WASHINGTON CROSSING ADVISORS

Market Commentary
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The Bright Side of Purgatory

Where we last left off in our August commentary, the Dow was at 10,644. Since then, the index fell to 10,000 and has bounced back to just above 10,500. In other words, the equity market continues to churn and mark time as it contends with the challenges at hand – namely the ongoing liquidation of private sector debt, periodic concerns about sovereign finances, and large amounts of excess slack in the global economy. Especially hard hit has been America's private sector workforce. All of this has conspired to produce a sub-par recovery that, in some ways, seems a lot like purgatory.

The Latin root for the word purgatory is *purgo*, which means to *clear away*. The economy today is in the process of *clearing away* many of the mistakes made during the credit and housing boom. Wasteful projects are being abandoned or put to some other use. Inefficient and insolvent firms are liquidated, reorganized, or merged into more efficient firms. Labor markets are gradually reallocating workers toward more productive uses. Housing markets are adjusting to improve affordability for those seeking a home. All of this is part of the process of purging the system of the mistakes from the prior credit boom. In this way, the painful process of rebalancing the economy can be seen as restorative rather than wasted time.

Part of the difficult, but necessary, clearing out process involves falling prices. Falling prices can be the result of short-term imbalances or changes in the rate of credit expansion. Today we have both. Not only are individual markets in a state of flux, but credit is flowing much more slowly into the economy, causing overall prices to be soft. We see this as an integral part of a necessary adjustment process. However, the Federal Reserve has purchased over $1.5 trillion in assets, lowered short-term interest rates to near 0%, and convinced the markets that there will be no rate increase for at least another year in order to stimulate credit expansion in an attempt to keep prices up. At the same time, the Federal Government is running annual deficits well in excess of $1.25 trillion to create demand (artificial demand, but demand nonetheless).

Such intervention efforts have hampered the more rapid liquidation of bad investments and establish a longer and more grueling process of adjustment. Additional efforts to inflate through artificially low interest rates, quantitative easing, price supports, or deficit-financed stimulus may succeed in the short-run objective of providing some stability, but the additional longer-run costs are unknowable. For now, we continue to see a very mixed picture in the data we observe.

Employment Clearing Very Slowly

Employment trends are part of what we observe in identifying cyclical turning points in the economy.

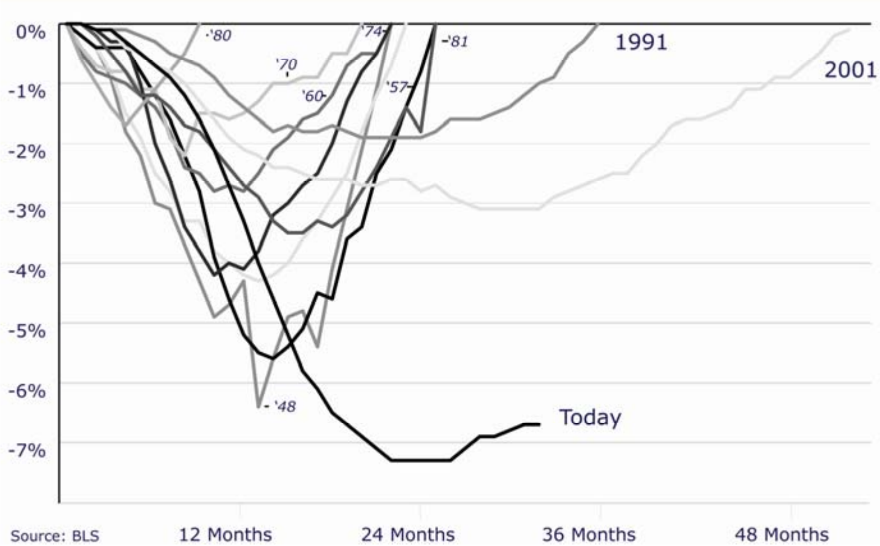
Unfortunately, employment trends continue to move sideways. During August, the unemployment rate rose slightly, to 9.6% from 9.5%, as more workers returned to the workforce in search of employment. Some of these workers were previously uncounted as part of the pool of eligible workers because they had reported that they had become discouraged from seeking employment. The number of unemployed persons rose by 261,000 to 14.8 million from 14.6 million, and the percent of the population who are estimated to be employed seems stuck at about 58.5% of the population.

