WASHINGTON CROSSING ADVISORS

Market Commentary
June 25, 2010

Joseph V. Battipaglia
Market Strategist

Kevin R. Caron
Portfolio Manager

Chad A. Morganlander
Portfolio Manager

On the Road to Recovery? Or Relapse?

"This is not the time for general expansion in public expenditure."

Herbert Hoover – *From a February 1930 message to Congress, where he tells Congress to economize or face a 40% tax hike.*

In early 1930, the Dow Jones Industrial Average was on a tear. The index had appreciated 50% in six months, and President Hoover was widely quoted as saying that prosperity was "just around the corner." However, just two months earlier, the President had embarked on his own "austerity" measures, similar to those talked about today in Europe and, increasingly, in the United States. As it would turn out, the Dow would soon resume its downward descent, thousands of banks would begin to fail, and the most wrenching stage of the Great Depression was underway. Many who watch markets today draw comparisons to the early 1930s and conclude that the end of robust, global, Keynesian-style stimulus might drive today's economy right back into the ditch. For those of us who have been concerned about the potential for a rapidly growing government to dampen the "animal spirits" of private enterprise, we are not entirely convinced that some restraint doesn't come without its benefits as well.

So we wait to see how the shifting attitudes of governments in regard to spending play out in the real economy. Excluding housing, we have seen little significant falloff in the majority of the data we monitor for changes in the U.S. economy.

This could be because there is a lag between the May drop in stock values and the reaction by businesses and households to the news. It will be very interesting to see what this month's data looks like, but for now, the composite picture on Main Street remains the same — business conditions are very poor, but improving at a snail's pace. It is now apparent, however, that the rate of improvement in credit conditions peaked in the fall of last year and May's stock market slide, chronic concerns over foreign sovereign debts, imminent job cuts expected by the states, and rising pressure on Washington to reign in spending have gotten the Keynesian camp very concerned about the future trajectory of the "V" shaped recovery.

Even though recent slippage in credit markets could threaten continued economic recovery if the slippage were to continue unabated, we have not yet "pulled the plug" on equities, since most of our indicators on the global economy, excluding housing, are still improving at this time.

The Role of Credit

There is a well-established history and body of literature that supports the fact that our economy tends to perform poorly (and, by extension, the stock market) when credit is not expanding. Since 1976, in years where the growth of net borrowing was less than the previous year, the average return of the equity market was 4% — about half the return of a "normal year" over that period. What makes this cycle so unusual is the fact that economy wide, total net new borrowing isn't just rising more slowly, but actually falling as the result of little new borrowing offset by debt write-offs and pay-downs. According to new data from the Federal Reserve, total net new borrowing (households, businesses, government, and financial firms) is currently creating about $0 new borrowing at an annualized rate. This is not unprecedented. It happened here before in the 1930s. Ultimately, this produces the deflationary pressures that policymakers have sought to counteract through spending.

Another example that shows that recent slippage in credit markets might threaten continued economic recovery and therefore warrant vigilance is seen in the tendency for upswings in the economy from recessions to be led by big ticket expenditures like automobiles and housing as businesses and consumers take advantage of lower interest rates to step up purchases of such durable items. These purchases, in turn, raise production and increase employment, which reinforces the economic recovery. Unfortunately, this isn't happening with much gusto on the auto side, and after a tax-credit induced spurt, housing now appears very shaky. If improvement doesn't materialize, it is difficult to see how a robust cyclical recovery proceeds without the important cyclical driver of housing along for the ride. But it is yet to be seen what happens to housing as we move further away from the expiration of the housing tax credit. As for automobiles, we have already seen auto sales rise to 11.5 million annualized unit sales from just over 9 million units in February 2009. On the other hand, new home sales are flagging just as the recovery could use a cyclical "booster shot." Annualized new home sales plummeted to just 300,000 units last month from a peak level of 1.39 million homes in July 2007. This dismally low level has never before been seen as far back as 1963 when the Census Bureau started keeping records on this data. Ultimately, without an eventual pickup and sustained expansion of borrowing to fund purchases of homes and automobiles, it is likely that deflationary forces will remain a challenge and the trajectory of this recovery will be lower than prior recoveries.

Even though the economy remains challenged and improvement in credit markets appears stalled, we continue to own stocks. Why? Because equities arguably are attractively valued, and because the array of data we monitor is moving in the right direction. If we look at the benefit of owning equities today, we see that we can buy the S&P 500 at 12.4 times $86.55 of expected 12-month forward earnings. Is $12.40 per dollar of earnings very cheap? No. It is not very cheap, but it is relatively low compared to most of the last 30 years. There were times in the late 1980s and early 1990s when the equity market

traded at a multiple of earnings in the 12-13 range, but in the late 1970s and early 1980s, it was more common to see that multiple in the single-digit range.

Valuations Aren't Enough

Valuations are not catalysts for stocks to go higher. Just ask the Japanese. But low valuations can set the stage for future returns, assuming that the economy cooperates. That's why the most important reason we should continue to own stocks is because most of our indicators on the global economy are still improving as of the time of this writing.

We regularly compile and analyze several dozen indicators that we have seen to be relevant and useful to determining whether to own risk assets like stocks, or safer assets like bonds, cash, or commodities to hedge risk. At present, all three categories of data are showing general expansion. This means that more than 50% of the credit indicators, U.S. economic indicators, and foreign indicators are moving in the right direction as we measure it.

For example, we see that a slightly larger percentage of the U.S. population has a job today compared to the start of the year. Retail sales are up roughly 7% year-over-year. New orders for non-defense capital equipment are again rising. Vehicle sales are rising. Aggregate personal income is up 2.5% compared to last year.

We also see that most of the indicators of market risk, while up from a month or two ago, are still far below the levels of severe stress seen in 2007-2008. Mortgage spreads that compare the national average rate on 30-year conforming mortgages to 30-year Treasury yields have risen from a low of 0.2% (20 basis points) over Treasuries to 0.9% over Treasuries since early April. At 0.9% over Treasury yields, the spread is still far better than the 3.0%+ yield spread during 2008. Yields on Baa-rated Corporate bonds have widened to 3% over 10-year Treasury yields from 2.4% over Treasuries in April. While 3% is higher than earlier in the year, it is materially less than the 7% premium over Treasuries that such corporate borrowers were confronted with in the depth of the credit crisis. On balance, we see some directional misbehavior in credit, but not yet sufficient to cause us alarm. Since we believe that credit conditions and investor risk appetite is critical for sustaining recovery, we are watching these trends closely.

Conclusion

So you can see that although recent slippage in credit markets might threaten continued economic recovery and therefore warrant vigilance, we should continue to own stocks for two main reasons. First, equities appear attractively priced relative to alternative assets. But most importantly, most of our indicators on the global economy are still improving at this time. Yet, we are aware of some of the many significant challenges that could derail the recovery. We have not lost site in the fact that China is growing at 10%, but its stock market is down over 20% year to date. We see that record low mortgage rates are in place, that new home prices have declined another 10% in a year, and an extraordinary tax credit giveaway, but we remain at record low levels for new home sales. Lastly, the Euro Zone rescue plan seems to have disappointed markets as Greece's credit default swaps move to record levels, suggesting potential for some sort of

default, and the latest obsession across Europe being that of fiscal constraint and austerity.

So it is with all of this in mind that we watch how restraint in government spending affects expectations for growth and performance of financial markets.

If exploding debt and rampant government spending was the problem, how, too, can it be the answer?