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Market Commentary

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A Big Hit to Wealth and What to Do Now

The magnitude of losses in equity markets have driven equity markets deep into what technicians would call "oversold" territory. The S&P 500, which used to trade at 2.4 times revenue in March 2000 now trades at 0.75 times revenue. At this level, our equity market has arguably reached a valuation level more typical of what the Japanese stock market has seen over the past decade.

The record decline in equity values has occurred far more rapidly than analysts have been able to reduce estimates. While estimates will likely continue to be cut, the persistent week-to-week declines in the stock market (this past week's rally notwithstanding) suggest that further cuts to estimates are largely priced into the market. No longer can we say that the market is overpriced because it is oblivious to the risks. Instead, we must conclude that we have entered into a more mature phase awaiting fundamental improvement.

To be even more clear (albeit a bit technical), an indicator of momentum called the relative strength index has recently hit the same level seen in July 1932. That indicator closely mirrors a variety of fundamental valuation measures, such as price-to-sales, price-to-book, and price-to-earnings, but actually compares the magnitude of recent gains to recent losses to determine the "cheapness" or "deariness" of the underlying security or index. As longer-term-oriented investors, we look at the index alongside other measurements of value from a longer-term perspective. It is our view that the index has reached extremely low levels.

These low levels are appropriate given the enormous distress in the macro-environment. We would expect nothing less considering the \$10 trillion in ongoing rescue efforts by the United States alone to shore up the economy; or the \$1 trillion of bank write-offs (with more to come in our view); or the accelerating rate of increase in unemployment; or the ongoing correction in residential and commercial real estate market. Unless these fundamental conditions improve, any "trader's rally" off of these distressed levels will most likely fade over time. Hence we are not yet changing our defensive posture.

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Fed Data Shows Severity of Downturn in Q4, 2008

An assessment of the economy comes each quarter in the form of the Federal Reserve's comprehensive "Flow of Funds Report." Yesterday, we got our first look at the fourth quarter 2008 report, and in it we saw a sobering set of new data on borrowing, credit, business investment, government spending, and wealth data.

Ten notable observations in this data are:

1. Households are still under distress and reluctant to borrow. In fact, households are, on net, paying back more than they are borrowing. In the fourth quarter, households were paying off debt at an annualized rate of \$280 billion. This is a remarkable shift, because the nation's households have not been net savers since the 1930s and because only three years ago households were borrowing close to \$1.4 trillion, net of debt retirement.
2. Mortgage borrowing has now been negative for three quarters. This means that mortgage debt is being paid down or written off, but generally not taken on to buy new homes. On balance, mortgage debt is being paid down at a rate of \$163 billion compared to the first quarter of 2006, when mortgage debt was being incurred at an annual rate of \$1.18 trillion (a 90% drop in net mortgage credit creation).
3. Consumer credit has turned negative for the first time since 1991 and is, on net, being paid off at an annual rate of \$83 billion as of the fourth quarter.
4. Business net borrowing is falling sharply and stood at a \$185 billion annualized rate as of the fourth quarter versus a peak level of \$1.4 trillion in the third quarter of 2007 (nearly a 90% drop-off).
5. Stated real estate values of households and non-profit organizations fell to \$20.5 trillion. This is down 15% from the 2007 peak. Owners' equity in real estate fell to \$7.9 trillion (43% equity / 57% debt) from \$12.5 trillion (59% equity / 41% debt) in 2005.
6. The value of household equities and mutual fund holdings fell to \$8.7 trillion versus \$14.8 trillion in 2007.
7. Total household liabilities fell to \$14.24 trillion versus \$14.33 trillion a year earlier. This is the first year-over-year decline in total household liabilities since records began in the early 1950s. **Never before has this happened.**
8. Losses from household net worth accelerated as net worth fell by 10% to \$51.5 trillion from \$56.6 trillion. Year-over-year net worth is off 18%.
9. Federal government net borrowing continues to surge to over a \$2 trillion annualized run-rate. This is about 10 times the "normal" rate seen before the start of the financial crisis.
10. The Federal Reserve's balance sheet has increased to \$2.3 trillion in size compared to \$932 billion in size a year earlier.

