# QUARTERLY 2Q16

## TACTICAL ASSET ALLOCATION

- United States Leads World Growth
- Looking for Second Half Bounce
- Focus on Income and Quality
- Wider Spreads Create Opportunity
- Increased Weighting in Emerging Markets
- Liquid Alternatives for Diversification and Return Potential

The economy is slowing. After growing 1.4% in the fourth quarter, estimates are below 1% for first quarter. The global economy is faring little better. The International Monetary Fund cut its 2016 global growth forecast to 3.2%. In January, this estimate stood at 3.4%. Why so slow? A steady erosion in productivity, anemic labor growth, and deleveraging all play a role. These facts, especially productivity and labor, are harder to influence through policy. Fiscal and monetary policy are simply incapable of addressing these remaining challenges head-on. The trinity of productivity, labor, and investment determine growth potential in the long run. Viewed in this light, we see better what is behind recent years' more gradual returns. Available market returns are, over time, inextricably linked to the economy after all. The economy is more global, interconnected, and slower growing than in the past. This is having a direct impact on returns.

STIFEL

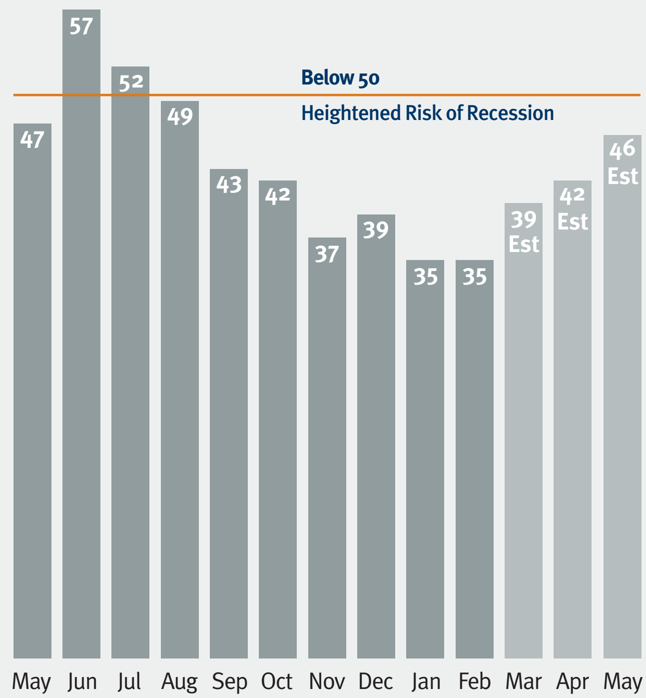
## Economy

We expect some improvement ahead after weak performance of late. Markets appear less concerned about further deterioration in China than they were in January. Commodity prices seem to be stabilizing. The U.S. dollar's rapid rise of 2014-2015 is giving way to some softening, taking pressure off emerging markets. Inventory overhang is getting worked off. These factors may help calm global growth concerns that gripped markets just a few weeks ago. Further improvement in these areas could provide a lift to growth in the months ahead, and our WCA Fundamental Conditions Index (graph, right).

Current growth is trending below expectations, however. First quarter domestic GDP growth again appears headed below 1%, and below our 2.25% baseline forecast. Fourth quarter growth was also weak, at 1.4%. Despite weak headline numbers, private payrolls are up a steady 2.25% from a year ago. This provides some support for the bull case on the economy. Demand for goods and services follow jobs and are up a respectable 2.75% versus last year. Steady job and income growth remain a central theme to the expansion, and to the pickup we envision in the months ahead.

The risk that global growth concerns return, causing a relapse in confidence, remains elevated given weak data trends (right, chart). If these trends do not improve as hoped, investment, employment, and income gains would falter, increasing downside risk further.

**WCA FUNDAMENTAL CONDITIONS BAROMETER**




We regularly assess changes in fundamental conditions to help guide near-term asset allocation decisions. Analysis incorporates approximately 30 forward-looking indicators in categories ranging from Credit and Capital Markets to U.S. Economic Conditions and Foreign Conditions. From each category of data, we create three diffusion-style sub-indices that measure the trends in the underlying data. Sustained improvement that is spread across a wide variety of observations will produce index readings above 50 (potentially favoring stocks), while readings below 50 would indicate potential deterioration (potentially favoring bonds). The WCA Fundamental Conditions Index combines the three underlying categories into a single summary measure. This measure can be thought of as a "barometer" for changes in fundamental conditions.

## Equities

Portfolios remain tilted toward bonds versus stocks on a short-term tactical basis. Within equities, we remain tilted on domestic stocks and underweight foreign versus our benchmark. We reintroduced emerging markets to portfolios in January given low valuations and higher long-run expected return potential.