One possible explanation of why the labor market is clearing slowly is that government, by changing the rules for healthcare, financial services, and energy, is creating a higher cost of employing labor. Additionally, because business owners are aware that government deficits come with a price tag, they are more inclined to run with a leaner payroll. If prices are stabilized, consumption growth remains positive, and wages remain relatively flat to down, the supply of excess labor will eventually be reabsorbed. However, it is very likely that this will be a much longer process than what we have seen in all other post-war cycles.

To emphasize the differences between today's employment recovery, and that of the other post-WWII recoveries, we have put together the following chart.

Note both the depth of the job losses, and the very slow trajectory of recovery.

Private Sector Job Losses Relative to Peak Employment (Percent Decline)



The U.S. economy has shed roughly 7% of jobs in the private sector.

In terms of time, we are beyond the time that most past cycles took to return to peak levels.

It is taking longer to recover private sector jobs, and losses appear to be deeper.

Earnings: Profitability Is Near Record

Based on analyst estimates, the S&P 500 is expected to have operating earnings of $92 in 2011. We estimate “normalized” earnings are closer to $70, given a book value assumption of $575 for the index multiplied by a 12% historical average return on equity. We believe that the roughly $20 of excess earnings is the cyclical result of extreme cost-cutting and a modest recovery in revenue.

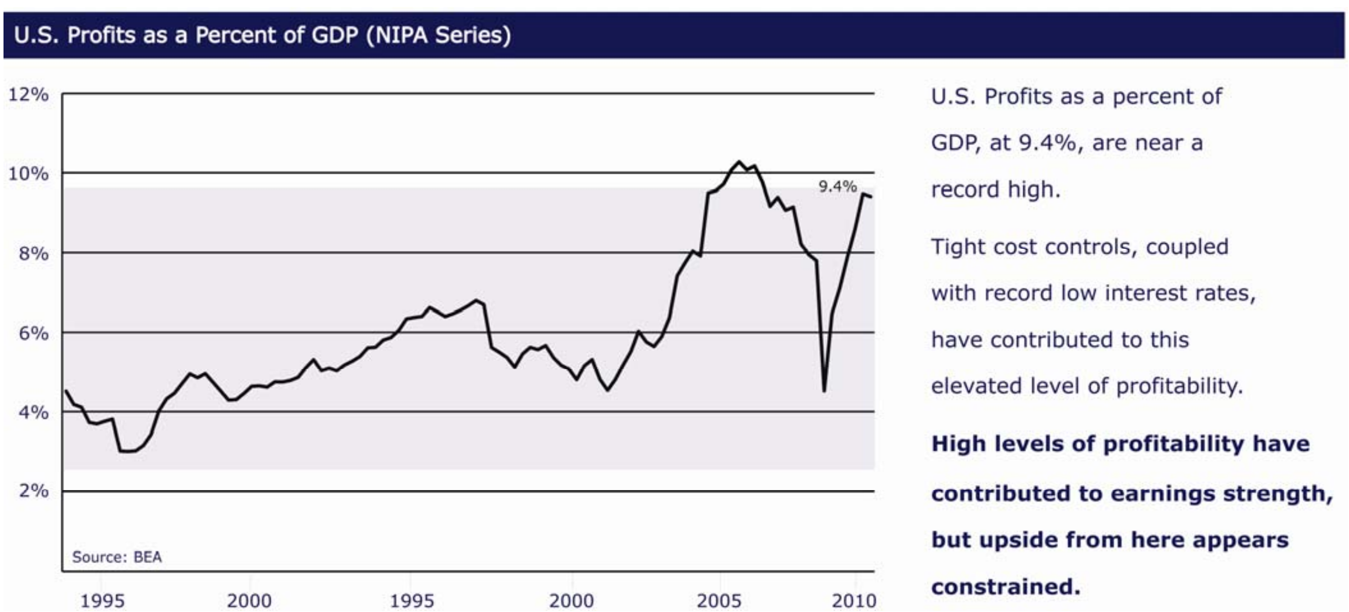
On an economy-wide basis, we also see profitability near record levels. At 9.4%, the ratio of after-tax profits as a percentage of GDP confirms that profitability is significantly above normal levels (see chart).

