Washington Crossing Advisors

www.washingtoncrossingadvisors.com

July 2012

Tactical Allocation: Third Quarter 2012

Bumper-to-bumper traffic

A stop-start growth pattern since 2009 makes this recovery feel vastly different than past recoveries. Large deficits and larger debts are major factors behind the uneven pace of recovery. Rather than accelerating smoothly into the economic fast lane, the journey away from the financial crisis seems more like being stuck in traffic. Forward progress continues, but progress is frustratingly slow.

With data for June starting to come in, evidence of slowing growth is once again mounting. This time, Europe is leading the slowdown as stimulus fades and uncertainty mounts over the future of the European Union. Along with Europe, global growth is slowing. This latest slowing marks the third time since the official start of recovery in 2009. Time will tell whether this proves to be a temporary setback or the beginning of a more significant decline. Either way, we know from recent experience that some caution is warranted when the economy fails to cooperate. January 2010 through September 2010 and May 2011 through December 2011 also saw slowing, and markets proved more difficult as a result.

Although the present data is less than encouraging, there are positives that may have longer-lasting implications. U.S. corporations, for example, are the most profitable and best capitalized of any time in recent memory. After-tax profits as a percent of GDP are at an all-time record high – 10.6%. Capital spending for the S&P 500 companies has increased for each of the past three years. The level of corporate indebtedness is lower than it has been for at least 20 years. Personal savings is rising. The pool of capital available for future spending and investment is growing. Although near-term uncertainties are increasing, we must not lose sight of these important facts as we look to the years ahead.

Europe

It is undeniable that, in the near-term, slowing growth and lingering concerns over Europe must be addressed. Europe continues to struggle with integration under a common currency as debts mount, and growth increasingly gives way to contraction. Eurozone "growth" was 0.00% in the first quarter and likely slipped further in the second quarter based on recent data. The basic problem is that individual countries appear unwilling to incur mutual debts and sacrifice sovereignty for the benefits of a common currency. In our view, actions (or lack thereof) mean more to markets and increasingly suggest the Eurozone is heading toward one of two outcomes.

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The improvement seen in job growth from late last fall into the spring has abated…

The first outcome involves the partial or complete reestablishment of individual national currencies. Full sovereignty and independence for each country would follow. Although disruptive in the short-run, this could produce a more sustainable situation over time. Currencies would stand alone and compete in global markets based on merit.

The second outcome involves a costly and politically challenging process of repairing holes in the existing patchwork of agreements. It is unclear exactly what the cost of bailouts might ultimately be, but we are mindful that the United States committed over two-thirds of GDP through loans, stimulus, backstops, and guarantees in *our* recent financial crisis. Existing European commitments are far less. If the Euro really offers the social value that its founders claim, then why is there such reluctance to pay for it and abide by commitments designed to ensure its survival?

Regardless of how Europe addresses their challenges, we continue to believe that the best investments will come from a focus on quality, consistency, and value. Balance is especially important at this time.

Manufacturing, Employment, Spending, and Inflation

Back in the United States, we continue to monitor a wide variety of data for changes in financial market risk appetite and the overall economy.

Manufacturing, employment, spending, and inflation are key indicators of fundamental progress in these areas. We take a month-to-month view of this data as it becomes available, and the last couple months have brought unequivocal evidence of slowing.

Purchasing manager indices for China, Germany, the United Kingdom, Spain, Italy, France, Greece, and the United States all came in below 50 for June. Readings below 50 are generally consistent with anemic growth or contraction.

The facts point to slower growth and lower inflation…

The improvement seen in job growth from late last fall into the spring has abated. In the first quarter, monthly job growth averaged 225,000 jobs *per month*. It took the entire second quarter to see the addition of 225,000 jobs.

Consumer spending, which was rising at about 5% last fall, is now below 4% and trending toward 3%. Growth is still positive, but appears to be slowing. Even automobile sales growth is slowing as the three-month average annualized total cars sold is near 14.05 million – slightly less than the 14.27 million three-month average pace.

Commodity prices, forward-looking inflation expectations priced into the bond market, producer prices, and consumer prices all have weakened. Oil has fallen from $105 a barrel to $85 a barrel, and a gallon of unleaded gasoline is down to $3.50 from $4.10 in April.

