

3rd Quarter
2010

ECONOMY & MARKETS

In response to a German Commander's request that U.S. forces at Bastogne (a strategically important city during the Battle of the Bulge in World War II) surrender, acting Division Commander General Tony McAuliffe responded "Nuts!" Well, despite the doom and gloom that prevailed during the summer investors decided in September that they weren't giving up either.

The market put in its best September (plus 8.9%) since 1939 ... after a dismal and depressing summer period. Perhaps investors have seen the worst.

For the third quarter of 2010, the DJIA moved higher by 11.1% while the S&P shot up by 11.3%. The NASDAQ was even stronger as it moved ahead by 12.5% for the quarter. International markets rocketed higher as the EAFE Index advanced by 16.5% for the quarter. Bond returns were reasonable as the Barclay's Aggregate Bond Index moved ahead by 2.5% for the quarter.

Year-to-date performance numbers for equities have all turned positive thanks to a great performance in September. The DJIA is up 5.6% for 2010 while the S&P 500 is ahead by 3.9%. The NASDAQ is higher by 5.1%. International markets posted a 1.5% gain for the year-to-date period through September. Bonds continue their unabated march higher as the benchmark is up by 7.9% in 2010 (*sooner or later bond investors will experience negative returns*).

Now that the markets have moved higher everything must be getting better for the economy. Not so fast ... headwinds continue to hold back our economy and the markets. The challenges remain the same - **unemployment, housing, consumer confidence, volatility and lack of clarity with regulatory reform**. The encouraging news is that these several of these issues are improving – albeit at a snail's pace.

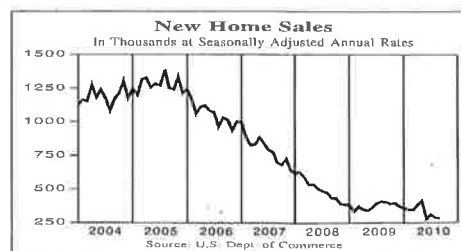
Nuts!

Let's take a look at **consumer confidence** (*see chart below*):



Consumers have a tough time feeling confident when they are worried about their jobs and a general lack of clarity in what the future holds. A quick look at the chart, however, indicates that perhaps we're seeing at least a leveling out of confidence. A Federal Reserve that feels that a \$1 trillion infusion of cash is necessary to keep the recovery going doesn't exactly add to one's level of confidence. Of course, consumer confidence numbers usually lag economic growth. Therefore, by the time the confidence numbers look strong we will have already experienced a nice move in the markets. One would expect terrible **retail spending** numbers given the low level of consumer confidence, yet we are beginning to see improving retail sales numbers. Perhaps the end of conspicuous consumption is here (*that's good*), but spending is recovering at a slow to moderate pace.

Housing (*see chart below*) appears to be in a bottoming process with no sustainable upturn likely for a few years.



There is no doubt that supply needs to come down for new and existing homes. The good news is that homes are more affordable today than they were just five years ago – a typical

Equities
are looking
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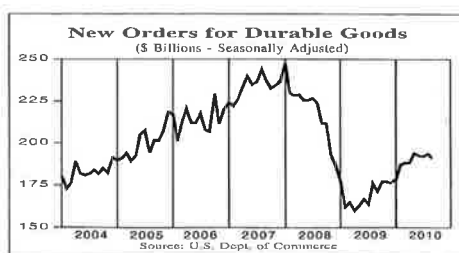
family (*does that really exist?*) can purchase a home today costing just 2.4 times their income versus 3.3 times five years ago. Today's low mortgage rates should serve to support housing prices and demand. Supporting this outlook is the recent Case-Shiller report that indicated a broad stabilization in pricing.

