# Washington Crossing Advisors

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About Washington Crossing Advisors
WCA strategies are offered through the Stifel Score Program (Research-Driven Portfolios). The management team has worked together for the past 20 years as market strategists and portfolio managers.

About Stifel
Founded in 1890, Stifel is one of the leading financial services firms in the U.S., providing full-service brokerage and investment banking services. Stifel is a leading underwriter and advisor for companies and a top provider of trade execution and securities distribution with nationally recognized research and a suite of asset management strategies.

STIFEL

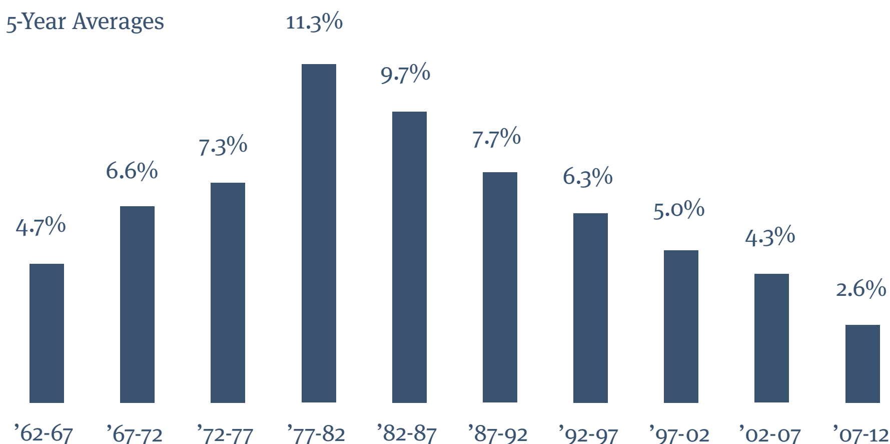
## TACTICAL ASSET ALLOCATION QUARTERLY

Investors Should Welcome Higher Rates

A stronger economy shouldn't need the kind of easy money central banks are providing. In terms of gross domestic product, the economy has grown 16% in the five years since the end of the recession, but an investment in a money fund has grown a cumulative total of 1.3%. Interest rates are being suppressed to provide a boost to borrowing and spending, while funneling returns away from savers. Buying a car or a home is now more affordable, and refinancing existing loans can free up additional cash for spending, but finding a decent yield on a relatively safe short-term investment is tough. By pushing rates to zero, the Fed has made it extraordinarily easy for creditworthy borrowers to spend more today, but low rates are hurting retirees and pensions who need income and a safe source of return. Investor risk and time preferences are being distorted in pursuit of growth, but if interest rates remain out of step with the economy for too long, savings and investment will also become distorted, which can create instability. Knowing this, the Fed must find a way to adjust monetary policy to accommodate recovery, maintain price stability, and avoid promoting bubbles.

Remember that the Fed went well beyond the traditional lowering of rates through a combination of money printing and the manipulation of market expectations. Markets were told to expect ultra easy money to remain for a very long time. Those expectations are beginning to be called into question as the unemployment rate ticks lower. If the Fed is right about long-run growth (they expect the economy to return to 4.3 - 4.5% growth in a few years), then interest rates should gravitate higher from here. We hope the Fed is right this time and would welcome a stronger economy, along with higher interest rates. From 1994 to 2000, interest rates moved from 3% to 6.5% as 17 million private sector jobs were added, and the stock market nearly tripled in value. A healthy economy can withstand higher interest rates just fine.

