WASHINGTON CROSSING ADVISORS

January 2013

www.washingtoncrossingadvisors.com

Tactical Allocation: First Quarter 2013

Kevin Caron
Portfolio Manager
(973) 549-4051

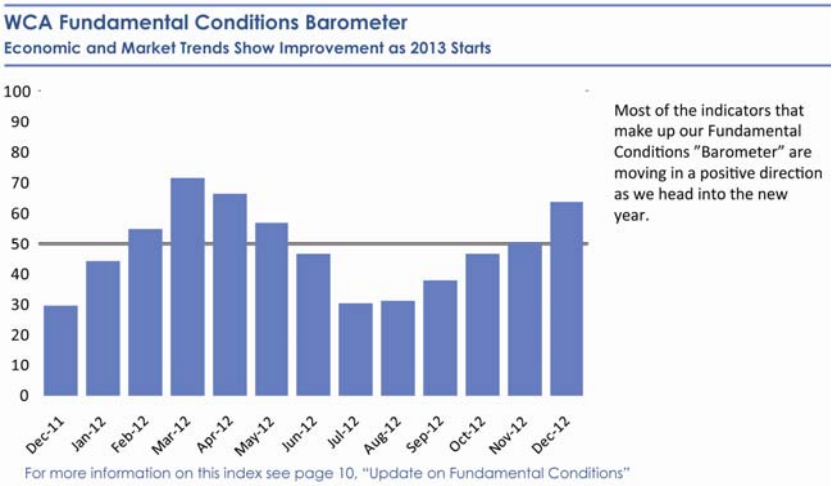
Chad Morganlander
Portfolio Manager
(973) 549-4052

Matthew Battipaglia
Analyst
(973) 549-4047

Positives Emerge Despite Political Rancor

Our analysis of incoming data suggests a decent start to 2013. These observations form the basis for our forecast as we start the year. Even though a policy misstep could always derail the economy, we expect a positive environment for investors because *valuations appear reasonable* and *economic fundamentals are gradually improving*.

Most indicators of change in the economy are pointing toward near-term growth. Consequently, our WCA Fundamental Conditions Barometer is moving higher (chart below). Improvement began last fall despite drought, hurricane Sandy, and rancor over the "fiscal cliff." (Detailed information on the index below can be found under the section titled "Update on Fundamental Conditions").



We see the following significant mileposts and challenges ahead:

1. The debt ceiling and related continuing budget resolutions in the United States must be successfully negotiated.
2. Europe needs to boost growth while advancing banking and fiscal reform. Such reforms are politically difficult, especially in places like Germany and Italy that hold elections this year.
3. Central banks must maintain the flow of credit while utilizing a weaker set of policy tools than previously available.

Forecasts and Assumptions

We expect to see moderate growth in the U.S. economy this year, near 2%. Growth should be helped by strength in final demand by consumers and augmented by positive contributions from business investment and residential investment (following years of slippage). The rate of unemployment should continue to decline slowly toward 7% while inflation remains modest and interest rates remain historically low. Corporate profits should advance, but at a much slower rate than recent years, as margins are near peak levels and sales growth is moderate.

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2013 GDP Forecasts and Assumptions

	2011 (Actual)	2012 (Estimate)	2013 (Estimate)	2012-2013 Change
Gross Domestic Product (Real)	**13,256**	**13,538**	**13,813**	**2.00%**
Consumption	9,429	9,610	9,754	1.50%
Investment	**1,706**	**1,846**	**2,005**	**8.60%**
Residential Investment	328	366	421	15.00%
Business Investment	1,378	1,480	1,584	7.00%
Government	**2,529**	**2,495**	**2,476**	**-0.80%**
Federal Government	1,047	1,033	1,043	1.00%
State & Local Government	1,482	1,462	1,433	-2.00%
Net Trade	**(408)**	**(413)**	**(421)**	**2.00%**
Unemployment Rate	9.00%	8.10%	7.00%	-1.1%
Corporate Profits (S&P 500)	$96.13	$98.28	$105.00	6.8%

Source: Bureau of Economic Analysis; Federal Reserve Bank of Philadelphia

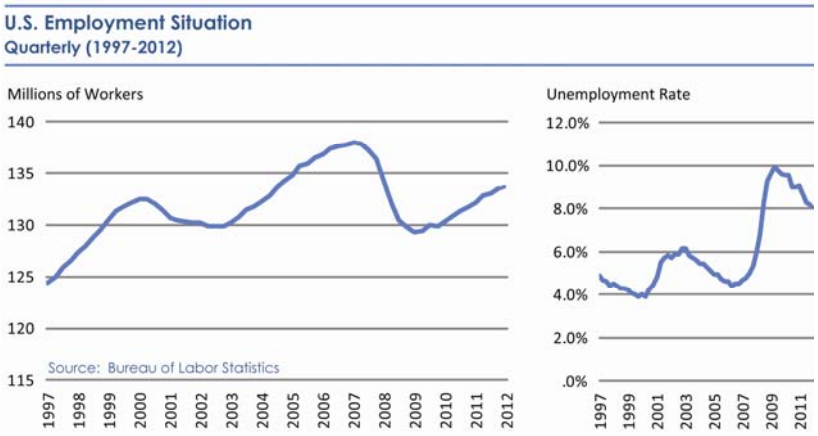
Key assumptions for 2013:

- Economy avoids recession, grows at a below-trend 2% rate
- Monetary policy remains accommodative, fiscal drag from "fiscal cliff" is modest
- Interest rates track with moderate levels of inflation. Rates remain low throughout 2013

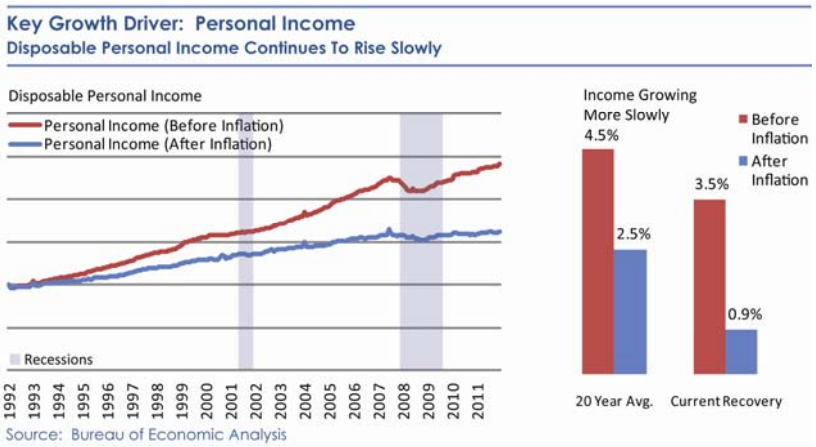
Factors Driving Growth

Businesses have increased their headcount every month since February 2010, but the growth has been slow. Jobs in the private sector increased at about 1.7% annually in 2011 and 2012. More telling is the fact that total employment among businesses is roughly the same as it was back in 1999 despite the addition of 30 million additional citizens.