Of course, the improvement in earnings is a welcome sign for investors who have been looking for a bright spot in the investment story. However, the hesitancy for companies to spend on hiring also extends to investment, evidenced by the fact that capital spending as a percent of revenue is at a record low 5.08% in 2009 – nearly 40% below the peak ratio of 8.08% in 1998, based on data from Standard & Poor’s. This weak commitment to investment may reflect continued overhang of capacity and a weak outlook for growth.

As for balance sheets, the ratio of debt to equity in the S&P 500 has fallen to 1.4X, from a peak of 2.4X in 2002, according to S&P. Cash, as a percent of total assets, is at a record high 12.3% – 25% higher than the 20-year average.

As for valuations, the S&P 500 earnings yield stands near 8.2% ($92 of forecasted earnings divided by the S&P 500 at 1125). Using our $70 “normalized” earnings figure, the same yield is 6.2%. Either way, equity valuations appear within a reasonable valuation range relative to 10-year Treasury yields near 2.7%.

In summary, the S&P 500 appears profitable, solvent, and fairly priced relative to Treasuries, but the slow pace of economic growth and capital investment suggests that earnings and multiple expansion may be constrained.



Credit: Where's the Growth?

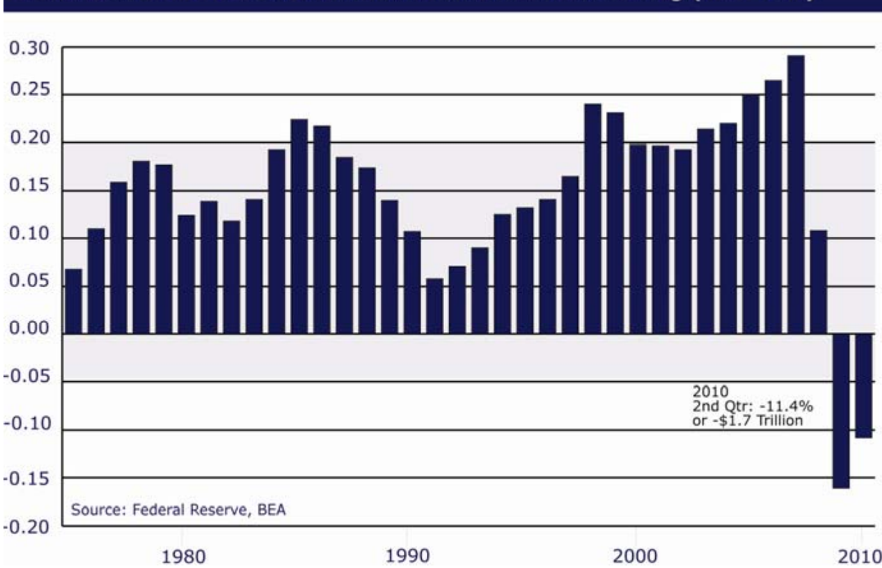
Credit expansion primarily takes place in the private sector through new loans to households and businesses. Since the 1930s, the amount of outstanding private sector borrowing has always increased. To do this, the private sector borrowed new money at a greater rate than old loans that were paid off. Most of the "money multiplier" within the banking system has occurred because of this phenomenon.

