WASHINGTON CROSSING ADVISORS

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The Election Is Over

Now What?

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A new phase of the economic recovery has begun. The slumping economy and cratering financial markets that greeted President Obama in 2008 are, thankfully, no longer with us. Today, we are in the third year of economic recovery, financial markets have substantially recovered, house prices are rising again, and employment rolls are expanding. As the crisis phase passes into history and the economy continues to grow, pressure to address deficits and debt will also grow.

The 2008 crisis unified government and provided the justification for a large government response. That response produced both recovery and unprecedented deficits. Five years of wartime-like deficits produced an unsustainable explosion of government debt in relation to national income (chart below). The good effects of recovery came first and eased the crisis, but the lingering side effects of debt and deficits must now be addressed.

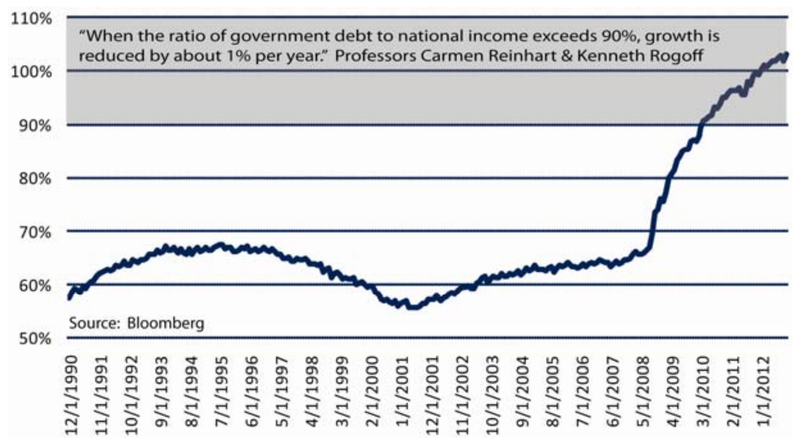
The hefty increase in borrowing, along with other factors, led Standard & Poor's to strip the United States of its "AAA" bond rating (excerpt, left). Confidence was dampened. Concern over future tax increases rose, and decisions to purchase, save, and invest were impacted. Potential growth may also have been lessened, based on recent research on the effect high national debt can have on growth (Reinhart & Rogoff, 2009).

Standard & Poor's Statement on U.S. Ratings Downgrade:

"We have changed our view of the difficulties in bridging the gulf between the political parties over fiscal policy, which makes us pessimistic about the capacity of Congress and the Administration to be able to leverage their agreement this week into a broader fiscal consolidation plan that stabilizes the government's debt dynamics any time soon."

Source: http://www.standardandpoors.com/ratings/articles/en/us/?assetID=1245316529563

U.S. Government Debt to National Income



In an effort to provide stimulus to the economy, the U.S. government has run significant deficits. The related rise in debt in relation to national income is unsustainable over the long run. A credible plan to reverse this trend is essential.

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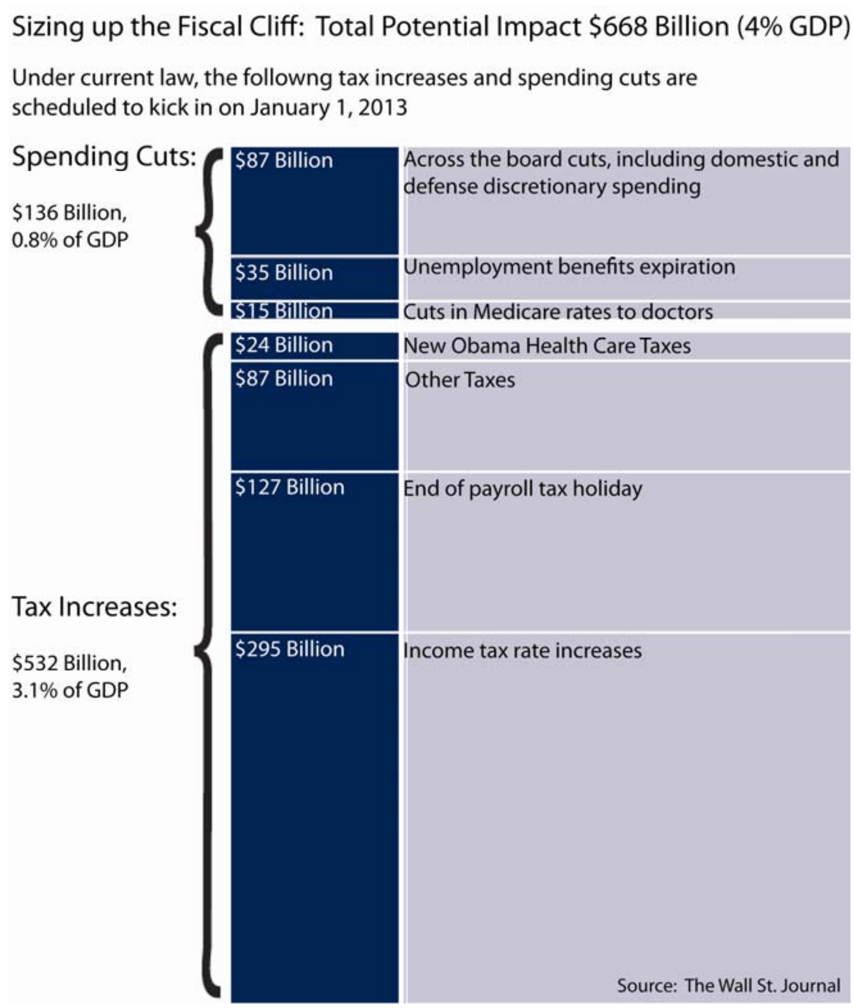
Fiscal Cliff