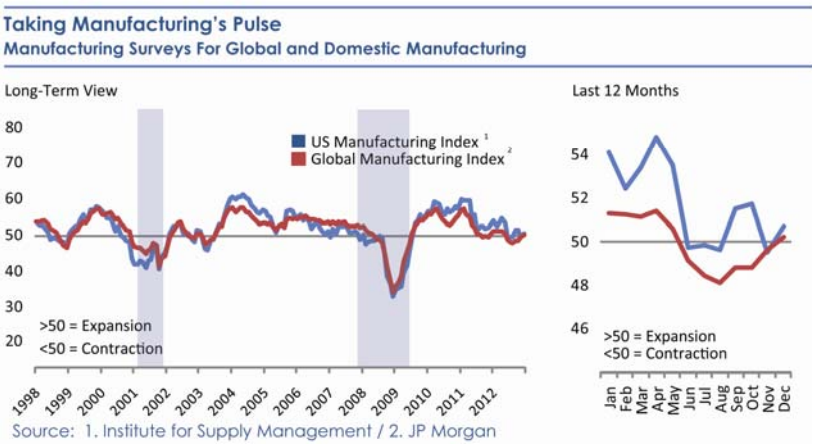
The fact remains that the job market is improving, but there is still a long way to go before the situation begins to "feel good."



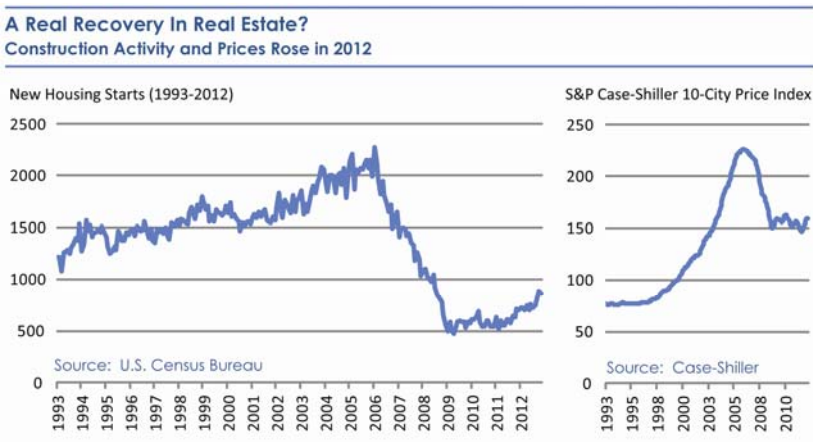
Income has grown slowly too, especially when adjusted for inflation. Since 1990, household income grew an average of 4.5% per year before inflation and 2.5% per year after inflation. At that rate, purchasing capacity was doubled about every thirty years. Recently, income growth is closer to 0.9% after inflation — a rate that would require a lifetime to see a doubling of purchasing capacity.



Manufacturing is another area that highlights important trends in the economy. The charts below show manufacturing as generally steady, with hopeful recent signs of improvement. Last summer saw a sharp drop in global production as Europe's recession deepened, but these trends improved toward year-end (see manufacturing chart, below-right).



Construction and real estate is also part of the story for 2013. After several years of powerful contraction, there are tentative signs of improvement in both construction activity and real estate prices (see below). We forecast continued improvement in 2013 helped along by modest increases in income and improved affordability given low interest rates and lower average home selling prices from the prior peak (nationally, prices are down by about one-third, based on the S&P Case-Shiller 10-City Home Price Index, below-right).

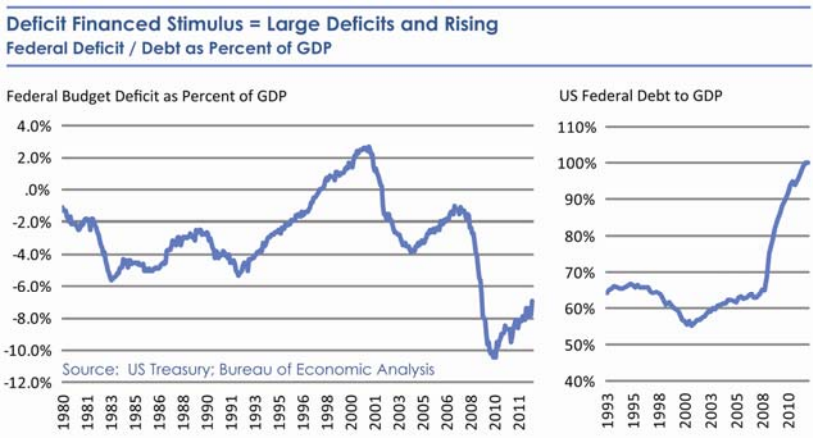


While the economy is improving, at least some of the gains achieved in employment, income, manufacturing, and real estate are being underwritten by extraordinary policies designed to spur growth.

Government Deficits and Debt

Whenever government spends more than it receives in taxes, output and employment get a boost, but deficits and debt grow as well (chart, below). Recent years' spending and tax policies enacted by Congress are no exception. The recovery has likely been better than would have been the case without these policies, but the related increase in debt will impose longer-term costs.

