Getting Better

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Highlights:

The economy is not fixed, but most of the data we monitor continues to show steady improvement.

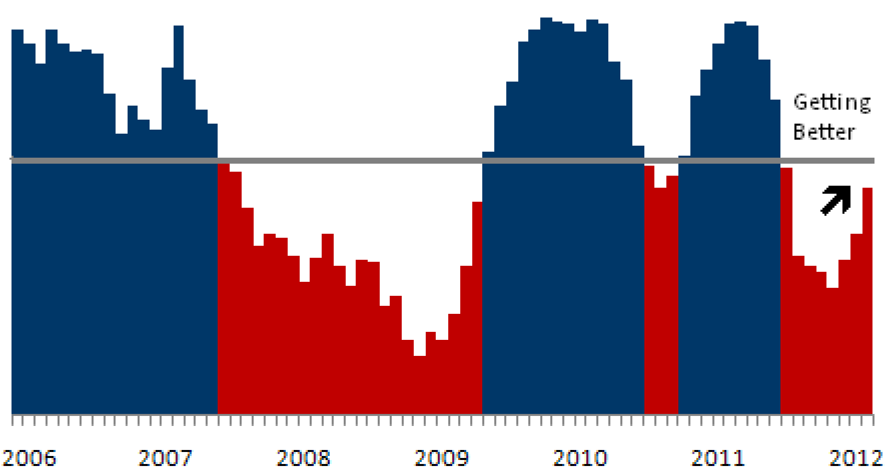
- ✓ *WCA Fundamental Conditions "Barometer" Rises Again:* After hitting bottom last quarter, fundamental conditions again appear to be moving in the right direction.
- ✓ *Stock valuations appear attractive:* The S&P 500 appears to be attractively valued on a variety of measures, including forecast earnings, normalized earnings, and compared to very low bond yields.
- ✓ *Borrowing Trends Set to Turn the Corner?* Don't look now, but the slowdown in borrowing that preceded the recession may actually be starting to reverse course.
- ✓ *Balance Sheets Getting Stronger:* As households rebuild their balance sheets, business balance sheets continue to benefit from high levels of profitability.

We regularly assess changes in fundamental conditions to help guide near-term asset allocation decisions.

The graph to the right incorporates approximately 30 forward-looking indicators in categories ranging from Credit and Capital Market inputs to indicators for U.S. Economic and Foreign Conditions.

The resulting measure can be thought of as a "barometer" for measuring general changes in fundamental conditions.

WCA Fundamental Conditions "Barometer"



Source: Washington Crossing Advisors

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The Economy IS Getting Better

Although we remain far from where we began before the recession, there is mounting evidence that the economy is moving in the right direction. Last week's employment report is another example of this progress. The overall unemployment rate remains at 8.3%, but a closer look at the numbers reveals some interesting trends. Over the last three months, for example, non-government jobs were up an average of about 250,000 per month. This is a very respectable figure and suggests that the handoff from government-led job creation to business-led job creation is taking root. We also are seeing more people come back into the workforce as a sign that there may be growing optimism about the job market. According to the February household employment survey, the number of new entrants to the labor pool (+476,000) approximately equaled the number of people who gained employment (+428,000). What this all means is that income and confidence should look better moving forward.

Stocks Seem Reasonably Priced

Underlying earnings power for S&P 500 companies remains strong. Analysts are expecting S&P 500 companies to earn just over $107 over the next 12 months. Based on this figure, the forward-looking "earnings yield" on the S&P 500 is about 7.8% — 40% higher than the last 20-year average.

A more conservative way to come at the question of valuation would be to use "normalized" earnings, which smooth out some of the cyclicality in the figure. By our measure, "normalized" earnings based on book value and average profitability are close to $80.92 ($614 book value times 13.2% average return on equity). Even on that basis, the earnings yield of 6% is still better than the 5.2% average yield over the past 20 years.

Such valuations indicate that investors continue to be skeptical about the economy's recent performance. Such skepticism should be viewed as healthy rather than a vindication of the bear case. Bull markets always carry with them a healthy dose of skepticism in the early years.

Borrowing Again?

An important thematic for us has long been the behavior of households with respect to borrowing. Increased borrowing can be an indicator of confidence and also has implications for the money supply and the broader financial system. The very households whose borrowing habits during the housing boom drove up property prices and created the conditions for subsequent losses appear to be more willing to borrow.

The Federal Reserve reported this week that households added to their outstanding borrowings in the fourth quarter for the first time since the second quarter of 2008. For the quarter, there was a $43 billion annualized total increase in household borrowing (including mortgages, credit cards, automobile loans, etc.). The $43 billion rate of loan growth is miniscule compared to the $1.4 trillion peak borrowing rate we saw in 2006. On the other hand, it is materially firmer than the $420 billion rate of debt liquidation we saw in early 2010.

Better Balance Sheets

In addition to improving fundamentals, decent valuations for stocks, and a more normal borrowing dynamic in the economy's largest sector, balance sheets appear to be improving too. The Federal Reserve's data shows that household net worth is up $1.2 trillion to $58.5 trillion in October and cash held by non-financial companies increased to $2.23 trillion from $2.12 trillion the prior quarter. Business' cash holdings as a percentage of assets are near a 50-year record high.

In short, the economy is far from healed. The last recession and ongoing stresses in the financial system will be with us for awhile to come. However, there are some clear signs of improvement in fundamentals at a time when equity markets are still priced with a healthy degree of skepticism.

Index Definitions

Barclays U.S. Government Inflation-Linked Bond Index measures the performance of the U.S. Treasury Inflation-Protected Securities ("TIPS") market. Used as a proxy for "inflation-protected bonds."

Bloomberg/EFFAS Bond Indices U.S. Government 1-3 Year Total Return Index is a transparent benchmark for government bond markets. Indices are grouped by country and maturity sectors. Bloomberg computes daily returns and index characteristics for each sector. Used as a proxy for "short-term Treasuries."

Bloomberg/EFFAS Bond U.S. Government 10+Year Total Return Index is a transparent benchmark for the total return of the 10+ year U.S. Government bond market. Used as a proxy for "long-term Treasuries."

FINRA-Bloomberg Active Investment Grade U.S. Corporate Bond Index and FINRA-Bloomberg Active High Yield U.S. Corporate Bond Index are comprised of the most frequently traded investment-grade and high yield U.S. corporate fixed coupon bonds represented by the Financial Industry Regulatory Authority (FINRA) transaction reporting facility. Used as proxy for "high-yield bonds."

FTSE NAREIT Equity REIT Total Return Index is a total return performance index of all equity REITs tracked by NARIET. Used as a proxy for REITs.

MSCI EAFE International Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets excluding the U.S. and Canada. As of June 2007, the MSCI EAFE Index consisted of 21 developed market country indices. Used as a proxy for "developed foreign."

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. Used as a proxy for "emerging markets."

Russell 1000 Index measures the performance of the 1,000 largest companies in the Russell 3000 index. The Russell 3000 Index measures the performance of the 3,000 largest US Companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market. Used as proxy for domestic "large cap stocks."

Russell 2000 Index measures the performance of the 2,000 smallest companies in the broader Russell 3000 index. Used as proxy for "small cap domestic stocks."

Russell 3000 Growth Index measures the performance of those Russell 3000 Index companies with higher price-to-book ratios and higher forecasted growth values. Used as proxy for "domestic growth stocks."

Russell 3000 Value Index measures the performance of those Russell 3000 Index companies with lower price-to-book ratios. Used as proxy for "domestic value stocks."