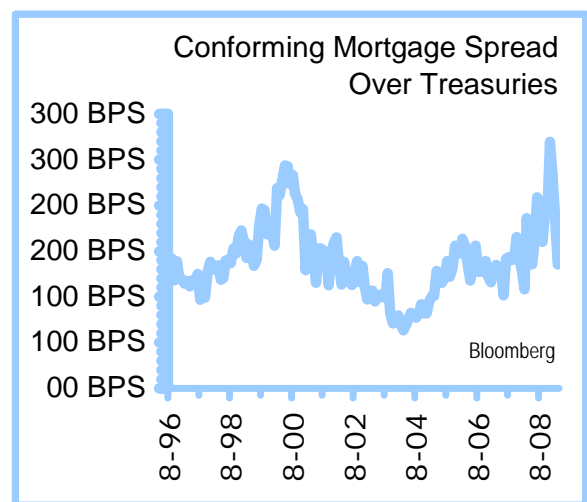
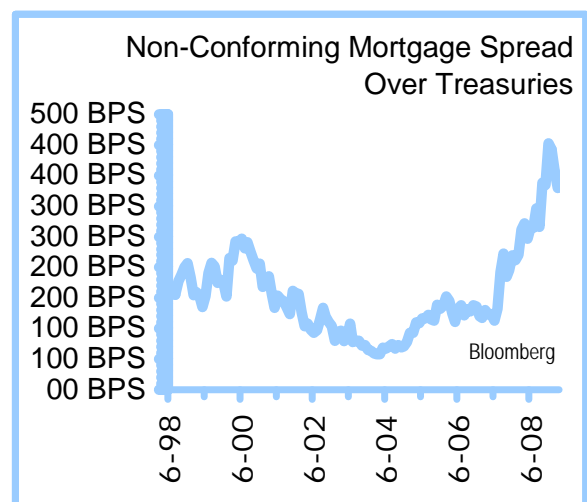
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To be clear, the data underscores a few key themes affecting the economy. First, there is an ongoing effort by the private sector to de-leverage by reducing spending, selling assets and paying off debt. Second, businesses are following the lead set by households and are similarly curtailing autonomous investment spending in capital investment and personnel. Third, asset prices are falling faster than overall indebtedness, which is causing a further rise in debt-to-income and debt-to-equity ratios. Fourth, the Federal Government and the central bank are working together to fill in the borrowing and spending void created by the retreat of the private sector. Note, however, that the private sector was the first mover in this chain of responses. Therefore, it is important to closely monitor the reaction of the private sector and private markets to governmental and central bank responses. To date, we have seen nothing that would indicate that the fundamental de-leveraging of the economy is ending or that the impact of this de-leveraging on prices has run its course.

Moreover, we see that markets have become split into two categories – those markets that are being actively intervened in by policymakers and those private markets that are being left to market forces. Take, for example, the behavior of the conforming mortgage market relative to the behavior of the non-conforming market. The conforming mortgage market is being actively intervened in by the Fed in conjunction with the government-sponsored entities (GSEs). In the conforming market, where there is an active effort by government to set rates, the spread, or cost, of credit has dropped sharply. However, in the market for non-conforming loans which are not being affected by government and central bank actions, these spreads continue to rise. Since many look to markets as signposts to evaluate changes in the economy, it would be incorrect to look at

the manipulated market and assume that things are improving. Instead, we believe that it is now important to distinguish between markets that are freely functioning compared to those that are being affected by the outside forces of government and banking intervention. Using this example, we believe that the non-conforming market for mortgages is far closer to the underlying reality of risk and return when discussing mortgages.



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Conclusion

Although the correction in risk assets, notably stocks, has been of historic proportions, and leads us to conclude that we have moved into the maturing stages of a bear market, we continue to see significant risks in the macro-environment that will hinder a sustained recovery. Specifically, ongoing declines in real estate values, coupled with massive portfolio losses, have forced a behavioral shift in households away from debt and risk-taking toward savings and thrift.

Recent indications of deteriorating country risk outside of our borders, notably the increasing distress in China, Japan, and Europe, suggest that the scope of the crisis has grown and increases downside risks to the scenario.

While we recognize the historic scope of the market corrections to date, we are similarly mindful of the size of the challenges that still lay before us. For this reason, we remain guarded in our asset allocation despite the deeply oversold levels of the market.

Recommended Asset Allocation

	Growth	Balanced	Conservative
INCOME & OTHER	48.0%	73.0%	98.0%
DOMESTIC BONDS	48.0%	73.0%	98.0%
Cash & Money Market	18.4%	28.0%	37.6%
Short-Term Treasuries	9.9%	15.0%	20.1%
Intermediate Term Treasuries	9.9%	15.0%	20.1%
Long-Term Treasuries	6.6%	10.0%	13.4%
Extended Duration (LT Strips)	3.3%	5.0%	6.7%
COMMON STOCKS	52.0%	27.0%	2.0%
DOMESTIC COMMON STOCKS	52.0%	27.0%	2.0%
U.S. SIZE & STYLE	52.0%	27.0%	2.0%
Large Cap Growth	19.3%	10.0%	0.7%
Large Cap Value	19.3%	10.0%	0.7%
Mid Cap Growth	7.7%	4.0%	0.3%
Small Cap Growth	5.8%	3.0%	0.2%
TOTAL PORTFOLIO	100%	100%	100%

U.S. ECONOMIC SECTORS

Energy	0%
Technology	12%
Materials	4%
Industrials	4%
Consumer Discretionary	10%
Health Care	26%
Utilities	8%
Consumer Staples	16%
Telecommunications	5%
Financials	14%

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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.