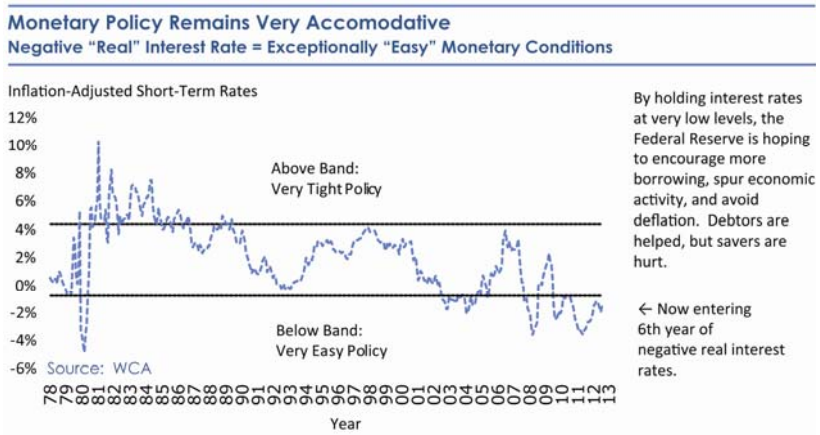
Such large deficits are creating concern, and are harder to sustain politically as the economy improves. The ongoing "fiscal cliff" negotiations illustrate this point. Add to the mix external pressure from markets and rating agencies to address fiscal imbalances, and the limits of governmentally underwritten stimulus initiatives become more apparent.



Current budget negotiations, therefore, add a degree of risk to the outlook. Large cuts in government spending and/or a sharp rise in taxes would significantly raise recession odds. Given Congress' low approval rating, an already slow economy, and dearth of additional policy levers to combat an unexpected recession, we expect to see only a modest reduction to this year's deficit. The partial budget deal reached at year-end was only the first step in a longer process that will recommence as Congress heads to a new round of budget negotiations in the weeks ahead.

Central Banks and Monetary Policy

We are six years into a period of exceptionally low interest rates. After adjusting for inflation, an investor in U.S. Treasury bills is losing 1.75%. Central banks, including the Federal Reserve, are responsible for setting interest rates and directing monetary policy. By holding down interest rates, they hope to spur spending in lieu of savings, encourage borrowing and extension of credit, and drive risk-taking over the safety of holding "risk-free" assets.

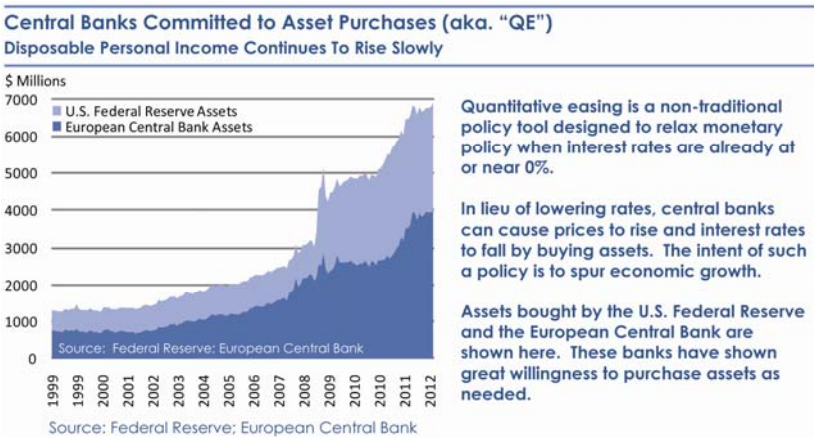


Changes in monetary policy have a strong influence on borrowing, credit, prices, and the economic cycle. Much of the economic phenomena of the past 40 years can be at least partly explained by changes resulting from monetary policy and the flow of credit (chart, below).

Central Banks (Continued)

A primary objective of central banks is to maintain a steady, moderate, and positive inflation rate. Under normal circumstances, central banks adjust interest rates and engage in purchases and sales of assets to regulate the flow of credit and the economy. Now that interest rates are effectively 0%, central banks must rely entirely on asset purchases to conduct monetary policy. Such asset purchase programs are often referred to as "quantitative easing," or simply, "QE."

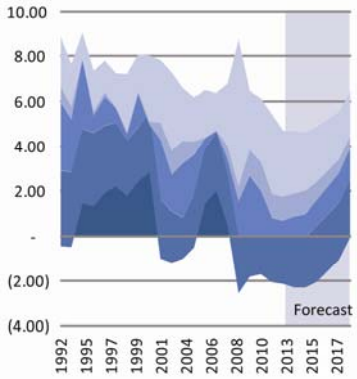
Central banks' balance sheets have been growing along with the assets they have been purchasing. The combined size of the Federal Reserve and European Central Bank balance sheet has tripled since the financial crisis (chart, below), indicating how resolutely determined banks have been in their attempts to forestall falling prices and deflation. We expect policymakers to continue to utilize "quantitative easing" as needed to maintain a positive inflation rate provided inflation remains at acceptable levels.



Rate Outlook

We expect to see relatively modest inflation through 2013 and a continuation of low interest rates. Given the size of the coordinated global effort to spur spending and avoid another recession, we believe that policymakers will err on the side of excessive ease over excessive tightening. Such an outcome may look like that pictured below.

Interest Rate "Repression" Remains For Now
Federal Reserve to Keep Rates Low Again in 2013

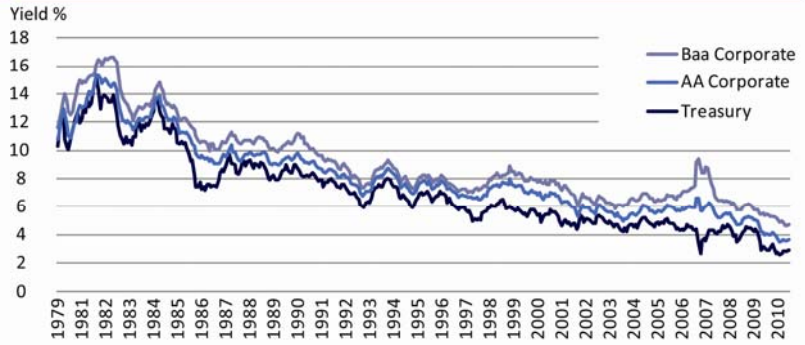


	20 Year Average	2012 Year-End	2013 Forecast
Corporate Bonds (Baa)	7.16	4.70	4.70
Long-Term Treasury Bonds	4.65	1.76	1.92
Intermediate Treasury Notes	4.11	0.72	0.92
Treasury Bills*	2.71	0.02	0.02
Expected Inflation	2.53	2.11	2.25
Real Short-Term Interest Rates	0.19	(2.09)	(2.23)

* Sum of Expected Inflation and Real Short-Term Interest Rates

In this scenario, we see some modest pickup in inflation and Treasury yields throughout 2013, eventually giving way to a more normal rate environment through the outer years. This means that the current level of low interest rates, while with us for a while longer, probably marks the end of a 30-year cycle (see below).

