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.

TACTICAL ASSET ALLOCATION QUARTERLY

Executive Summary

Most of the data we examine is moving in a direction consistent with continued growth. This is being reflected in the performance of markets, which seem to be anticipating further growth ahead. Portfolios are tilted toward U.S. dollar assets, especially U.S. equities. Bond allocations are focused on shorter-duration and high-quality issues. We remain cautious on gold.

Growth Resumes

The U.S. economy continues to perform admirably as we start the fourth quarter. Jobless claims continue to fall, private sector jobs continue to climb, capital goods orders are at an all-time high, consumption remains relatively steady, and automobile sales are back to running near a 17 million annualized pace. September's jobs report revealed the first sub-6% unemployment rate in over six years.

All of this good news is being well received by markets. Stock markets are enjoying rising earnings expectations. Credit markets are admiring generally improved balance sheets for many issuers. Bond investors are witnessing very little inflation. This improved attitude is being reflected in prices, resulting in a growing pool of relatively cheap and available capital for U.S. companies.

This is not entirely the case around the world. Growth continues to soften in China. Europe continues to struggle with integration, and growth is paltry at best. Countries such as Brazil, South Africa, and Turkey are struggling with large imbalances in trade and financial flows from the rest of the world. Consequently, different countries appear headed down different roads when it comes to formulating policies regarding government spending, taxation, and interest rates. While the United States appears to be crawling toward the start of a rate-hiking cycle, places like Europe, Japan, and many emerging markets seem to be moving in the opposite direction. The net result of this perceived divergence is being expressed in the foreign exchange value of the dollar.

The dollar continues to rise in value. Measured against other major currencies, the dollar is up 8% since the start of the third quarter. This means that U.S. exports become more expensive overseas and consumers in the United States enjoy lower prices for imported goods. This latter phenomenon is already having an effect on long-run inflation expectations.

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The mirror image of the strong dollar is the fall in long-run inflation expectations priced into the Treasury bond market. Essentially, the end of quantitative easing, coupled with continued improvement in the U.S. labor market, and indications of a tightening bias from the Fed itself are lowering inflation expectations, raising real interest rates, and promoting a stronger dollar. In essence, the mere suggestion of eventual tightening by the Fed is bringing some deflationary forces back into the United States and increasing the prospects for capital inflows from the rest of the world.

Why does this matter for portfolios? It matters first to bond investors, because it makes the rest of the world potential new buyers of U.S. bonds. It also matters to equity investors, because capital flows into the United States make investment capital cheaper and more abundant. Relatively better growth, relatively higher interest rates after inflation, and a strengthening dollar are all attractive characteristics to foreign buyers of U.S. domiciled assets and securities denominated in U.S. dollars. Consequently, we remain **overweight U.S. dollar assets in the equity mix of portfolios**.

Equities

The stock market depends most critically on earnings to drive value. Investors cheered the second quarter earnings results by pushing the S&P 500 above 2,000 during the last quarter for the first time in history. The 500 largest companies, which comprise the S&P 500, are now expected to generate $134 in index earnings in 2015 and $149 in index earnings in 2016, according to Bloomberg. The market trades, therefore, at 14.7 times next year's expected earnings and 13.2 times 2016 earnings. Although we question the reasonableness of those estimates (the expected growth rate is above 10% and seems a bit unrealistic to us), the fact remains that forward progress on the earnings front is being made.

As the earnings season approaches, we again see that analysts are expecting to see only about 5% growth in third quarter S&P 500 earnings compared to the year-ago quarter. This is the same exact expectation that was laid down at the start of last quarter, which proved easy to beat. Last quarter's earnings growth turned out to be closer to 8%. Although recent dollar strength could sap some of the strength out of the earnings growth story, we still expect the 5% third quarter earnings growth estimate to be an achievable hurdle.

Outside the United States, we see a mixed picture. Europe, for example, continues to struggle to find growth. Growth across the continent ground to a halt in the second quarter, registering a 0% reading, according to Eurostat. The standoff with Russia over Ukraine did little to help matters, and reciprocal economic sanctions dampened an already weak picture. Germany, the largest economy in Europe, contracted by 0.2% during the second quarter as tensions with Russia rose. Forecast growth for Europe is also supposed to be modest. Still, price-to-earnings multiples for European equity indices are generally higher than for the Standard & Poor's 500 index of U.S. companies. We are further inclined to favor U.S. equities over Europe, since less than 2% of S&P 500 sales come from the non-EU region (which includes Ukraine and Russia).

Emerging markets continue to offer some value, although many emerging markets are still suffering from slow growth. After a decade or more of strong investor interest, the emerging markets lost their luster starting in mid-2010 as China's credit growth slowed, Europe's financial crisis began to emerge, and global commodity prices fell. Since that time, they have returned only a small fraction of what developed markets like our own have. At the current index level of $1,000, the MSCI emerging market index now carries an earnings multiple of just 10 times next year's expected $99 in index earnings. We **moved from underweight to a neutral target weight on emerging markets** last spring to acknowledge that valuations seemed to already recognize much of the cyclical slowdown that has occurred across most of the emerging market economies.

Fixed Income

The bond market continues to benefit from a lack of appreciable increase in inflation. Core consumer prices, the preferred measure of inflation at the Fed, is up 1.5% from a year ago. The last three months trend is moving even lower, and annualized core inflation based on the June-August data put core inflation running closer to 1.3%. Should the dollar continue to appreciate, further downward pressure on inflation is to be expected, thus containing yields on long-term bonds.

