



## WASHINGTON CROSSING ADVISORS

June 15 2007

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S&P 500 Index: 1502 (Intraday)  
10 yr Treasury: 5.21% (Intraday)

### **Data Affirms Tactical Asset Allocation Posture**

A 20% gain in the major equity indices with low inflation and unemployment rates can create a false sense of security and complacency in markets. Our recommendations for portfolios are strongly influenced by the *relative* value of one asset class compared to another. Many of the assets that represented large parts of our recommended model portfolios in the past no longer offer an attractive risk / reward tradeoff and we have made necessary adjustments along the way. Periods of transition in the economy introduce additional uncertainties that can result in the sudden re-pricing of assets as was the case during the sub-prime mortgage rout earlier in the year. The recent sharp rise in interest rates, tighter credit, and imbalances in the residential real estate market are all potential contributors to a less certain environment in the months ahead.

### **Some Markets Are Mis-Pricing Risk**

Pricing of risk has become more aggressive as many asset classes have been priced higher as to eliminate spreads that previously had compensated investors for assuming risk. For example, credit markets are pricing corporate bonds of varying quality with yields far closer to those of risk free Treasuries than before (compensating investors less for the potential risk of default); Long-term Treasury bonds are now priced with little advantage over shorter-term interest rates (rather than providing more yield to compensate for the potential for a rise in inflation); real estate investment trusts and utilities now typically carry yields that are below the yield offered on long-term Treasuries (despite the fact that those dividends are far less predictable than coupon payments); micro-capitalization, small and mid capitalization stock indices trade with much larger premiums compared to larger capitalization stock indices (despite the fact that these segments of the market are prone to bouts of periodic illiquidity); and more speculative foreign markets like China, Brazil, Russia and India appear to be overheated (despite a lack of transparency into the operations of those markets); and away from financial markets, we note that residential real estate valuations are still

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severely stretched relative to personal income (2.1 times income versus an average of 1.5 times income during the 1990s) and a record number of homes and condos for sale (over 4.1 million units versus an average of 2.3 million units during the '90s). These are all examples of how some markets have mis-judged, and are likely mis-pricing risk, in our view.

## **Comprehensive New Data On The Economy**

Last week's new data from the Federal Reserve's *Flow of Fund Report* gave us a better composite picture of the economy. Buried in that report were three important new trends that have caught our attention. These include:

1. *a very sharp falloff in net new borrowing by households;*
2. *a divergence in aggregate economy-wide profit growth rates versus the earnings per share profits reported by companies in the S&P 500; and*
3. *an accelerating trend toward substituting corporate debt for equity.*

### ***Household Borrowing Drops***

Starting in 2001, households responded to record low interest rates and booming real estate by accelerating the pace of net new borrowing. Between 2001 and 2005, the annualized growth rate in net new borrowing topped 18% — more than twice the usual rate of growth. As a percent GDP, net new borrowing hit an unprecedented **9%** in 2005 — easily exceeding prior peak records and well above the “normal” 4-6% range seen during the prior 30 years. Mortgage debt also ballooned from \$4.8 trillion in 2001 to \$9.8 trillion currently and aggregate savings has also turned negative for the first time since World War II. The record levels of borrowing was very effective in stimulating the economy following the stock market meltdown in 2000-2002 and also produced a 130% increase in the price of homes in major cities and suburbs across the country<sup>i</sup>.

But these trends have come to an abrupt halt. After household new borrowings topped out in Q3, 2005 near a \$1.4 trillion annualized rate, borrowing has been in decline and the Federal Reserve now estimates that households are borrowing at a rate near \$770 billion and debt growth has slowed from double digit-rates to 6% — a rate of



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deceleration equal to the late 1980s and late 1970s slowdown. As with these past cycles, the added debt burden, coupled with higher interest rates and tighter credit produced temporary pullbacks in demand. With the economy now growing at less than 1%, we can't help but wonder if the same process might be unfolding once again.