What to Do Now?

The facts point to slower growth and lower inflation. This outcome favors bonds over stocks in the short-run. We recognize, too, that should fundamental conditions continue to slip in the months ahead, a more aggressive monetary easing or other policy response could be forthcoming (and could change the outlook). If past evidence is a guide, however, some further weakness in fundamental conditions, like those mentioned above, would need to become more evident first, in our view. Specifically, we note that policy responses tend to coincide with much lower points on our Fundamental Conditions Barometer, seen at the end of this report.

Although a major new policy initiative could emerge and change the outlook at some point in the future, we believe that such an event is not imminent. Left with slipping growth, a modest lightening of equity exposure (particularly foreign) in favor of dollar-denominated bonds is reasonable until slowing trends abate.

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).

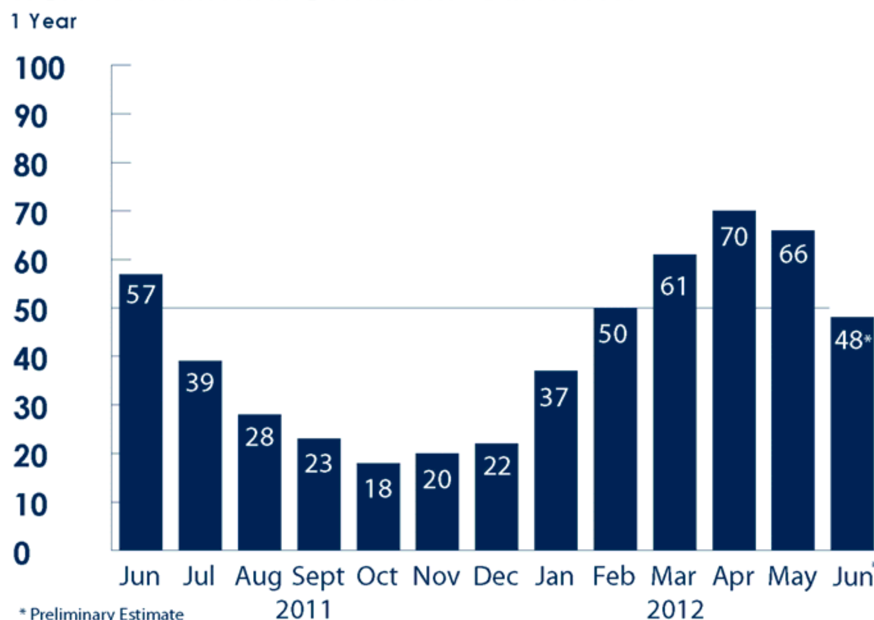
The WCA Fundamental Conditions Index™ combines the 3 underlying categories into a single summary measure. This measure can be thought of as a "barometer" for changes in fundamental conditions.

Update on Fundamental Conditions

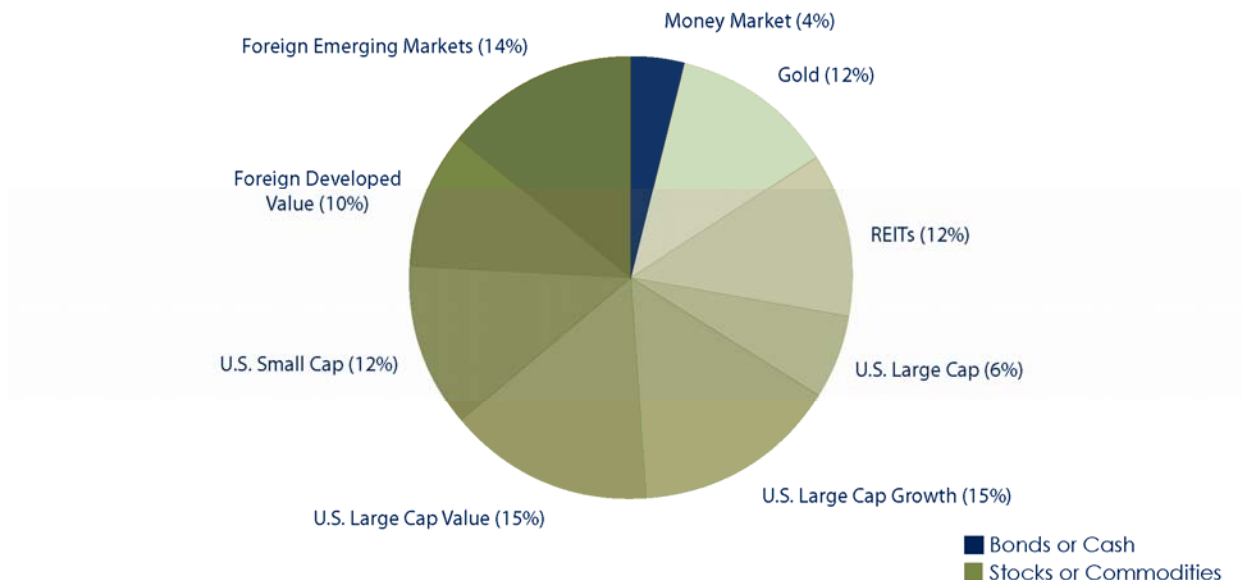
Two changes occurred with our "barometer" since the last quarterly report. First, the barometer stopped rising and has slipped back toward 50. Second, we substituted several of the indicators within the foreign conditions category of the index with more timely and forward-looking purchasing managers' survey data. Our June 13 commentary titled "Global Focus" discussed this substitution.

