

## WILTING GREEN SHOOTS

2<sup>nd</sup> Quarter  
2009

### ECONOMY & MARKETS

Green shoots began to appear in the U.S. and worldwide economies during the second quarter, and stock markets reacted accordingly (with hefty gains). The question now is will these green shoots continue growing or will they wilt? We see the myriad challenges facing our markets and economies, and we have to conclude that many of the green shoots are wilting (or worse .... beware the weed-whacker). Fortunately, it is not too late to save them ... a bit of fiscal prudence and patience is in order. Hopefully, the current administration has the fortitude to focus their efforts away from simply political gains.

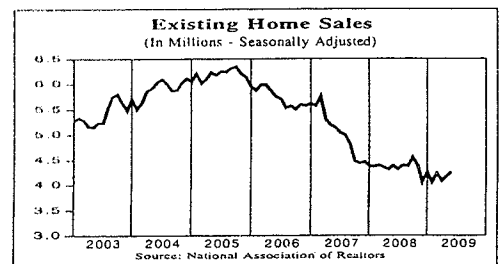
After a miserable 1<sup>st</sup> quarter, the markets bounced back nicely in the 2<sup>nd</sup> quarter. For the quarter, the DJIA moved higher by 11% while the S&P moved ahead by a solid 15.2%. The NASDAQ had very strong gains as it recorded a 20% quarterly gain. International markets recovered a lot of ground as the EAFE Index finished ahead 23.7% for the quarter. Bonds were steady as the Barclay's Aggregate Bond Index moved by 1.8% ... not surprising was the fact that U.S. government bonds were generally negative for the quarter as bond investors moved to corporate bonds for higher yields.

Year-to-date numbers are looking better thanks to a nice rebound off of the lows of early March. The DJIA is down 3.8% for 2009 while the S&P 500 is positive by 1.8%. The NASDAQ is now higher by 16.4% while the EAFE is up 5.6% for the year-to-date. The overall bond market is up 1.9% for 2009. Who would have thought that the markets could bounce back so strongly ... wasn't it just a few months ago when most investors wanted to abandon the markets entirely? Timing this market is extremely difficult and is often fraught with risk.

Most recent economic data suggest a change in the rate of decline; however, we've yet to see much substantive/actual growth. Sure,

economic data must slow down before they begin to improve, but we have to be careful about reading too much into this second derivative issue (*less bad is still not all that good*). One important area that has improved is the credit markets. We are very pleased with this improvement since it wasn't long ago that the credit markets were at the very center of the financial meltdown. Some examples of progress include the following: spreads (difference in yields between treasuries and other bonds) have tightened considerably, corporate bonds have gained back nearly 50 percent from their lows while equities have recovered almost 40 percent, the credit default swap market has regained a substantial percent of its losses since late 2007, and the recent outperformance of many corporate bonds relative to equities. This improvement in the credit markets has led to an increased issuance of corporate debt ... a necessary step to help companies reignite capital spending and refinance existing debt. We are grateful that credit markets have improved, but what will be the catalyst for future growth? It looks like a slow and bumpy road to recovery.

New and existing home sales (*see chart below*) continue to be weak, but we've seen a bit of a jump lately.



Perhaps we're in a bottoming process for housing, but there is no doubt that housing has to get better before this economy improves. Housing inventories remain way too high, and it's tough to see a decent recovery without a concomitant improvement in employment. With unemployment rising (and going higher),

Nice 2<sup>nd</sup>  
quarter  
gains  
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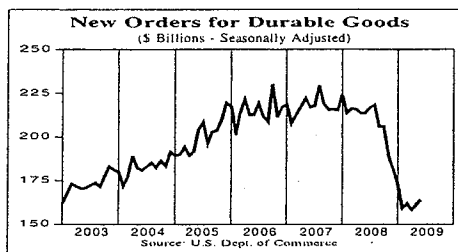
... slow  
and choppy  
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Some  
improvement...

it is hard to fathom a recovery in housing anytime soon. June's 467,000 decline in non-farm payrolls (to a 9.5% rate ... a 26-year high) highlights the fact that the economy continues to struggle. Of course, this bad report was on the heels of three months of improving employment trends. We see unemployment going beyond 10% before it begins to improve. Average weekly hours in June dropped to a new low of 33.0 from 33.1 – a possible indicator of labor market woes. So can we have a jobless recovery? Possibly, but the recovery will likely be slow and choppy. Let's not forget that the unemployment report is a lagging (4-5 months) indicator, and may not be that predictive.

