WASHINGTON CROSSING ADVISORS

Market Commentary
May 17, 2010

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Our Take on Europe's Troubles

What do troubles in the Euro-zone mean to U.S. investors? The answer is relatively simple. Growth rate expectations will likely be cut, dollar translation will have a negative impact on U.S. company profits, and dollar strength will make U.S. exports more expensive to Europeans.

It also implies that policy changes will impact the perceived growth rates on the Continent. Remember that what governments do in Europe have a larger impact on their economies, because of the larger size of government there. Euro-zone government spending as a percent of GDP is much higher than in the United States. For example, government spending as a percent of GDP is 54% in Greece, 48% in Ireland, 51% in Italy, 51% in Portugal, 46% in Spain, and 52% in the United Kingdom. The recommended austerity programs, meaning lower spending and higher taxes for several European countries, will be quite a shock to the system.

It is also important to realize that what is happening over there is in many ways the exact opposite of what happened here in the United States. Not only will there be more taxes and less spending, but obviously, there will be no inter-governmental fiscal stimulus. For example, the Germans certainly will not be spending money to pump up the Greek economy. The French will not be looking to aid in pump-priming the Spanish economy. No, the situation in Europe is fundamentally different than the situation here in the United States.

There are monetary implications as well. It is widely perceived to be true that for a financial system to be stable, it must have stable prices. In the eyes of most economists, "stable" means a gradually and continually rising price level as opposed to falling prices, or deflation. But to achieve this, it is helpful to have three things: a paper money system, a unified central government willing to borrow and spend, and a central bank willing to monetize government borrowing. The United States possessed all of these things when pump-priming began here in 2008. The Euro region *does* have a paper money system, and it *does* have a central bank, but it *lacks* the critical third element — a central governmental authority to orchestrate a standard Keynesian-

style spending response. This fact has been highlighted in recent days through the electoral process in Great Britain and Germany, civil riots in Greece, threatened strikes in Portugal and Spain, and increased tension among EU community member countries.

Dollar Benefits

While there are near-term challenges for the European community, and the global growth story, there may be a silver lining in this for the United States, vis-à-vis the dollar and the U.S. recovery story. With the dollar now becoming stronger relative to the Euro, U.S. interest rates may well remain low for a longer period of time, foreign investors may find U.S. debt more attractive on a relative basis, and foreign direct investment flows may once again find the U.S. a more hospitable environment. It is too early to say that this will be the case for sure, but it is one potential side benefit for the domestic story which might proceed from the troubles now facing the European continent.

As for the U.S. recovery, we continue to see positive momentum in the data we watch. Our WCA Composite Index™ now stands at 80, which means that 80% of the roughly three dozen indicators we monitor to measure changes in the economy are still exhibiting positive movement. Granted, many of the statistics are still down materially from the cyclical peak of 2007 (auto sales are at a 12 million unit annual run rate versus 16 million unit run rate in 2007, housing starts are near a 600k unit annual run rate versus approximately 2 million units at the peak, and the unemployment rate is still near 10% versus approximately 4% at the peak).

Nonetheless, the rate of decline clearly ended last year, and many other data points have begun to move in a positive direction. Consumers have begun to deleverage, there has been some increase in the percentage of the population working, retail sales are up year-over-year, the price index has moved back up into positive territory, payrolls are expanding in the private sector as of the most recent monthly employment report, non-defense capital goods orders are up, most leading economic indicators are up, auto sales have improved from depressed levels, initial jobless claims are falling, personal income is up from last year on a nominal basis (although hourly earnings remain week). All in all, these indicators are showing tentative early signs of recovery.

Credit markets appear better too. While credit indicators, and measures of risk aversion in financial markets, can be among the most fickle of indicators, our WCA Credit and Risk Index™ shows continued willingness on the part of investors to take risk here in the United States. For example, domestic stocks are outperforming domestic bonds on a total return basis, the yield curve remains positively sloped (encouraging banks to lend), overall short-term rates are very low (LIBOR and Fed Funds, in particular), the cumulative advance-decline line on the NYSE is moving in the right direction, commodity prices (the recent slide in oil notwithstanding) are generally moving higher, corporate credit and liquidity spreads remain tight, and underperforming defensive sectors (like utilities and consumer staples) are still underperforming the broad market. All of this despite recent increased market volatility stemming from problems in Euro-land.

If there is any place foreign troubles are most apparent, it is in the WCA Foreign Index™. Here we see that the index has gone from a hyperventilating level of 100 in September 2009 back to 79 today. This drop does not suggest collapse overseas, since any reading over 50 is generally indicative of strength, but 79 is clearly lower than 100, and we would be remiss not to acknowledge that.

While the majority of indicators on foreign conditions are still positive, there has been some change in momentum (to be fair, the index could not have gone above 100, so momentum was bound to move lower at some point). Nonetheless, we have seen slippage in the relative performance of equity markets compared to bonds in France, Japan, and Germany. We have also seen some slippage in China, where leading indicators such as money supply growth, stock market performance, and new orders seen by purchasing managers have all appeared to have stalled. All in all, the robust ramp-up of foreign activity still remains strong, but the recent trend bears watching for sure.

As a reminder to our clients, we significantly cut in January, and then eliminated, our exposure to foreign assets in our tactical portfolios. Given our observations in our various diffusion indices, we remain overweight equities at the present time, with an emphasis on domestic issues, and with a bent towards smaller capitalization stocks, along with a bias toward value over growth.