

# WASHINGTON CROSSING ADVISORS



## Market Commentary

May 20, 2008

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## Buy the Dips

*"If no one ever took risks, Michelangelo would have painted the Sistine floor."*

- Playwright Neil Simon

In managing portfolio risk, there is always a balance between risk-taking and care-taking of assets. Taking risk is certainly laudable, but we believe taking *calculated risks* is a far preferable way to approach portfolio decisions and tactical asset allocation.

Over the past year, we have seen rising to the economy and markets have adjusted in response. Readers of our commentary know that we have been paying close attention to the supply and demand for credit in the economy; the rate of growth in private sector employment; the supply of unsold houses as a leading indicator of growth; and corporate profits and cash flow. We must also weigh against these risks the prospects for returns over the horizon. Thus, even though the above mentioned trends remain negative, we now believe that investors should gradually seek to add riskier assets on "dips" because negative news on housing and the economy has become better understood and equity valuations have become far more attractive when compared to bonds and hard assets.

## Expect the Economy to Stay Sluggish

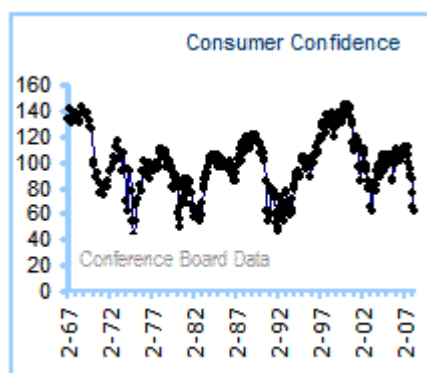
Facts are stubborn things. Today, bank write-offs have exceeded \$340 billion, while new assets raised have amounted to only \$260 billion. Net new demand for credit throughout the economy, which once was growing at high double-digit rates, has slowed to a low-single-digit trickle. Private sector jobs are down 326,000 from November's peak and up only 0.2% over this time last year. The supply of homes for sale is 70% above normal, and further price erosion is expected. Corporate profits are expected to be down 16% for the first quarter – led by declines in financials and the consumer sector. Almost none of this was expected a year ago when forecasts for growth were high and risk was systematically priced out of many markets (see our March 19, 2007 and June 15, 2007 Market Comments for more on this).

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## Risks Now Better Understood

While this assessment of the economy is sobering, markets remain flexible and are forward-looking. Therefore, while current trends remain negative, we are adjusting our portfolio posture to allow for the gradual addition of riskier assets to portfolios on "dips" because negative news on housing and the economy has become commonly accepted.



The bad news on housing, rising energy costs, and employment can now be plainly seen in the data on consumer confidence. The most recent survey measure taken by the Conference Board shows that consumer confidence has dropped to levels that typically coincide with past recessions (see graph). The unrelenting and ongoing stream of negative economic news has become part of today's landscape and the appreciation for downside risk is now much better understood than it was a year ago.

This adjustment in attitudes is a good proxy for profit expectations, which also are coming down, as earnings for the second quarter are now expected to be down 7% versus a +4.7% expected growth rate at the start of the year. We also know that the 34% underperformance by stocks (the S&P 500 index was down 16%)

relative to bonds (long-term Treasury bonds were up 18%) between July 12, 2007 and March 17, 2008 represents a historic re-pricing of risk. This 34% relative adjustment is in the realm of magnitude of past re-pricing episodes including the 1973 OPEC oil embargo (a 40% relative adjustment); the 1980-81 credit shock (a 30% adjustment); the 1987 stock market correction (a 32% adjustment); and the bursting of the tech bubble in 1999 (a 61% adjustment). These pricing adjustments, while painful and generally accompanied by negative news, often yield to better times for investors.

To demonstrate this, we return to the Conference Board data on consumer confidence. Recently, we examined how equity markets have historically performed following major low points in confidence. Not surprisingly, we found that equity markets did well in the six, twelve, and twenty-four month periods following such lows (see table).

### Confidence as Contrarian Market Indicator

Troughs in Confidence =====	S&P 500 Return		
	6 Mo.	12 Mo.	24 Mo.
=====	=====	=====	=====
December '70	9.9%	14.3%	36.0%
December '74	41.8%	37.2%	69.9%
March '82	10.8%	44.0%	56.7%
December '91	-0.6%	7.7%	18.4%
March '03	18.5%	35.1%	44.2%
	=====	=====	=====
<b>Average Stock Mkt Return:</b>	16.1%	27.7%	45.0%
Peaks in Confidence =====	S&P 500 Return		
	6 Mo.	12 Mo.	24 Mo.
=====	=====	=====	=====
June 1969	-4.2%	-22.8%	9.5%
December 1972	-10.4%	-14.7%	-37.2%
June 1978	3.3%	13.6%	33.1%
December 1988	16.4%	31.5%	27.3%
September 2000	-18.8%	-26.7%	-41.7%
	=====	=====	=====
<b>Average Stock Mkt Return:</b>	-2.7%	-3.8%	-1.8%

\* Conference Board Data, Morningstar

Indices are unmanaged, and you cannot invest directly in an index.

