

# QUARTERLY<sub>3Q16</sub>

## TACTICAL ASSET ALLOCATION



- Near-Term Domestic Growth Looking Better
- Bond Yields Hitting Record Lows
- Tactical Bond Exposure Reduced
- Corporate Bonds Attractive vs. Treasuries
- Precious Metals Retain Luster

**T**he first half of the year saw a turnaround in several indicators we watch. While bonds managed to outperform stocks in the first half, signs of improvement in the domestic economy are emerging. Our read of recent trends in the data gives us a basis for optimism on near-term growth. Overseas prospects are still fading, and growth rates are still coming down. Britain's "exit" referendum poses challenges to Europe at a time when growth is already weak, for example. Our WCA Fundamental Conditions Barometer remains below 50, but is showing signs of improvement.

The "core" of portfolios were recently rebalanced to align with our long-run return forecasts. Tactical allocations within the "satellite" portions of portfolios saw an increase in equity weights, but equity exposure is still below neutral.

## Economy

A variety of indicators showed improvement through the spring. In the United States, forecasts for growth are improving. After growing an average of only 1.25% in the fourth and first quarter, there seems to be a pickup underway. Automobile sales bounced back in May after falling below 17 million annualized units earlier in the year. Corporate bond spreads narrowed, and inflation expectations priced into the bond market picked up. S&P 500 earnings forecasts even got a lift to \$126 from \$123 for the next 12 months. Fundamental conditions seem to be moving in the right direction as we head into the second half of the year. The WCA Fundamental Conditions Index (graph, right) is forecast to improve in the months ahead.

Prospects overseas are not as bright, in our view. European and Japanese stocks, for example, remain in the red for the year. China's manufacturing output is barely in expansion territory despite new stimulus. Britain's referendum to exit the European Union (EU) will pose challenges and weigh on growth. European financial conditions improved through the spring, but have likely weakened since Britain's "leave" referendum. European growth remains chronically below potential, increasing risk of a recession there. Elsewhere, we see an Olympics-induced pop in Brazilian production, but expect that to be short-lived.

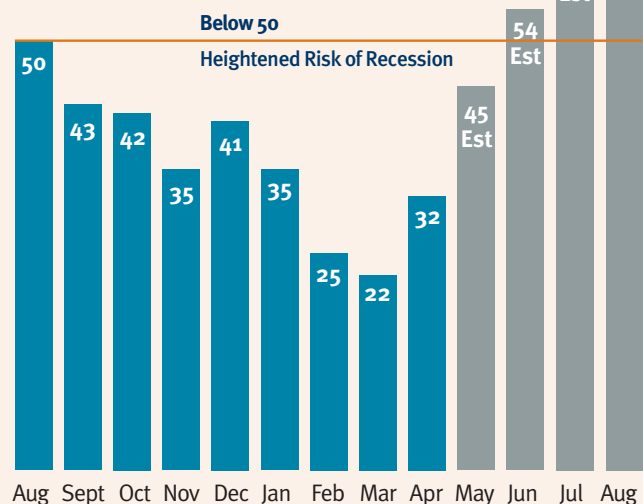
The balance of risks remain skewed to the downside in several key foreign economies. We think the United States and the U.S. dollar still offer a better risk-reward profile.

## Equities

We added a small amount of equity exposure on a tactical basis. Within equities, we remain tilted toward domestic stocks and underweight foreign. Emerging markets, heavily dependent on financials and commodities, were cut from portfolios. An outlook calling for challenged global growth and low rates favors domestic growth instead. Core equity exposure remains tilted toward domestic and growth-oriented equities.

Earnings growth for the first quarter appears lackluster. According to FactSet Research, earnings should decline roughly 2% year-over-year in the second quarter. This figure excludes the energy sector. Including energy, earnings will likely be down over 5%. If earnings decline, it will be the first time since 2008-2009 that earnings fell for

## 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.

five straight quarters. Still, analysts project a rebound to 2% full-year growth for 2016 and 14% growth in 2017. The S&P 500 index trades at 16.9 times forward operating earnings, versus a 10-year average multiple of 14.2. The dividend yield on the S&P 500 stands at 2.2%, above the 10-year U.S. Treasury Bond yield of 1.44%. Including net share buybacks, the expected S&P 500 income return increases to 4.5-5%.

### Fixed Income

Treasury yields pressed lower through the quarter. Falling 10-year Treasury yields caused the yield curve to flatten to just 120 basis points (1.20%) above Treasury bill yields. The yield curve is flatter now than any other point since the recession. The Federal Reserve slashed their forecast for policy interest rates again recently. Increasingly, it is looking like only one more rate increase is in the cards this year. The next decision on rates comes on July 27.

Long-dated Treasuries returned 16% through the first half of the year. Since the end of 2013, Treasuries with maturities over 20 years generated cumulative total returns of 45%. These gains topped the S&P 500 total return, which amounted to 18% over the same period. Investment-grade corporate bonds, measured by the iBoxx USD Liquid Investment Grade Index, returned 9% so far for the year. Corporate bonds got a boost as oil prices bottomed in March, and worry over the energy sector faded.

The globe remains starved for yield. Over \$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, a much smaller amount yields more than 2%, much of that amount consisting of U.S. Treasury debt.