Long-Term Interest Rates
5-Year Averages




Source: U.S. Treasury

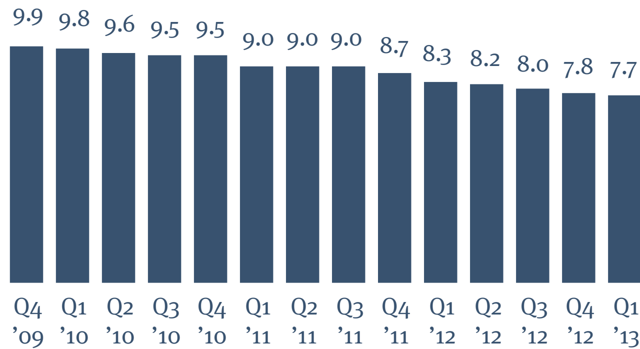
## Back to Normal

***By raising their growth projections, the Fed is laying out an optimistic case for the economy.*** June forecasts from the Fed have the economy accelerating from today's 1.8% pace of real, inflation-adjusted growth to around 3.25% in 2014–2015. To put this in perspective, growth averaged just 2.5% over the past 20 years, a prosperous period which saw 76 million baby boomers pass through their peak borrowing and spending years with rising income and falling inflation, credit expanded easily and regularly, where tax rates were cut, and the cost of borrowed money was becoming ever cheaper.

Those conditions don't exist today. Thus, the Federal Reserve's forecasts may well prove overly optimistic. Today, boomers are focused more on saving and maintaining income, private borrowing remains weak, taxes are rising, and government outlays are shrinking. If we look past all of this and just accept the Fed's assumptions at face value, then there is plenty of room for rates to rise. A 3–4% short-term rate might well be the eventual "normal" given the Fed's assumptions and a reasonable spread over the growth rate. Such rates would be above the inflation rate but still below the 5.25% short-term rates seen in 2007. Long-term rates would also likely rise.

This is just an academic exercise, of course, unless the economy actually picks up steam. Growth today is an acceptable, but slow, 1.8%. We continue to expect something close to 2% growth this year and next given the headwinds mentioned above. Yet unemployment continues to fall despite sluggish growth. Last year, the Fed stated they would continue suppressing interest rates so long as the unemployment rate remained above 6.5%. That target is now in sight, and the Fed thinks a 6.5% unemployment rate is achievable by next year, making endless monetary accommodation less assured.

Unemployment Rate
Percent (%)




Source: Bureau of Labor Statistics

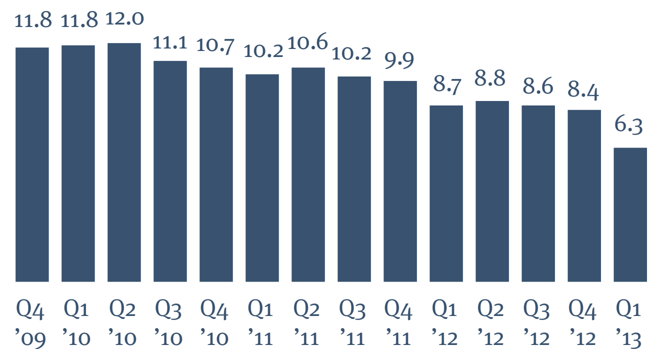
## Good News

***A drop in the unemployment rate is always welcome news.*** Given a choice between a stagnant economy with low interest rates and a more dynamic one with rising output and fuller employment, there are few who would choose the former.

***A balanced transition from government-led growth to private-led growth implies an improved outlook for business, investment, and wages.*** Without these, it is hard to imagine a situation where growth proceeds organically from confidence. It is yet to be seen exactly how ready the economy is to have the policy "training wheels" removed, but insofar as no major disruption to final demand occurs, then the winding down of stimulus can be made palatable in the short run and a net positive in the long run.

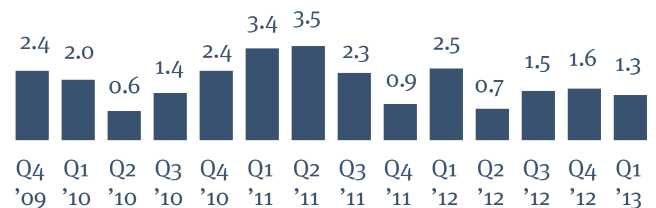
***For example, the "fiscal cliff" was supposed to derail the economy. It hasn't.*** Deficits have been reduced from 12% to 6% of GDP, and final demand has been growing between 1.5 and 2.5% annually since deficits were cut (charts below). An upward adjustment of interest rates that imparts costs to some and benefits to others may prove to be tolerated similarly in the near term and provide a more sound footing for growth over the long haul. Gradualism and transparency is key to success here.