This rising trend of debt and credit ended abruptly with the housing downturn. In 2009, net new borrowings turned negative, falling to -16% of GDP. Thus far, in 2010, net new borrowing has again declined, but by a smaller percentage relative to GDP (about -11% of GDP). In our view, most of the deflationary pressure that the Federal Reserve and others are concerned about stems from this sharp reversal of a trend in credit that had existed for most of the past century.

To offset the contraction of credit within the private sector, government has stepped in as the "borrower of last resort" to ensure that the outstanding stock of debt and credit continued to remain stable. By doing so, they assisted the central bank in preventing a contraction in the supply of money and credit.

Without private sector willingness to borrow, and with a strong drive for savings, the possibility of price weakness or deflation remains a concern. The Fed has announced a new round of asset purchases to further offset the continuing contraction of private credit. It is unclear at this point whether the contraction in credit signals a new long-term secular trend for the world's largest economy or a temporary shift, which will, once again, reverse. For now, we continue to see contraction, albeit at a less rapid pace than a year ago.

Credit Creation in Reverse: Net New Private Sector Borrowing (% of GDP)



This chart shows the sum total of all new borrowing from the U.S. private sector, net of amounts retired.

This number has not been negative since the 1930s.

A shrinkage in the supply of borrowing and credit raises the likelihood of deflation.
To prevent further liquidation, the Fed has "printed" $1.5 trillion of new money, while the Federal Government has borrowed and spent an additional $3.2 trillion.

Government's Role

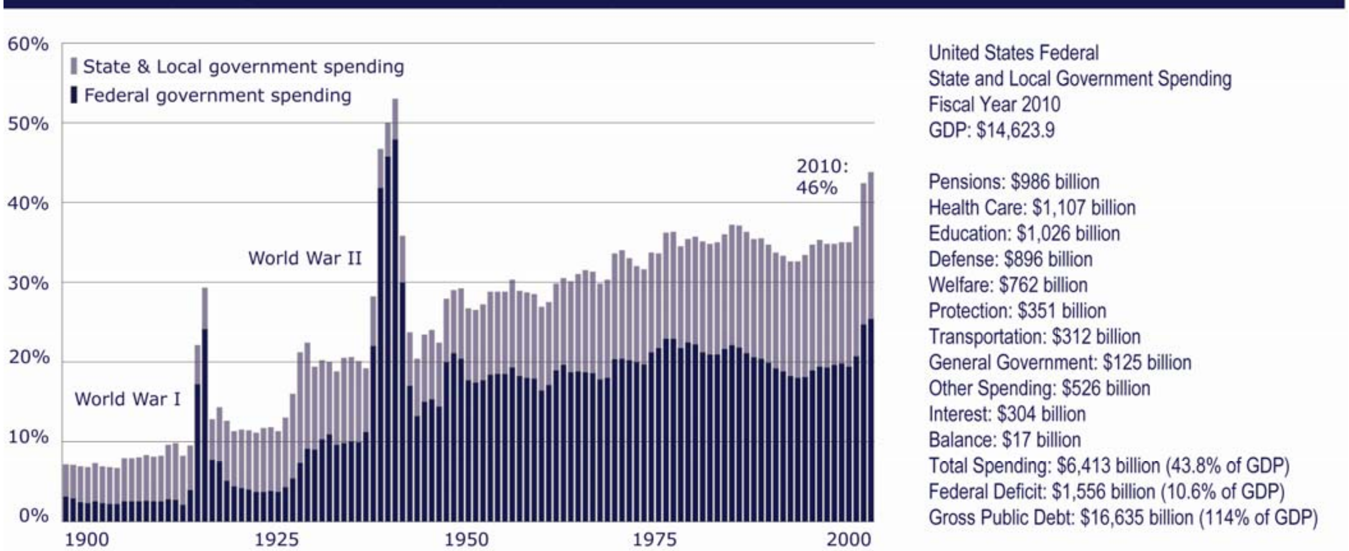
There can be no denying that government has been playing an increasingly important role relative to the overall economy. Extraordinary measures by the Federal Government to stimulate the economy have elevated Federal spending as a percent of GDP to over 25% – a peacetime record. As part of this, the Federal Government transferred approximately $500 billion to the states to sustain spending at the state levels. If we add together all spending at the Federal, State, and Local levels (net of transfers to the states), total government spending sums to $6,413, or 43.8% of 2010 estimated GDP. The Federal deficit sums to $1.56 Trillion, or 10.6% of 2010 GDP, and Gross Public Debt sums to $16.6 Trillion, or 114% of GDP.

