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

Newman Dignan & Sheerar
INVESTMENT ADVISORS

I Dreamed a Dream

4th Quarter 2012

ECONOMY & MARKETS

Victor Hugo's 1862 novel – *Les Misérables* – is a dramatic and inspiring story of the underlying belief in the redemptive power of mankind. The recent movie release certainly did not compare to the Broadway version, but Anne Hathaway's performance as Fantine was worth watching. Fantine's solo, *I Dreamed a Dream*, reminds us of the debacle in Washington and the hopelessness often felt by investors.

There was a time when men were kind
When their voices were soft
And their words inviting
There was a time when love was blind
And the world was a song
And the song was exciting
There was a time
Then it all went wrong

I dreamed a dream in time gone by
When hope was high
And life worth living
I dreamed that love would never die
I dreamed that God would be forgiving
Then I was young and unafraid
And dreams were made and used and wasted
There was no ransom to be paid
No song unsung, no wine untasted

But the tigers come at night
With their voices soft as thunder
As they tear your hope apart
As they turn your dream to shame

He slept a summer by my side
He filled my days with endless wonder
He took my childhood in his stride
But he was gone when autumn came

And still I dream he'll come to me
That we will live the years together
But there are dreams that cannot be
And there are storms we cannot weather

I had a dream my life would be
So different from this hell I'm living
So different now from what it seemed
Now life has killed the dream I dreamed.

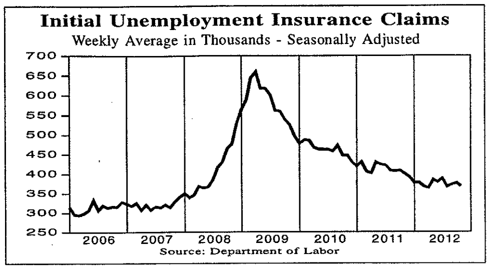
We dreamed a dream … that our leaders in Washington would wake up and act like adults, that Europe would get its affairs in order, that the Middle East would cease to be a cauldron of trouble and terror, that people desperately looking for jobs would not be disappointed and that profligate spending in this country would be reigned-in. But these things will likely not happen anytime soon. Our leaders in Washington are acting like Thénardier's *Masters of the House* … unfortunately there's no comic relief like in the movie. But markets climb a wall of worry, and 2012 was no exception. Despite myriad challenges and moments of hopelessness, markets finished 2012 better than most economists and strategists had predicted.

An uncertain election and a looming fiscal cliff were not enough to derail the markets by much in the fourth quarter *(besides, the Mayans were wrong, and the world didn't end!)*. For the fourth quarter of 2012, the **DJIA** was lower by 3% while the **S&P** declined by just 1%. The **NASDAQ** gave back 3.1%. International markets jumped higher as the **EAFE** Index advanced by 6.2% for the quarter. Bond returns were just above even as the Barclay's Aggregate **Bond Index** inched up by 0.2% for the quarter.

Thanks to *Helicopter Ben and The Wall of Worry* (see our last quarterly newsletter), yearly performance numbers for equities were surprisingly good. The **DJIA** was up 7.3% for 2012 while the **S&P 500** closed higher by 13.4%. The volatile **NASDAQ** raced ahead by 15.9%. International markets posted strong returns as the **EAFE** index gained 13.6% for the year. **Bonds**, yet again, finished the year higher by 4.2% in 2012. Bond investors benefited from continuing low rates and uncertainty around the world.

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** *(see chart below)*, moderate **inflation** *(so far)*, solid **productivity** numbers, strong **auto sales**, high **rail car loads**, improving existing **home sales**, and declining mortgage **delinquency rates**.