Fiscal Deficit (Percent of GDP)




Source: U.S. Treasury

Final Domestic Demand (Percent Growth)




Source: Bureau of Economic Analysis

## Outlook for Equities

A 13% move by equities in the first half of the year ***pushed the S&P 500 to the upper portion of our "fair value" range***. Rising analyst earnings forecasts explain some of this move, but most of the lift is explained by increased investor willingness to take on risk in search of return. Earnings forecasts were ratcheted up by 4%, and multiples expanded 9%. The rise in stock valuations and fall in risk premium formed part of our rationale for ***rebalancing portfolios on May 13.***

We expect earnings to grow more slowly than consensus. According to Bloomberg, analysts are expecting a 12% increase in earnings for S&P 500 companies over the next 12 months. It is hard to explain this given flat revenue growth and already elevated profit margins. Without a catalyst or explanation for the expected jump in earnings, we are sticking with our more conservative view that earnings grow closer to 5%. A choppy and sideways move in markets in the next few months is a likely outcome.

This is not to imply that we are bearish on stocks. We are not. ***From a long-term perspective, we see value in equities.*** We recognize that stock valuations are attractive when compared to bonds under just about any growth scenario. One interesting measure of value equates the S&P 500 "earnings yield" to the yield on a 10-year U.S. Treasury bond. Based on current earnings, the S&P 500 index is priced with an earnings yield of 6.7% — about 4.2% higher than long-term Treasury bonds. The long-term historic average difference is closer to 1.1%. This means that today's 4.2% yield advantage places stocks in a considerably better valuation position relative to bonds.

***We believe that international equities now offer better potential for growth in the months ahead***. While some parts of Europe continue to suffer through a deep recession, we think the severity of the downturn will begin to ease. Europe's dividend yields, meanwhile, are roughly twice the yield offered on United States equities and provide some support. At the same time, Japan is undertaking major changes to address deflation and growth issues. Japan's economic growth rebounded to 3% last quarter on a weaker yen, monetary easing, and a boost in confidence.

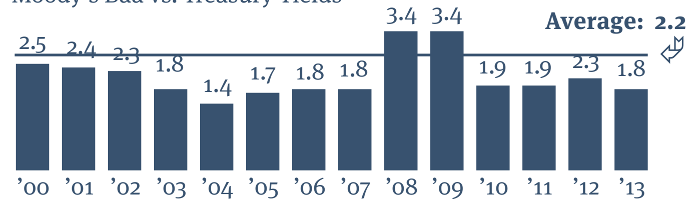
Emerging markets have fallen in response to weakness in China, but longer-term growth drivers, such as a rising consumer class, accelerating household formation, expanding wages, and a generally youthful population, speak to potentially higher future growth rates. ***We think emerging markets are attractively valued and well positioned for long-run growth.***

## Outlook for Bonds

Rates are rising, and credit spreads are tighter. As unemployment falls and growth continues, we see a better risk/reward trade-off in shorter duration and floating rate bonds. Some yield advantage can still be had in owning corporate bonds relative to Treasuries, but spreads have narrowed. Baa rated corporate bond yields are roughly 1.8% higher than the yield of a 30-year U.S. Treasury bond. This is now below the 20-year average spread of 2.2% and significantly lower than the average peak spreads seen during the financial crisis.

The ***combination of low yield, potential for higher rates ahead, and less generous spreads suggests to us that some caution is warranted***. Accordingly, we lessened both duration and credit risk in portfolios during the past quarter and favor higher overall credit quality and shorter duration paper despite the lower yield at this time.

Average Credit Spreads (Percent %)
Moody's Baa vs. Treasury Yields




## Summary

Our expectations for the year were for the economy to expand slowly despite fiscal drag, for monetary policy to remain accommodative, and for the private sector to pick up. Thus far, this is exactly what we have seen. Continued gradual improvement is leading financial markets to consider the future path of interest rates, and this has introduced some risk into the equation. Still, we believe this challenge, like the "fiscal cliff" challenge, can be accommodated if done slowly, and markets are given plenty of notice. The change in tone from the Fed is a necessary prerequisite for this to happen.