As stimulus was spent into the economy, production rose. In the fourth quarter of 2008, real GDP fell at an annualized -6.8% rate. A year later, as stimulus was spent into the economy, the growth rate accelerated to +5%. However, now that stimulus is waning, the growth rate has again slipped to just 1.6% in the second quarter of this year. This low rate of growth suggests that the spending may have failed to create a multiplier effect to generate sustained strong growth.

From an investment point of view, government spending can be tradeoffs between short-term business cycle effects versus longer-term crowding out effects and tax burdens. Government actions can also affect the speed at which markets *clear*. In the current situation, where government has expanded its role in markets, the pace at which market excesses will clear away slows.

Nonetheless, there appears to be a direct correlation between short-run GDP growth and government spending. The longer-lasting effects of intervention depend upon policy choices that lie in front of us, and the way in which emergency response measures to the financial crisis are withdrawn.

Government Spending At Peacetime Record (% of GDP)



Source: Office of Management and Budget, Census Bureau, www.governmentspending.com

Home Price Trends Better, But Supply Remains a Concern

The deflating of the housing bubble has been a primary catalyst for the financial crisis, and the recession. We must remember that the 2000-2006 boom in housing speculation, coupled with a doubling of mortgage debt over that period, was unsustainable. In that boom, the price of the average home increased by 123%, based on the change in the 10-City S&P Case/Shiller Home Price Index (see chart on next page).

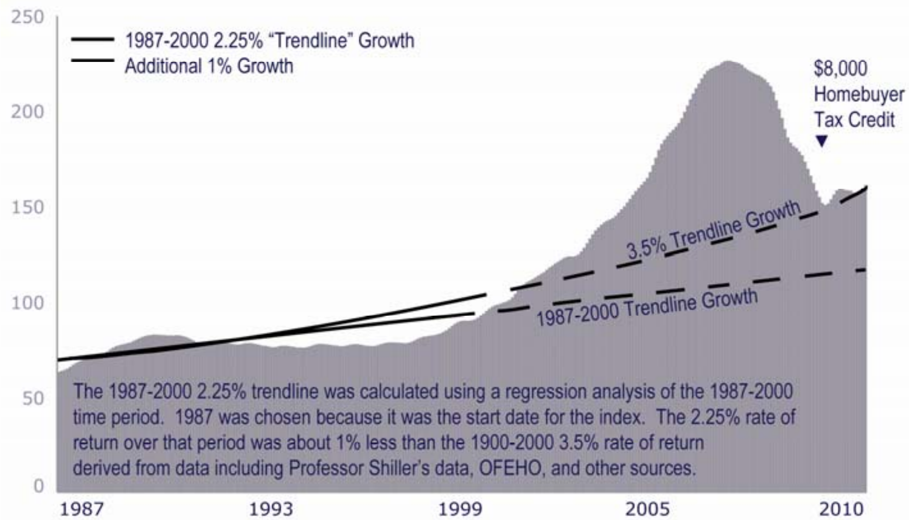
Much of the credit expansion that occurred within the financial system was linked to the housing boom and the historic rise in mortgage borrowing. Home mortgage debt rose from $4.4 Trillion at the start of 2000 to $10.6 Trillion when it peaked in early 2008, according to Federal Reserve data. This large, 140% increase in debt caused the ratio of debt to disposable income to rise sharply, to 1.4X from 0.7X at the start of the millennium. During the boom, as asset prices rose and home equity values expanded, household perceptions of wealth seemed to increase, allowing households to forego savings. As the housing bubble has become unwound, and incomes have grown more slowly, the burden of debt has prompted individuals to replenish assets through increased savings. Additionally, owner equity in real estate has fallen to 38% from 60% since the housing market's peak in 2006.