Interest Rates at 30-Year Lows
(1979-2012)



What Happens to Bond Returns When Interest Rates Start to Rise?

The answer depends on the time it takes for rates to rise to more normal levels and how high rates eventually move. The longer the adjustment period and the less the adjustment, the more favorable it is for bond investors. The opposite also holds true.

While a fall in yields is unlikely, it would produce gains (below, left) but an increase may or may not yield losses, depending on the time horizon (below, right). Either way, it is hard to envision significant and sustained long-run returns coming from long-term Treasury bonds given today's yields. Therefore, we continue to favor corporate bonds over Treasuries as a source for incremental yield.

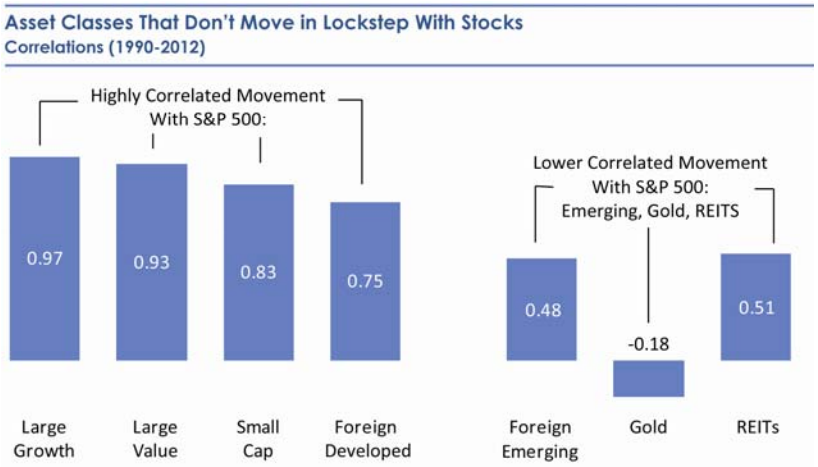
Holding Period Total Returns Under Different Rate Scenarios
Example: 10-Year U.S. Treasury Bond

A Place for "Alternative" Assets

Given the inherent risk of equity investments and the low yields available in bond markets, investors have turned increasingly to assets that have traditionally not performed in lockstep with either stocks or bonds. Two areas where historically low correlations have been found are real estate investment trusts and commodities (including gold).

The chart below shows three categories of investments that, over the past two decades, have proven to have a lower correlation with the stock market. To one degree or another, each asset class (foreign emerging, gold, and REITs) offer some connection with physical assets. Because physical assets respond differently to inflation than bonds and stocks, inflation may partly explain the lower correlation.

REITs, in addition to providing a historically lower correlation with the broad stock market, offer a yield that is about 1.4% higher than the yield available on a long-term U.S. Treasury bond. That incremental 1.4% yield is higher than the average spread of 1.0% over the past 20 years.

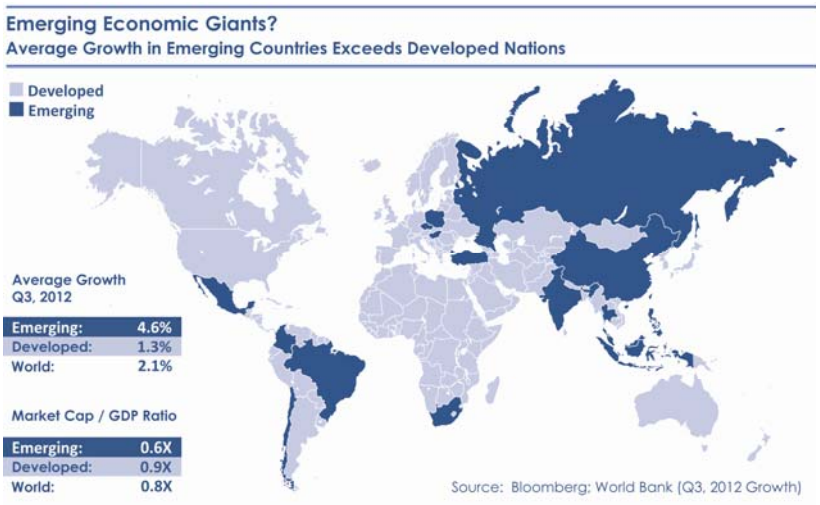


Gold has served as a portfolio diversifier and an effective hedge against accommodative, inflation-oriented monetary policies. Ongoing pledges by central banks to continue asset purchases create some tail risk of higher inflation down the road. Since 1972, gold outpaced inflation by annualized 4.4%, demonstrating its role as a store of value. However, gold can be volatile and difficult to value, since it provides no coupon payment or dividend. Accordingly, we believe it should be considered only one part of a diversified portfolio.

Foreign Investing

We see opportunity overseas for faster growth that is not directly linked to the United States.

Large portions of the global equity markets are comprised by faster-growing, emerging markets. These economies are in various stages of development. Formerly agrarian and commodity-driven economies are evolving toward industrialization and higher levels of mass consumption. The majority of the world's population lives in these areas, and most are experiencing a rising standard of living.



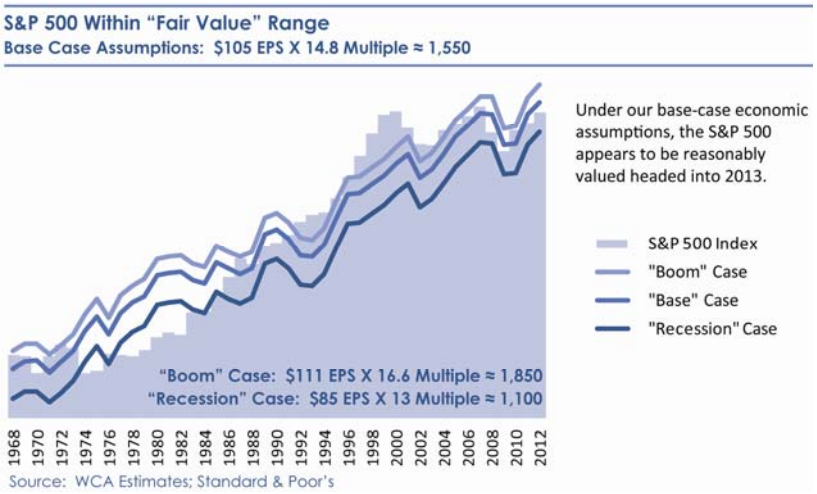
The graphic above highlights the opportunity provided in emerging markets. The first thing to note is the overall growth of the leading emerging markets (Brazil, China, Russia, India, etc.) far exceeds the developed world (United States, Europe, etc.). As of the third quarter, 2012, the average growth rate among emerging economies was 4.6% versus 1.3% in developed countries. Additionally, these emerging countries' stock markets were valued favorably versus developed nations, all else being equal, at 0.6X market cap-to-GDP for emerging markets vs. 0.9X for developed markets.

