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Market Commentary

Joseph V. Battipaglia
Market Strategist

Kevin R. Caron
Portfolio Manager

Chad A. Morganlander
Portfolio Manager

Past Commentaries

March 13, 2009

[A Big Hit to Wealth and
What to Do Now](#)

March 5, 2009

[A Questionable Plan and a
Free Market Silver Lining](#)

January 7, 2009

[Can Policymakers Create Just
a Little Inflation?](#)

November 21, 2008

[Credit: Don't Want It... Can't
Get It...](#)

September 24, 2008

[Downgrading Outlook Based
on Credit Freeze](#)

September 15, 2008

[Conference Call Replay on
Market Conditions](#)

September 15, 2008

[Equity Markets Stumble on
Lehman, Merrill, and AIG](#)

Signs of Improvement

Broadening Out Portfolios & Raising Equity Exposure

- ❖ Composite data from our three diffusion indices on the U.S. economy, economies outside the United States, and credit markets suggest some improvement.
- ❖ We believe that the Fed is “in a box” and will proceed with loans, guarantees, and “quantitative easing” for some time. This has negative implications for the dollar.
- ❖ S&P profit recovery should begin slowly next year, and will accelerate in 2011-2012.
- ❖ Equities are arguably attractively valued relative to Treasuries when comparing the trailing S&P 500 earnings yield to the 10-year Treasury bond yield, assuming recovery gains strength.
- ❖ Recommended investment posture is mildly defensive, but we have increased exposure to growth segments of the equity market (technology, healthcare, consumer), and have increased overseas asset exposure.

Since our last commentary, we have seen signs of improvement in a variety of economic indicators (see WCA Economic Conditions Index), above and beyond the improvement already seen in the supply indicators of credit (see WCA Credit Conditions Index). In no particular order, we have seen:

1. a rise in some commodity prices;
2. an improvement in confidence;
3. a slowdown in jobless claims;
4. stabilization in the inventory-to-sales ratio; and
5. signs of increased overseas activity.

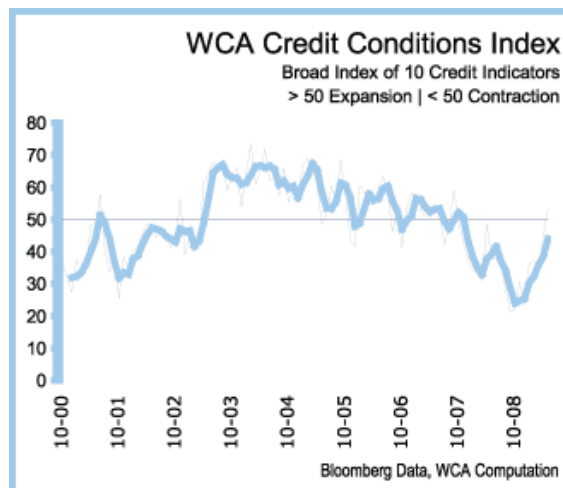
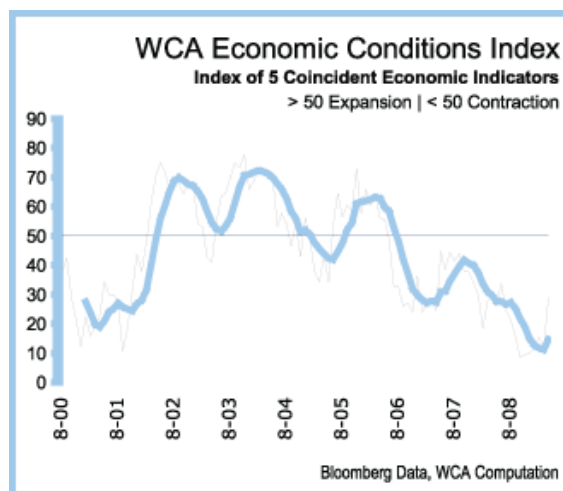
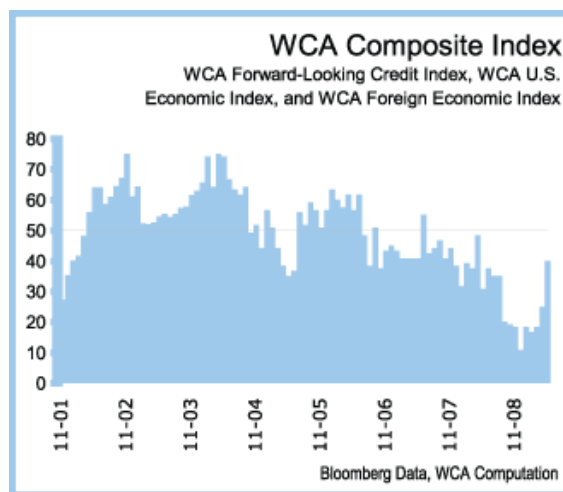
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Quantitative Economic Observations

