



## Market Commentary

March 10, 2008

Joseph V. Battipaglia  
Market Strategist

Kevin R. Caron  
Portfolio Manager

Chad A. Morganlander  
Portfolio Manager

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## Investing During Recession

The economy has lost private sector jobs for three straight months, credit markets continue to worsen, and confidence levels for businesses and consumers alike have plummeted. Corporate profit growth has been declining, especially for banks, where write-offs are impacting book value and impinging upon the ability of financial institutions to extend credit.

This is not an environment that is conducive to growth. We now believe that the economy has entered into a recession that began in the fourth quarter of last year. This, however, should not come as much of a surprise to those who follow economic cycles. Martin Feldstein, the head of the National Bureau of Economic Analysis, has patiently deflected direct questions about recession with probabilistic answers. However, we now see that there is a significant decline in economic activity that has spread beyond homebuilders – notably to banks, automobile manufacturers, and retailers.

The Federal Reserve, despite their best intentions to create an environment that stimulates credit creation, has not been successful. Since the first Fed Funds rate cut last September, the Dow has lost an additional 12%; bonds have advanced 7%; gold has advanced another 35%; home prices have slipped 7%; and the dollar has declined 7%. The banks have become less willing and able to lend as much of the economy's recently minted — and poorly collateralized — debt has become too much for financial institutions to hold on their balance sheets.

## A Debt-Induced Problem

The real issue is the amount of debt (credit) that has been taken on (extended) by banks in the last cycle for the funding of everything from mortgages to private equity deals. Based on Federal Reserve data, the ratio of debt-to-disposable income has risen to 140% of incomes from an already elevated 100% ratio seen at the end of the 1990s equity-led economic boom.

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## A Debt-Induced Problem (Continued)

Before the clamor for a “super-SIV” and government-sponsored efforts to save the housing market, there were banks and borrowers who, through a carefully orchestrated dance, created additional money (also known as “liquidity”) which primed the economic machine. There are limits, however, to how much liquidity can be absorbed by the economy the same way that there are limits to how much can be consumed at any given meal (and consequences that arise when we go overboard).

Between 2000 and 2005, new borrowing as a percent of GDP rose to 17.5% — far higher than the 9% ratio seen in the 1990s but not quite as high as the prior peak of 22% set in 1985. During these five years, total household debt increased to \$14.3 trillion from \$6.7 trillion while incomes grew to \$10.3 trillion from \$6.7 trillion. As mentioned earlier, the ratio of debt-to-income now stands at 1.4 to 1 versus 1 to 1 in just seven years.

The resulting increase in money supply that accompanied such massive credit formation has hurt the value of the dollar and propelled asset prices, notably housing, to previously unheard of levels. Now, the unwinding of the asset bubble and the re-evaluation of the creditworthiness of the borrowers is throwing the cycle in reverse.

In short, the inability and unwillingness of banks to extend loans relates directly to the fact that residential real estate prices have begun to fall and what little underlying collateral there was for newly minted mortgages is now impaired. It is currently estimated, by a Goldman Sachs economist, if home prices continue to slide by an additional 10% in 2008

that 30% of all mortgaged homeowners will have negative equity in their homes. In other words, \$3 trillion of mortgages will have a face value in excess of the underlying real estate.

As employment trends head negative, the effect will likely accelerate the foreclosure rate, force additional home price adjustments nationally (there are nearly 5 million unsold home and condominium units), and further erode banks’ capital and capacity to lend. Thus, the Federal Reserve must take action on two fronts -- address the credit market's immediate problems and cut short term rates to help the economy through recession.

The rate cuts to date, 2.25 percentage points, with additional cuts likely should help the economy later this year and into 2009. Rate cuts, while quite visible and welcomed by investors, are not solutions for the credit market squeeze which is expanding. Most credit spreads are now wider (worse) than they were when the credit crisis first hit last summer.

The Fed's plan to combat this condition is to pump another \$200 billion into short-term funding markets through a newly created term auction facility alongside traditional repurchase agreements. While such short-term facilities have been in use since last summer, this time the Fed is accepting a wider variety of collateral, including mortgages and corporate loans which are part of the credit market's problem to date. Providing liquidity for assets that have been harder to sell in the open market is a tangible relief step for bank capital. But the Fed can only do so much.

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## The Public Policy Solutions

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The emergence of these problems during a Presidential election cycle multiplies the number of proposed solutions and amplifies the sense of urgency. It is appropriate to recall, however, that wrong-headed policies can make matters worse. Attempts by bank regulators in Japan during the 1990s to sweep their banking woes under the rug backfired, and decisions made by our Federal Reserve in the 1920s and 1930s to raise interest rates while remaining tied to the gold standard further compounded the problems of that era.

Today, there are a variety of proposals to fix what ails the housing market, and ultimately, the economy. There has been talk of mortgage remediation, expansion of the government and their sponsored agencies, and now a dialogue is emerging about direct write-downs of mortgages by banks. As all of this unfolds, falling home prices does improve housing affordability and increases expected rates of return to prospective buyers of property and mortgage-related assets. In the end, the prospective rate of return to new investors must be sufficient to attract risk capital. In the coming years, however, the difficult lessons now being (re)learned will likely result in a more costly credit with greater requirements for collateral on the part of borrowers.

