ND&S
Newman Dignan & Sheerar
INVESTMENT ADVISORS

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

Guarded Optimism

1st Quarter 2010

ECONOMY & MARKETS

After a bumpy start to the year, the markets finished the 1st quarter on a good note. Despite a number of looming headwinds, the market climbed a wall of worry with just a bit of prompting from some positive economic data. Investor psyches have been a bit scarred from a punishing decade in the markets, but the healing process seems to be getting underway. What we experienced over the last two months of the quarter was somewhat of a reluctant bull market. But let's not get too excited.

For the first quarter of 2010, the DJIA moved higher by 4.1% while the S&P moved ahead by a solid 4.9%. The NASDAQ experienced strong gains as it recorded a 5.7% advance. International markets didn't fare as well with the EAFE Index finishing up just 0.2% for the quarter. Bond returns were moderate as the Barclay's Aggregate Bond Index moved ahead by 1.8%.

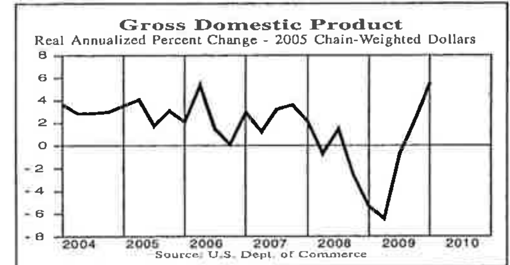
Encouraging signs →

The quarter presented investors with a number of encouraging signs: increasing productivity, continued low inflation, rising manufacturing and non-manufacturing data, increasing vehicle sales, increasing consumer spending, rebounding pending home sales, increased mergers and acquisition activity, and a stabilizing U.S. dollar *(winning a least ugly contest)*. Of course, these encouraging signs are coming off very distressed levels, but an improvement in overall economic activity seems to be taking hold.

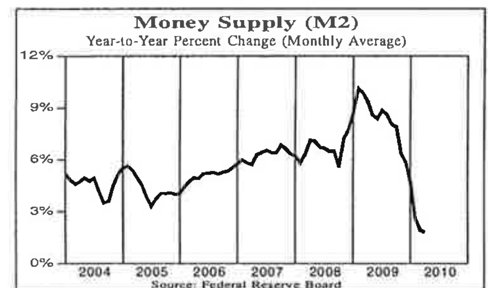
Headwinds are very real →

Headwinds continue to challenge the markets: naggingly-high unemployment, soaring national debt, increased protectionism, rising taxes, slowly rising interest rates, and increased bankruptcy filings. These headwinds are all very real, and we will continue to monitor their impact on the economy and the markets.

GDP growth *(see chart below)* continues to improve. We do not expect the typical 6-7% growth that normally follows severe economic recessions, but we're expecting growth somewhere in the 3-4% range for the quarter.

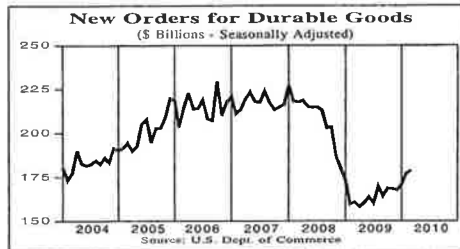


The good news about the GDP growth rate is that it is occurring with low inflation. High unemployment levels, low capacity utilization, and low wage pressures should contain inflation. Of course, the forces of nature and the ongoing printing of money will push inflation higher in the years ahead, but it will likely be contained for awhile. Furthermore, **M2 money supply** *(see chart below)* has declined dramatically, and the velocity of money remains quite low.



The Index of Leading Economic Indicators posted its 11th straight monthly gain in February. Personal spending advanced 0.3% in February for the fifth straight month, and March's ISM Non-Manufacturing Index rose to 55.4 … the highest since May 2006. On the manufacturing side, U.S. factory operators saw their best month of activity in nearly six years during March. The closely-watched factory report has historically been a good leading indicator of economic recoveries. Similarly strong factory data came out of Asia and Europe … a sign that perhaps a global economic recovery is developing.

New orders for **durable goods** *(see chart below)* appear to be turning a corner. Of course, we're not getting overly giddy as a result of every improving piece of economic data, but we are encouraged. It remains to be seen whether or not the pick-up in spending *(personal and business)* is sustainable.