During the quarter, we saw that the rate of improvement in fundamental conditions moderated from the first quarter. Currently, about half of the indicators we follow are moving in the direction of continued growth, while the other half suggests that growth is slowing. The June data is far from complete, but the preliminary reading is near 50.

	Last Quarter	Current (Preliminary)	Change
Credit & Capital Markets	53	60	+
U.S. Economic Conditions	65	50	-
Foreign Conditions	60	45	-
Fundamental Conditions	59	52	-



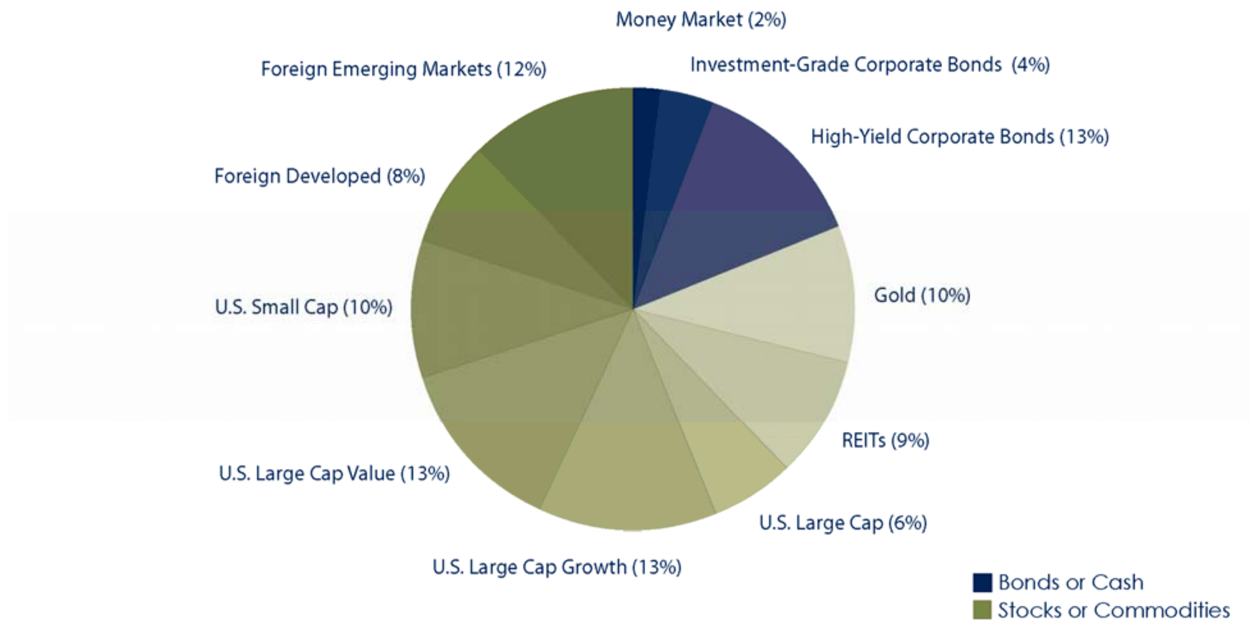
Aggressive Portfolio Allocation
Equity Policy Range: 80-100%
Current Equity Exposure: 96%
June 30, 2012