Overall, we are in the camp that would prefer to see a healthier economy with higher interest rates over time, rather than the opposite. The transition from recovery to expansion will create both uncertainty and opportunity, but change is the product of progress and something that should ultimately be welcomed by investors with foresight.

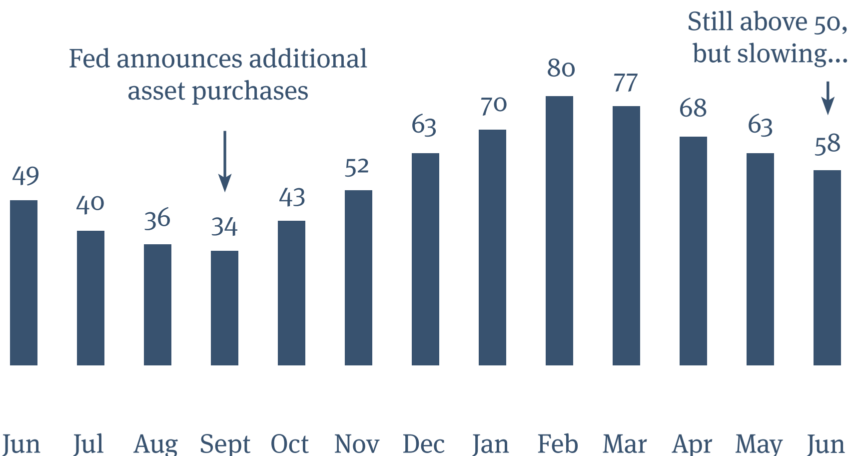
## FUNDAMENTAL CONDITIONS UPDATE

The WCA Fundamental Conditions Barometer (below) corroborates recent slippage in economic growth estimates. Forecasters now expect second quarter growth to slow to just 1.8% from earlier expectations of 2.3% growth, according to the Philadelphia Federal Reserve's *Survey of Professional Forecasters*. Falling government outlays and rising tax collections are contributing to headwinds.

### WCA Fundamental Trend Indicators

| | Last Quarter | Current (Preliminary) | Change |
|---|---|---|---|
| Credit and Capital Markets | 85 | 59 | Lower |
| U.S. Economic Conditions | 75 | 50 | Lower |
| Foreign Conditions | 70 | 65 | Lower |
| Fundamental Conditions | 77 | 58 | Lower |

### WCA Fundamental Conditions Barometer




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.

## LAST QUARTER PORTFOLIO CHANGES

| | Conservative | | Balanced | | Moderate Growth | | Aggressive Growth | |
|---|---|---|---|---|---|---|---|---|
| | Current | Change | Current | Change | Current | Change | Current | Change |
| Core Bonds | 15% | -4% | 10% | 1% | 5% | 5% | 0% | - |
| Floating Rate Securities | 16% | 16% | 10% | 10% | 4% | 4% | 0% | - |
| Cash & 1-3 Year Treasuries | 10% | 3% | 7% | 5% | 3% | 1% | 10% | 7% |
| Mortgage-Backed Bonds | 16% | 16% | 11% | 11% | 6% | 6% | 0% | - |
| 7-10 Year Treasuries | 6% | -5% | 3% | -6% | 2% | 2% | 0% | - |
| 10+ Year Treasuries | 0% | - | 0% | - | 0% | - | 0% | - |
| Investment-Grade Corp Bonds | 9% | -9% | 7% | -3% | 3% | -1% | 0% | - |
| High-Yield Corporate Bonds | 3% | -6% | 2% | -10% | 2% | -11% | 0% | - |
| International Treasury Bonds | 0% | -5% | 0% | -3% | 0% | - | 0% | - |
| Domestic Stocks | 5% | -1% | 10% | 4% | 15% | - | 15% | -5% |
| Large-Mid Cap Growth | 3% | -2% | 6% | -4% | 9% | -4% | 12% | -3% |
| Large-Mid Cap Value | 3% | -2% | 6% | -4% | 9% | -4% | 12% | -3% |
| Small Cap | 2% | -1% | 3% | -6% | 5% | -10% | 6% | -10% |
| Developed Foreign Markets | 5% | 5% | 12% | 12% | 18% | 18% | 22% | 22% |
| Emerging Foreign Markets | 2% | -1% | 3% | -2% | 5% | -1% | 5% | -2% |
| Gold | 2% | -4% | 5% | -3% | 7% | -3% | 9% | -3% |
| REITs | 3% | - | 5% | -2% | 7% | -2% | 9% | -3% |
| Subtotal Bonds & Cash | 75% | 6% | 50% | 5% | 25% | 6% | 10% | 7% |
| Subtotal Equities & Other | 25% | -6% | 50% | -5% | 75% | -6% | 90% | -7% |
| Total | 100% | 0% | 100% | 0% | 100% | 0% | 100% | 0% |