Fairly Valued

Valuations seem reasonable. Consensus S&P 500 earnings of $75 or so would indicate that the market is fairly valued at 15 times earnings.

OUTLOOK

Bottom Line – Nothing has changed from our year-end outlook. We continue to believe that the S&P 500 will close in the 1215 – 1275 range for 2010 *(perhaps a bit higher)*. This implies a gain in the high single-digit to low double-digit range for equities. Bond returns will likely be challenged in 2010 with returns in the low single-digits. We do not expect a double-dip recession in 2010.

1st quarter GDP should come in around 3-4%, and the markets should continue to recover albeit at a slower pace than the past few quarters. 1st quarter earnings should be pretty solid based on recent economic results, but we will be watching closely for evidence of top line growth for businesses. Top line, or revenue, growth will be critical to sustainable profits and a solid recovery.

The World doesn't end that often...

The markets will correct, but remember that the world doesn't end that often. Of course, we will evaluate the next correction as it comes along *(when we all least expect it)*, and we will likely use it as an opportunity to put money to work in equities. Perhaps the expected correction doesn't come anytime soon … a bit like waiting for Godot.

Bonds have acted as we thought … pretty much flat to up a bit for the year-to-date period. We continue to believe that rates will move higher as the year progresses, but we do not see a dramatic increase in rates *(at least not yet)*. The low velocity of money (banks are hoarding cash and not aggressively lending) along with stubbornly-high unemployment will keep rates fairly contained. The Fed has reiterated that it expects to keep short-term rates "exceptionally low" for an "extended period." Investors who poured over $90 billion into bond mutual funds during the first quarter will be sadly disappointed if rates move materially higher.

A still large amount of cash on the sidelines *(with very little yield)* will most likely find its way to equities. Equity inflows during the first quarter remained fairly anemic at $3 billion. This gives us a bit of confidence as investors are still somewhat reluctant to chase this market *(too many over-confident investors will tell us when it is time to reduce equity positions)*.

Small and mid-cap equities along with *international equities (developed and emerging)* continue to look attractive. At the risk of sounding like a broken record, we also believe that *large-cap companies with higher quality attributes* should begin to play a more significant role in market leadership as the year progresses. This will be particularly true as the market advance gets challenged from time-to-time. *Commodities* may come under pressure as the U.S. dollar moves slowly higher (or sideways) and economic growth projections moderate.

Corporate and international bonds continue to look reasonable. *High yield bonds* should perform better than the overall bond market as underlying credits improve. *U.S. treasuries* remain overvalued – particularly long bonds. *TIPS* appear to be fairly valued; however, a trampling of investors into TIPS as a result of pundits crying "inflation is coming!" may support current prices.

The recession is over, and the long road to recovery is underway. There will be bumps along the way, no doubt, but we look forward to participating in the potential gains that lie ahead. Investors will be well served by remaining diversified, keeping risk levels in check and reviewing their asset allocation.

Happy Spring!

POLITICS & MORE

Our Investment Committee tries very hard to avoid getting bogged down with Washington politics. However, with the passage of the aggressive Health Care Reform Bill and with an emboldened President Obama our political discussions are now more heated than ever. Housing, Financial, Tax, Energy, Immigration.... reforms bear watching and are deserving of carefully analyzing their effects on our economy and society as a whole.

HEALTH CARE – The accommodations made as a result of the loss of Senate control by the Democrats has greatly lessened Obamacare's effect on the health care sector. Our biggest concerns are its costs and pressure on deficit reductions in the form of higher taxes. The cost of expanding insurance coverage is estimated to be $938 billion by the CBO over the next 10 years. Spending cuts, primarily to the Medicare program, finances about half of that cost. The other half is financed by increased taxes. According to the CBO, the bill is expected to reduce federal budget deficits by $143 billion over the next 10 years.

FINANCIAL – Obama's plan is to turn the behemoth banking institutions back into the controllable, regional banks they once were. Megabanks, especially Citi, are scrambling to raise equity while some regional banks are better capitalized and in position to participate in lucrative asset sales or downsizing by their larger competitors. Goldman and JP Morgan must lobby hard and create strong public relation campaigns to maintain their dominance in investment banking. The powerful financial service industry lobbyists together with a weaker Democratic position will undoubtedly water down Obama's financial reform effort. Despite this, a stronger SEC and better oversight of hedge funds, derivatives and custodial services is desperately needed.