A few positive signs emerging include June's ISM index and the declining price of oil. June's ISM manufacturing index of 44.8, and the non-manufacturing index of 47.0 suggest modest GDP growth and that the recession may be coming to an end. Lower oil prices are a big boon to consumers and businesses. As we have stated many times before, high oil prices serve as an added tax on businesses and individuals. Bloated supplies and lack of demand will likely keep oil prices contained for much of 2009.

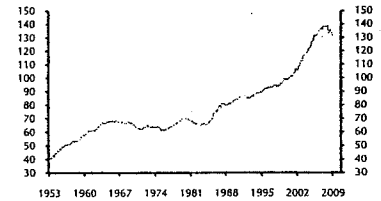
New orders for durable goods may have bottomed (*see chart below*). In May we saw a 1.8% increase in durable goods orders ... the third increase in the past four months. Perhaps another sign that we are close to a bottom.



Historically, two critical factors in the ultimate direction of markets and economies are inflation and monetary policy. Monetary policy is very accommodating with the Fed funds rate at 0-0.25%. Additionally, inflation is contained for the near-term (*see article on next page*). Inflation and monetary policy are both quite favorable, but we're not convinced that consumers will spend their way out of this recession. Consumers are tapped out with an enormous amount of debt (*see chart ahead*), and the process of deleveraging their own balance sheets will take some time.

... but risks  
remain  
↘

CHART 9: HOUSEHOLD DEBT (AS A % OF DISP. INCOME)



Source - Thomson Datastream

Capacity utilization and inventory levels for businesses are at close to historical lows ... these indicators will keep inflation low and wage pressures in check while setting-up companies for positive earnings surprises as demand improves.

Valuations seem reasonable with the S&P trading at roughly 16X forward earnings. Considering low inflation and the 10-year yield at 3.5% we see investors willing to accept slightly higher absolute P/E ratios.

## OUTLOOK

Perhaps the markets have moved a bit too far too fast. No doubt, the markets experienced a significant bounce off of what will prove to be the market low (just when most investors gave up hope). We would not be surprised to see our markets lower over the next few months; however, market pullbacks should be looked at as opportunities to purchase and/or add to solid long-term holdings (we have a growing wish list). We continue to believe that investors will be rewarded over the next few years and longer.

Small-cap and emerging market equities look attractive as well as large-cap defensive names with strong balance sheets and nice dividends. We are being patient, and we are beginning to see quite a few beaten-down equities at attractive prices (a bit of dumpster diving).

Corporate bonds (and high yield bonds?) continue to look reasonable. We see treasuries as overvalued, yet yields could stay low until economic growth and inflation resume.

The recession will officially end soon, but risks remain. We will continue to be vigilant with higher than normal cash and short-term investments.

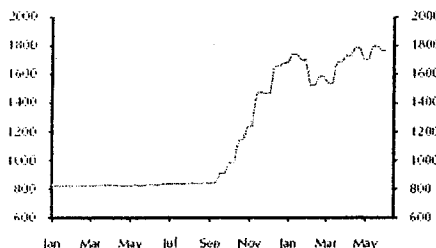
Happy Summer.

## From Deflation to Inflation?

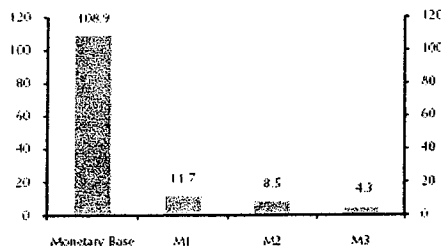
The US economy continues its high-wire act: the illiquidity crisis has been averted, at least for now, but the economy continues to contract. The rate of decline may be moderating, but that is small solace for those who have or soon will lose their jobs. The whirlwind federal government activity helped restore counterparty confidence after last fall's Lehman Brothers failure. However, the massive monetary expansion coupled with an enormous increase in the amount of deficit spending under the guise of "stimulus" has raised the risks of unintended consequences while producing very little incremental growth.

The following charts illustrate the conundrum faced by inflation forecasters who rely on monetary statistics:

**The Monetary Base**



**Growth in Monetary Aggregates, 9/08 to 6/09**



The Monetary base has more than doubled, but broader monetary aggregates have been, thus far, much more subdued.