## Time Passing

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*“time heals all wounds...”*

The adjustment process that has led us to our current, more difficult economic times began in 2005. The cost of money began to move higher as the Federal Reserve raised interest rates, hurricane Katrina brought about destruction in

the Gulf, which fanned existing concerns about energy prices, and for the first time in many years, the national homeownership rate began to decline due to the unaffordability of homes.

Meanwhile, credit and equity markets remained oblivious to these changes and continued to price assets (especially mortgage-related assets) to levels that seemed to imply a riskless environment despite ongoing rate increases that led to an inverted yield curve — a classic warning signal for the economy.

As reality began to set in last summer, we saw markets start to reprice risk. Real estate investment trusts offered very little yield to investors prior to last July. In fact, the yield on the National Association of Real Estate Investment Trusts’ index fell far below the yield on risk-free Treasury bonds. Today, that yield is more than 2% over long-term Treasury bond yields and close to their historic average. This sort of re-pricing is healthy and creates incentive for new capital to enter markets.

This is not to suggest that markets have completed this process. One meaningful measure of overall market expectations is the relative performance between stocks and bonds. Here, we see equities (measured broadly by the Russell 3000 Index) down 25% over eight months. While that performance is about average for a bond-led cycle, it is less severe than a bond-led cycle that coincides with recession. The average bond-led cycle during those periods is closer to 1.5 years and a 35% underperformance by stocks (outperformance by bonds). Thus, with recession looking increasingly like reality, we would expect that equity markets will likely correct for an additional period of time.

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## Trends to Watch

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The four key items to watch in order to gauge where we are in the economy have been and remain:

- Trends in Household Demand for credit;
- Trends in Private Sector employment;
- Trends in corporate behavior vis-à-vis capital expenditures and hiring plans in response to uncertainty and declining profit growth;
- Rate of drawdown of excess supply of real estate still for sale.

Unfortunately, we are unable to convincingly say that any of these four trends have improved. Each category continues to show accelerating deterioration at this time, with household credit expanding at just 5% in the last quarter of '07, with corporate hiring and capital spending flat-to-down according to the Federal Reserve's recently released Flow of Funds Survey, and last week's negative employment report for February and the recent data from the National Association of Realtors on housing supply.

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## How Much Longer and Farther to Go?

While the ultimate outcome is anyone's guess, history has shown that bonds tend to outperform stocks headed into recessions. The table to the right looks at past recessions; the length of the recession; and the performance of stocks compared to bonds headed into recovery.

If we assume that a recession began late last year and will last for a median length of time (about 8-13 months historically, see table) we might conclude that an ordinary recession would take us through most of the year this year with some hope for recovery in the later part of the year or in the first part of 2009. Since markets also tend to anticipate recovery about 3-9 months prior to the start of recovery, would expect to see some change in market leadership, from bonds to stocks in the second or third quarter of the year. If we do not see such a change in leadership the market's message would obviously be more ominous as it relates to the economy in 2009.

Our tactical asset allocation recommendations continue to offer a highly conservative profile for the current market. In light of the ongoing issues confronting markets and the economy, we continue to emphasize large over small capitalization stocks, growth over value, and consistent sectors such as staples, healthcare, and utilities (including telecommunications). Outside of the domestic equity component, we maintain a diversified portfolio of bonds, foreign equities, and a modest exposure to gold as a hedge against potential future erosion of dollar-based assets.

### LENGTH OF PAST RECESSIONS:

(Months of Recession from Peak to Trough)

Start of Recovery		
November 1927 (IV)		13
March 1933 (I)		43
June 1938 (II)		13
October 1945 (IV)		8
October 1949 (IV)		11
May 1954 (II)		10
April 1958 (II)		8
February 1961 (I)		10
November 1970 (IV)		11
March 1975 (I)		16
July 1980 (III)		6
November 1982 (IV)		16
March 1991 (I)		8
November 2001 (IV)		8
	=====	=====
Median:		11 Mo.
Quartile Range:		8-13 Mo.

### MARKETS ANTICIPATE RECOVERY:

(#Months Stocks Start To Outpace Bonds Before Recovery)

Start of Recovery		
November 1927 (IV)		19 Mo.
March 1933 (I)		9 Mo.
June 1938 (II)		3 Mo.
October 1945 (IV)		23 Mo.
October 1949 (IV)		4 Mo.
May 1954 (II)		8 Mo.
April 1958 (II)		4 Mo.
February 1961 (I)		5 Mo.
November 1970 (IV)		5 Mo.
March 1975 (I)		3 Mo.
July 1980 (III)		20 Mo.
November 1982 (IV)		2 Mo.
March 1991 (I)		5 Mo.
November 2001 (IV)		1 Mo.
	=====	=====
Median:		5 Mo.
Quartile Range:		3-9 Mo.

