WASHINGTON CROSSING ADVISORS

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Europe: After the Honeymoon

Highlights:

- ✓ *Credit markets on hold awaiting Europe outcome*
- ✓ *Fundamental U.S. data holding up well*
- ✓ *WCA Fundamental Conditions Index™ at 30 (chart, page 3)*

The Cost of Union

Europe has less debt and a smaller deficit than the United States, yet the market is far more concerned whether Europe has the will to repay its debts than the United States. Why? Questions about the European commitment to its own union offer a potential explanation. A union, like a marriage, is the joining together of one or more entities, usually for the benefit of both parties. With any union, there will typically be costs as well as benefits.

Originally, the benefits conveyed to European Union members included freer trade, a more consistent set of laws, and a greater sense of social cohesion among member states. Those benefits came first for Europe, and now the cost of unification in the form of debt, and the loss of some sovereign independence, is coming second. Europe's "honeymoon" phase is over, and the real work of union-building has begun.

Testing the Level of Commitment

At some point in the process, one group or another is going to have to write a check they do not want to write, and another group is going to have to accede to demands that they, too, do not want. The ongoing "benefits" from the European Union will still accrue, but will be largely taken for granted. Again, it is not the ability of Europe as a whole to pay its debts which has created the unrest, but the unwillingness of the union to accept the costs involved with its own voluntary choices.

Investors, meanwhile, are left to sort out the driblets of information coming from the European Commission, the European Central Bank, or the International Monetary Fund. A collection of partially formed plans has been circulated, revised, left for dead, and resurrected, which has frustrated the rest of the globe's efforts at recovery. This week there is, again, speculation that some form of progress may be reached prior to a meeting of European Finance Ministers, and in anticipation of an upcoming meeting of the European Central Bank. Perhaps this round of meetings will prove successful, but as was the case in Aesop's Fable "The Boy Who Cried Wolf," Europe must be aware that credibility is being lost with each successive failed attempt at resolution.

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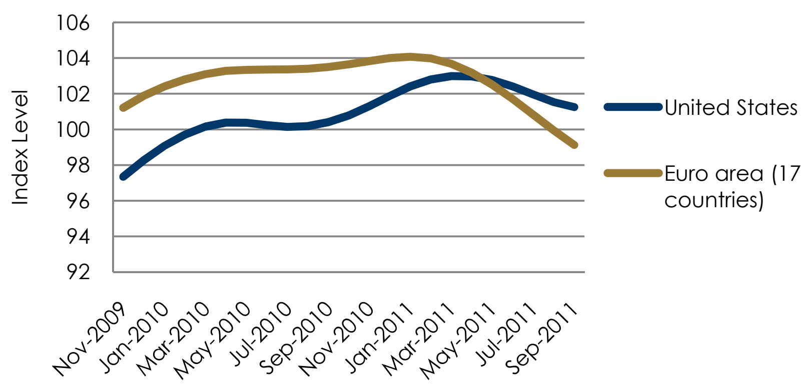
The Cost of Uncertainty

It is not in Europe's best interest to allow the debt crisis to linger longer than necessary. The economy suffers as long as uncertainty remains. Neither Greece nor Germany, nor politician nor worker benefits from this uncertainty. Banks, in particular, are incentivized to accommodate a solution. The graph below depicts a general measure of manufacturing activity across Europe. Notice how activity trails off beginning in late spring as renewed concerns about sovereign finances re-emerged.

Europe's Financial Crisis Weighs on the European Economy - OECD Purchasing Manager's Index



The United States Economy as Leader

Here in the United States, where the stock of savings is being rebuilt, there has been some reason for optimism in recent months. That optimism stems from the relative stability that can be seen in our own economic data, which has held relatively firm in important areas. Automobile sales remain positive at 13.2 million units sold at an annualized rate in October (was below 10 million in 2009); retail sales are positive (3.7% year-over-year growth in chain store sales in October and 6% increase in "Black Friday" sales); manufacturing orders increased faster than inventories in October (by a ratio of orders-to-inventories of 1.1 to 1); and most employment data held relatively steady despite a volatile market backdrop for most of the past six months. These figures are not robust. They are, however, reasonably steady in the face of a difficult environment.

Market-based indicators of risk appetite are somewhat more stressed. Yields on Italian debt remain near 7% peak levels (were below 5% earlier this year). Spain and France's bond yields are also near highs (6.5% and 3.4%, respectively). Bank funding spreads are also elevated (near 1% compared to 0.25% earlier this year based on the Eurobor-OIS 3-month spread). Corporate bond spreads are near 2.20% over Treasuries compared to 1.5% earlier this year (based on the Moody's Baa – 10-year Treasury spread).

