Washington Crossing Advisors

Market Commentary

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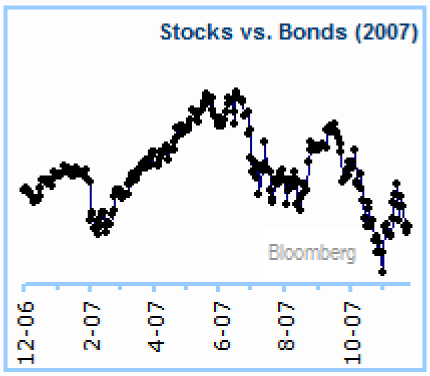
2008 Outlook

We start the new-year with a guarded view of financial markets. Specifically, we expect the past year's volatility to spill into 2008 and cause financial markets to remain volatile as they adjust further to a weak economy. The economy continues to struggle against a housing recession that could last for several years; consumer indebtedness that has reached a record 130% of disposable income (was 90% pre-2000); and ongoing credit issues which should continue to manifest itself in a variety of ways for some time to come. We also think today's profit and growth expectations are too high and are likely to be cut with business' response to falling profits remaining the critical "swing issue" for 2008. As this all unfolds, we expect risk aversion to remain high and traders to be short-sighted and intolerant of negative surprises. Until adjustments are made and fundamentals once again begin to show positive momentum, equity markets may find it difficult to sustain rallies.



2008 could also be a year that refreshes investor appetites and becomes the staging ground for a renewed equity bull market. We note that most of the recent excesses in investing (i.e. real estate, emerging markets, credit markets, and commodities) have occurred away from the mainstay U.S. equity markets. The S&P 500 is essentially at the same level it was at the start of the millennium, and large-capitalization stocks have returned little more than 2% above the long-term Treasury bonds over the last twenty years (that same number was close to 6% when Alan Greenspan made his infamous statement about "irrational exuberance" ten years ago). Now, with the S&P 500 trading closer to its underlying earnings potential, we can begin to envision a bullish case emerging once we navigate through the choppy waters that we see immediately before us.

Stocks vs. Bonds

The equity markets, measured by the S&P 500, have advanced for each of the past five years. This stretch of uninterrupted gains was accompanied by a long stretch of rising quarterly profit growth. This growth ended in the third quarter of 2007. We also saw an end to growth in non-financial, economy-wide profits in the second quarter of 2007, according to data found in the National Income and Product Accounts. This also was the quarter that equities began to lag in performance compared to long-term Treasury bonds (see chart). Despite the data and the markets' reaction, most analysts expect earnings growth to rebound sharply in the second half of 2008 and produce another year of double-digit growth. We believe that peak profit margins, trough tax rates, rising credit costs and slower domestic volume growth might make it more difficult for companies to generate earnings growth much above 5-10% for the year, net of dollar translation effects.

Equity & Yield Forecast 2008

	2007E	2008E
S&P 500	1,430	1,588
10-Year Treasury Yield	4.3%	4.5%
3-Month Treasury Bill Yield	3.0%	3.0%
Fed Funds Target Rate	4.3%	3.5%

Pulling it all together, we see the potential for a recovery in equity prices following some initial volatility early in the year with a 5-10% rate of return on major market indices from current levels. Our initial "fair value" estimate for the S&P 500 at year-end 2008 is in the range of 1,550 to 1,625 with a midpoint target of 1,588.

Further drops in the Federal Funds Target Rate are likely, and longer-term yields are likely to be stuck near current levels so long as core inflation on personal consumption remains in the range of 1-2%, excluding food and fuel, and below 3% overall.

Economy in '08

The economy decelerated in 2007 as the unemployment rate rose to 4.7% from 4.4% in 2006 led by a deceleration in private sector job creation. Year-over-year, private sector job growth has slowed to a "stall speed" growth rate of 1%. While employees of the government certainly count in the economy, the hiring trends in the private sector tell us more about the forward view on the economy as businesses expand and contract hiring plans. We continue to see layoffs in the Financial and Construction industries, which threaten to jeopardize overall private sector job expansion in 2008, and therefore, we expect the unemployment rate to rise to above 5% during the year.

Economic Forecast 2008

	Real GDP (Bil$)			Change %	
	2006A	2007E	2008E	2007E	2008E
Consumption	8,044	8,278	8,402	2.9%	1.5%
Investment					
Non-Residential	1,306	1,364	1,432	4.4%	5.0%
Residential	569	475	380	-17%	-20%
Government	1,981	2,020	2,081	2.0%	3.0%
Net Exports	-624	-524	-498	-16%	-5%
Real GDP	11,276	11,613	11,797	3.0%	1.6%
Inflation				2.6%	3.0%
Nominal GDP				5.6%	4.6%
Unemployment Rate				4.7%	5.5%

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With further slippage in job creation likely, we envision an economy which starts out with negative-to-slightly positive real growth in the first half of the year accelerating to a low single-digit growth rate later in the year. We note that slippage in demand in the United States has had the effect of depressing the dollar throughout 2007. Taken together, the lower demand for imports coupled with currency driven exports, has served as an "automatic stabilizer" for domestic production as calculated by the Bureau of Economic Analysis. With the dollar already off significantly from its highs and other banks such as the Canadian, Australian, and British central banks have already taken action to lower rates in response to what they see as slowing growth, we expect to see narrowing trade deficits to contribute less to GDP growth next year while trends in consumption and investment remain soft.

2008 Recommended Sector Allocation

Our recommended sector allocation continues to emphasize those sectors that are consistent generators of earnings or exhibit a strong long-run secular growth dynamic. The sectors are concentrated more heavily in those groups whose earnings are less leveraged to changes in global economic growth rates.

Conclusion

We begin 2008 with a guarded outlook and lingering concerns about credit, real estate, and the consumer. The largest potential "swing factor" for the year should be business' response to the changing environment. We continue to monitor the relative performance between stocks and bonds, private sector employment, and profits to identify a potential entry point for signals as to what comes next for the economy.

However, as we navigate these volatile markets, we expect to find opportunities. We still perceive value in large-capitalization equities and sectors that demonstrate consistent growth in earnings. Our year-end target for the S&P 500 is 1,588, and our year-end target for long-term Treasury bond yields is 4.5% with a 3.5% Fed Funds Rate.

Recommended Asset Allocation

	Growth	Balanced	Conservative
INCOME & DEFENSIVE	25%	50%	75%
Bonds & Cash Equivalents	23%	45%	68%
Money Market Fund	1%	2%	3%
Short-Term Treasuries	5%	10%	15%
Intermediate-Term Treasuries	3%	5%	8%
Long-Term Treasuries	2%	4%	6%
Inflation-Protected Treasuries	3%	5%	8%
Investment-Grade Corp Bonds	8%	16%	24%
High-Yield Corporate Bonds	2%	3%	5%
GOLD	3%	5%	8%
EQUITIES & GROWTH	75%	50%	25%
U.S. Equities	54%	36%	18%
Large-Cap Growth	27%	18%	9%
Large-Cap Value	12%	8%	4%
Mid-Cap Growth	9%	6%	3%
Mid-Cap Value	6%	4%	2%
Foreign Equities	21%	14%	7%
Brazil	5%	3%	2%
Germany	3%	2%	1%
South Korea	3%	2%	1%
EAFE Growth	11%	7%	4%
TOTAL PORTFOLIO	100%	100%	100%

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