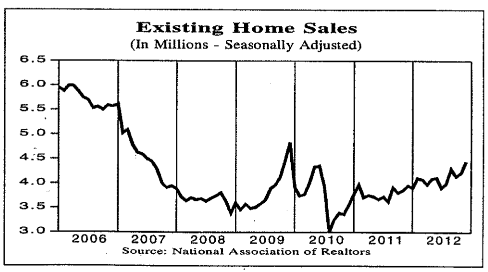
Encouraging sign



Improving **unemployment claims** *(above)* are critical to a recovery in the U.S. economy. Unemployment remains too high at 7.8%, but the trend is quite positive (and lower than last year's closing rate of 8.5%). Of course, more people working improves consumer confidence, helps consumers pay-off debt and ultimately puts more money back into the economy. Even Congress has helped with the unemployment rate –

"Say what you will about Congress, but it has created jobs for people who would be unfit to work anywhere else." -- Andy Borowitz

Expansion in U.S. housing is finally taking hold. **Existing home sales** *(see chart below)* have moved nicely higher due to an improving labor market and extremely low mortgage rates.



…plod along

OUTLOOK

Bottom Line – Economic and market consensus is almost always overly optimistic at the beginning of each year. Expectations for 2013 are probably a bit ahead of themselves given the concerns over the debt ceiling debate, sequestrations and rising taxes in the U.S.. The U.S. will likely plod along in 2013 with GDP growth around 2% … not great, but certainly not in recession territory. With 2013 consensus earnings estimates for the S&P 500 around $107, the market is selling at a reasonable valuation of just over 13X … cheaper than the historical average of 15X. However, we expect earnings numbers to come down to around $103 – thus bringing valuations closer to 14X *(still reasonable)*. Relative to bonds, stocks are cheap … the equity risk premium *(the difference between the expected return on stocks and bonds)* is still quite elevated compared to its historical average. Given improving housing and labor market data, decent valuations, solid balance sheets, increasing dividend payouts, increasing consumer confidence and mild inflation, *we expect the S&P 500 to close 2013 in the 1497 - 1550 range (5% to 9% higher).*

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*, *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. We are sanguine on *international equities* – both *developed* and *developing,* and we anticipate adding to existing positions in 2013. Again, we believe that *large-cap companies with higher quality attributes* should begin to play a more significant role in market leadership over the next several years (they're relatively cheap and they've underperformed for nearly 10 years … we expect mean reversion to be alive and well). We like companies with excellent dividend growth potential *(not necessarily just high dividend yields)*. *Commodities* offer investors some protection from potential inflation and dollar weakness. *Alternative assets* will 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. *Let's make it a good year.*
Happy New Year!

The Estate and Gift Tax - Update

The *federal estate tax rate* for 2013 will be **40%**, and the *exemption amount* will be at **$5.25 million**. Also, there is a portable exemption, allowing the surviving spouse to use the unused exemption from the first spouse's estate. This means that if the first spouse to die did not use any of the $5.25 million exemption, the surviving spouse has a $10.5 million estate tax exemption available. The lifetime gift tax and the estate tax exemptions remain unified. Individuals can now give away $5.25 million and not pay any gift tax; however, these gifts reduce their estate tax exemption. The annual gift tax exclusion rises to $14,000 per donee in 2013.

Due to an inflation adjustment provided for in RI estate tax law, as of January 1, 2013 the state estate tax exemption will be **$910,725**. The MA estate tax exemption remains at **$1 million**.

Tax Considerations

Death and taxes...

For 2013, the *maximum annual employee contribution to 401(k)s, 403(b)s and 457s* is **$17,500**. The catch-up contribution for people 50 and over is **$5,500**. The annual benefit limit for defined contribution plans for 2013 is **$51,000**. *Traditional and Roth IRAs* can receive contributions up to **$5,500** with an additional **$1,000** for those 50 and older. The *income limit for Roth IRA* contributions begins to phase-out at **$178,000** for married couples and **$112,000** for singles. There is still no income limit for IRA conversions to Roth IRAs. Individuals can, however, contribute to an IRA with after-tax money, and then convert to a Roth. We recommend that clients review this opportunity with their tax advisors.