**Implication for Tactical Asset Allocation:** *Financial stocks, consumer discretionary sector likely experiencing peak earnings. Expectations for market earnings should continue to put a 50/50% probability weight on our good case and "recession" case for S&P 500 earnings for the purpose of determining an index price target.*

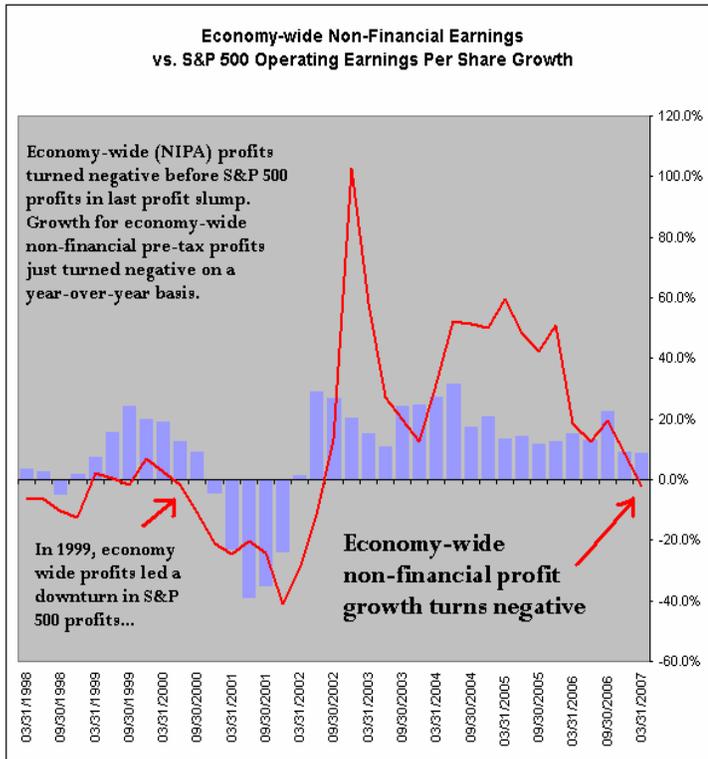
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### ***Non-Financial, Pretax Profit Growth Turns Negative***

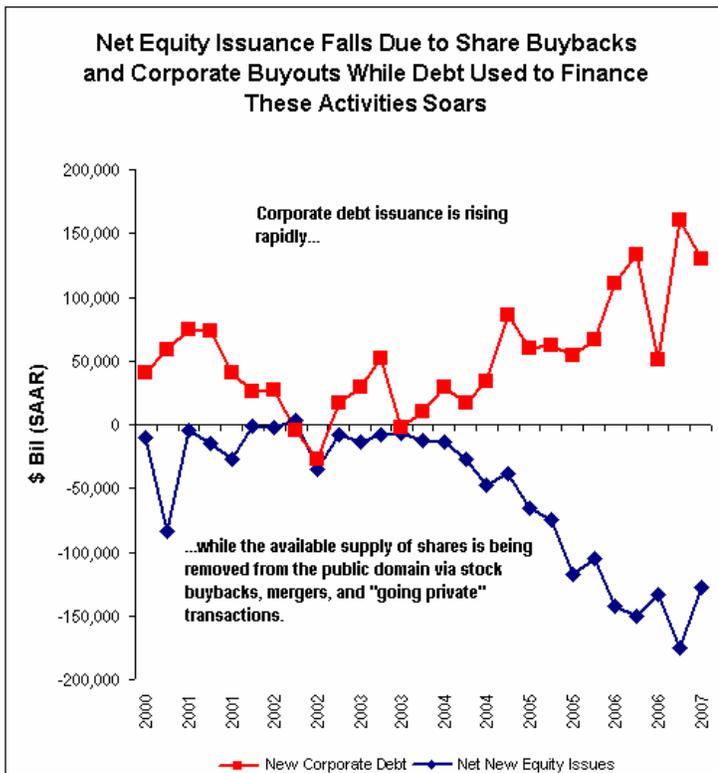
This is important to watch because in the last cycle, weakness in earnings for the S&P 500 showed up first in the non-financial profits for economy-wide corporate profits and it was not for another two quarters before S&P 500 profit growth slipped into negative territory. It is also important because it may speak to the health of small business in the U.S. which was instrumental in driving growth in employment gains during the last few years. Weakness in earnings comes at a time of very high profits as a percent of GDP and the strong profit growth for the economy is even more pronounced in the “per-share”

earnings that are produced for S&P 500 companies which are helped by rising share repurchases.