While opportunities exist, it is important to remember that emerging markets tend to be sensitive to changes in commodity prices and swings in currencies can impact returns. Still, we believe these investments have a place in investor portfolios given the long-run potential in these areas.

Stock Market Valuation

Under our base case scenario for 2013, we see the S&P 500 moving higher. This scenario has the S&P 500 index generating $105 of earnings and trading at a median multiple near 14.8 times those earnings. That would place a "fair value" near 1,550 on the index — roughly an 8% return on the index from the 2012 close.

This estimate marks the mid-point in a broader "fair value" framework. The broader range of 1,100 to 1,850 encompasses both "recession" and "boom" extreme cases. The range will be updated periodically throughout the year, as it is forward-looking with a 12-month rolling "window."



Concluding Remarks

Although it remains possible that an unforeseen event or policy misstep could impact the year, we are encouraged by recent trends that are plainly evident in the data. The economy and financial markets appear to be performing in a way consistent with continued moderate growth despite a series of challenges in 2012 (Europe, elections, hurricane Sandy, drought, etc.). In addition, we see the overall stock market as reasonably valued, and inflation appears to be modest.

These factors, coupled with continued monetary and fiscal policy support all have contributed to our portfolio positioning and view as we start the year.

A Barometer for Assessing Changing Conditions

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

Analysis incorporates approximately 30 forward-looking indicators in categories ranging from **Credit and Capital Markets** to **U.S. Economic Conditions** to **Foreign Conditions.**

From each category of data, we create 3 diffusion-style sub-indices that measure the trends in the underlying data. Sustained improvement that is spread across a wide variety of observations will produce index readings above 50 (potentially favoring stocks); while readings below 50 would indicate potential deterioration (potentially favoring bonds).

The WCA Fundamental Conditions Index™ combines the 3 underlying categories into a single summary measure. This measure can be thought of as a "barometer" for changes in fundamental conditions.

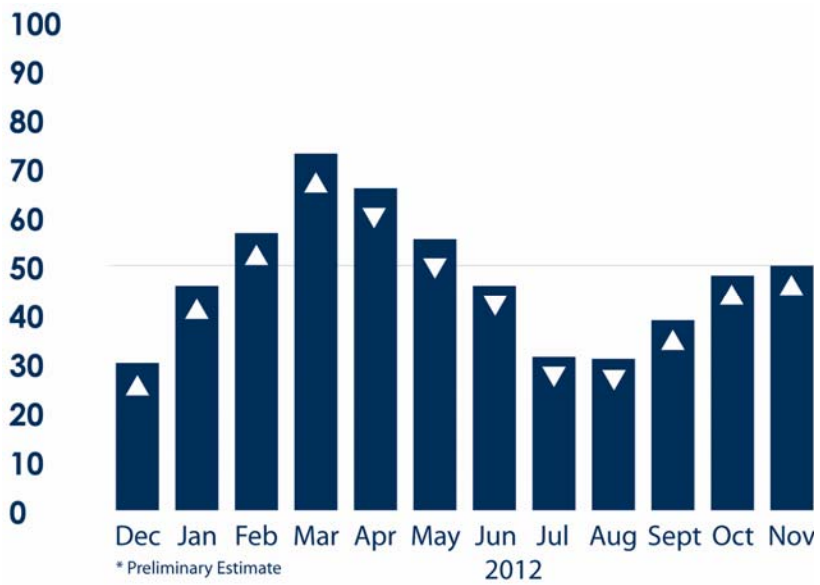
Update on Fundamental Conditions

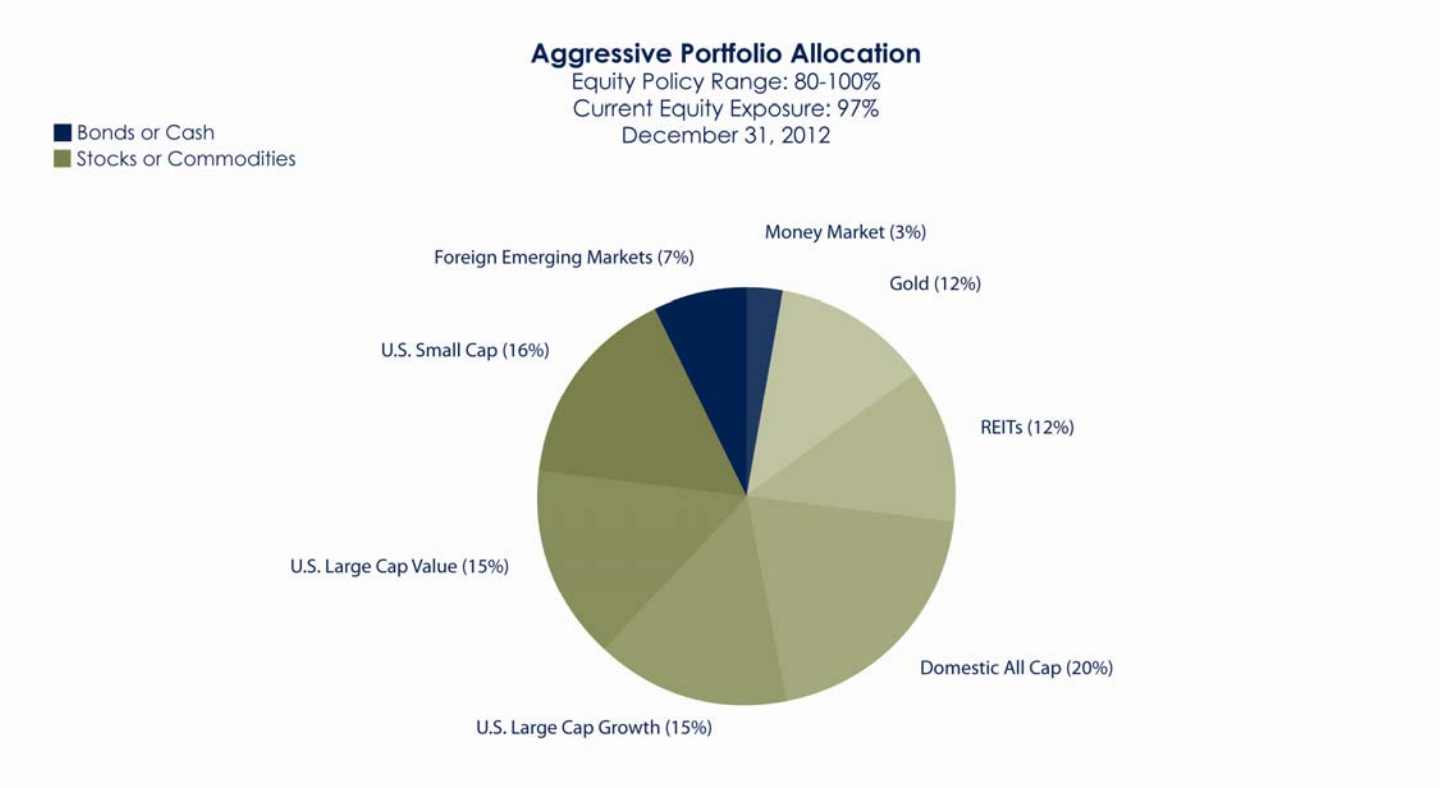
Fundamental conditions strengthened last quarter. Further central bank easing in both Europe and the United States helped markets overcome challenges posed by politics (U.S. elections and "fiscal cliff") and weather (drought and hurricane Sandy).