It is difficult to see whether these "green shoots" will grow deeper roots, or die from the economy's chill in the months ahead. Despite these improvements, we are aware of the complexities brought about by over-indebtedness, de-leveraging, monetization of massive amounts of new Federal debt, and high levels of government involvement in private sector business. These all introduce new levels of uncertainty into the investing equation that cannot be easily understood or anticipated. That said, we must recognize the good with the bad, and investment decisions must take all relevant facts into account.

Therefore, we have decided to increase our exposure to equities (both foreign and domestic) primarily within the growth categories (technology, consumer discretionary, healthcare) which are performing better and tend to be less levered than most value sectors. We also add corporate debt (both high grade and high yield), and add foreign government bonds (both developed and emerging market). We are utilizing some of our cash, Treasury bills, Treasury bonds, and gold positions as sources of funds to make these investments. As the result of these changes, our tactical portfolio recommendations will have a higher equity position, but remain below the midpoint of our target ranges for equity exposure pending further developments.

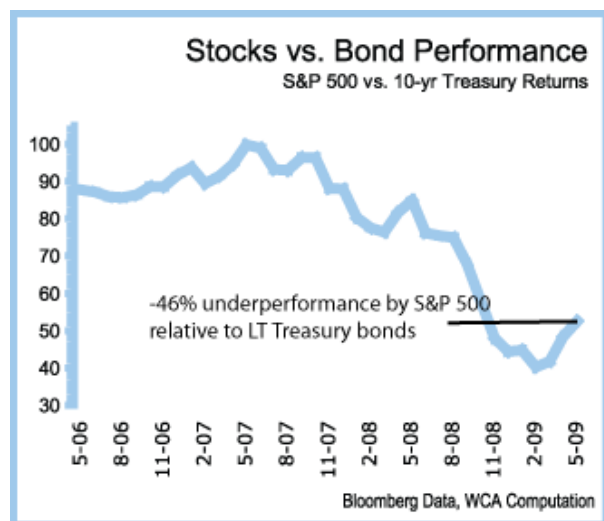


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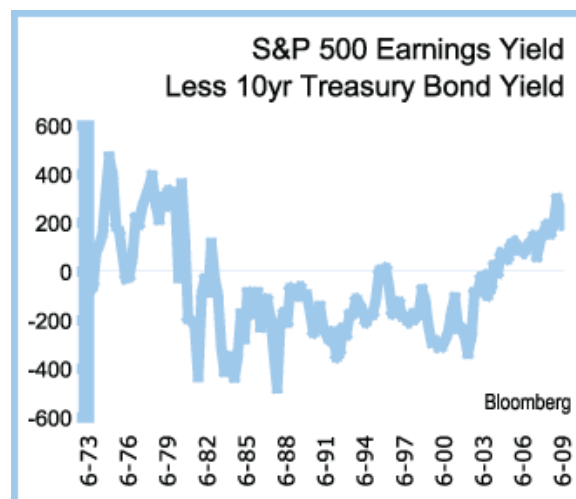
Extreme Risk Aversion May Create Opportunity

Before the market lows of March, risk investment in equities had underperformed full "faith and credit" U.S. Treasury bonds by 63% from July 2007. ***The equity market's recent improvement from the March lows, coupled with a backing up of long-term interest rates, narrows this margin of underperformance to 46% (see chart).*** By either measure, this large re-pricing of risk has been consistent with the enormity of the challenges that have confronted, and will continue to confront, the economy. Nonetheless, such a correction ranks among the largest re-pricings of risk seen in U.S. financial history.



In this corrective process, the equity risk premium has risen sharply. This can be seen when comparing the trailing 12-month S&P 500 "earnings yield" (or inverse of the price-to-earnings ratio) to the yield offered on 10-year U.S. Government Treasury Bonds. At present, this difference (called a spread) is 2% higher (200 basis points) for the equity "yield" than the yield offered on the Treasury (see chart).

