



Market Commentary

November 21, 2008

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September 15, 2008

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[Valuation Are Better, But Markets Are Not Out of the Woods](#)

Credit: Don't Want It... Can't Get It...

Massive losses have been seen across all asset classes (except Treasuries) and time zones (so much for decoupling). While it is not yet time for broad-based risk-taking, it is important to weed out any and all financially weak issues. Investors, in consultation with their financial advisors, should review their bond and stock positions and the issues held by mutual funds and managed accounts with an eye toward identifying those that:

1. Have the capacity to meet their current dividend and interest payments for the next several years;
2. Do not depend on external financing to meet current obligations; and
3. Maintain financial integrity based upon balance sheet fundamentals with only a secondary emphasis on other issues.

There are certain expectations that we have built into our forecast. These expectations directly affect our investment recommendations and posture at this time. Key assumptions include:

1. That we have moved into a "hard dollar" environment where those with cash and equity in their investments will be provided with the most opportunity. Those who are highly leveraged will confront significant difficulty.
2. That the coming environment will feature low interest rates that will encourage risk-taking that could then prompt recovery and the beginning of the next bull market.
3. The new administration's campaign agenda will likely be trumped by the immediacy of the financial and economic turmoil.
4. More Keynesian-style stimulative packages, coupled with broadening bailouts for a wide variety of entities over the next several years. Tax increases are postponed in this scenario while tax cuts are accelerated and the Federal budget deficit will likely rise to over \$1 trillion for the 2009 fiscal year.
5. Based on updated inputs to our model, we now expect S&P 500 earnings in the range of \$55 (bad case) to \$82 (good case) in after-tax operating earnings. Our best target estimate for earnings is \$62 given our current outlook for the depth of the recession.

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Where We Are Now

We believe we are witnessing a rare event in our financial history. This is not the textbook recession where inventories are the culprit. This is a different process, and one that will likely take a longer time to process. The essential difficulty is that policy-makers have little ability to change the behavior of actors in the economy who are attempting to save rather than spend and pare down debts rather than take on more credit. As economic conditions worsen, and as asset values decline, it is even more difficult to reverse these trends, which makes for a vicious cycle. This is why governmental efforts to stimulate have taken on Herculean proportions and will likely continue.

How Did We Get Here?

The assumption of enormous levels of debt by virtually every sector of the economy has triggered a period of debt liquidation. This process began in earnest earlier this year as Bear Stearns, Lehman Brothers, Fannie Mae, Freddie Mac, and AIG became essentially insolvent or in jeopardy of becoming so. The root cause, we believe, was the unsustainable expansion of debt within the financial system, which made both borrowers and lenders uncomfortable. This expansion of borrowing is easily seen here as the sharp rise in the household debt-to-income ratio that took place from 2000-2006 (see chart 1).

Once joined by falling collateral values in the form of home prices (see chart 2), both borrowers and lenders pulled back from the issuance of new debt, which caused a historic decline in new credit and money creation as evidenced by net U.S. household borrowing falling from a peak \$1.4 trillion annualized level to under \$200 billion (see chart 3). We believe that household credit demand will not recover quickly as it has in past cycles because both borrowers and creditors look to de-lever balance sheets, hoard cash, and lessen risk. This is due not only to the absolute levels of debt in the system, but also demographic changes as the "baby boom" generation moves closer to retirement. In this environment, we expect savings rates to rise at the expense of consumption.

Chart 1

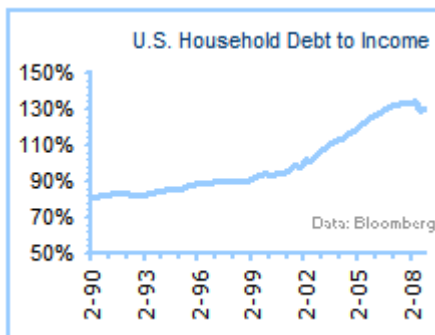


Chart 2

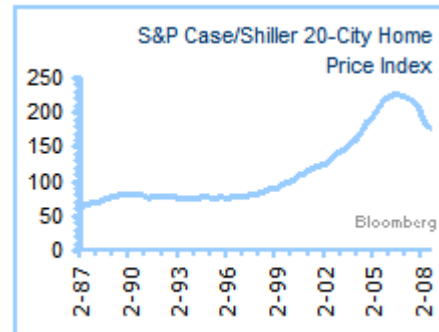
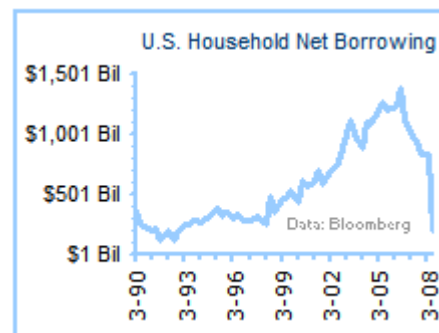