WCA Fundamental Trend Indicators

	Last Quarter	Current (Preliminary)	Change
Credit & Capital Markets	56	88	+
U.S. Economic Conditions	35	65	+
Foreign Conditions	15	50	+
Fundamental Conditions	35	67	+

WCA Fundamental Conditions "Barometer" 1-Year





Increasing Risk ---------->

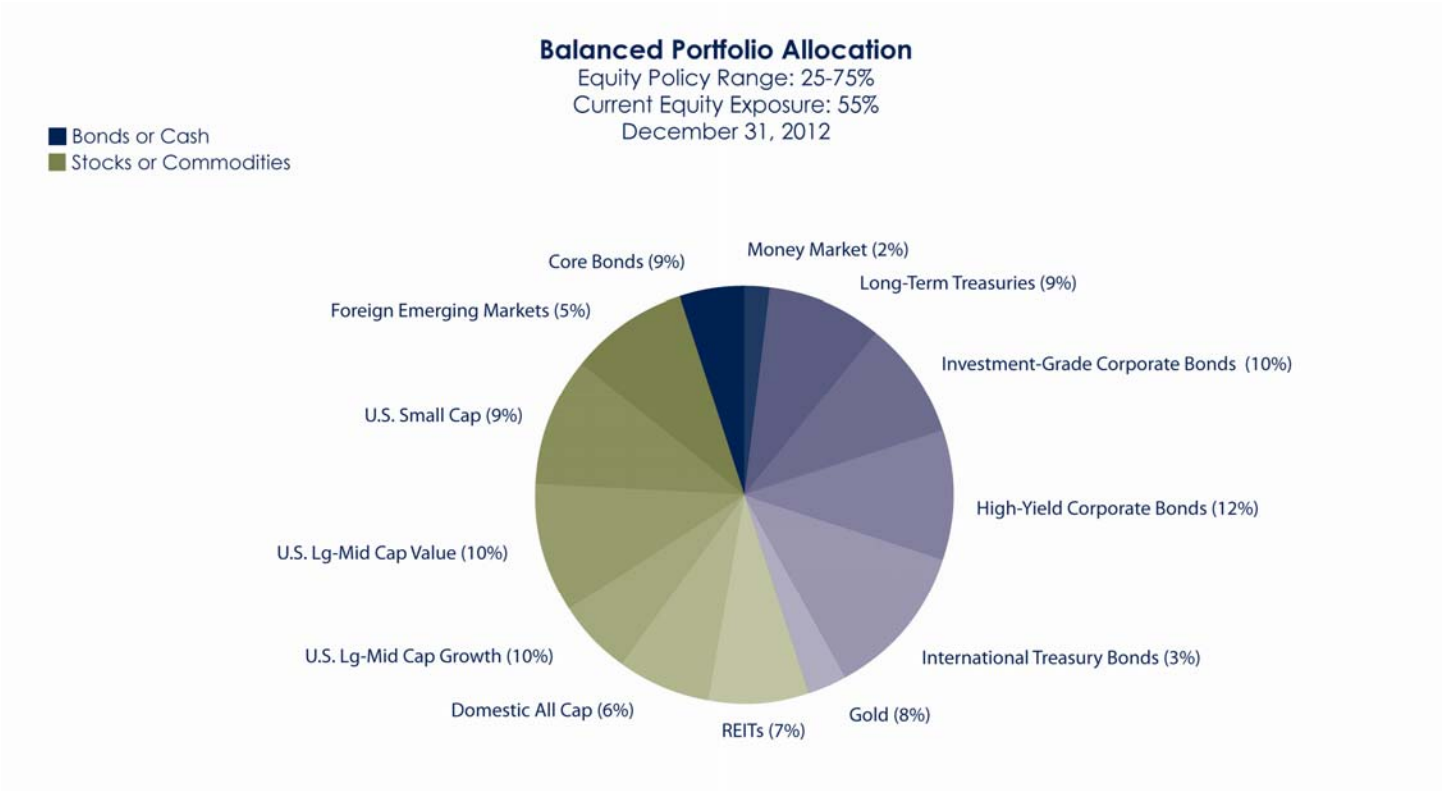
Conservative	Balanced	Moderate Growth	Aggressive Growth

The AGGRESSIVE PORTFOLIO invests between 80-100% in equities based on fundamental market and economic conditions. The strategy seeks to provide a risk-adjusted return, over time, better than that of a fixed portfolio comprised of 90% stocks and 10% bonds. Because of the high degree of exposure to stocks, investors in this portfolio should have an investing time horizon of at least 20 years or be able to accept greater variability of returns associated with stock market investing.

