WASHINGTON CROSSING ADVISORS

Market Commentary

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Valuations Are Better, But Markets Are Not Out of the Woods

We believe the housing recession will continue for several years yet. We estimate that home prices, on average, may decline by as much as another 20-30%. The current inventory of unsold homes and condominiums is far too great and will take years to work off. Fundamental imbalances in housing will trump government efforts to re-inflate home values and loan availability will remain an issue for some time to come. Therefore, we do not expect a quick resolution to the national housing market's woes.

Make no mistake about it. Housing problems have definitely spilled over into the broader economy. Since last year, the consumer has watched the value of their largest asset fall; has had access to credit curtailed; oftentimes has a large mortgage to pay; is plagued by rising prices for goods and services; and is burdened by a weak economy that is no longer creating net new jobs. As a result, the economy will likely slog along in recessionary-like conditions for several quarters to come.

This then leads to, unfortunately, a profit contraction which typically accompany recessions. We believe that profits peaked in the third quarter last year. If so, it is doubtful that we are near the bottom in profits, as profits as a percent of GDP remain far above past peaks and even garden-variety profit contractions generally last from 6-12 quarters. If we are on point about the economy and profits did peak last year, we are only one quarter to one half of the way through the profit slump.

Profit Recessions

Peak-Trough Dates	Duration (Qtrs)	Profit Drop (%)	Market Moved Higher...
Q4'00-Q2'02	5 Qtrs	-63%	4 Qtrs Post-Trough
Q3'89-Q2'92	11 Qtrs	-36%	5 Qtrs Pre-Trough
Q1'85-Q3'87	10 Qtrs	-15%	5 Qtrs Pre-Trough
Q4'74-Q4'75	4 Qtrs	-18%	3 Qtrs Pre-Trough
Q4'69-Q2'71	6 Qtrs	-15%	5 Qtrs Pre-Trough
Q3'66-Q2'67	3 Qtrs	-12%	3 Qtrs Pre-Trough
Q2'60-Q2'61	4 Qtrs	-14%	4 Qtrs Post-Trough
Average	6 Qtrs	-25%	

The good news is that the stock market doesn't typically perform poorly all the way through the down-cycle in profits. Normally, markets sense recovery halfway to three-quarters of the way through the profit slide. Therefore, if we assume that profit recovery commences somewhere between the second half of 2009 and the second half of 2010, then it would not be unreasonable to see the stock market make a sustained move higher later this year or sometime early next year. In the meantime, expect markets to remain volatile.

One other bullish observation, despite the gloom over banks and real estate, is that the S&P 500 is now roughly 3% below the midpoint in our fair value range of 1,168 to 1,400. While we could not justify higher values for stocks a year ago, there is a chance that stocks now represent an attractive value to investors under a set of conservative assumptions.

To get to this range, we use what is commonly known as the "Fed Model." This model is one equity valuation method that relies on relationships between government bond yields and stock market earnings yields as the basis for identifying when equity prices have become relatively cheap or expensive. If the earnings yield for the S&P 500, for example, is higher than Treasury bond yields, then investors are likely being compensated properly for assuming the risks of owning equities compared to bonds and vice versa. While there are several inputs to the model, key among them are expectations for earnings, inflation priced into the bond market, and current interest rates. At this time, we are using an assumed $70.42 in fully diluted, net earnings and for the S&P 500 over the next twelve months. This, coupled with the current 4% 10-year government bond yield, assumed range of equity risk premiums of 3.5-4.5% over long-term Treasuries, and a 2.5% long-run inflation expectation priced into the TIPS market, brings us to a fair value range of 1,168 to 1,400.

While the S&P 500 is trading near 1,250, the forward multiple on net earnings is near 18X. The low end of our fair value range is at 16.5X, and the high end of our fair value range is at 20X. While these multiples may appear high, consider that they are based on reported rather than operating earnings and remember that in past cycles, earnings multiples usually expand during profit contractions in anticipation of recovery.

Falling Home Prices are Still a Major Risk

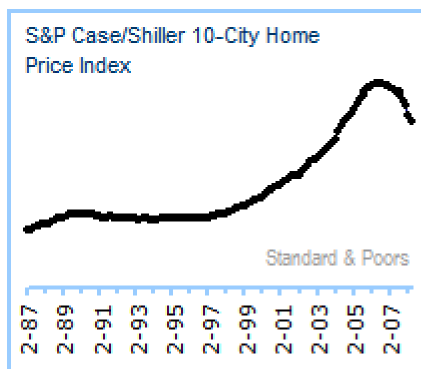
"You're thinking of this place all wrong. As if I had the money back in a safe. The money's not here. Your money's in Joe's house..."

- George Bailey, It's A Wonderful Life (1946)

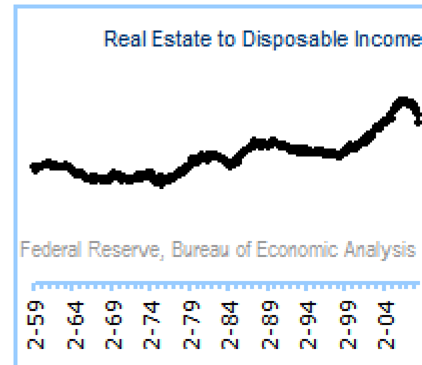
Housing is not a sideshow issue to the economy. It is the largest asset held by Americans and represents the collateral that backstops the banking system. George Bailey in the movie It's A Wonderful Life understood the importance of housing, as the quote above suggests. Since housing is so critical to the environment for banking, we need to remain focused on how the housing market unfolds and what that means for banks, credit creation, and the economy.