Chart 3



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The Federal Reserve was unsuccessful in prompting additional lending through rate cuts and traditional measures due to the desire of banks, financial institutions, and homeowners to pare down debts. Consequently, an array of historic measures have been taken to force inter-bank lending. This has resulted in a doubling of the size of the central bank's balance sheet, from roughly \$1 trillion to \$2 trillion virtually overnight (see chart 4), as the bank became the central repository for troubled assets. While the Federal Reserve would like to see a resumption of a vibrant level of lending, they cannot force it on a public that is not interested. In the meantime, the Fed and the Treasury will continue to try to shore up the inner workings of the banking system.

If they are unsuccessful, the main risk to the system and to our outlook is that a cessation of lending makes it difficult to expand the supply of new money coming into circulation. As money becomes more scarce, it increases in value and there can develop a tendency for households and businesses to hoard cash as it gains in purchasing power. If such hoarding goes on for an extended period, it can further retard growth by discouraging productive investment, and by making the burden of debtors even greater, since outstanding debts must be repaid with increasingly valuable currency. This negative feedback loop is commonly referred to as "debt-deflation" and would be visible in a general fall in inflation expectations priced into the bond market along with a coordinated fall in asset prices (see chart 5, which shows the forward-implied inflation rate priced into the market for long-term Treasury Inflation Protected Securities).

Chart 4

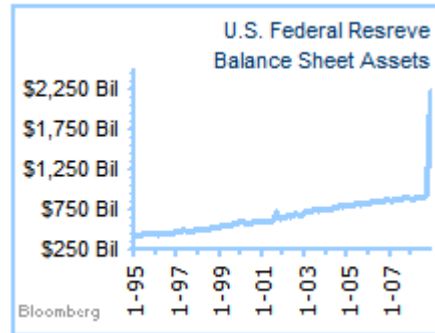
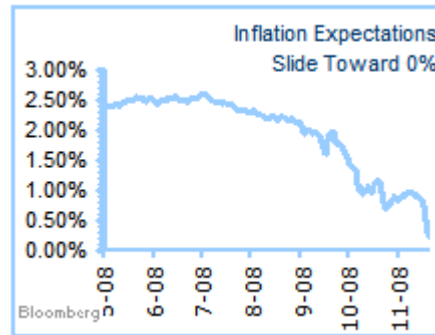


Chart 5



To date, the ongoing liquidation of assets to pay off debts appears, in many ways, to reflect a debt-deflation rather than a traditional inventory-driven recession. We have seen all major asset classes, excluding Treasuries, come under pressure, and equities have been notably roiled as evidenced by a historic 68% downward revaluation of the S&P 500 relative to long-term Treasury bonds (see chart 6). While this is a painful process, this re-pricing is helping to restore attractive values and yields for risk-takers, which is an important precondition to a bull market. In time, **the re-pricing of risk we have seen in this bear market will likely help restore balance to financial markets.**

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Profitability has come under pressure due to falling demand and falling prices. Note that net after-tax profits as a percent of GDP are falling from very elevated levels and have yet to stabilize (chart 7). To adjust to the lower expected volume demand, both production (chart 8) and employment (chart 9) must also be cut. This, in turn, leads to a lack of confidence (chart 10).