Of all the challenges that lay ahead, the upcoming "fiscal cliff" is most pressing. Beginning early next year, a series of tax increases and spending cuts that could amount to a 4% drag on the economy are set to kick in, based on Congressional Budget Office estimates (chart, below). The President and lame duck Congress have between now and the mid-December recess to find a compromise that reduces and delays the size of the "fiscal cliff's" impact on the economy. The White House remains adamant that tax increases on upper income earners be implemented, despite opposition from a Republican-controlled House of Representatives. Republicans in the House of Representatives are interested in finding ways to "revise the tax code" to aid "small businesses." Both President Obama and House Speaker John Boehner recently expressed interest in finding ways to a "bridge" that avoids this outcome and allows more time for substantive negotiations on a budget.



United States Treasury Statement on Debt Ceiling:

Treasury continues to expect the debt limit to be reached near the end of 2012. However, Treasury has the authority to take certain extraordinary measures to give Congress more time to act to ensure we are able to meet the legal obligations of the United States of America. We continue to expect that these extraordinary measures would provide sufficient "headroom" under the debt limit to allow the government to continue to meet its obligations until early in 2013.

Source: http://www.treasury.gov/press-center/press-releases/Pages/tg1753.aspx

Tax Increases

Emboldened by the election and compelled by earlier promises to veto legislation that fails to raise taxes on the wealthy, it is likely that at least some of the Bush-era tax cuts will expire at the start of 2013. Taxes on earned and investment income will rise under current law, unless a compromise is reached. Without an agreement, taxes on all Americans will rise.

The income tax rates for 2013 are scheduled to change, and the change will produce an $800 billion tax increase over 10 years on earners in the top two tax brackets and a $3.2 trillion increase over 10 years for the rest of Americans, according to the Congressional Budget Office. Personal income tax rates are expected to change as follows:

Income Tax Rate Changes

Bracket	Old Rate	New Rate	Change
Top	35%	39.6%	+4.6%
Next	33%	36%	+3%
Next	28%	31%	+3%
Next	25%	28%	+3%
Bottom	10%	15%	+5%

Source: Taxfoundation.org

Additionally, a 2% payroll tax holiday will expire, and Medicare payroll taxes will increase by 0.9%. A 3.8% tax on investment income to finance the Patient Protection and Affordable Care Act (PPACA) will be implemented. Taxes on dividends are set to move from 15% to ordinary income tax rates (near 40% in some cases). Capital gains taxes are set to rise to 23.8% from 15%.

President Obama's promise to raise taxes on the "wealthy" stands at odds with Speaker Boehner's insistence that taxes are not increased on "small businesses." We anticipate that both parties will eventually compromise on changes to the tax code that creates tax incentives for small businesses, while also increasing marginal income tax rates for high-income earners.

Debt Ceiling

The United States is again approaching the statutory debt ceiling limit of $16.4 trillion (current government debt stands at $16.3 trillion). The debt limit is the total amount of money that the government is legally authorized to borrow to meet its existing obligations. The debt limit has been increased nearly 80 times since 1960 without issue, but that string of automatic increases ended in 2011. During that summer, a divided Congress threatened a sovereign default by not automatically increasing the debt ceiling as they had done previously. Rating agency Standard & Poor's responded by stripping the United States of its "AAA" credit rating. The sharp rise in debt in recent years is at the heart of the issue (see debt to GDP ratio chart on the first page). The Treasury department currently expects that the current $16.4 trillion debt ceiling limit will be reached by year's end but believes that Congress will have time to act to ensure there is sufficient "headroom" for the government to meet its obligations (quote – left).

Monetary Policy – Steady As She Goes

Federal Reserve Chairman Ben Bernanke was granted a reprieve from speculation that he be may be replaced under a Romney administration. In the face of a potential fiscal tightening, the Federal Reserve has embarked on a historic, open-ended program to buy assets. The program could be extended or adjusted as needed in response to projections for economic growth, employment, and inflation.