This level has not been seen since 1980, and while it can go higher (as was the case in the 1970s), the purchase of S&P 500 earnings is today more attractive than the purchase of long-term Treasuries based on a comparison of current yields. However, the important question is, "What kind of recovery can we expect in S&P 500 earnings in a post credit bubble environment?"



Earnings Are Key

We expect to see a slow earnings recovery starting in 2010-2011. We now expect \$51 in 2009 S&P operating earnings; \$54 in 2010 earnings (5% growth); \$65 in 2011 operating earnings in 2011 (22% growth); and \$84 in 2012 (24% growth). Using the current S&P 500 index level of approximately 950, we estimate that the U.S. equity market now trades at 18.5X 2009 earnings, with earnings expected to grow at 15% over the next four years. A link to a spreadsheet containing our full set of assumptions can be found [here](#).

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Our assumptions underlying our forecast are:

1) ***The most severe part of the recession is behind us***; that 2010 will begin a transition toward gradual recovery; and by 2011, the economy will be well beyond the current period of negative growth. We place the odds of recession lingering through 2010 at less than 50% and have no expectation for recession to continue beyond 2010.

2) ***A slow process of recovery in employment, output, and profits will emerge*** from the initial early signs of recovery that we have identified in our economic and credit analysis (as discussed above). This recovery will be typified by higher unemployment and lower profitability than earlier cycles because:

- ❖ the percentage of employment in government and socialized fields will most likely continue to expand relative to private sector employment;
- ❖ the capacity for expansion of private sector debt and credit are fading;
- ❖ demographic shifts in the age of the population are underway; and
- ❖ highly cyclical sectors such as manufacturing continue to shrink from cycle to cycle.

Hence, the level of “full employment” in recovery may well be less than in previous cycles, and the sharp “snap backs” in labor trends may not repeat themselves in this recovery as they have in most post-war recoveries. Under these special circumstances, our initial assessment is that we see contracting nominal GDP this year (of 1-3%), a return to muted-but-positive (1-2.5%) growth in the transitional 2010-2011 timeframe, and a “new normal” growth rate of 3-5% not returning until 2012.

3) We expect further top-line pressure on profits as further de-leveraging in the economy mutes the normally sharp earnings recovery that typically follows recessions. While bottom-line results have been beating estimates due to cost-cutting, top-line results still seem to be falling below most analysts’ expectations. While inventory and cost-cutting provide some positive support to earnings, challenges in generating top-line growth lead us to conclude that pre-tax corporate profits will likely return to a range of 6-10% of GDP rather than the 12-15% levels which were experienced during the credit and commodity boom of recent years. Currently, corporate profits as a percent of GDP stand at 9.5%.

4) A key assumption is that the tax burden on corporations remains steady. Here, we have chosen to assume no increase in corporate profits until we learn more about the legislative agenda for this in 2010. While it is likely that corporate tax rates will prove to be an appealing political target, it is far too soon to assess whether this issue is ultimately a viable one given economic conditions. As of the last period, after-tax corporate profits amounted to roughly 78% of pre-tax profits according to National Income and Product Account data.

Sub-Asset Class Choices

Foreign assets have outperformed U.S. dollar-denominated assets in recent weeks, and the dollar sell-off was echoed in U.S. Treasury markets. A zero-interest rate policy coupled with significant new borrowings by the United States to fund these deficits are contributing factors to dollar weakness. At the same time, inflationary expectations have increased in anticipation of the monetization of this debt. Under these circumstances, it would not surprise us to see global capital seek a more

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diversified "basket" of investments in other currencies and assets to be held alongside existing dollar assets.

For more clarity on debt and deficits, we look to the Congressional Budget Office (CBO). According to the CBO, debt held by the public will increase to 82% of GDP by 2019 from 57% of GDP today under current spending plans. If we add in new guarantees and obligations of companies in conservatorship (not to mention under-funded entitlement programs and state deficits), the fiscal "house" of the United States has deteriorated markedly. One cause of the expected increase in Federal debt burden is increased Federal spending relating to "stimulus." The CBO now estimates that the new budget will produce deficits of \$1.7 trillion (11.9 percent of gross domestic product, or GDP) this year and \$1.1 trillion (7.9 percent of GDP) next year. These deficits will be the largest deficits as a share of GDP since 1945 and the largest peacetime deficits in history. Whatever the cause, these deficits must be financed through taxes and borrowing — both of which have negative implications for the dollar.