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As the table above shows, from times of maximum distress in confidence, large-cap stocks returned 27.7% in the ensuing 12 months from the trough, on average. By contrast, investing during times of high confidence often led to disappointing results and produced an average -1.8% over the next 12 months following peak levels. The current low readings on confidence suggest that we may be nearing a turning point for equities.

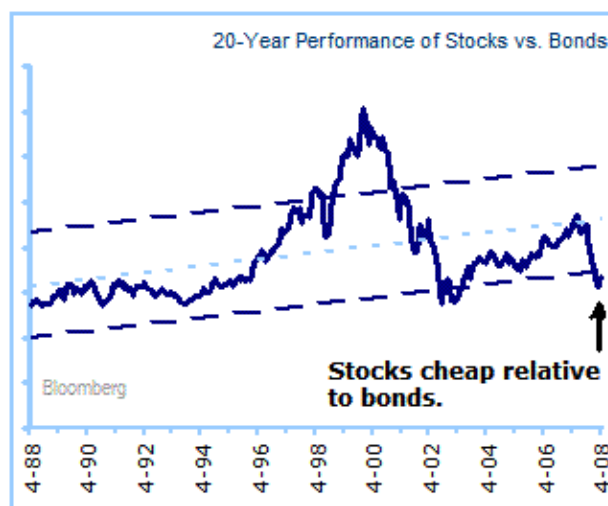
## Valuations Suggest Opportunity to Raise Risk Exposure

The most important reason investors should gradually add to riskier assets on "dips" is because equity valuations are currently cheap compared to bonds and hard assets.

The following graph is a ratio of the 20-year performance with the S&P 500 index (representing stocks) in the numerator and with the U.S. 10-year Treasury bond (representing bonds) in the denominator. Both returns are cumulative and include dividends and interest.

On a total return basis, we see that stocks have returned a modest 1% per-annum return above the U.S. Treasury asset. This suggests that the "irrational exuberance" of the late-1990s has run its course and that we may be entering a new cycle of out-performance by equities. Because the comparison only involves two assets, however, it is difficult to determine whether stocks are undervalued or bonds are simply overvalued.

Coming at it another way, we can also make the case that the S&P 500 has also become far less expensive relative to commodities and other hard assets as the commodity price surge continues. This is true across a variety of categories such as energy, agricultural commodities, and gold. Since April 28, 2000, the S&P 500 has returned 9.2%, including dividends, while the Commodity Research Bureau's commodity price index has returned 94% and gold has risen by over 220%. As a result of this lagging performance, it could be said that the stocks are becoming not only a better value than bonds, but also a better value than commodities.



Solid blue line: Cumulative Stock / Bond Return  
Dashed lines: Measure of extremes (1 Standard Deviation)

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## Conclusion

So you can see that although employment, housing, credit, and profit trends remain negative, we believe portfolios should tactically add to riskier assets on "dips" for two main reasons. First, negative news on housing and the economy has become commonly accepted knowledge. But most importantly, equity valuations have improved materially compared to bonds and hard assets and the recent re-pricing of risk from July, 2007 through March, 2008 has been of historically significant proportions.

If we are right about our evaluation, investors – like the builders of the Sistine Chapel – will be rewarded for patience and prudent risk-taking by gradually modifying their portfolio posture to emphasize riskier assets over defensive ones during this difficult period, despite what will likely be negative ongoing headlines for awhile longer.

## Current Recommended Tactical Asset Allocation

	Growth	Balanced	Conservative
Income & Other	20%	45%	70%
Bonds & Cash Equivalents	18%	40%	62%
Money Market Fund	1%	2%	3%
Short-Term Treasuries	2%		8%
Intermediate Term Treasuries	2%		8%
Long-Term Treasuries	2%		6%
Inflation Protected Treasuries	2%		8%
Investment Grade Corp Bonds	7%		25%
High Yield Corporate Bonds	1%		5%
Short-Term Municipals	0%	27%	0%
Long-Term Municipals	0%	11%	0%
Foreign Developed Bonds	0%		0%
Foreign Emerging Bonds	0%		0%
PREFERRED STOCK	0%	0%	0%
REITs	0%	0%	0%
GOLD	2%	5%	8%
Common Stocks	80%	55%	30%
U.S. Equities	60%	41%	22%
Large Cap Growth	29%	20%	11%
Large Cap Value	15%	10%	5%
Mid Cap Growth	10%	7%	4%
Mid Cap Value	6%	4%	2%
Small Cap Growth	0%	0%	0%
Small Cap Value	0%	0%	0%
Micro Cap	0%	0%	0%
Foreign Equities	20%	14%	8%
Brazil	4%	3%	2%
Germany	3%	2%	1%
South Korea	3%	2%	1%
Taiwan	0%	0%	0%
Mexico	0%	0%	0%
EAFE Growth	10%	7%	4%
EAFE Value	0%	0%	0%
Emerging Markets	0%	0%	0%
Developed Markets	0%	0%	0%
TOTAL PORTFOLIO	100%	100%	100%



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