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

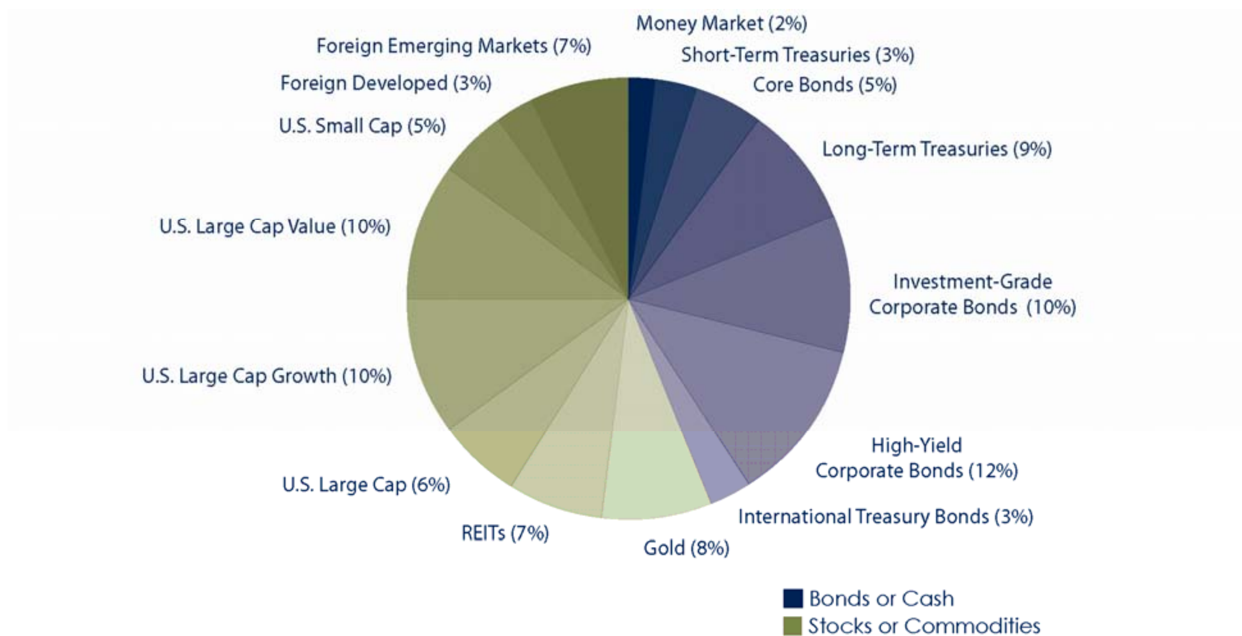
The AGGRESSIVE PORTFOLIO invests between 80-100% in equities based on fundamental market and economic conditions. The strategy seeks to provide a risk-adjusted return, over time, better than that of a fixed portfolio comprised of 90% stocks and 10% bonds. Because of the high degree of exposure to stocks, 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.

Moderate Growth Portfolio Allocation
Equity Policy Range: 50-100%
Current Equity Exposure: 81%
June 30, 2012