Earnings growth for the first quarter appear lackluster. According to FactSet Research, earnings should decline roughly 4% year-over-year in the first quarter. This figure excludes the energy sector. Including energy, earnings will likely be down over 8%. If earnings decline, it will be the first time since 2008-2009 that earnings fell for four straight quarters. Still, analysts project a rebound to 2% full year growth for full year 2016 and 14% growth in 2017. The index trades at 16.9 times forward operating earnings, the 10-year average multiple is 14.2 times.

Buybacks and dividends remain a source of return, but future cash returns should slow. Slower cash distributions should follow slower overall growth, and an elevated ratio of distributions to total cash flow provides an additional constraint. Cash from dividends and buybacks should still constitute a high percentage of equity total return.

## Fixed Income

Treasury yields pressed lower through the third quarter as growth slowed. Falling 10-year Treasury yield caused the yield curve to flatten to 160 basis points (1.60%) above Treasury bill yields. Inflation expectations priced into the bond market for the next one and ten years remained anchored near 1.5% and 1.75%, respectively. The Fed continues to forecast short-term rates moving toward 1.5% to 2.0% later this year before eventually rising to 3.5% to 4%.

In contrast to long-term U.S. Treasuries, which returned 8% during the quarter, high-yield corporate debt returned just 2% after declining 5% in the first five weeks of the year. Corporate bond yields rose versus Treasuries as concern mounted about defaults related to soured energy investments. The spread, or difference in yield, between the Moody's Baa corporate bond index and the 10-year U.S. Treasury bond rose sharply during the first weeks of the year. As oil began to recover into March, concerns about credit losses abated. Corporate yields ended the quarter with a slightly lower spread over Treasuries than at the start of the year.

The globe remains starved for yield. $7.8 trillion of debt issued by developed world governments now yields below 0%. This is about 25% of total outstanding developed world sovereign debt. By contrast, only $3 trillion yields more than 2%, much of that amount consisting of U.S. Treasury debt.

## REITs

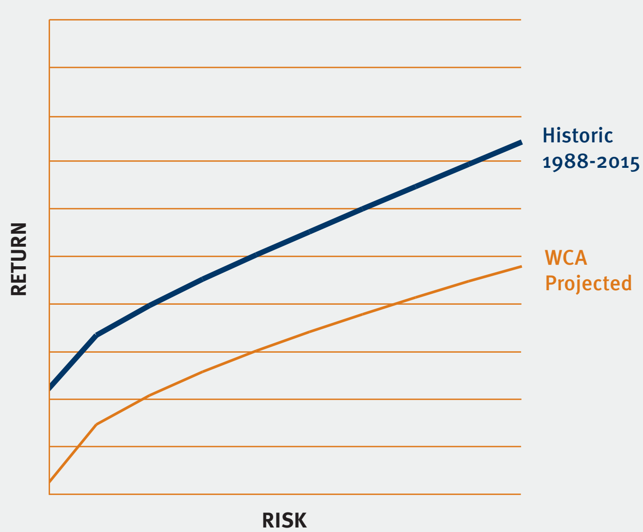
Real estate investment trusts rose as bond yields fell, and equity rallied in the back half of the quarter. The Dow Jones Real Estate Index returned 5% during the quarter versus just over 1% for the S&P 500. The yield on REITs is roughly 90 basis points (0.90%) higher than Baa corporate bond yields, in line with long-term historic averages.

## Currencies and Commodities

The most significant event during the quarter was the Fed's reversal on rates. Coming into the year, the Fed forecast a series of four rate increases in 2016. As data weakened early in the year, the Fed reassessed this position and struck a more dovish stance. The Fed saw worsening global financial conditions as adding downside risk to the economy. Slower Fed rate increases, coupled with more stimulus out of China and the European Central Bank, helped the dollar to weaken, commodities to rally, and helped tighten corporate bond spreads and other risk premia.

The dollar index fell 4% during the quarter. This allowed the dollar price of many commodities to move higher through the second half of the quarter. Gold rallied 16% during the quarter, and oil, which fell toward $30 a barrel in January, showed signs of improvement through February and March. A strong correlation between dollar movements, commodities, and global risk appetite was again seen through the first months of this year.