As long as this continues, inflation will remain in check. However, once the normal links between the monetary aggregates and economic activity have been restored, either the "Ms" will catch up with the Monetary Base {producing unacceptably accelerating inflation}, or the Fed will withdraw the then excess Monetary Base in a timely and well-modulated manner. This would be difficult for Paul Volker's Fed, but it will be a high-wire act for today's increasingly politicized Fed, led by a deflation-obsessed chairman.

As this drama plays out economic activity, commodity prices {especially gold} and the dollar will provide the best leading indicators. For now, inflation is not a problem, but please stay tuned.

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### We Welcome Morgan Paxhia to our Firm

We would like to welcome Morgan Paxhia who has just recently joined ND&S as an Investment Associate. Prior to joining ND&S, Morgan was a Financial Advisor Associate with UBS Financial Services in Providence, RI. At UBS, Morgan participated in a rotational program focused on building a strong wealth management and finance skill set and knowledge base. He was responsible for working with Senior Management in leading a new wealth management team. He also trained on the municipal bond desk at UBS in New York. Morgan is a graduate of the University of Rhode Island and received a Bachelor of Science Degree in Applied Mathematics. He is a member of URI's Alumni Finance Committee, which oversees the management of the University Endowment. Morgan resides in Newport, RI, which is ideal for him as it fosters his passion for the ocean. He is very active - splitting his free time between working on his house and as an accomplished sailor in Narragansett Bay.

*100 inflation remains in check.*

Relief!  
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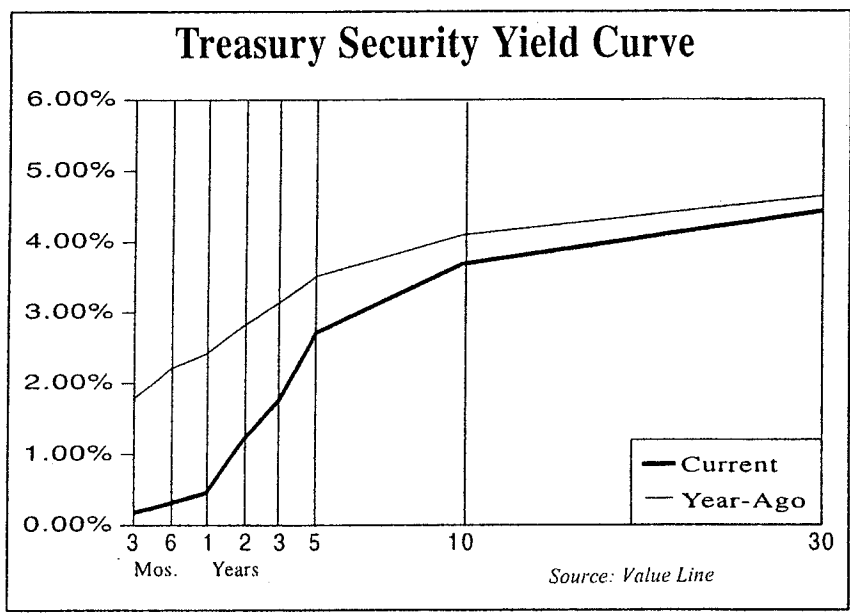
### 2<sup>nd</sup> QUARTER 2009 SCOREBOARD

Index	Close	2 <sup>nd</sup> Quarter % Change	Year-to-Date % Change
DJIA	8447.0	+ 11.0	- 3.8
S&P 500	919.3	+ 15.2	+ 1.8
NASDAQ	1835.0	+ 20.0	+ 16.4
Nikkei	9958.4	+ 22.8	+ 12.4
MSCI EAFE	1056.2	+ 23.7	+ 5.6
3 Month T-Bill	0.17%	Fed Funds Rate	0 - 0.25%
5 Year T-Note	2.55%	Prime Rate	3.25%
10 Year T-Note	3.53%	Gold	\$927.10
30 Year T-Note	4.31%	Oil	\$69.89

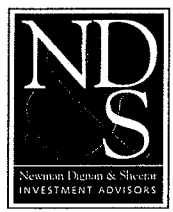
Oil should pull-back from here  
 Gold is up nearly 5% in 2009

Rates remain steady before moving slowly higher towards year-end.

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