**Implication for Tactical Asset Allocation:** *Slowing profit growth tends to hit the aggregate data first and we would not be surprised to see smaller company growth rates slip faster than larger company's earnings growth prospects. This again reinforces our position to remain conservative in calculating index earnings and price targets and strengthens our case that smaller capitalization stocks have greater risk in the event of a slowdown.*



## Stock Buybacks, Debt Issuance Soar



Clean balance sheets, lots of cash flow and receptive credit markets made it easy to leverage companies using inexpensive capital and reduce the outstanding supply of public equity (theoretically more expensive capital). Just as households jumped at the opportunity to borrow at advantageous interest rates, companies are using investor appetite for yield and the pricing anomalies mentioned earlier to take advantage of available and inexpensive borrowing. Not only have long-term interest rates been less than the growth rate in the economy (itself a sign of inexpensive capital), but credit markets have been willing to accept a relatively small amount of additional yield over default-risk free government Treasury bonds. We note that the yield

spread (or difference) between long-term, Baa rated corporate debt and 10-year Treasury bonds has fallen to 164 basis points (or 1.6%) from a high of 380 basis points in October, 2002. For the record, the lowest level this spread reached over the past 20 years was 123 basis points seen in August, 1996. In short, we are not likely to see investors accept much lower yields for assuming default risk and, now with long-term Treasury bond rates higher, the prospect for corporate debt to become more costly is growing more realistic.



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**Implication for Tactical Asset Allocation:** *Larger companies that continue to have access to ample cash flow, that have strong balance sheets and can access capital markets will likely continue to seek to make acquisitions and buy back shares. Reduced share availability can help sustain per-share earnings growth figures for the large cap S&P 500 index.*

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### **Conclusion**

We see a greater amount of risk in the composite picture given what we see as several markets' mispricing of risk. The risks are further augmented by clear signs of deterioration in household borrowing behavior, tighter and more expensive credit, and our expectation that profit margins are near peak levels as a percent of GDP. We continue to focus our tactical asset allocation among more "conservative" assets that offer us the best risk / reward, given our current assessment of relative valuations and the economy.

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### TACTICAL ASSET ALLOCATION RECOMMENDATIONS

Thursday, June 14, 2007

Asset Class	Growth	Balanced	Conservative
<b>INCOME &amp; DEFENSIVE ASSETS</b>	<b>38%</b>	<b>63%</b>	<b>88%</b>
<b>Bonds</b>	<b>39%</b>	<b>63%</b>	<b>87%</b>
Money Market Fund	2%	2%	2%
Short-Term Treasuries	15%	25%	35%
Intermediate Term Treasuries	3%	5%	7%
Long-Term Treasuries	6%	10%	14%
Inflation Protected Treasuries	3%	5%	7%
Investment Grade Corporate Bonds	10%	16%	22%
High Yield Corporate Bonds	0%	0%	0%
REITs	0%	0%	0%
GOLD	0%	0%	0%
<b>EQUITIES &amp; GROWTH ASSETS</b>	<b>62%</b>	<b>37%</b>	<b>12%</b>
<b>U.S. Equities</b>	<b>57%</b>	<b>34%</b>	<b>11%</b>
Large Cap Growth	23%	14%	5%
Large Cap Value	20%	12%	4%
Mid Cap Growth	7%	4%	1%
Mid Cap Value	7%	4%	1%
Small Cap Growth	0%	0%	0%
Small Cap Value	0%	0%	0%
Micro Cap	0%	0%	0%
<b>Foreign Equities</b>	<b>5%</b>	<b>3%</b>	<b>1%</b>
Europe	0%	0%	0%
Japan	0%	0%	0%
South America	0%	0%	0%
Developed Markets	5%	3%	1%
Emerging Markets	0%	0%	0%
<b>TOTAL PORTFOLIO</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

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