WASHINGTON CROSSING ADVISORS

Market Commentary
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U.S. Economy Gaining Strength

Excluding Housing, Most U.S. Economic Data Improving

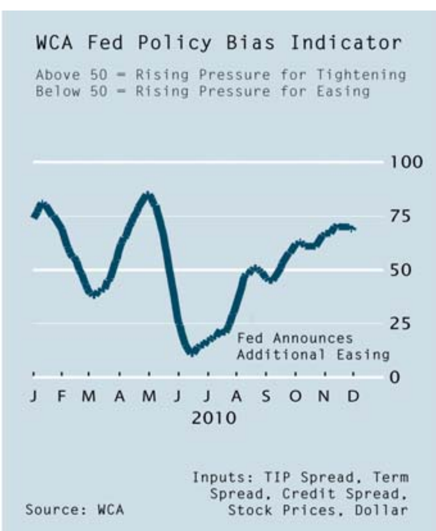
Although credit issues should remain in the headlines for some time to come, we cannot help but recognize some of the positive trends that are being picked up in our various diffusion indices. Since the end of summer, we have seen an improvement in the direction of most data relating to the U.S. employment picture. Last week, we saw a sharp drop in initial jobless claims, and the four-week average weekly job loss statistic has dropped sharply to 436,000 weekly job losses from an average statistic this year of 460,000. This improvement is confirmed by yesterday's ADP employment survey, which registered a 93,000 net gain in payrolls from companies included in their survey (consensus was for 70,000). Perhaps most important is that private sector (non-government) jobs continue to rise month to month and have risen to just over 108 million employed persons (was as high as 116 in early 2008, and as low as 107 million early this year).

Beyond employment, we also see that manufacturing continues to expand. Both the Institute for Supply Management and the Chicago Purchasing Managers' reports indicate ongoing expansion in manufacturing. The expansion is not limited to the United States. China's manufacturing sector, for example, is also posting gains based on various purchasing managers' indices, including one compiled by China's Logistics Federation and another compiled by HSBC Holdings, Plc.

The Federal Reserve's Beige Book, released today, indicated that there have been increases in activity across most districts from the lull in activity seen over the summer.

QEII Is Working For Now

It was that lull, you may recall, that prompted the Fed to move forward with a second round of asset purchases that have come to be known as *Quantitative Easing II,* or simply *QEII.* Our own index for measuring various pressures on the Fed to ease or tighten policy has rebounded from last summer's weakness, which is exactly what the Fed was looking to accomplish. Specifically, recent changes in inflation expectations, the slope of the yield curve, credit spreads, stock prices, and the dollar's direction are all indicative of dissipating deflationary pressure. We choose to focus on these elements in assessing monetary policy because the Federal Open Market Committee has referenced these items in past meetings as a means for gathering market feedback on their own policies. We have simply assembled these market-based indicators into a single measure. Under more normal conditions, readings above 50 suggest a tighter policy stance is appropriate, and vice versa (see chart below).



In short, we have seen the following since the announcement of the Fed's second round of asset purchases:

1. Expected inflation priced into the bond market has bounced back to 2.22% from an August low of 1.51%;
2. The yield curve has become more positively sloped, as evidenced by the 10-year / 3-month yield spread (difference between yields) rising to 2.78% from 2.2% in August;
3. No net change in the spread between Baa rated corporate bonds and long-term Treasury bonds from August levels (the spread between the yield on Moody's Baa Index and the 10-year Treasury is near 3%, nearly the same as August). However, today's spread is higher than the 2.4% spread in April;
4. Stock prices higher (S&P 500 is 17% higher from the level when the Fed announced further asset purchases).
5. The dollar has declined by 3% (having rebounded from an initial 10% decline).

So you can see that markets are pricing in more inflation (consumer, monetary, and asset price). We see this heightened inflation expectation spread widely across a wide swath of markets. In addition, we have now had three months in which to observe market response to the Fed, along with other data on the economy. Euro-area concerns aside, the improvement in the data on jobs, manufacturing, and foreign business activity — along with what appears to be market acceptance of QEII — appears to have been sufficient to move the needle in favor of equities and increased risk-taking.

Diffusion Indices Update

These shifts have had a positive impact on our various diffusion indices. These indices are designed to take the pulse of changes in credit and capital markets ("Wall Street"), changes in the U.S. economy ("Main Street"), and foreign conditions. This week saw the first movement of our WCA Composite Conditions Index™ back above 50 since early last spring. In addition, the WCA Credit and Capital Markets Index™ and the WCA Foreign Conditions Index™ have moved back above the 50 mark.

While it may be premature to declare the beginning of a new "bull market," these changes mark a break in the general downward trend seen in most data over roughly the April through October timeframe.

A recap of current readings on our various diffusion indices are as follows:

The WCA Credit and Capital Markets Index™ increased to 57 from 44 on September 30.

The WCA U.S. Economic Conditions Index™ remains at 70 (was also 70 on September 30).

The WCA Foreign Conditions Index™ increased to 50 from 25 on September 30.

The WCA Composite Conditions Index™ increased to 59 from 46 on September 30.

In addition, the downtrend in the composite data (which we estimate began in January) reversed in recent weeks and has been broken. We see the current overall trend in the data to be neutral-to-higher at this time.

Addition of Emerging Markets

Given the aforementioned improvements in the data discussed above, we have deployed cash into emerging market equities.

Presently, emerging markets appear to be outperforming developed markets, commodity prices appear to be strong, and valuations appear reasonable relative to the S&P 500 companies based on trailing price-earnings ratios (emerging: 16.1x vs. S&P 500: 16.7x) and current dividend yields (emerging: 2.3% vs. S&P 500: 1.9%). Importantly, we continue to see growth in the underlying emerging market economies that exceeds that of the United States. China, Brazil, and India are all growing GDP in excess of 8% on a year-over-year basis. These countries have an average fiscal deficits to GDP ratio of less than 3.5%, compared to the United States' deficit ratio of nearly 9%. The average jobless rate for these countries is also about half that of the United States.

Emerging markets now account for 25% of world market capitalization, are experiencing higher rates of inflation than the developed world, and are highly sensitive to commodity markets. Credit markets have generally recognized relative improvement in emerging market countries' sovereign credit quality.

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