Despite the prevailing doom and gloom of just a few weeks ago, investors must be cautious of over-reacting to headline news. Take the following quote:

The U.S. economy remains almost comatose. The slump already ranks as the longest period of sustained weakness since the Depression. The economy is staggering under many "structural" burdens, as opposed to familiar "cyclical" problems. The structural faults represent once-in-a-lifetime dislocations that will take years to work out. Among them: the job drought, the debt hangover, the banking collapse, the real estate depression, the health-care cost explosion and the runaway federal deficit.

Sounds just like today, right? The above was taken from *Time Magazine* in 1991 just a year before the last big bull market. We're certainly not calling for a great bull market, but we're not running for the hills either. The lost decade has passed us and a new decade is at hand ... we plan to participate just like David Tepper. Tepper, the much heralded hedge fund manager at Appaloosa Management, appeared on CNBC recently and said that the Fed's recent commitment to **quantitative easing (QE II)** was a win-win for the stock market. Namely, the Fed will bail-out investors if the market weakens. We're not drinking Tepper's kool-aid, but we see markets moving higher by year-end and into 2011. History is also on the side of investors as markets usually move higher in the 4th quarter of a mid-term election year and during the third year of a presidential cycle.

Along with encouraging **manufacturing** sector news, **durable goods orders** look promising (*see chart below*).



Good news
↪

Businesses are flush with cash, and we expect business spending to pick up.

OUTLOOK

Bottom Line –We expect the S&P 500 closing 2010 in the 1100 - 1250 range. The markets will likely move in what we have heard described as a *Woody Hayes Economy* – three yards and a cloud of dust.

We expect 3rd quarter GDP to come in around 2%. 3rd quarter earnings should be up nicely, but companies will likely temper guidance based on an overall lack of clarity. The markets seem to have discounted a slowing economy, but corporate guidance will be critical to investor confidence going forward.

Bond prices continue to move higher and yields lower as investors plow money into U.S. Treasuries. Rates ought to slowly trickle higher, but it is possible that they stay low for an extended period of time should the economy continue to sputter and deflation fears take hold. International bonds continue to look attractive as the U.S. dollar weakens over time. High yield bonds remain a decent investment as the underlying credit quality of these companies improves. We expect to keep average bond durations in the short-to-intermediate range.

Small and mid-cap equities still add value to an overall asset allocation strategy. We are slightly underweighting *developed international equities* while adding to *emerging market equities*. We continue to believe that *large-cap companies with higher quality attributes* should begin to play a more significant role in market leadership as the year progresses. *Commodities* offer investors some protection from ongoing dollar weakness. *Alternative assets* continue to prove their worth, and we will continue to hold them in most portfolios.

According to the National Bureau of Economic Research (*the official arbiter of recessions in the U.S.*) the recession ended in June 2009. Double-dip fears are abating as the economy slowly recovers. Investors will be well served by remaining diversified, keeping risk levels in check and reviewing their asset allocation.

Happy Fall!

Dividends
matter!

Increasing Income with Dividend Growth

Despite an increase from the current 15% tax rate ceiling to the proposed 20% for qualified dividend income next year, there are significant tax savings for receiving dividends over taxable interest. Another reason for favoring dividend income is that companies tend to increase their dividend payout, which can help offset cost of living increases. Finally, the Dow Jones Industrial Average is now yielding 2.6% versus only .14% for 3-month Treasuries.

ND&S carefully evaluates companies for their total return potential - both price appreciation and dividend growth. We analyze the company's fair value, ability to generate cash, debt levels, strength of management, market position and the net present value of their dividends versus safer investments. Given our market outlook we feel strongly that solid companies with dividend growth potential offer excellent investment opportunities.