The boom in home price appreciation over the past ten years was unprecedented by historic standards. Over long periods, home prices tend to rise in line with real GDP. Consider that since 1948, American household real estate was estimated to be worth $200 billion. By 1998, real estate was estimated to be worth $9,200

billion. That is an 8% annual appreciation in overall value. However, there are always new contributions and additions to the housing stock in the form of new construction. Such new construction has averaged 5% of the existing value of home stocks over our 60-year timeframe. By removing the 5% contribution of new value from the 8% accretion of the overall value, that leaves 3% as a function of price appreciation. Price appreciation, according to the S&P Case/Shiller 10-City Home Price Index (below), was 12% per year in the decade leading up to the peak in housing. Given that fact, it could be a long time before housing reaches bottom. This is an unpleasant reality, and one that need not sink the United States economy, but it is meaningful, and markets are right to be more risk averse in the face of ongoing correction.



Not to beat a dead horse, but if we look at it another way, we see that the ratio of real estate value ($19.7 trillion) to disposable personal income ($11.1 trillion) peaked at 2 times and has fallen with home prices to a current level of 1.8. In the decade before the boom, a ratio of 1.2 to 1.4 times income was considered normal. A 20-30% further reduction in valuations would put this ratio back in line with this historic range.



Businesses Respond Negatively to Uncertainty

We said we would monitor business follow-on response to falling demand. To date, hiring activity has been limp and layoffs have continued. The unemployment rate has risen quickly to 5.5% as the fall in the number of people working in the private sector has continued unabated since November. These trends confirm our belief that the U.S. economy has entered a recession.

Economy to Remain Weak As De-Leveraging Begins

Recovery from this downturn is likely to be subdued, in our view, as leverage needs to be worked down in many parts of the economy and banks need to be recapitalized. While housing, profit, credit, and employment recovery should eventually emerge, at this time we expect any resurgence to be moderate. We also expect to see further tightening of lending standards by banks as home prices soften and even GSE loans will become more difficult to finance, despite the anticipated passage of a bill next week that would move toward a more explicit government guarantee of that debt.

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As an example of how leverage has increased, consider the nation's debt as it relates to mortgages, housing, and incomes. Between 1988 and 2008, for example, the ratio of mortgage debt to income rose from 54% to 100% for U.S. households in aggregate. Over the same period, mortgage debt relative to home equity increased from 51% to 93%. This leveraging process now must be reversed and will take several years to work through, in our view. Therefore, while the consumer should eventually be back, it could be with a more moderate spending profile than the consumer that drove the economy for the past two decades.

Conclusion

We are not as bearish as we had been a year ago, when risks were on the rise but markets appeared oblivious to those changes. Now, we are confronted with difficulties that are large but not insurmountable over time.

Arguably, equity prices have become much more attractive compared to bonds and commodities commensurate with one's risk tolerance. Our portfolio posture continues to be relatively defensive, with a focus on more liquid segments of equity markets, an emphasis on growth over value, with a diverse array of income-producing assets, including government Treasuries, and even a small exposure to gold bullion.

Recommended Asset Allocation

	Growth	Balanced	Conservative
INCOME & OTHER	16%	41%	66%
CASH & EQUIVALENTS	13%	34%	55%
DOMESTIC BONDS	13%	34%	55%
Money Market	1%	2%	3%
Short-Term Treasuries	2%	5%	8%
Intermediate Term Treasuries	2%	5%	8%
Long-Term Treasuries	0%	0%	0%
Extended Duration (LT Strips)	0%	0%	0%
Inflation Protected Treasuries	2%	5%	8%
Investment Grade Corp Bonds	5%	12%	19%
High Yield Corporate Bonds	2%	5%	8%
Short-Term Municipals	0%	0%	0%
Long-Term Municipals	0%	0%	0%
FOREIGN BONDS	0%	0%	0%
Foreign Developed Bonds	0%	0%	0%
Foreign Emerging Bonds	0%	0%	0%
COMMODITIES & OTHER	3%	7%	11%
Preferred Equity	0%	0%	0%
REITs	1%	2%	3%
Gold	2%	5%	8%
COMMON STOCKS	84%	59%	34%
DOMESTIC COMMON STOCKS	64%	45%	26%
U.S. SIZE & STYLE	64%	45%	26%
Large Cap Growth	33%	23%	13%
Large Cap Value	16%	11%	6%
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	20%	14%	8%
DEVELOPED	13%	3%	5%
MSCI Devleoped Markets	0%	0%	0%
EAFE Growth	10%	7%	4%
EAFE Value	0%	0%	0%
Germany	3%	2%	1%
EMERGING	7%	5%	3%
MSCI Emerging Markets	0%	0%	0%
Brazil	4%	3%	2%
South Korea	3%	2%	1%
Taiwan	0%	0%	0%
Mexico	0%	0%	0%
TOTAL PORTFOLIO	100%	100%	100%

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