### REITs

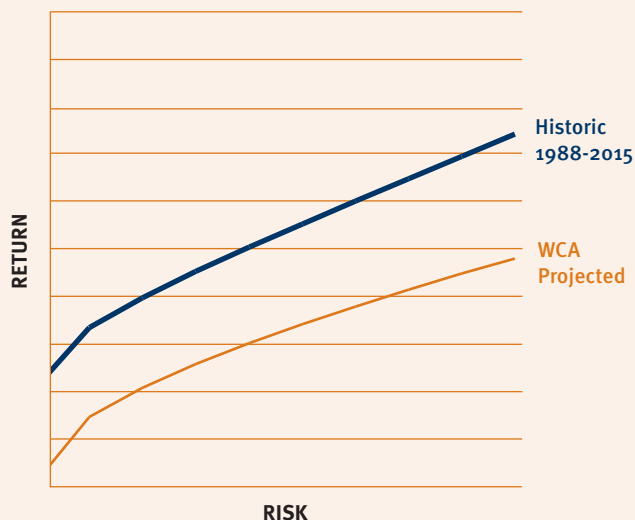
Having returned 230% from the start of the expansion, we see REITs having less forward-looking appeal. From a risk/return perspective, we believe there is better opportunity elsewhere at this time. Accordingly, we are underweight REITs.

### Currencies and Commodities

The long slide in the dollar that began post-2000 ended when the Fed signaled it would end asset purchases and started raising rates in 2014. The dollar jumped in 2015, and has been headed sideways for most of the past year. The U.S. dollar index is near its 20-year average and, in our view, is fairly valued. Growth in the United States appears relatively solid compared to the rest of the world. Although interest rates are low by historic standards, they are higher compared to other places around the world. Removing inflation, we see that real domestic interest rates are edging higher. For these reasons, we expect the dollar to remain relatively firm.

Among commodities, we believe gold has a place in portfolios over the long run. Tail risks, including a lapse back into central bank accommodation or unexpected inflation, are possible. While further increases in real interest rates could prove to be a headwind, we believe gold still provides a long-run diversification benefit.

#### EFFICIENT FRONTIER



#### LONG-RUN ESTIMATES (10-15 YEARS)

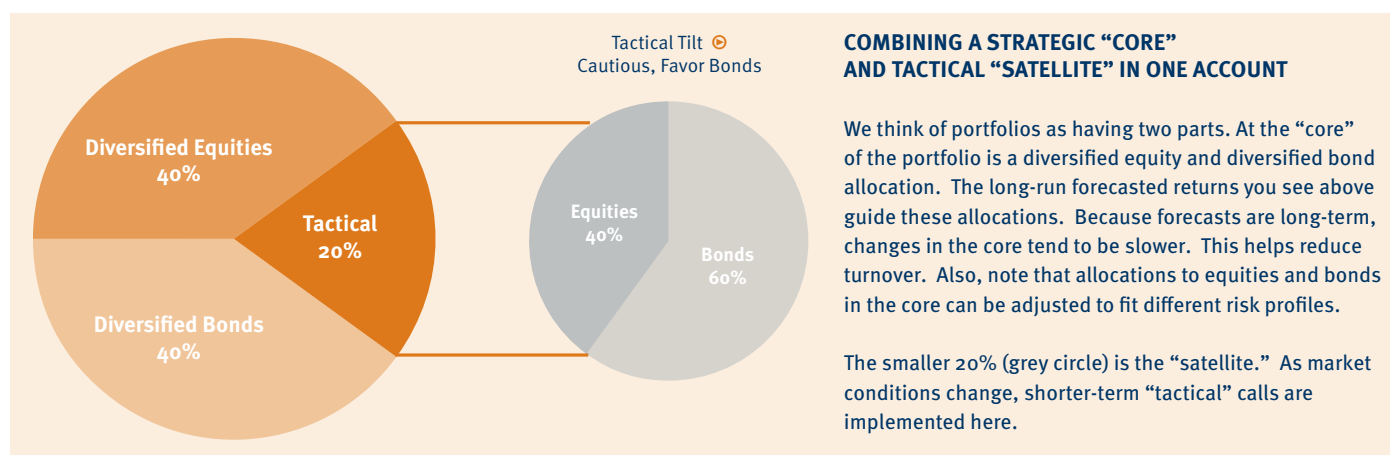
	Long-Run Estimates
Real GDP Growth	2.25%
Inflation	1.75%
S&P 500 Margin Growth	2.25%
S&P 500 Valuation Growth	2.50%
S&P 500 Dividend Yield	2.25%
S&P 500 Net Buyback Yield	3.00%
Neutral T-Bill Rate	2%

Asset Names	Under Weight	Neutral	Over Weight
Core Bonds			
1–3 Year Treasury			
Mortgage Bonds			
Intermediate Government/Credit			
Long-term U.S. Treasuries (20-yr)			
Investment Grade Corporate Bonds			
High Yield			
U.S. Equity			
Large Cap Growth			
Large Cap Value			
Small Cap			
Foreign Developed			
Foreign Emerging			
REITs			
Gold			

■ Tactical
 ■ Diversified Equities
 ■ Diversified

### Asset Allocation

Our long-run forecasts lead us to overweight large cap domestic growth stocks, high-yield corporate bonds, and gold in the diversified “core” of portfolios. Underweight positions in “core” are long-term U.S. Treasuries, foreign developed equities, and REITs. Meanwhile the equity allocation in the short-term tactical “satellite” portion of portfolios was increased to 40% equity / 60% fixed income from 33% equity / 66% fixed income. Mid-year rebalancing took place at the end of June to reflect updated long-run forecasts.



*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. Volatility refers to an expected standard deviation of returns, a measure of uncertainty around our estimate. 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.

**iBoxx USD Liquid Investment Grade Index:** An index of U.S. dollar-denominated, investment-grade corporate bonds.

**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 significantly 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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