While it is difficult to accurately predict home prices, we can measure the variation of the S&P/Case Shiller Home Price Index compared to trends (see chart, next page). To do this, we took the period prior to 2000, which began the housing boom, going back to when the index begins in 1987. From that data, we drew a trend line based upon a regression of the data. That trend line was positively sloped, and measured approximately a 2.25% annual gain. If that trend were to be extended forward, the index should be approximately 27% lower than where it is today. However, we have also studied data available from Professor Shiller's web site (www.irrationalexuberance.com). His historical data combines his research with that of others to drive a long-horizon time series of home prices dating back more than a century. We studied this data and measured an average long-term annualized growth of 3.5% per year. If we were to apply a 3.5% rate of appreciation to the S&P Case/Shiller 10-City Index beginning at its inception in 1987 and created another trend line through today based upon a 3.5% growth rate, then U.S. home prices appear to have returned to trend.

Indeed, the upward track for home prices since early 2009 has also coincided with an $8,000 tax credit for homebuyers. Therefore, it is difficult to ascertain whether the improvement in the index is based upon home prices finding a bottom relative to trend or whether they have experienced a temporary upward adjustment due to the tax credit.

Lastly, we have noticed some rise in unsold supply in new and existing homes through July, which is in excess of the 5-10% "normal" seasonal increase that would not be at all worrisome (see chart, next page). However, this rise occurring (especially in the wake of the tax credit) is worthy of our attention. Given still lack mortgage demand, we remain less than confident that the U.S. real estate market has reached price stability based on supply / demand conditions.

S&P 10-City Case/Shiller Home Price Index

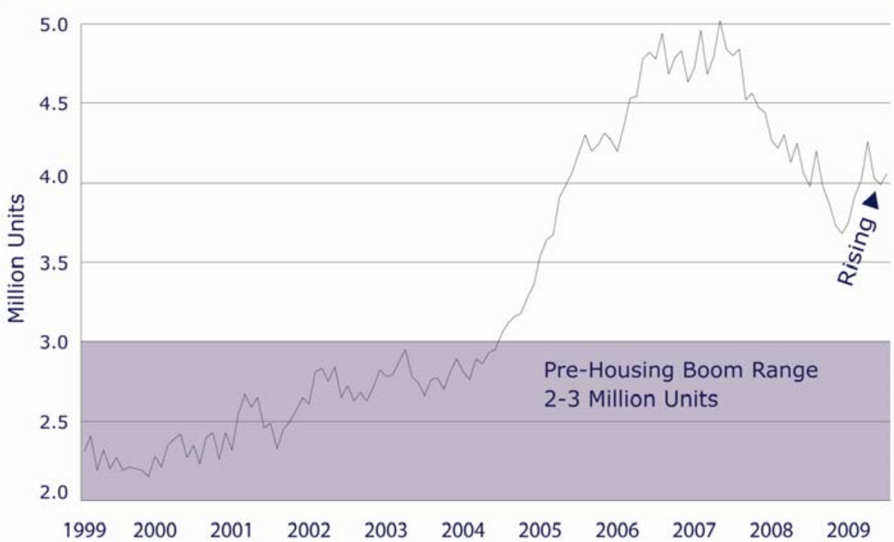


Source: Standard & Poor's, www.irationalexuberance.com, WCA

Have home prices returned to trend, or has the $8,000 tax credit provided a temporary boost?