Improving fundamentals last September led us to overweight stocks in portfolios at that time (see *Upgrading Outlook, September 11, 2012*). Our call was to remain overweight stocks as fundamentals were accelerating. Momentum was interrupted in April, and portfolio weights were returned to their long-run stock / bond target mixes.

Other tactical shifts during the quarter included 1) a return of foreign stocks to the mix, 2) a paring back of gold positions, 3) a shortening of bond duration and lessening of credit risk, and 4) an opportunistic rebalancing to account for a sharp rise in stock valuations relative to bonds and earnings, and some moderation in fundamentals.

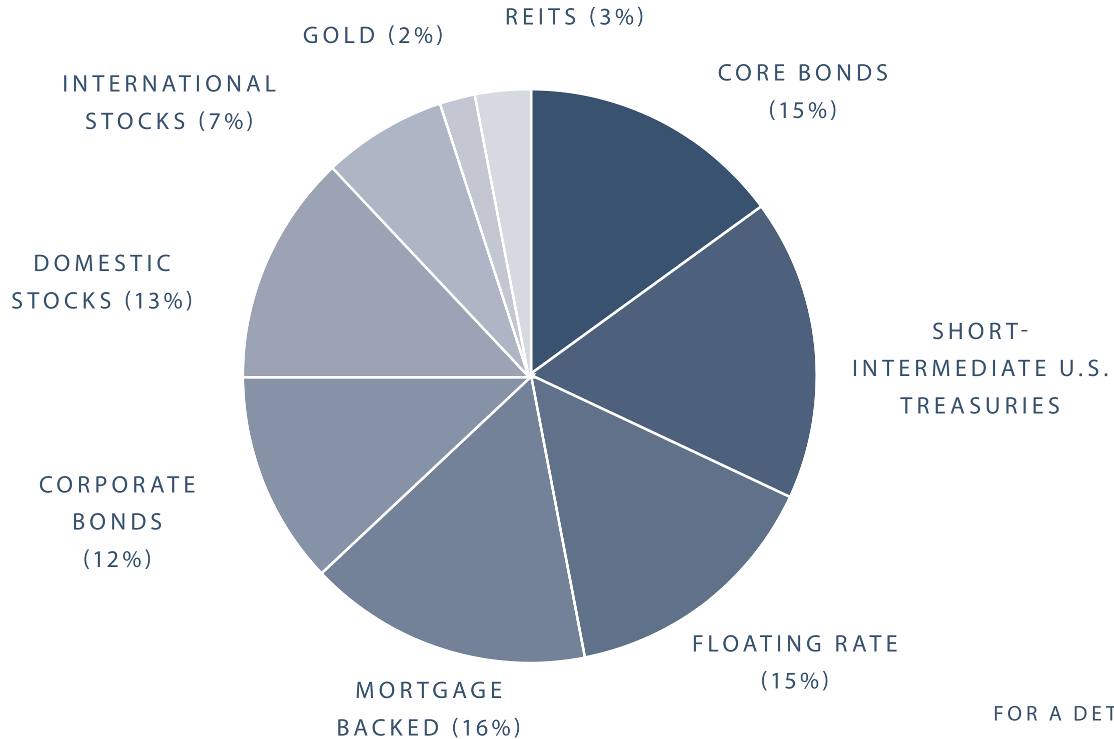
Floating rate securities were recently included in portfolios (which float with U.S. LIBOR) to provide yield flexibility should short-term rates start to normalize (see below).