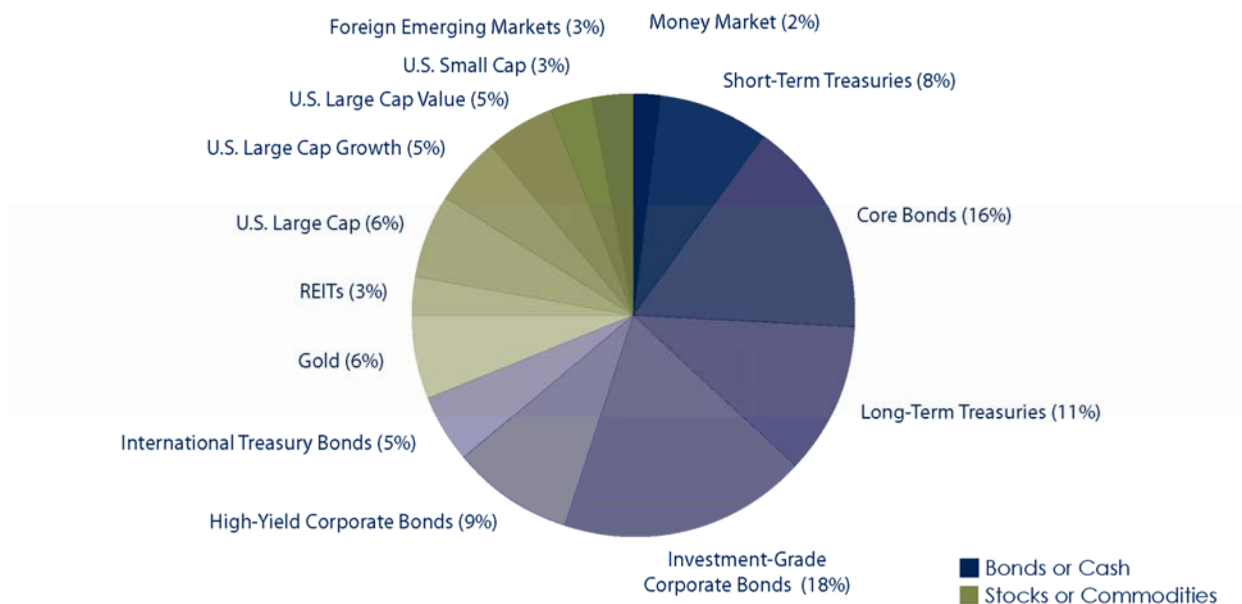


Increasing Risk ---------------------->

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.



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
(Sector-Enhanced Portfolios Only)

	Portfolio Weight	S&P 500 Weight	Relative Weight
Energy	17%	11%	+6%
Technology	23%	21%	2%
Materials	3%	3%	0%
Industrials	10%	11%	-1%
Consumer Discretionary	10%	11%	-1%
Cyclical Sectors	63%	57%	+6%
Health Care	13%	11%	2%
Utilities	7%	3%	4%
Consumer Staples	10%	11%	-1%
Telecommunications	0%	3%	-3%
Financials	7%	15%	-6%
Non-Cyclical Sectors	33%	45%	-6%
Total	100%	100.0%	0.0%

Portfolio Changes
Second Quarter 2012

	Conservative		Balanced		Moderate Growth		Aggressive Growth	
	Current	Change	Current	Change	Current	Change	Current	Change
Core Bonds	16%	-	5%	-	0%	-	0%	-
Cash & 1-3 Year Treasuries	10%	-	5%	-	2%	-	4%	-
3-7 Year Treasuries	0%	-	0%	-	0%	-	0%	-
7-10 Year Treasuries	11%	-	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%	-	6%	-	6%	-
Large Cap Growth	5%	-	10%	-	13%	-	15%	-
Large Cap Value	5%	-	10%	-	13%	-	15%	-
Small Cap	3%	-	5%	-	10%	-	12%	-
Developed Markets	0%	-	3%	-	8%	-	10%	-
Emerging Markets	3%	-	7%	-	12%	-	14%	-
Gold	6%	-	8%	-	10%	-	12%	-
REITs	3%	-	7%	-	9%	-	12%	-
Subtotal Bonds & Cash	69%	0%	44%	0%	19%	0%	4%	0%
Subtotal Equities & Other	31%	0%	56%	0%	81%	0%	96%	0%
Total	100%	0%	100%	0%	100%	0%	100%	0%