Taken together, these facts seem to point to a "holding pattern" that leaves us committed to a cautious and balanced approach in portfolios for now.

Fundamental Conditions

Our readers know that we base our investment posture on changes in fundamental conditions. Over 30 different indicators are evaluated to determine the underlying trends in each series. Improving trends that support a growing economy and risk taking will lead to a higher tactical weighting in stocks, while deteriorating trends will lead to a higher tactical weighting in bonds. Using a consistently applied and quantitative approach is important for maintaining an unbiased approach to investing.

Beginning last spring, the data stopped moving higher and began to drift lower, which led us to reduce equity holdings and increase bond holdings in portfolios. We see that the index is now declining less rapidly. Some combination of factors, including continued rebuilding of savings, pent up demand for goods and services, and historically low interest rates, are all potential positives that could contribute to improvement in a good-case scenario in 2012.

We are not yet at the turning point, however. Therefore, we remain somewhat cautious in our asset allocation at this time.

Fundamental Conditions Index™ Detail

WCA Credit Conditions Index™ is at 20

WCA U.S. Economic Conditions Index™ is at 45

WCA Foreign Conditions Index™ is at 30

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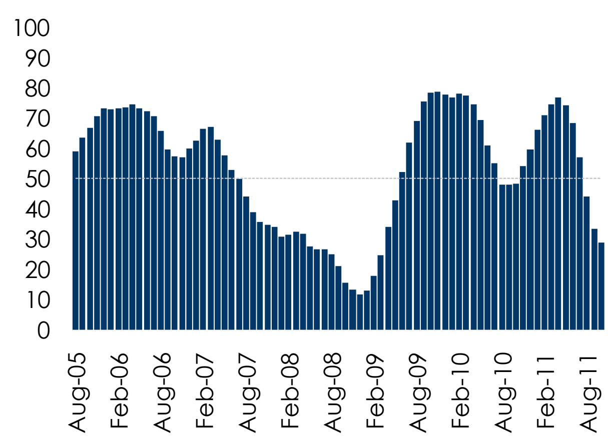
WCA Fundamental Conditions Index™ is at 30

Fundamental Conditions Index™



Index Definitions

Barclays U.S. Government Inflation-Linked Bond Index measures the performance of the U.S. Treasury Inflation-Protected Securities ("TIPS") market. Used as a proxy for "inflation-protected bonds."

Bloomberg/EFFAS Bond Indices U.S. Government 1-3 Year Total Return Index is a transparent benchmark for government bond markets. Indices are grouped by country and maturity sectors. Bloomberg computes daily returns and index characteristics for each sector. Used as a proxy for "short-term Treasuries."

Bloomberg/EFFAS Bond U.S. Government 10+Year Total Return Index is a transparent benchmark for the total return of the 10+ year U.S. Government bond market. Used as a proxy for "long-term Treasuries."

FINRA-Bloomberg Active Investment Grade U.S. Corporate Bond Index and FINRA-Bloomberg Active High Yield U.S. Corporate Bond Index are comprised of the most frequently traded investment-grade and high yield U.S. corporate fixed coupon bonds represented by the Financial Industry Regulatory Authority (FINRA) transaction reporting facility. Used as proxy for "high-yield bonds."

FTSE NAREIT Equity REIT Total Return Index is a total return performance index of all equity REITs tracked by NARIET. Used as a proxy for REITs.

MSCI EAFE International Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets excluding the U.S. and Canada. As of June 2007, the MSCI EAFE Index consisted of 21 developed market country indices. Used as a proxy for "developed foreign."

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. Used as a proxy for "emerging markets."

Russell 1000 Index measures the performance of the 1,000 largest companies in the Russell 3000 index. The Russell 3000 Index measures the performance of the 3,000 largest US Companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market. Used as proxy for domestic "large cap stocks."

Russell 2000 Index measures the performance of the 2,000 smallest companies in the broader Russell 3000 index. Used as proxy for "small cap domestic stocks."

Russell 3000 Growth Index measures the performance of those Russell 3000 Index companies with higher price-to-book ratios and higher forecasted growth values. Used as proxy for "domestic growth stocks."

Russell 3000 Value Index measures the performance of those Russell 3000 Index companies with lower price-to-book ratios. Used as proxy for "domestic value stocks."

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Asset allocation and diversification do not ensure a profit and may not protect against loss. 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.