ENERGY REFORM – If the stock market is a leading indicator, the recent poor performance of clean energy stocks would appear to make the environment a sacrificial lamb for the passage of the Health Care Plan. The market appears to feel that clean subsidies are in play, but cap and trade carbon taxes are not. With oil prices exceeding $80 per barrel, Democrats fear the rebounding gas prices and sticky high unemployment are issues to be handled with potholders.

Taxes are going ↑...

TAXES – We see Obama trying to lower the income level on which to impose higher tax rates. With all $250,000 income earners contributing less than 20% of our tax base, and with 38% of Americans not paying taxes, Obama does not have a lot of space to work with. Income, dividends and capital gains taxes are expected to increase.

Hopefully, the legacy of an unknown Republican taking Ted Kennedy's Senate seat and a more vocal middle class will water down tax legislation and place pressure on government spending. We'll be sure to keep you informed and your portfolio well positioned.

TAX TIBITS - Remember that Required Minimum Distributions (RMDs) are back for 2010 after being suspended in 2009. IRA investors must take their first RMD no later than April 1st of the year after they turn 70 ½. Thereafter, annual RMDs must be taken no later than December 31st.

For 2010, the federal estate and generation-skipping taxes have been repealed thus making it possible to transfer unlimited amounts at death free of federal estate and gen-skip taxes. Legislative changes are being considered to re-instate these taxes (and possibly make new laws retroactive to January 1st). As we mentioned in our year-end newsletter, estate plans should be reviewed to ensure that they avoid potential pitfalls.

1st QUARTER 2010 SCOREBOARD

Index	Close	1st Quarter % Change	Year-to-Date % Change
DJIA	10856.6	+ 4.1	+ 4.1
S&P 500	1169.4	+ 4.9	+ 4.9
NASDAQ	2397.9	+ 5.7	+ 5.7
Nikkei	11089.9	+ 5.2	+ 5.2
MSCI EAFE	1584.2	+ 0.2	+ 0.2

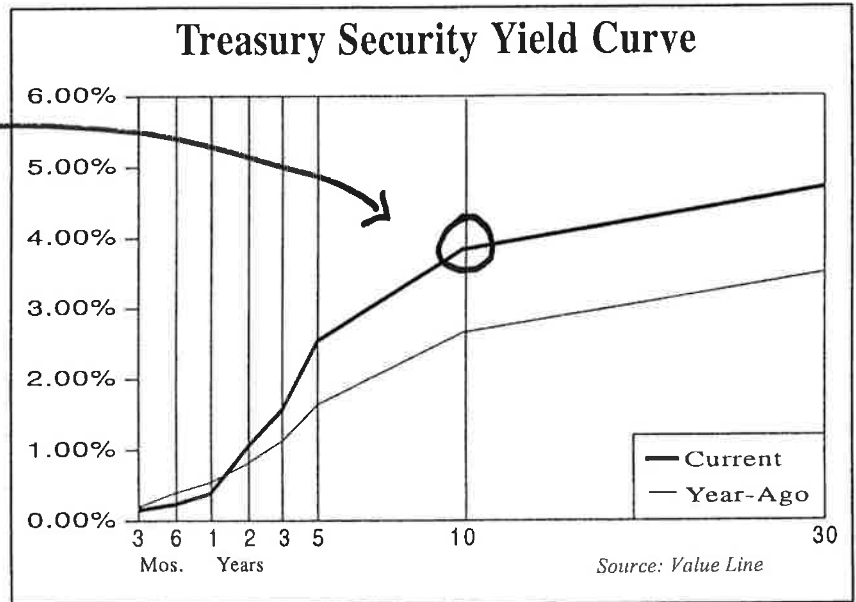
~ Int'l weak

3 Month T-Bill	0.15%	Fed Funds Rate	0 - 0.25%
5 Year T-Note	2.55%	Prime Rate	3.25%
10 Year T-Note	3.83%	Gold	$1113.30
30 Year T-Note	4.71%	Oil	$83.76

Gold resting before likely move higher

Oil prices are up 5.5% so far in 2010

10-year treasury approaching 4%



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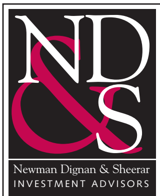

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