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August 7, 2012

Are Fundamentals Bottoming?

Focus on Mid-Risk and Domestic Assets for Now

Our posture has been a bit more cautious since our fundamental barometer began to head south a few weeks ago. However, we are ever watchful for signs of improvement in the landscape. The past few trading sessions has shown at least a temporary willingness for global investors to let their hair down, throw caution to the wind, and go long equities. Our assessment is a bit more sober, but we are paying attention to what the data is telling us.

Last week's jobs report showed some improvement in hiring in the United States. The Bureau of Labor Statistics said that 163,000 jobs were created in July compared to expectations for 100,000 jobs. The report also showed that the initial figures for June were overly optimistic as the June figure was revised down to 64,000 from 80,000. No matter how you look at it, the July data was better than many feared and supports continued modest income and spending gains here in the United States.

The same cannot be said about the rest of the world, where final demand is very weak across Europe and production is being hurt globally and across Europe (see table below). We note that for most of the forward-looking production data we monitor there continues to be a dim near-term outlook caused by weak orders and high inventory levels. The combination of these two factors suggests that global growth will remain weak in the months ahead.

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Sampling of Global Purchasing Manager Survey Indices

	July Reading	3-Month Average	Cycle Low	Conclusion
Manufacturing				
Globe†	48.4	49.4	34.3	Contraction
Germany‡	43.0	44.4	32.0	Contraction
United Kingdom‡	45.4	46.6	34.5	Contraction
France‡	43.4	44.4	34.8	Contraction
China‡	50.1	50.2	38.8	Neutral

† JP Morgan ‡ Markit

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European Central Bank Greases the Wheels for Policy Action

Last week, Europe's central bank laid out a new way to help struggling countries. The new plan allows the bank to buy bonds of countries whose interest rates have risen to levels that would hurt growth. The country receiving the help would first ask for assistance and agree ahead of time to meet certain conditions. This process helps in several ways. It involves the aid recipient country from the start who voluntarily and knowingly agrees to both the aid and its conditions. It creates a buffer between the central bank and individual governments which could speed the process of intervention. Lastly, and most importantly, it makes central bank actions more acceptable to politicians in northern Europe who need to find a way to help their southern neighbors without looking soft regarding open-ended commitments and lax monetary policies in the face of their electorates.

If the plan is agreed upon, and there is some sense that it may be, it could improve the European Central Bank's ability to act in a timely way and keep order in bond markets. Although this doesn't solve Europe's bigger issue of fostering growth given large debts, it potentially alleviates some of the "tail risk" that has been unnerving markets in recent months. Just the suggestion of additional short-term bond purchases, for example, was enough to drop the interest rate on Spanish short-term debt nearly in half since late July (Spanish 2-year Treasuries now yield near 3.5% versus 6.5% on the 24th of July).

We await further clarification of the plan and the extent to which it is formally adopted by Europe's politicians. Markets appear optimistic that the plan will go forward with unified consensus, but where European politics enters the picture, we think it is wise to follow the "bird in hand" dictum.

Observations on Recent Data

Indicators on credit and capital market conditions, the U.S. economy, and foreign conditions all slipped in July, but the biggest falloff was again seen in the foreign data. Manufacturers around the world have been caught by a combination of falling demand (notably from Europe) and relatively high inventories. This is a bad combination for production growth.

Service-related areas are faring better, and the data out of the United States is among the best categories. In the United States, leading indicators were mixed in July (ECRI was up / Conference Board was down), employment was mixed (percent employed fell while weekly jobless claims dropped), confidence waned (households remain reluctant to part with savings), and capital goods orders slipped, with overall orders falling slightly faster than inventories. While automobile sales ticked down, both overall spending and retail sales appeared respectable.

All-in-all, the current environment in the United States appears far better than other parts around the world. Continued decent performance in the United States will be a key factor in carrying the rest of the world back onto a solid growth path.

