Washington Crossing Advisors

Portfolio Comment

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UKRAINE CLOUDS ALREADY MURKY DATA

Ukraine's interim government is calling for more support from its western allies to force Russian troops to leave the country, increasing pressure on the United States and Europe to craft an appropriate response. Ukraine adds further uncertainty on top of an already noisy data flow obscured by weather, inventory, and other effects. This week brings another update on the employment situation and forecasts from the ECB.

Macro View

The situation in the Ukraine adds uncertainty to the near-term outlook – particularly as it relates to risk appetite. As of this morning, the BBC is reporting that Ukraine's interim government is calling for more international support to force Russian troops to leave. Reports also indicate that Russia has positioned thousands of troops inside western portions of Ukraine. Russia is exerting what it sees as its right to influence events on its border, protect the interests of Russian-speaking Ukranians, and project strength by defying demands of the United States and the European Union. The ultimate objectives are not yet clear, however, and Russian movements in Crimea will create persistent tension. A split of Ukraine, reclamation of Crimea, and bolstering the bargaining position of Eastern Ukrainians in the formation of new political structures are all possible Russian objectives. Russia wants to avoid a "winner take all" situation as these new political structures are formed, and limit outside military influences from operating along the Russian border. However, we recognize also that Russia is Ukraine's largest trading partner, and strong financial linkages exist between Russia and Ukraine. It is, therefore, in both countries' best interest to seek some sort of compromise.

Meanwhile, lingering effects of bad winter weather, the Chinese Lunar New Year, and inventory adjustment continue to add noise to the underlying data we track. Taken at face value, there has been a sharp deceleration in many of the items we routinely track, but equity markets have largely ignored it. Major market averages recently moved to record highs, against the backdrop of weaker data. For example, industrial production in the U.S. fell 0.3% and retail sales dropped 0.4% in January. The past two months' employment reports were very disappointing, with only 75,000 jobs created in December and 113,000 jobs added in January. Existing home sales also dropped 5.1% in January, including a drop in sales out west, where the weather has been fine. Inventory adjustment, weather, higher mortgage rates, slowing China, a new sales tax in Japan, emerging market worries, and unsettled geopolitics are all turning out to be a new set of headwinds to growth as we start the year.

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We monitor changes in conditions via our barometer (description, right). The WCA Fundamental Conditions Barometer is at 70, compared to a reading of 78 in October. A closer look at the sub-components is more revealing, however. We see that both the domestic and foreign economic data components are moving lower, but the financial component of the index is moving higher. This is unusual. Normally, it is the other way around, as credit conditions tend to lead, while economic data tend to follow. Either financial markets will be right and the real economy will pick up, or expectations priced into capital markets will need to be reduced to square with economic reality.

WCA Fundamental Barometer Observations:
Credit Indicators Remain Strong, While Economic Indicators Slow

⇣ The overall barometer is at 70 (vs. a high water mark reading of 78 last fall)
⇡ The credit barometer is at 85 (vs. a low water mark reading of 50 last August)
⇣ The domestic economy barometer is at 55 (vs. 80 last August)
⇣ The foreign barometer is at 70 (versus a high water mark reading of 100 last fall)

Earnings Season Update

The Q4 earnings season is essentially over. With 97% of S&P 500 companies done reporting, S&P 500 earnings are up 8.5% compared to the prior year. A surge in margins through the fourth quarter accounts for most of the pickup in earnings growth during the quarter. According to FactSet, the fourth quarter net margin for the S&P 500 surged to a record 9.9%, well above the 8.3% average of the past 10 years and last year's Q4 margin of 9%. The current forward P/E ratio for the S&P 500 is 15.3 times S&P 500 earnings, slightly ahead of the 10-year average multiple of 13.9 times.

Asset Allocation Portfolios Posture

NEAR-TERM TACTICAL POSTURE: Equity exposure is just slightly ahead of "neutral" allocations in model portfolios. Tactical portfolios were rebalanced at the start of the year in response to last year's large excess return earned by stocks compared to bonds. Bond duration is below benchmark, as is commodity and emerging market exposure. Portfolios are currently overweight dollar assets through domestic equities. Portfolios are overweight small-to-mid capitalization stocks and roughly balanced between growth and value styles.

LONG-RUN STRATEGIC POSTURE: Strategic allocations are set to reflect our long-run forecasts for key asset classes. We expect policy rates to remain low as central banks continue to push lower-for-longer rate strategies. Eventually rates should rise back to more normal levels, but this is expected to happen gradually and unevenly. Fixed income returns are expected to lag current yields as rates rise. Equity returns will track moderate growth in global GDP with little to no further lift from margin expansion (margins are already elevated). Equity valuations appear reasonable and in-line with historic multiples, so no additional return is being attributed to margin expansion.

A Barometer for Assessing Changing Conditions

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 to Foreign Conditions.

From each category of data, we create 3 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 3 underlying categories into a single summary measure.
This measure can be thought of as a "barometer" for changes in fundamental conditions.

DISCLOSURES

The Standard & Poor's 500 Index is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market.

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Asset allocation and diversification do not ensure a profit and may not 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. Due to their narrow focus, sector-based investments typically exhibit greater volatility. Small company stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies. Property values can fall due to environmental, economic, or other reasons, and changes in interest rates can negatively impact the performance of real estate companies. 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.