Gold positions were pared back by 25-50% to a more neutral position on April 12 on weakening fundamentals. This action was taken prior to the April 14 slide.

Portfolios were rebalanced on May 13 near the market highs on slippage in our barometer and rise in stocks compared to bonds and underlying earnings during the preceding months.

# Conservative Portfolio

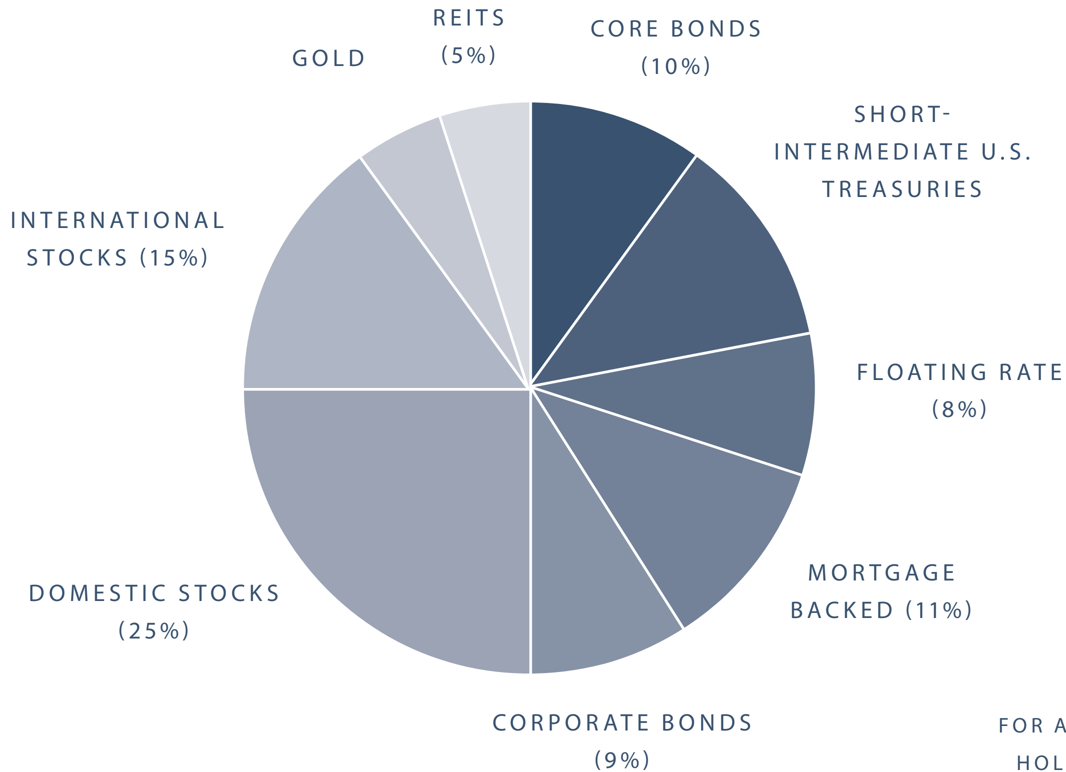
CONSERVATIVE PORTFOLIO
EQUITY POLICY RANGE: 0-50%
CURRENT EQUITY EXPOSURE: 25%




FOR A DETAILED LIST OF HOLDINGS, INCLUDING SUB-ASSET CLASSES, SEE PAGE 5

## Portfolio Description

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.