### EFFICIENT FRONTIER




### LONG-RUN FORECASTS

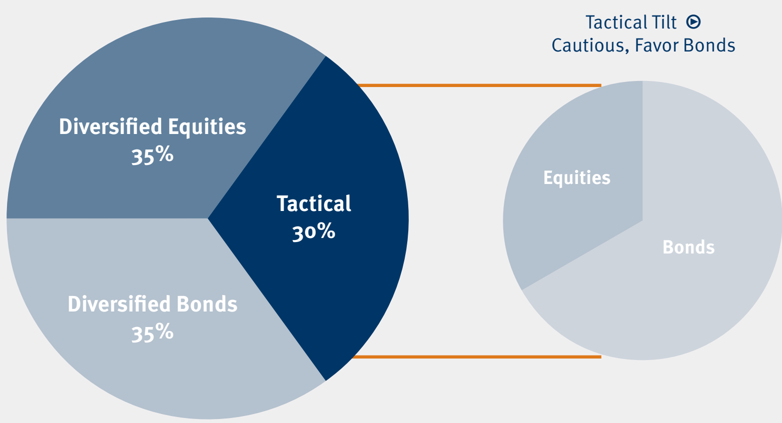
| | Long-Run Forecast Range |
|---|---|
| Real GDP Growth | 2.25% |
| Inflation | 1.75% |
| S&P 500 Margin Growth | 2.25% |
| S&P 500 Valuation Growth | 2.50% |
| S&P 500 Dividend Yield | 2.25% |
| S&P 500 Net Buyback Yield | 3.00% |
| | |
| Neutral T-Bill Rate | 2% |
| 10-Year U.S. Treasury Spread Over T-Bill | 150 basis points |
| Baa Corp Spread Over 10-Year Treasury | 180 basis points |

| Asset Names | View Return* (10–15 Years) | Volatility | Under Weight | Neutral | Over Weight |
|---|---|---|---|---|---|
| Core Bonds | 2.25% | 3.6% | | | Tactical |
| 1–3 Year Treasury | 1.75% | 1.6% | | Diversified | |
| Mortgage Bonds | 2.25% | 2.8% | | | Diversified |
| Intermediate Government/Credit | 2.50% | 3.2% | Diversified | | |
| Long-term U.S. Treasuries (20-yr) | 2.25% | 9.8% | | Diversified | |
| Investment Grade Corporate Bonds | 3.00% | 5.5% | | | Diversified |
| High Yield | 3.25% | 8.8% | | Diversified | |
| U.S. Equity | 5.75% | 15.0% | Tactical | | |
| Large Cap Growth | 5.75% | 17.0% | | | Diversified Equities |
| Large Cap Value | 6.00% | 14.7% | | Diversified Equities | |
| Small Cap | 5.75% | 19.3% | Diversified Equities | | |
| Foreign Developed | 5.25% | 16.9% | | Diversified Equities | |
| Foreign Emerging | 6.50% | 23.7% | | Diversified Equities | |
| REITs | 4.25% | 20.4% | Diversified Equities | | |
| Gold | 4.50% | 15.8% | | Diversified Equities | |

■ Tactical ■ Diversified Equities ■ Diversified

## Asset Allocation

Portfolios are tactically tilted toward bonds with an emphasis on core bonds, with a tilt toward high-grade corporate bonds (over high-yield). The overweight in bonds is matched by an underweight in equities and alternatives. Within equities, we are underweight developed foreign and small cap. Emerging markets went from a zero weight at the start of the year to a modest underweight allocation, based on valuation and better long-run return expectations.




### PORTFOLIO POSTURE

The portfolio is currently tilted more heavily toward bonds, given weak readings in our WCA Fundamental Conditions Index (graph prior page).

Diversified segments of the portfolio are aligned with the policy allocations outlined earlier this year. The report titled Outlook 2016 highlights our longer-run expectations as the basis for this segment of the portfolio. No changes to the diversified equity or bond segments of the portfolio were made during the last quarter.

** Combines long-run forecast with near-term observations of financial conditions. As of January 6, 2016.*
*These views are provided by Washington Crossing Advisors. Assumptions are estimates based on historic performance and an evaluation of the current market environment. These are estimates only and not intended to represent future performance. References to future expected returns and performance do not constitute a promise of performance for any asset class or investment strategy. The forecasts contained herein are for illustrative purposes only and not to be relied on as advice or interpreted as a recommendation to engage in the purchase or sale of any security or financial product. These forecasts are based upon subjective estimates and assumptions about circumstances and events that may not have taken place and may never do so. In addition, Washington Crossing used historic index returns in evaluating past return relationships. This information was gathered from third-party sources we deem reliable, but no independent verification has been undertaken. Actual returns could be higher or lower than shown herein. Opinion subject to change without notice.*



## About Washington Crossing Advisors

Washington Crossing Advisors is an investment advisory program offered through Stifel. WCA helps supervise and manage over $1 billion in discretionary assets for individuals and institutions.

The team is managed by Kevin R. Caron and Chad A. Morganlander, who were among the first founding members of Washington Crossing Advisors.

Washington Crossing Advisors' views on investing and markets are regularly sought by national media outlets, including *CNBC*, *Bloomberg*, *Fox Business News*, *The Wall Street Journal*, *Forbes*, and *Reuters*.