Chart 7

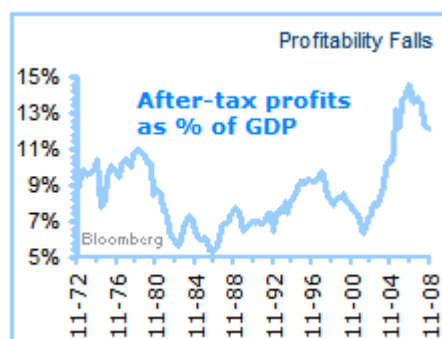


Chart 8

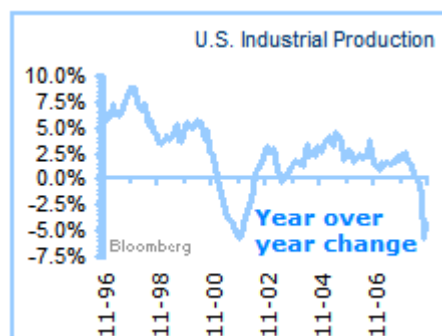


Chart 9

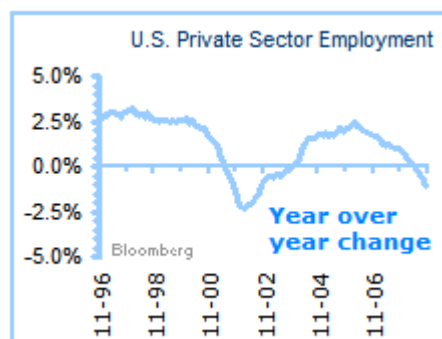
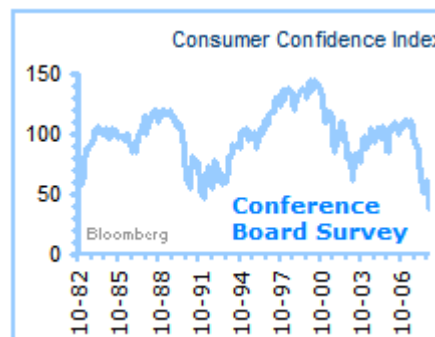


Chart 10

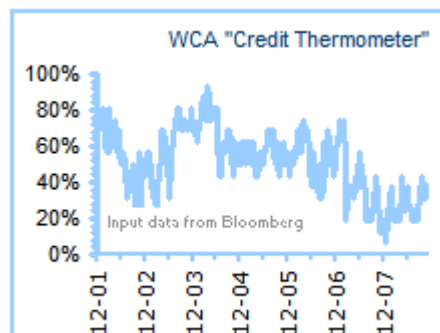


What is Needed to Create a Bullish Case

The re-pricing of risk has been a positive start. We have spoken at length about markets that had been priced as if risk was a thing of the past. With bond yields at the short end of the yield curve at nearly 0% and 10-year Treasury yields near 3.25%, it appears that investors have reversed course and are now clamoring for the safety of government bonds and have abandoned riskier assets like stocks, commodities, real estate, and corporate credits where default risk seems omnipresent. In time, the re-setting of risk will be seen as an important pre-requisite for an eventual recovery in financial markets. In the here-and-now, however, we remain unconvinced that the environment is supportive of a sustained bull market -- especially as the de-leveraging process continues.

For now, we continue to watch for improvement, but there is little substantive fundamental improvement to be found. One slight bright spot is in the small improvement that can be seen in our Credit Thermometer, which seeks to measure the liquidity within the banking system that became frozen in recent months (chart 11). To learn more about the indicator, please refer to our September 24 [Market Commentary](#).

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At present, we conclude that credit conditions remain poor despite some modest improvement in credit conditions in response to a variety of government-sponsored programs enacted to stimulate lending at the institutional level (see chart 10 above). We will continue to monitor these and other inputs and make changes accordingly to our recommended tactical asset allocation exposures in the weeks and months ahead.

Current Portfolio Posture

We await some sign of improvement in financial market conditions before committing risk capital. Our current portfolio emphasizes high grade and liquid assets, including government bonds and bills.

Recommended Asset Allocation

	Growth	Balanced	Conservative
INCOME & OTHER	41.0%	66.0%	91.0%
DOMESTIC BONDS	39.8%	64.0%	88.2%
Money Market	1.2%	2.0%	2.8%
Short-Term Treasuries	8.7%	14.0%	19.3%
Intermediate Term Treasuries	6.8%	11.0%	15.2%
Long-Term Treasuries	6.2%	10.0%	13.8%
Extended Duration (LT Strips)	6.2%	10.0%	13.8%
Investment Grade Corp Bonds	7.5%	12.0%	16.5%
High Yield Corporate Bonds	3.1%	5.0%	6.9%
COMMODITIES & OTHER	1.2%	2.0%	2.8%
Preferred Equity	1.2%	2.0%	2.8%
COMMON STOCKS	59.0%	34.0%	9.0%
DOMESTIC COMMON STOCKS	59.0%	34.0%	9.0%
U.S. SIZE & STYLE	59.0%	34.0%	9.0%
Large Cap Growth	17.4%	10.0%	2.6%
Large Cap Value	17.4%	10.0%	2.6%
Mid Cap Growth	6.9%	4.0%	1.1%
Mid Cap Value	6.9%	4.0%	1.1%
Small Cap Growth	5.2%	3.0%	0.8%
Small Cap Value	5.2%	3.0%	0.8%
TOTAL PORTFOLIO	100%	100%	100%

Recommended Sector Allocation

	Suggested Weight	S&P 500 Weight*
U.S. Equity Sectors		
Energy	0%	13%
Technology	12%	17%
Materials	4%	3%
Industrials	4%	12%
Consumer Discretionary	10%	8%
Health Care	26%	12%
Utilities	13%	4%
Consumer Staples	16%	10%
Telecommunications	0%	4%
Financials	14%	18%
Total	100%	100%

* Source: Bloomberg

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