housing prices**, improving **retail sales**, encouraging **industrial production**, good **manufacturing activity**, and low **interest rates** and **inflation**.



The U.S. housing recovery is still on track, but there are some faint signs of a temporary pause. As mentioned above, housing starts and existing home sales appear to be improving, but **new home sales** *(see chart below)* and mortgage applications seem to be trending lower. Higher interest rates, Washington dysfunction, and lackluster business and consumer confidence have all contributed to the recent pause in housing.



Generally encouraging economic news is not just confined to the United States … the global economy appears to be finally improving. Economic news out of China suggests a turn for

Improving Global Economy

the better … Chinese electricity consumption, railway freight traffic, and exports are on the upswing. At the same time, the European economy has shown signs of a bottom … September European PMI pointed to moderate growth. Of course, Europe's 12% unemployment rate will be a drag on any potential recovery. In Japan, Abenomics is helping that economy exit from deflation and show some fresh signs of growth. Business and consumer confidence in Japan is quite strong.

A natural reaction to negative headline news out of Washington is a turndown in business and consumer confidence *(see chart below)*. A lingering government shutdown will certainly have an impact on U.S. and global GDP growth. Real income growth in the U.S. is up just 2% year-over-year which suggests that real consumption growth will be a rather anemic 2%. The U.S. economy is simply not strong enough to withstand a longstanding shutdown … our policy makers know this, and we suspect that a compromise will be reached.

OUTLOOK

Bottom Line – A very good year-to-date period for the markets will likely be followed by a month or so of increased volatility. Uncertainty surrounding the government shutdown, debt ceiling debate, 3rd quarter earnings, and Fed actions along with headwinds from geopolitical risk will continue to weigh on investors' minds. The markets have gone quite some time without a material correction, and we suspect that a correction is overdue. But remember, market corrections are normal. We plan to selectively add to positions on any material weakness in the markets.

Still OK…

Market valuations have certainly risen lately, yet valuations are still lower than historical averages. The S&P 500 is trading at 15.4X 2013 estimated earnings of $109. Low inflation and low interest rates will allow valuations to creep higher before they become a concern. Risk management becomes even more critical as markets move higher, and proper asset allocation and portfolio diversification will help investors to weather most storms.

Bond prices should move lower over the next quarter as bond yields resume their march higher. It is our intention to lighten-up on fixed income positions as bonds rally temporarily on any flight-to-safety moves into U.S. treasuries. Of course, the current government shutdown will most likely compel the Fed to hold-off on tapering until sometime in 2014 … thus keeping interest rates artificially low for the time being. 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. *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 remain attractive. 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.

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-offs.

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

We're Moving!

We're very happy to announce that we will be moving our offices on or about November 1st. After being in our current office space for over 21 years, we thought that it was time for a move to a new location where we can all share the same office space (rather than be located in essentially two offices right now). Fortunately, we'll be moving right down the block – literally. ***Our new address will be 56 Exchange Terrace, Suite 200, Providence, RI 02903.*** Clients will now be able to park for free in the Capitol Grille parking lot when visiting with us. We're excited about the move, and we'll be sure to notify everyone once the move is complete.

The Case for International

Investors have been concerned about the health of international markets especially over the last 12 months. Their fears have been warranted by political upheaval in the Middle East, economic deceleration in China, high unemployment rates in the Euro Zone and recent riots in Brazil and Turkey.

Reversion...

We have maintained a less-than-benchmark exposure to international markets – both developed and developing - given the issues listed above. However, we are a bit more sanguine on international equities (and fixed income to a lesser extent) given their underperformance for the past three-to-five years. Reversion to the mean is alive and well … sooner or later. Historically, international equities have outperformed U.S. equities while adding considerable diversification benefits (a bit less diversification today as globalization expands). Although depressed since January, the EAFE Index (Europe, Australia, Far East) returned 11.56% for the third quarter (outperforming both the Dow and the S&P). We expect continued benefits of international equities and debt as the dollar begins to weaken and global economies improve.

The Next Fed Chairman (nominee) – Janet Yellen

President Obama recently nominated current Fed vice-chairman, Janet Yellen, to be the next chairman of the Federal Reserve Bank. If confirmed, Yellen will be the first female chairman of the Federal Reserve Bank. Yellen will most likely be confirmed by the Senate, but we suspect her confirmation process could be a bit contentious (the Senate Banking Committee voted 17-6 to confirm her as vice chairman in July, 2010).

The 67 year old economist has a very solid resume – summa cum laude from Brown University in 1967; Ph.D in economics from Yale in 1971; chair of the Council of Economic Advisors under Bill Clinton from 1997-1999; professor at Harvard, London School of Economics and University of California at Berkeley; and husband of George Akerlof – winner of the 2001 Nobel Prize in economics.

Janet Yellen is known as a "dove" – essentially being more concerned with unemployment than with inflation. Therefore, it is widely expected that Yellen will continue many of the current policies of the Fed – chief among them keeping interest rates low – at least until the data suggest otherwise. Banks will not get a free pass under Yellen as she is known for being tough on banks – ensuring stringent capital requirements to preserve our financial integrity.

It is always difficult to remove the punch bowl in a timely manner, and chairman Yellen may have more trouble than most (given her dovish predilection). Will she be the next G. William Miller?

Record Highs (again)

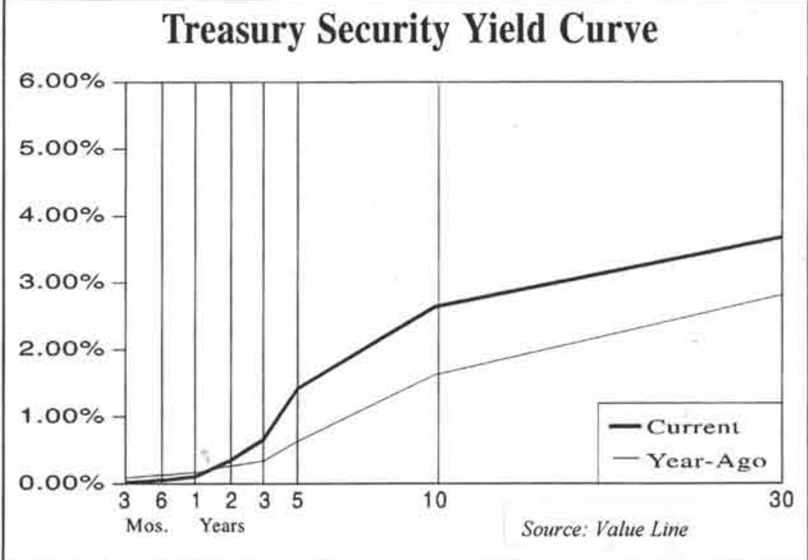
3rd QUARTER 2013 SCOREBOARD

Index	Close	3rd Quarter % Change	Year-to-Date % Change
DJIA	15129.7	2.1	17.6
S&P 500	1681.6	5.2	19.8
NASDAQ	3771.5	11.2	26.1
Nikkei	14455.8	5.7	39.1
MSCI EAFE	1818.2	11.6	16.1

3 Month T-Bill	0.01%	Fed Funds Rate	0 - 0.25%
5 Year T-Note	1.38%	Prime Rate	3.25%
10 Year T-Note	2.61%	Gold	$1326.50
30 Year T-Note	3.69%	Oil	$102.33

Gold is down 21% year-to-date. Oil is higher by 11% this year.

Trending Slowly Higher



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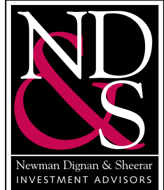

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