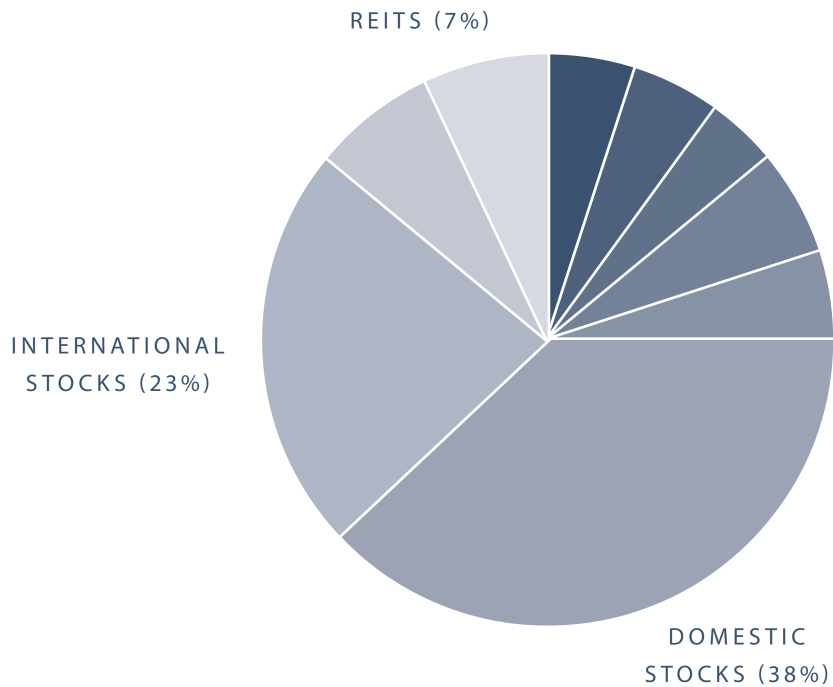

FOR A DETAILED LIST OF HOLDINGS, INCLUDING SUB-ASSET CLASSES, SEE PAGE 5

## Portfolio Description

**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.**

## Moderate Growth Portfolio

MODERATE GROWTH PORTFOLIO
EQUITY POLICY RANGE: 50-100%
CURRENT EQUITY EXPOSURE: 75%

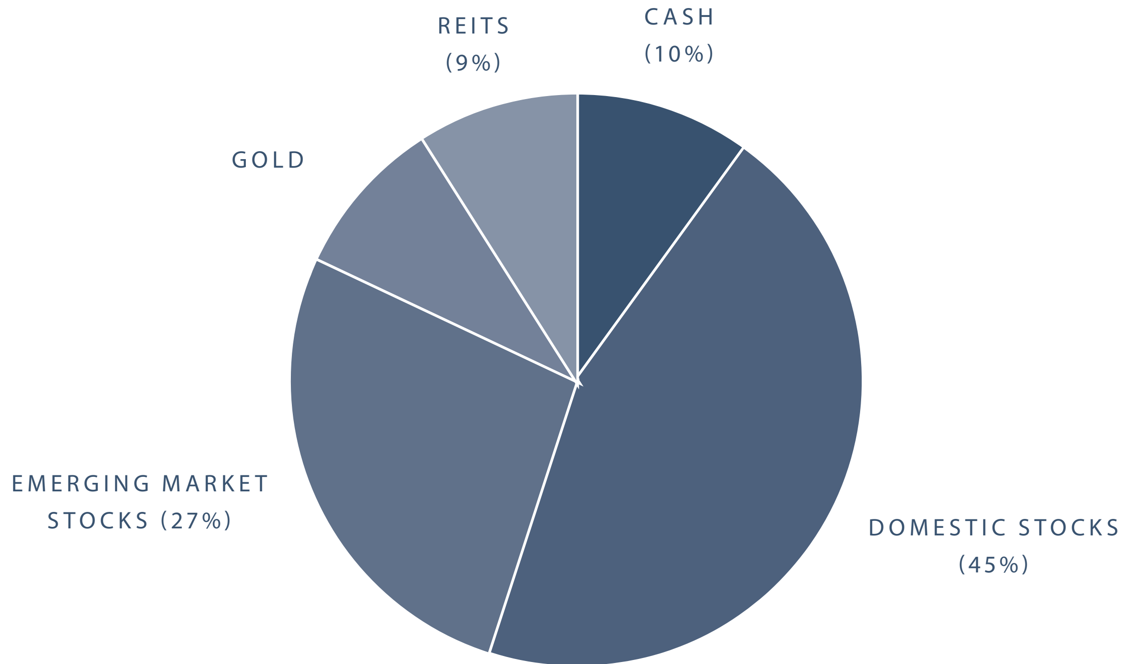



FOR A DETAILED LIST OF HOLDINGS, INCLUDING SUB-ASSET CLASSES, SEE PAGE 5

### Portfolio Description

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.

AGGRESSIVE GROWTH PORTFOLIO
EQUITY POLICY RANGE: 80-100%
CURRENT EQUITY EXPOSURE: 90%




FOR A DETAILED LIST OF HOLDINGS, INCLUDING SUB-ASSET CLASSES, SEE PAGE 5

## Portfolio Description

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.

## FORECASTS AND ASSUMPTIONS: ECONOMY

| | 2010 (Actual) | 2011 (Actual) | 2012 (Actual) | 2013 (Estimate) | 2012-2013 (Growth Est.) | 2010-2013 (Growth Est.) |
|---|---|---|---|---|---|---|
| Real Gross Domestic Product | 13,063 | 13,299 | 13,593 | 13,865 | 2.0% | 2.0% |
| Gross Domestic Product | 14,499 | 15,076 | 15,685 | 16,351 | 4.3% | 4.1% |
| | | | | | | |
| Consumption | 10,216 | 10,729 | 11,120 | 11,600 | 1.5% | 4.3% |
| % GDP | 70% | 71% | 71% | 71% | | |
| Investment | 1,737 | 1,855 | 2,062 | 2,263 | 8.6% | 9.2% |
| % GDP | 12% | 12% | 13% | 14% | | |
| Government Spending | 3,058 | 3,060 | 3,063 | 3,075 | -0.8% | 0.2% |
| % GDP | 21% | 20% | 20% | 19% | | |