\* NBER Declared Date

RECOMMENDED ASSET ALLOCATION

	CORE PORTFOLIO					SECTOR ENHANCED PORTFOLIOS			
	Aggressive	Growth	Balanced (Tax Free)	Balanced	Conservative	Aggressive	Growth	Balanced (Tax Free)	Balanced
<b>INCOME &amp; DEFENSIVE</b>	<b>1%</b>	<b>20%</b>	<b>45%</b>	<b>45%</b>	<b>70%</b>	<b>1%</b>	<b>20%</b>	<b>45%</b>	<b>45%</b>
<b>Bonds &amp; Cash Equivalents</b>	<b>1%</b>	<b>18%</b>	<b>40%</b>	<b>40%</b>	<b>62%</b>	<b>1%</b>	<b>18%</b>	<b>40%</b>	<b>40%</b>
Money Market Fund	1.0%	0.9%	2.0%	2.0%	3.1%	1.0%	0.9%	2.0%	2.0%
Short-Term Treasuries		2.2%		5.0%	7.8%		2.2%		5.0%
Intermediate Term Treasuries		2.2%		5.0%	7.8%		2.2%		5.0%
Long-Term Treasuries		1.8%		4.0%	6.2%		1.8%		4.0%
Inflation Protected Treasuries		2.2%		5.0%	7.8%		2.2%		5.0%
Investment Grade Corp Bonds		7.1%		16.0%	24.9%		7.1%		16.0%
High Yield Corporate Bonds		1.3%		3.0%	4.7%		1.3%		3.0%
Short-Term Municipals		0.0%	27.1%	0.0%	0.0%		0.0%	27.1%	0.0%
Long-Term Municipals		0.0%	10.9%	0.0%	0.0%		0.0%	10.9%	0.0%
Foreign Developed Bonds		0.0%		0.0%	0.0%		0.0%		0.0%
Foreign Emerging Bonds		0.0%		0.0%	0.0%		0.0%		0.0%
<b>PREFERRED STOCK</b>	<b>0.0%</b>	<b>0.0%</b>	<b>0.0%</b>	<b>0.0%</b>	<b>0.0%</b>	<b>0.0%</b>	<b>0.0%</b>	<b>0.0%</b>	<b>0.0%</b>
<b>REITs</b>	<b>0.0%</b>	<b>0.0%</b>	<b>0.0%</b>	<b>0.0%</b>	<b>0.0%</b>	<b>0.0%</b>	<b>0.0%</b>	<b>0.0%</b>	<b>0.0%</b>
<b>GOLD</b>	<b>0.0%</b>	<b>2.2%</b>	<b>5.0%</b>	<b>5.0%</b>	<b>7.8%</b>	<b>0.0%</b>	<b>2.2%</b>	<b>5.0%</b>	<b>5.0%</b>
<b>EQUITIES &amp; GROWTH</b>	<b>99%</b>	<b>80%</b>	<b>55%</b>	<b>55%</b>	<b>30%</b>	<b>99%</b>	<b>80%</b>	<b>55%</b>	<b>55%</b>
<b>U.S. Equities</b>	<b>74%</b>	<b>60%</b>	<b>41%</b>	<b>41%</b>	<b>22%</b>	<b>74%</b>	<b>60%</b>	<b>41%</b>	<b>41%</b>
Large Cap Growth	36.0%	29.1%	20.0%	20.0%	10.9%				
Large Cap Value	18.0%	14.5%	10.0%	10.0%	5.5%				
Mid Cap Growth	12.6%	10.2%	7.0%	7.0%	3.8%	12.6%	10.2%	7.0%	7.0%
Mid Cap Value	7.2%	5.8%	4.0%	4.0%	2.2%	7.2%	5.8%	4.0%	4.0%
Small Cap Growth	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Small Cap Value	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Micro Cap	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
<b>U.S. Equity Sectors</b>						<b>54%</b>	<b>44%</b>	<b>30%</b>	<b>30%</b>
Energy						3%	2%	1%	1%
Technology						9%	7%	5%	5%
Materials						2%	1%	1%	1%
Industrials						4%	3%	2%	2%
Consumer Discretionary						3%	3%	2%	2%
Health Care						13%	10%	7%	7%
Utilities						2%	1%	1%	1%
Consumer Staples						7%	6%	4%	4%
Telecommunications						4%	3%	2%	2%
Financials						8%	6%	4%	4%
<b>Foreign Equities</b>	<b>25%</b>	<b>20%</b>	<b>14%</b>	<b>14%</b>	<b>8%</b>	<b>25%</b>	<b>20%</b>	<b>14%</b>	<b>14%</b>
Brazil	5.4%	4.4%	3.0%	3.0%	1.6%	5.3%	4.3%	3.0%	3.0%
Germany	3.6%	2.9%	2.0%	2.0%	1.1%	3.5%	2.9%	2.0%	2.0%
South Korea	3.6%	2.9%	2.0%	2.0%	1.1%	3.5%	2.9%	2.0%	2.0%
Taiwan	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Mexico	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
EAFE Growth	12.6%	10.2%	7.0%	7.0%	3.8%	12.3%	10.0%	7.0%	7.0%
EAFE Value	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Emerging Markets	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Deleped Markets	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
<b>TOTAL PORTFOLIO</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

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