Capital gains rates for 2013 remain favorable. Short-term capital gains (assets held less than one year) are taxed at one's marginal tax rate while long-term capital gains are (assets held for one year and more) are taxed at **0%** for those in the 15% tax bracket and below, and **15%** for those in higher tax brackets with the exception of a new higher rate of **20%** for couples with incomes over **$450,000** and singles with taxable income above **$400,000**. The Medicare surtax (see below) can boost the top rate to 23.8%.

Qualified dividend tax rates will be treated the same as capital gains above (maximum of 23.8%) for 2013. Interest income will continue to be taxed at one's marginal tax bracket.

A *3.8% Medicare surtax* begins in 2013 on net investment income for singles with modified AGI over $200,000 and couples with modified AGI over $250,000. The surtax is levied on the smaller of the taxpayer's net investment income or the excess of modified AGI over the applicable dollar threshold. A *0.9% Medicare/payroll surtax* on earned income over the above limits will kick-in for 2013. The surtax applies to the employee's share of Medicare tax.

Important Compliance Update

Pursuant to the ongoing written disclosure requirement placed upon registered investment advisers, we are required, on an annual basis, to make available to our clients our most recent written disclosure statement as set forth on our Form ADV Part 2A (our *"Brochure"*). As such, please contact ND&S should you wish to receive our most recent *Brochure*.

ND&S maintains a proxy voting policy that highlights our handling, research and voting of proxies. Please contact ND&S should you wish to receive a copy of our Proxy Policy. *As always, we ask that you also notify us of any significant changes to your financial situation.*

A GOOD YEAR...

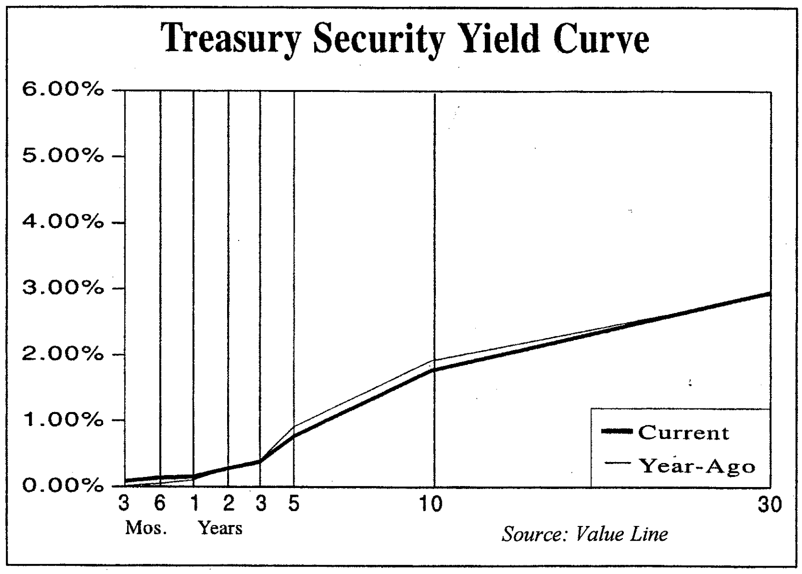
4th QUARTER 2012 SCOREBOARD

Index	Close	4th Quarter % Change	Year-to-Date % Change
DJIA	13104.1	- 3.0	7.3
S&P 500	1426.2	- 1.0	13.4
NASDAQ	3019.5	- 3.1	15.9
Nikkei	10395.2	18.2	22.9
MSCI EAFE	5377.5	6.2	13.6

3 Month T-Bill	0.05%	Fed Funds Rate	0 - 0.25%
5 Year T-Note	0.72%	Prime Rate	3.25%
10 Year T-Note	1.78%	Gold	$1674.80
30 Year T-Note	2.95%	Oil	$91.82

Oil was lower by 7% in 2012.

Expect rates to move higher over the course of 2013



We at Newman Dignan & Sheerar, Inc. wish to extend to our clients and friends our best wishes for a happy, healthy and prosperous New Year.

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