| Exports | 1,844 | 2,094 | 2,184 | 2,357 | 4.0% | 8.5% |
| % GDP | 13% | 14% | 14% | 14% | | |
| Imports | (2,356) | (2,662) | (2,744) | (2,944) | 3.0% | 7.7% |
| % GDP | -16% | -18% | -17% | -18% | | |
| | | | | | | |
| Government Deficit | (1,651) | (1,542) | (1,358) | (1,193) | -12.1% | -10.3% |
| % GDP | -11% | -10% | -9% | -7% | | |
| Government Revenue | (1,407) | (1,518) | (1,705) | (1,882) | 10.4% | 10.2% |
| % GDP | -10% | -10% | -11% | -12% | | |
| | | | | | | |
| Private Saving | 2,835 | 2,828 | 2,840 | 2,872 | 4.0% | 0.4% |
| % GDP | 20% | 19% | 18% | 18% | | |
| Households & Institution | 862 | 791 | 780 | 753 | -0.6% | -4.4% |
| % GDP | 6% | 5% | 5% | 5% | | |
| Business Profits | 1,973 | 2,036 | 2,060 | 2,119 | 3.0% | 2.4% |
| % GDP | 14% | 14% | 13% | 13% | | |
| | | | | | | |
| Employment (Nonfarm Payroll) | 130,395 | 132,498 | 134,691 | 136,981 | 1.7% | 1.7% |
| Employment (Private Sector) | 108,128 | 110,548 | 112,817 | 115,637 | 2.5% | 2.3% |
| | | | | | | |
| S&P 500 EPS | $84.70 | $96.26 | $100.73 | $105.77 | 5.0% | 7.7% |
| | | | | | | |
| Inflation Index | 111 | 113 | 115 | 118 | 2.3% | 2.1% |

Bureau of Economic Analysis NIPA Tables 1.1.5 / 5.1

## NOTES

# 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 NAREIT. 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. 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 U.S. 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.