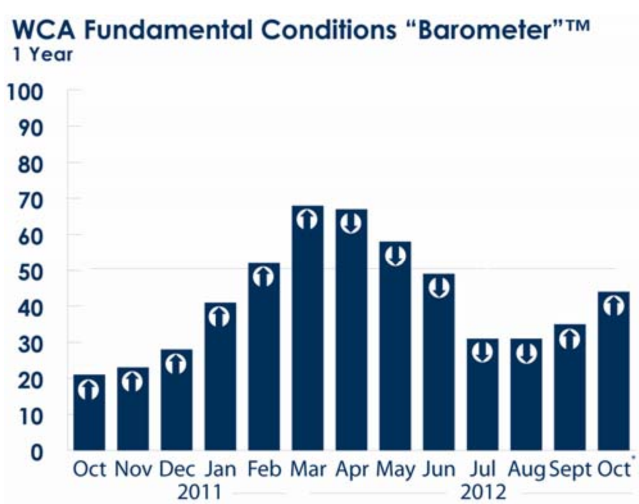
We believe that the program was so designed in order to provide a means of adding monetary stimulus in the face of potential fiscal tightening. The Fed has unlimited authority to purchase assets and create reserves in the banking system. In economic theory, there is a line of causation that extends from central bank asset purchases, to reserve creation, to the money supply, to economic activity, and to inflation and asset prices. In the event of fiscal tightening, the Fed would be put in the position of potentially further expanding monetary stimulus. With Ben Bernanke's job more secure following the reelection of President Obama, uncertainty over direction at the Fed is lessened.

The fiscal impulse provided by government since 2008 is set to fade. As this happens, it is important that private investment provide an offset. Absent this, further monetary accommodation may prove to be the policy option of choice.

Portfolio Posture

We expect the months ahead to be filled with high drama as Congress and the President attempt to negotiate a compromise. At the same time, the data we follow is indicating some improvement. Employment, production, final demand, financial market conditions, all seem modestly improved from summer levels (see "WCA Fundamental Conditions Barometer" (below). Portfolios are allocated in a balanced way that also recognizes these important trends (see next page).

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.



Tactial Asset Allocation

Thursday, November 08, 2012

	================= CORE ===================							====== SECTOR-ENHANCED =====				
	======= TAXABLE ========				==== MUNICIPAL ====			==== TAXABLE ====			= MUNICIPAL =	
Asset Class	**Aggressive**	**Moderate Growth**	**Balanced**	**Conservative**	**Moderate Growth**	**Balanced**	**Conservative**	**Aggressive**	**Moderate Growth**	**Balanced**	**Moderate Growth**	**Balanced**
Fixed Income	**10%**	**25%**	**50%**	**72%**	**25%**	**50%**	**72%**	**10%**	**25%**	**50%**	**25%**	**50%**
CASH	10%	2%	2%	2%	2%	2%	2%	10%	2%	2%	2%	2%
DOMESTIC BONDS		23%	48%	70%	23%	48%	70%		23%	48%	23%	48%
Short-Term Treasuries			3%	8%						3%		
Core Bonds		6%	11%	19%					6%	11%		
Long-Term Treasuries (7-10 Yr)			9%	11%						9%		
Investment-Grade Corp Bonds		4%	10%	18%					4%	10%		
High-Yield Corporate Bonds		13%	12%	9%					13%	12%		
International Treasury Bonds			3%	5%						3%		
Short-Term Municipals					13%	28%	38%				13%	28%
Long-Term Municipals					10%	20%	32%				10%	20%
Equity & Other	**90%**	**75%**	**50%**	**28%**	**75%**	**50%**	**28%**	**90%**	**75%**	**50%**	**75%**	**50%**
DOMESTIC	66%	56%	35%	19%	56%	35%	19%	66%	56%	35%	56%	35%
All Cap Domestic	20%	15%	6%	6%	15%	6%	6%	20%	15%	6%	15%	6%
Large Cap Growth	15%	13%	10%	5%	13%	10%	5%					
Large Cap Value	15%	13%	10%	5%	13%	10%	5%					
Small Cap	16%	15%	9%	3%	15%	9%	3%	16%	15%	9%	15%	9%
FOREIGN												
Developed Markets												
Emerging Markets												
OTHER	24%	19%	15%	9%	19%	15%	9%	24%	19%	15%	19%	15%
Gold	12%	10%	8%	6%	10%	8%	6%	12%	10%	8%	10%	8%
REITs	12%	9%	7%	3%	9%	7%	3%	12%	9%	7%	9%	7%
LARGE CAP U.S. SECTORS								30%	26%	20%	26%	20%
Energy								9%	7%	6%	7%	6%
Technology								7%	6%	3%	6%	3%
Materials												
Industrials												
Consumer Discretionary								3%	3%	3%	3%	3%
Cyclical:								19%	16%	12%	16%	12%
Health Care								4%	3%	2%	3%	2%
Utilities												
Consumer Staples								5%	5%	4%	5%	4%
Telecommunications												
Financials								2%	2%	2%	2%	2%
Non-Cyclical:								11%	10%	8%	10%	8%
TOTAL	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

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."