Increasing Risk ---------->

Conservative	Balanced	Moderate Growth	Aggressive Growth

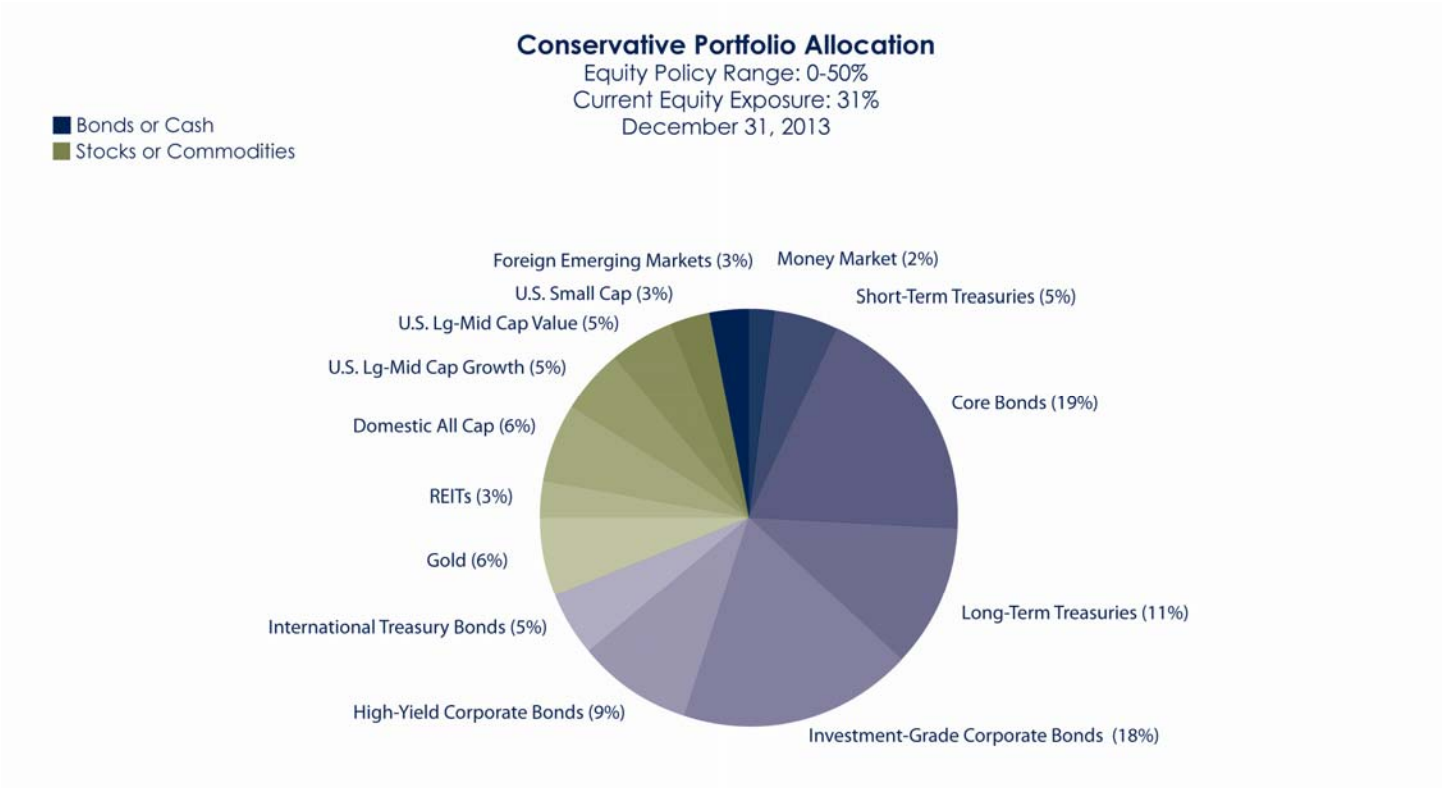
The MODERATE GROWTH portfolio invests between 50-100% in equities based on fundamental market and economic conditions. The strategy seeks to provide a risk-adjusted return, over time, better than that of a fixed portfolio comprised of 75% stocks and 25% bonds. Because the portfolio invests primarily in stocks and secondarily in bonds, the portfolio may be appropriate for investors with a time horizon of at least 15 years or those who seek principal growth with a moderate amount of income. amount of income.



Increasing Risk ---------->

Conservative	Balanced	Moderate Growth	Aggressive Growth

The BALANCED PORTFOLIO invests between 25-75% in equities based on fundamental market and economic conditions. The strategy seeks to provide a risk-adjusted return, over time, better than that of a fixed portfolio comprised of 50% stocks and 50% bonds. The portfolio provides a mix of stocks and bonds without a bias toward either. It may be appropriate for investors with a time horizon of at least 10 years with a moderate risk tolerance.



Increasing Risk ---------->

Conservative	Balanced	Moderate Growth	Aggressive Growth

The CONSERVATIVE PORTFOLIO invests between 0-50% in equities based on fundamental market and economic conditions. The strategy seeks to provide a risk-adjusted return, over time, better than that of a fixed portfolio comprised of 25% stocks and 75% bonds. This portfolio offers the most conservative mix of stocks and bonds relative to the other portfolios mentioned herein. Investors with a short-to-medium investment horizon of at least 5 years or lower risk tolerance who desire modest growth may prefer this option over a portfolio with greater exposure to stocks.

Sector Allocation

	Portfolio Weight	S&P 500 Weight	Relative Weight
Energy	10%	12%	-2%
Technology	20%	19%	+1%
Materials	10%	4%	+6%
Industrials	10%	10%	0%
Consumer Discretionary	10%	12%	-2%
Cyclical Sectors	60%	57%	+3%
Health Care	13%	12%	+1%
Utilities	0%	3%	-3%
Consumer Staples	10%	10%	0%
Telecommunications	0%	3%	-3%
Financials	17%	15%	+2%
Non-Cyclical Sectors	40%	43%	-3%
Total	100%	100.0%	0.0%