Several companies that we actively follow have recently boosted their dividends:

- Microsoft (MSFT) is the world's largest software company. It develops PC software, including the Windows operating system and the Office application suite. On September 21st the company raised its quarterly dividend 23% to \$0.16/share. The yield based on the new payout is 2.60%.
- McDonald's (MCD) is the largest fast-food restaurant company in the world, with about 32,500 restaurants in 117 countries. On September 23rd the company raised its quarterly dividend 11% to \$0.61/share. The dividend is payable on December 15, 2010 to shareholders of record at the close of business on December 1, 2010. The ex-dividend date is November 29, 2010. MCD is a Dividend Aristocrat and has raised its dividend for 34 consecutive years. The yield based on the new payout is 3.25%.
- Covidien (COV) develops, manufactures and distributes medical devices and supplies, diagnostic imaging agents, pharmaceuticals and other health care products used in both clinical and home settings. On September 23rd the company increased its quarterly dividend by 11% to \$0.20/share. The dividend is payable on November 8 to shareholders of record on October 4. The ex-dividend date is September 30. The yield based on the new payout is 2.04%.

The above list is just an example of a few stocks increasing dividends, and is not necessarily a list of recommended buys.

Quantitative Easing ... or QE II

There has been a lot of discussion recently regarding quantitative easing (or QE II). QE II refers to the monetary process whereby the Federal Reserve (or any other central bank around the world) increases the money supply in order to stimulate increased lending and liquidity (hopefully leading to increased economic activity). QE II involves the Federal Reserve purchasing treasury and other assets.

Central banks resort to quantitative easing after traditional monetary policy like lowering rates to near 0% fails to produce the desired effect of stimulating economic growth. Some argue that QE II is necessary today to get the economy jump started. Others argue that QE II is not necessary and that it will lead to abnormally high inflation. Let's hope that Chairman Ben Bernanke and the Fed know what they're doing ... the stakes are very high.

Nice
Rebound
↘

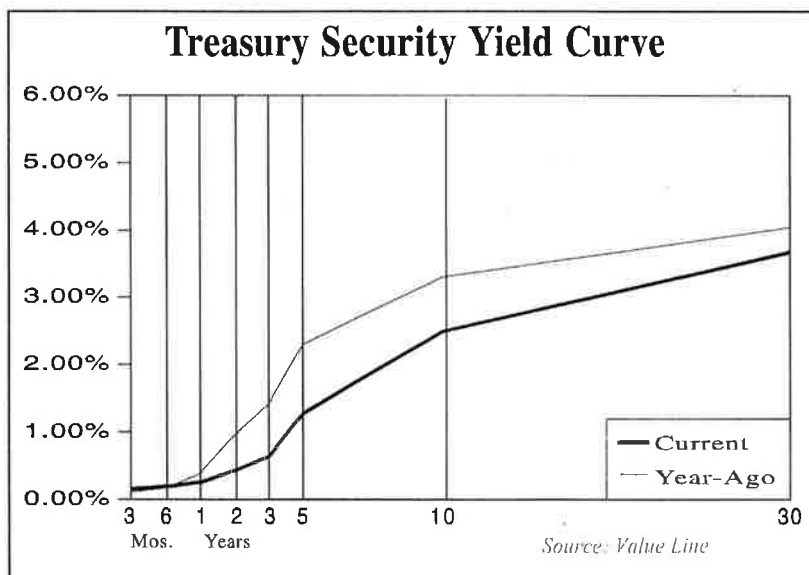
3rd QUARTER 2010 SCOREBOARD

Index	Close	3 rd Quarter % Change	Year-to-Date % Change
DJIA	10788.0	10.4	3.5
S&P 500	1141.2	10.7	2.3
NASDAQ	2368.6	12.3	4.4
Nikkei	9369.3	- 0.1	- 11.2
MSCI EAFE	1561.1	15.8	- 1.2
3 Month T-Bill	0.16%	Fed Funds Rate	0 - 0.25%
5 Year T-Note	1.28%	Prime Rate	3.25%
10 Year T-Note	2.54%	Gold	\$1307.80
30 Year T-Note	3.71%	Oil	\$79.97

Gold prices continue to move higher ... up 19.4% in 2010.

Oil prices are unchanged in 2010

The Fed remains on hold... rates stay low into year-end
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