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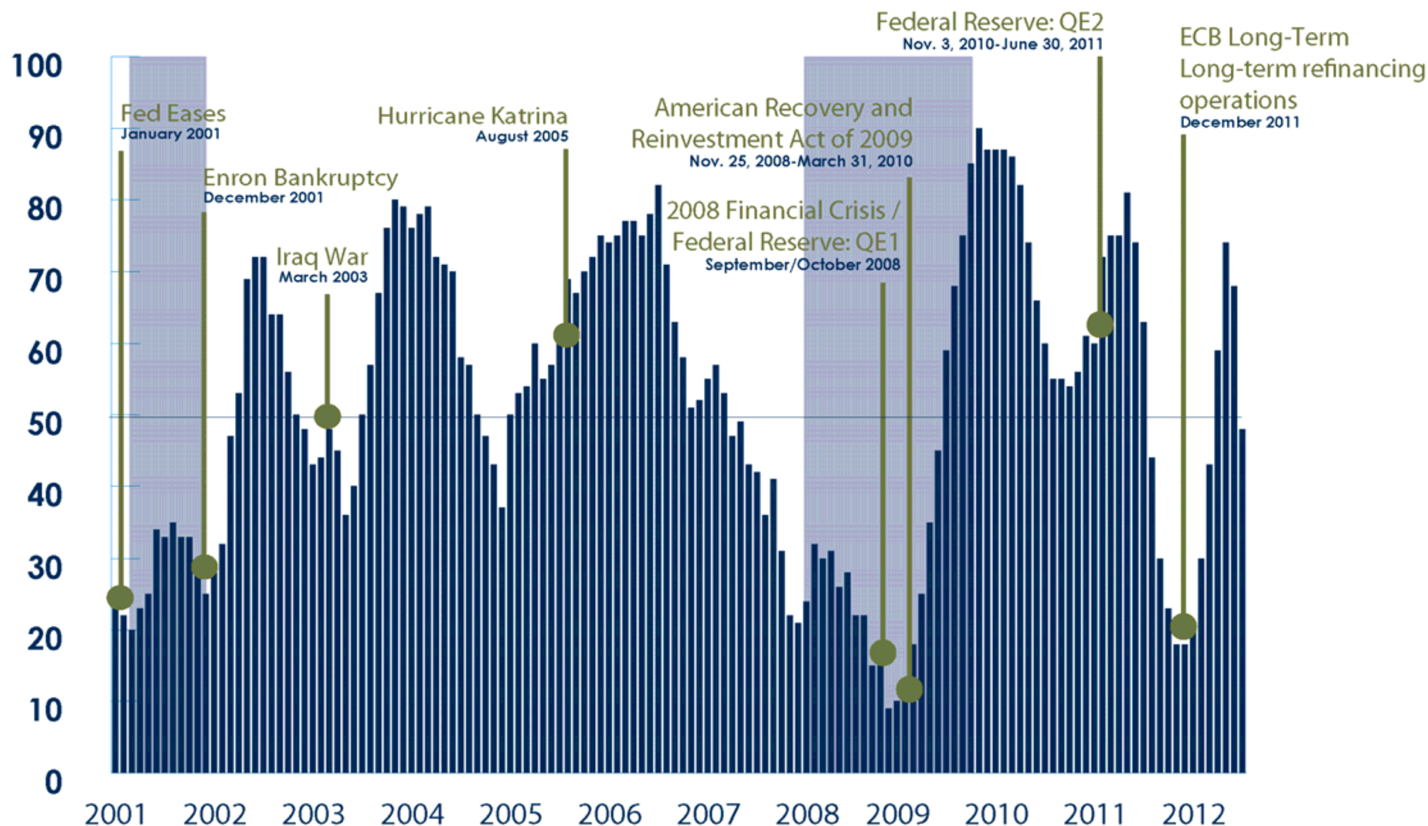
WCA Fundamental Conditions Index™ (Long-Term View)

2001-2012



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

Since 2009, the recovery has proceeded in an uneven way. Although the official recovery continues uninterrupted through today, there have been obvious sub-cycles of improvement and slippage since the recovery's official start in 2009. Those periods have coincided with periods of changes in investor appetite, as reflected in stock prices and stock price volatility as well as bond returns.

The table to the right summarizes these episodes.

Barometer "Sub-Cycles" Since 2009			
	Stocks	Bonds	Volatility
Falling Barometer			
January 2010 - September 2010	0.078	0.063	Down 3.7%
May 2011 - December 2011	-0.045	0.048	Up 46%
	=======	=======	=======
Average (Falling Barometer)	2%	5.60%	Up 21%
Rising Barometer			
February 2009 - December 2009	54.00%	6.20%	Down 60%
September 2010 - May 2011	18%	1.40%	Down 34%
January 2012 - June 2012	0.05	0.01	Down 13%
	=======	=======	=======
Average (Rising Barometer)	26%	3.00%	Down 36%

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.