## Philosophy and Process

We believe that investments should be selected only after clear and quantified measures of value, risk, and potential reward have been made. Our investment approach combines top-down analysis of the macro economy with fundamentally rooted, bottom-up security analysis.

## Description of Indices and Terms

*All performance calculations of indices are calculated on a total return basis (reflecting reinvestment of dividends and other earnings). Indices are unmanaged, are not available for direct investment, and have no associated management fees.*

*Barclays Aggregate Bond Index: A composite of the Barclays Gov't/Corp Index, Mortgage-Backed Securities Index, and Asset-Backed Securities Index, including securities that are investment grade or better, have at least one year to maturity, and have an outstanding par value of at least $100 million.*

*S&P 500 Index: Capitalization-weighted composite of 500 stocks traded on the NYSE, AMEX, and NASDAQ; not the largest 500 stocks in U.S., but rather a blend of leading companies in leading industries in the U.S. economy; index comprised of 10 broad industrial sectors.*

*Dow Jones U.S. Select REIT: The Dow Jones U.S. Select REIT Index intends to measure the performance of publicly traded REITs and REIT-like securities. The index is a subset of the Dow Jones U.S. Select Real Estate Securities Index (RESI), which represents equity real estate investment trusts (REITs) and real estate operating companies (REOCs) traded in the U.S.*

*GSCI Commodity Index: The S&P GSCI indices are designed to be a "tradable" index, providing investors with a reliable and publicly available benchmark for investment performance in the commodity markets. The index comprises the principal physical commodities that are traded in active, liquid futures markets. The S&P GSCI Precious Metals and Industrial Metals indices are subcomponent indices of the broader GSCI Commodity Index.*

*Barclays U.S. Corporate High Yield: The Barclays U.S. Corporate High Yield Bond Index measures the U.S. dollar-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded. The U.S. Corporate High Yield Index is a component of the U.S. Universal and Global High Yield Indices.*

*HFRI Merger Arbitrage Index: Merger Arbitrage strategies which employ an investment process primarily focused on opportunities in equity and equity-related instruments of companies which are currently engaged in a corporate transaction.*

*HFRI Fund of Funds Diversified Index: Fund of Funds invest with multiple managers through funds or managed accounts. The strategy designs a diversified portfolio of managers with the objective of sig-nificantly lowering the risk (volatility) of investing with an individual manager. A manager may allocate funds to numerous managers within a single strategy, or with numerous managers in multiple strategies. The investor has the advantage of diversification among managers and styles with significantly less capital than investing with separate managers.*

*40/40/20 Alternative Mix: A static-weighted blend consisting of a 40% allocation to the S&P 500 Index, a 40% allocation to the Barclays Aggregate Bond Index, and a 20% allocation to a diversified mix of alternative assets, including REITs, commodities, high-yield bonds, merger arbitrage funds, and hedge funds.*

## Disclosures

*Alternative investment strategies may include individual securities, commodities, real estate investment trusts (REITs), and hedged investment strategies. These strategies may include the use of derivatives, the use of leverage, and/or short positions in securities. Specific asset class and securities disclosures follow.*

*Asset allocation does not ensure a profit or 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.*

*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.*

*When investing in real estate companies, property values can fall due to environmental, economic, or other reasons, and changes in interest rates can negatively impact the performance.*

*There are significant risks associated with managed futures, and they are not suitable for all investors. You could lose all or a substantial amount of your investment. Risk of loss is due to the speculative and leveraged aspects of trading, fluctuating prices, and the unpredictability of market direction. Exchange rules limiting price fluctuations and setting speculative position limits may also increase risk.*

*Investors should be aware that hedge funds often engage in leverage, short-selling, arbitrage, hedging, derivatives, and other speculative investment practices that may increase investment loss. Hedge funds can be highly illiquid, are not required to provide periodic pricing or valuation information to investors, and often charge high fees that can erode performance. Additionally, they may involve complex tax structures and delays in distributing tax information. While hedge funds may appear similar to mutual funds, they are not necessarily subject to the same regulatory requirements as mutual funds.*

*Score Disclosure: The Washington Crossing Advisors Stifel VICTORY Portfolio requires a $50,000 minimum investment. Strategies in the Stifel Score Program are proprietary products developed by Stifel. More information on the Score Program is included in the Stifel Consulting Services Disclosure Brochure and Part II of the Manager's Form ADV, which may be obtained from your Financial Advisor and which further outlines the fees, services, exclusions, and disclosures associated with this program. The information contained herein is believed to be reliable and representative of the portfolios available through Stifel; however, the accuracy of this information cannot be guaranteed. Investors should consider all terms and conditions before deciding whether the Score Program is appropriate for their needs.*

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