Sub-Asset Class Choices

The most important factor (and most difficult to understand and forecast) is the level of prices as seen through the value of the dollar. We have seen a marked and historic shift away from the private sector acting as the economy's borrower of last resort. The Federal government is now taking up that role. While it might seem odd that we need a "borrower of last resort" at all, the fact is that the supply of money is dependent on having willing borrowers. This is because the monetary structure of the economy is tied to debt. Bank credit (deposits) is the primary form of money in the modern economy, and these deposits result from new borrowings.

The retirement of debt, on net, will produce a drain of the same. Hence, the new drive for debt reduction in the private sector (whether such reduction comes through defaults or early retirement) is a drain on the availability of money and produces downward pressure on prices. If falling prices become the expected outcome, it is difficult to get spending and investing back on track, and the economy can remain mired in a prolonged slump.

In 2002, Ben Bernanke explored the deflation problem and concluded that, "under a paper money system, a determined government can always generate higher spending and, hence, positive inflation." This was a very telling statement, because it reminds us that the Fed, by itself, cannot bring about inflation through the direct printing of money. It suggests that only in "partnership" with Congress and other investors is the Fed capable of converting government-issued debt into new dollars that could prevent dollars and bank credit from contracting. Therefore, the Fed Chair's statement assumes that there will be both a commitment by government to expand debt at a rate sufficient to offset private sector contraction and that foreign investors will remain committed to buying and holding their dollar assets. It is far too early to assess whether or not the Fed will be successful in their undertaking to create just the right amount of inflation.

Recently, there has been a sharp increase in commodity prices in both the industrial and precious metal markets. Gold prices have crossed above \$950 an ounce, silver has just had its strongest monthly return since 1987, and the Commodity Research Bureau's index of commodities is 25% higher than February. This suggests monetary inflation, especially as stockpiles of oil and other commodities

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remain curiously high. At the same time, the decline in the trade-weighted dollar seems to be calling out for the Fed to raise interest rates. Again, this suggests monetary inflation. The difference in yield between the 10-year Treasury and the 10-year Inflation Protected Treasury bond has risen to nearly 2% from 0%. Again, this is another potential indication of monetary inflation. And, lastly, the "term spread" or difference between 3-month bond yields and 10-year bond yields has risen to 345 basis points (3.45%) which are near record highs. All of this is suggesting not only monetary inflation, but that the Fed is now "in a box" on interest rates. They appear "boxed in" because they cannot respond to inflationary signals for fear of undoing improvements they have seen to date and, at the same time, they are limited in the use of traditional policy tools (setting short-term interest rates and changing reserve requirements) because these policy tools have already been exhausted. Instead of being focused on the longer-term inflationary impact of large-scale debt monetization, we believe that Fed policy is more focused on:

1. the "output gap" (the economy is running well below potential output);
2. the lack of inflationary wage and employment trends;
3. potential new losses in commercial real estate and consumer credit; and
4. a new and large wave of Option ARM and ALT-A mortgage resets.

Therefore, they will be forced to continue down the road of direct purchases and guarantees of a wide variety of assets that were once considered too risky for the Fed to own under past governance. The long-run

effects of these programs (both good and bad) are unknown, but it is our sense that the Fed will find it difficult to withdraw from these programs now that market participants have come to expect Fed involvement in these markets. These observations, together with a lack of hawkish language from the Fed, suggest to us that Fed policy will remain on the current track for some time to come, and the dollar to remain relatively weak.

Conclusion

There has been improvement in our credit and economic "diffusion indices." Market-based indicators suggest fading deflationary pressure, along with some improvement in economic activity. These improvements come on top of government-sponsored improvement in the supply conditions for credit. At the same time, there has been some improvement in the relative performance between stocks and bonds, but the equity risk premium still suggests a potentially attractive entry point for equities from a historic perspective (assuming that the economy and earnings continue to improve from here).

We still have concerns about what the quality of the recovery will ultimately be, but believe it is appropriate to add some exposure to equities and broaden out portfolios to include foreign assets and corporate bonds, given recent improvement in our indices. We continue to see relatively better performance from growth sectors such as technology, healthcare, and consumer discretionary over value sectors.

These changes are subject to change in either direction depending upon the progression of inputs on the economy from this point going forward. We may add or reduce exposure to assets based on the relative performance of

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those assets and changes to the macro-economic environment as demonstrated through our various economic indicators. We will continue to monitor and update you on the progress of the economy and our recommendations as we track progress from here.

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