We believe that global fundamentals will likely bottom out in the third quarter, assuming decent U.S. demand continues and absent a significant policy error.

Portfolio Posture

As fundamentals have yet to find bottom (see the WCA Fundamental Conditions Barometer below), we are focused on mid-risk asset levels in portfolios rather than reaching for outsized return in higher risk categories. United States and dollar-denominated investments remain the primary focus of tactical asset allocation portfolios, with an emphasis on higher grade and better yielding corporate bonds on the one hand, and larger domestic multinational equities on the other. Sector positioning remains focused on defensives over cyclical. We maintain positions in gold and real estate investment trusts.

We continue to watch for three "trigger events" that could change the tactical positioning of portfolios. These events include:

1) An overall change in direction for the data we track,

2) a meaningful and convincing policy response to address financial market instability and weak growth, or

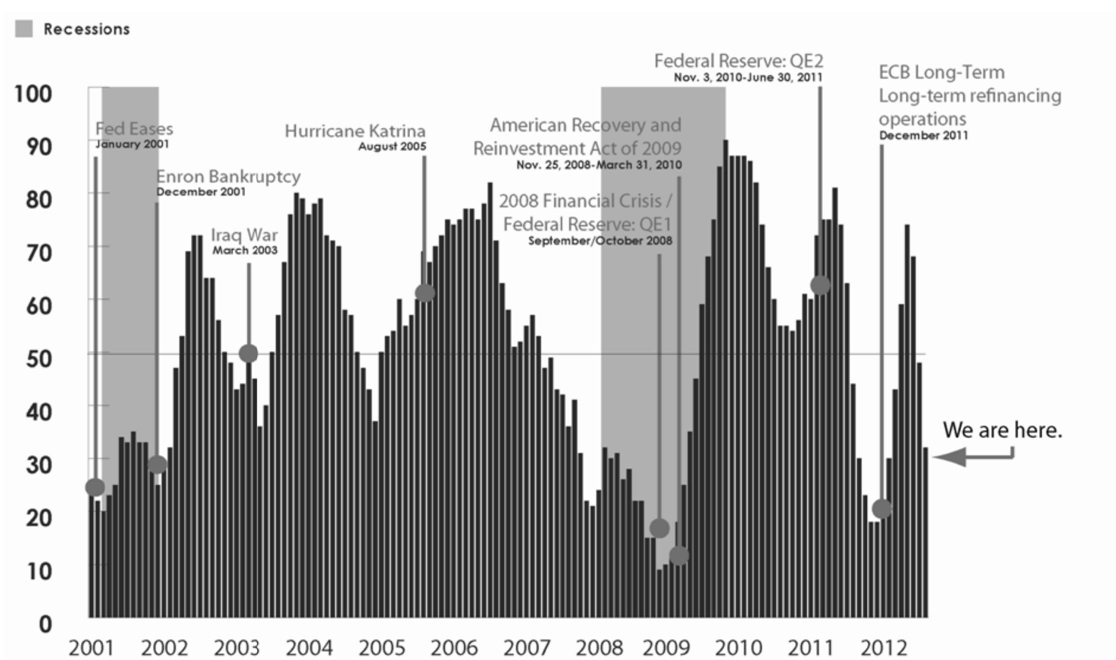
3) a significantly attractive valuation.

Any or all of these events might prompt a move to a more aggressive posture.

We will give significant attention to these three "trigger events" in future commentaries and updates.

WCA Fundamental Conditions Barometer

The WCA Fundamental Conditions Barometer measures changes in a wide range of indicators, ranging from risk-taking appetite in financial markets to performance of the domestic and foreign economies. A reading near 50 indicates no significant change in fundamental conditions, while readings above 50 are more consistent with near-term fundamental improvement. A reading below 50 is more consistent with worsening near-term fundamental conditions.



Includes amendments to WCA Foreign Conditions sub-index
For more on changes, see June 12, 2012 report titled *Global Focus*

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."

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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.