The 10-City S&P Case/Shiller Home Price Index rose along a trendline 2.25% growth rate from the late 1980s through 2000. The growth rate then accelerated to 16% per year from 2000-2006 (123% total rise) during the housing boom. The index remains 27% above the 1987-2000 trendline and is tracking a 3.5% trend, which is consistent with long-term nominal growth rates based on data from researchers, including Prof. Robert Shiller.

Supply of Unsold Homes Rising Again (Seasonally Adjusted)



Source: NAR, NAHB, WCA

We saw progress toward reducing the supply of unsold homes in 2007, 2008, and 2009.

Unfortunately, the trend reversed this year despite homebuyer tax credit incentives earlier in the year.

Rising supply suggests heightened risk of further price weakness.

Portfolio Posture

So you can see that while there are many cross-currents in the current environment, there is a process of reparation unfolding in the economy. It may not be proceeding at the same pace as past recoveries for a variety of reasons. However, markets are responding to forces of supply and demand, which in turn, is pulling the broader economy through a much needed, albeit painful, process of clearing away excesses.

Over the past year, we have seen an improvement in the overall set of data that we monitor with regard to credit, the U.S. economy, and foreign markets. The overwhelming majority of that data (near 90%) had been clearly improving throughout the second half of 2009 through the first quarter of 2010.

Beginning in the second quarter, however, that trend across the wide swath of data had begun to slip. Currently we see less than 50% of the data observations registering positive momentum. Accordingly, we have lowered the equity exposure and risk characteristics of our tactical models to levels more appropriate for the evolving climate.

In our balanced model portfolio, for example, equity exposure has been reduced to 46% of portfolio value (in a range of 25-75%, with a 50% "neutral" midpoint). This adjustment squares with a decline in our WCA Composite Conditions Index™ to a current reading of 41 from a peak reading of 89 in November of last year.

This process of purging away excess and clearing markets is a positive step toward recovery despite the sometimes painfully slow movement. While we see several positives emerging from this process, we remain mindful of the fact that imbalances have not yet been fully cleared away and that volatility is far from vanquished. That said, we remain committed to a measured, patient, and unemotional approach to investing diversified and tactical portfolios.

To view the most recent tactical model portfolio allocations, please visit:

http://www.washingtoncrossingadvisors.com/investor/conquest.html

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The WCA Diffusion Indices™ are designed to help interpret a broad array of data. In general, the index is a measure of the percentage inputs that are moving in a positive direction. The WCA Credit and Capital Market Conditions Index™, WCA U.S. Economic Conditions Index™, and WCA Foreign Conditions Index™ each focus on a particular category of data. The WCA Composite Conditions Index™ is the average of the WCA Credit and Capital Market Conditions Index™, the WCA U.S. Economic Conditions Index™, and the WCA Foreign Conditions Index™. In general, levels above 50 suggest potential economic expansion, which typically benefits equity investors. Levels below 50 suggest potential business cycle contraction that typically tends to favor defensive assets like Treasury Bonds, Bills, and Cash.

There are special considerations associated with **international** investing, including the risk of currency fluctuations and political and economic events. Investing in **emerging markets** may involve greater risk and volatility than investing in more developed countries. Due to their narrow focus, **sector-based investments** typically exhibit greater volatility. **Small company stocks** are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies. Property values can fall due to environmental, economic, or other reasons, and changes in interest rates can negatively impact the performance of **real estate companies**. When investing in **bonds**, it is important to note that as interest rates rise, bond prices will fall. **High-yield bonds** have greater credit risk than higher quality bonds. The risk of loss in trading **commodities** and futures can be substantial. You should therefore carefully consider whether such trading is suitable for you in light of your financial condition. The high degree of leverage that is often obtainable in commodity trading can work against you as well as for you. The use of leverage can lead to large losses as well as gains.