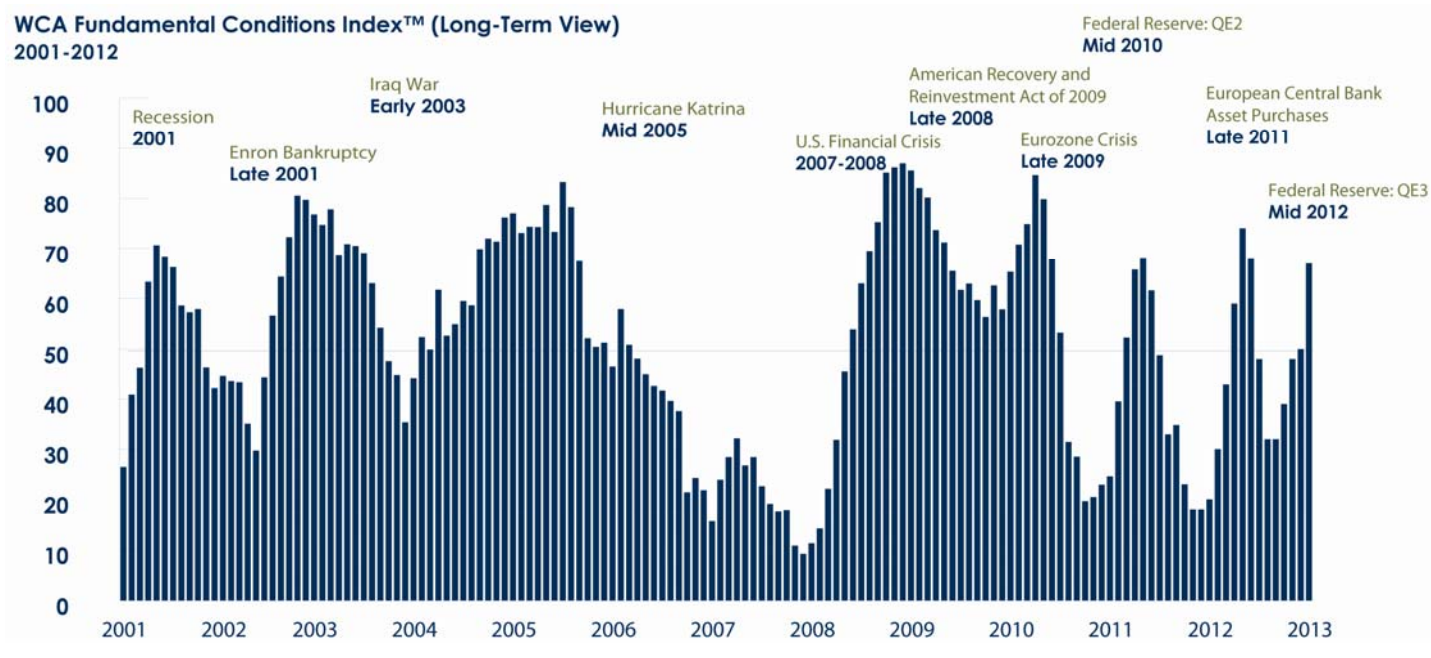
Portfolio Changes

Fourth Quarter, 2012

	Conservative		Balanced		Moderate Growth		Aggressive Growth	
	Current	Change	Current	Change	Current	Change	Current	Change
Core Bonds	19%	-	9%	-2%	0%	-6%	0%	-
Cash & 1-3 Year Treasuries	7%	-3%	2%	-3%	2%	-	3%	-7%
3-7 Year Treasuries	0%	-	0%	-	0%	-	0%	-
7-10 Year Treasuries	18%	7%	9%	-	0%	-	0%	-
10+ Year Treasuries	0%	-	0%	-	0%	-	0%	-
Investment-Grade Corp Bonds	18%	-	10%	-	4%	-	0%	-
High-Yield Corporate Bonds	9%	-	12%	-	13%	-	0%	-
International Treasury Bonds	5%	-	3%	-	0%	-	0%	-
Domestic Stocks	6%	-	6%	-	15%	-	20%	-
Large-Mid Cap Growth	5%	-	10%	-	13%	-	15%	-
Large-Mid Cap Value	5%	-	10%	-	13%	-	15%	-
Small Cap Growth	3%	-	9%	-	15%	-	16%	-
Developed Markets	0%	-	0%	-	0%	-	0%	-
Emerging Markets	3%	3%	5%	5%	6%	6%	7%	7%
Gold	6%	-	8%	-	10%	-	12%	-
REITs	3%	-	7%	-	9%	-	12%	-
Subtotal Bonds & Cash	76%	4%	45%	-5%	19%	-6%	3%	-7%
Subtotal Equities & Other	31%	3%	55%	5%	81%	6%	97%	7%
Total	107%	7%	100%	0%	100%	0%	100%	0%

A Long-Run View

These long-run expectations are the starting point for asset allocation. Events will inevitably take place that cannot possibly be anticipated or forecast, and as a result, these expectations will almost certainly change over time. To help identify such changes in the investing environment, we constructed The WCA Fundamental Conditions Index™ seen below. It is similar to a barometer that focuses on changes in financial market and the economic trends. We believe that combining a long-run strategic outlook with shorter-term tactical observations represents a practical method for addressing uncertainty and change in the short run without losing sight of the longer term.



Over the long run, we believe that deleveraging in the private sector will keep unemployment rates high and inflation and interest rates low. Developed nations, including the United States, Europe, and Japan, are most affected. To combat deleveraging and potential deflation, aggressive, sustained, and coordinated efforts by central banks to reflate should eventually lead to a higher overall price level. Away from the developed world, emerging markets should see rising demand for commodities and a growing consumer class. Growth and investment returns in these economies should, therefore, outstrip the growth and return profiles of many developed economies.

Cash and other short-term instruments remain very low through 2016, and central banks should move gradually to normalize interest rates beyond 2016. Spreads on corporate bonds relative to Treasuries may narrow in the intermediate term, but longer-term returns will be constrained by already low Treasury yields. Higher-yielding corporate bonds should generate income returns that are above high-grade corporate bonds and Treasuries, but expect higher volatility.

Large capitalization domestic stocks should generate high-single-digit long-run returns driven by three key factors. These factors include earnings per share growth, dividend yield, and some modest multiple expansion. Corporate earnings per share should rise faster than domestic output due to cost discipline, rising demand from emerging economies, and technological innovation. Technology, healthcare, and consumer sectors are logical beneficiaries of these trends. Corporate tax policy is expected to be neutral to positive. Dividend yields should rise due to cash flow and earnings growth and some increase in the dividend payout ratio. Small to mid-sized firms should benefit from acquisition activity by larger companies with a growing cash hoard and the potential for smaller firms to grow faster and adapt more quickly to change than large companies.

Real estate is likely to provide above-trend longer-run returns given recent underperformance. Commodities and Gold should provide returns near global GDP growth with potential near-term variations strongly affected by inflation expectations.

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."

The Standard & Poor's 500 Index is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market.

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."