Still, it is hard to conclude long-term bond yields are attractive given continued signs of economic improvement. Consequently, we continue to favor shortening portfolio duration. The 10-year U.S. Treasury bond provided investors an average "real" yield (yield in excess of inflation) of 2% over the past 20 years. Prior to the financial crisis, a 3% "real" yield was considered about average. If we are to assume that the days of 2-3% real long-term rates will eventually return and inflation stays constant, then the 10-year bond yield would need to climb back toward the 4.5-5.5% range. If that is true, then conventional mortgages would likely end up in the 5.5-7.5% range. Simply put, it is hard to see how we get from here to there without some significant pain along the way.

Corporate bonds are benefiting from generally improved corporate balance sheets. As of 2012, total balance sheet debt for S&P 500 companies stood at 60% of total capital and 340% of total equity. This compares favorably with prior peak levels for debt to capital and debt to equity of 101.34% (1998) and 574% (2002), respectively. Looking at it another way, total debt in the S&P 500 (short- and long-term) could be retired in 14 years from current free cash flow after all taxes and capital expenditures are accounted for. By comparison, the average potential repayment period was closer to 30 years given S&P data from 1994-2011. Any way you cut it, the average S&P 500 company balance sheet appears to be in a better financial condition now than any time in the recent past.

The question confronting corporate bond investors is to what extent is this improvement already reflected in prices. If we look at the spread between the yield on the Moody's Baa Corporate Bond Index and the yield on the long-term U.S. Treasury bond, we see that spreads are slightly below average. The spread on Baa corporate bonds over Treasuries averaged about 200 basis points (2%) over the past 20 years. During good economic times, the spread was commonly close to 125-150 basis points (1.25-1.50%), and during recessions, the spread widened to 250-300 basis points (2.5-3.0%) above Treasuries. At the depths of the financial crisis, the spread rocketed to 600 basis points (6%).

Given today's 170 basis point (1.70%) spread and continued signs of economic momentum, we are inclined to see some very modest spread-tightening upside from here. On the other hand, we are aware that the rate of new credit issuance has increased sharply, that spreads generally tend to widen during the later part of an economic expansion, and that the Fed's exit from asset purchases presents a unique set of uncertainties. Hence, to the extent that we are overweight credit, we prefer to express that in very high-quality, short-duration instruments.

Commodities

Most commodities remain weak, reflecting slack demand from emerging markets and China in the case of oil, natural gas, and industrial metals. Little new production or threat of quota increases by OPEC, for example, are adding to the surplus supply of oil in the global market. Meanwhile, precious metals, such as gold, continue to lose luster as their "hedge appeal" fades with growing confidence in the financial system and as inflationary pressures remain absent from the scene. **We remain underweight gold**.

Conclusion

Most of the data we review shows the U.S. economy moving in the right direction. Valuations and risk spreads have tightened to reflect this improvement in many instances. We continue to look for areas where risk-reward appears appealing on a forward-looking basis.

FUNDAMENTAL CONDITIONS UPDATE

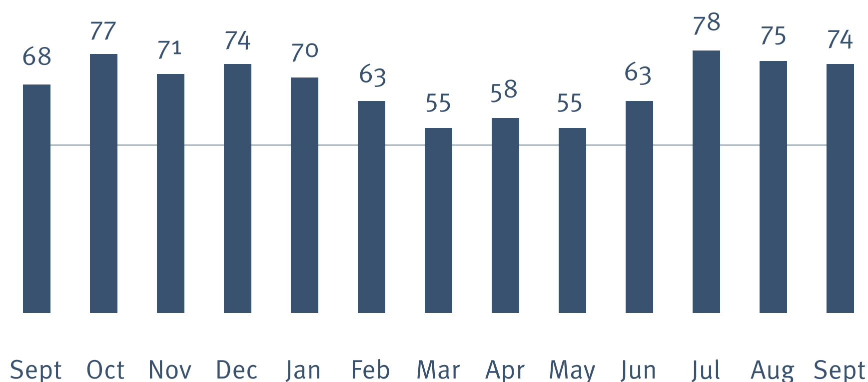
Across-the-board improvement was seen in each of the categories of data we track during the quarter. The economy's first quarter contraction in output gave way to a bounce back through the summer months. Fundamental conditions appear supportive of accelerating growth given broad-based improvement. We remain overweight equities.

WCA Fundamental Trend Indicators

	Last Quarter	Third Quarter Estmate	Change
Credit and Capital Markets	67	73	Higher
U.S. Economic Conditions	70	79	Higher
Foreign Conditions	50	69	Higher
Fundamental Conditions	63	74	Higher

WCA Fundamental Conditions Barometer

Rising /Above 50 = Lower recession odds



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 and 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
Bonds	Core Bonds	15%		10%		5%		0%	
	Floating Rate Securities	15%		10%		6%		0%	
	Cash & 1-3 Year Treasuries	17%		10%		4%		5%	
	Mortgage-Backed Bonds	11%		6%		0%		0%	
	7-10 Year Treasuries	0%		0%		0%		0%	
	10+ Year Treasuries	0%		0%		0%		0%	
	Investment-Grade Corp Bonds	9%		7%		3%		0%	
	High-Yield Corporate Bonds	3%		2%		2%		0%	
	International Treasury Bonds	0%		0%		0%		0%	
Equities and Other	Domestic Stocks	9%		18%		27%		29%	
	Large-Mid Cap Growth	3%		6%		9%		12%	
	Large-Mid Cap Value	3%		6%		9%		12%	
	Small Cap	5%		5%		5%		6%	
	Developed Foreign Markets	5%		12%		18%		22%	
	Emerging Foreign Markets	2%		3%		5%		5%	
	Gold	0%		0%		0%		0%	
	REITs	3%		5%		7%		9%	
	Subtotal Bonds & Cash	70%		45%		20%		5%	
	Subtotal Equities & Other	30%		55%		80%		95%	
	Total	100%		100%		100%		100%	

LONG-RUN STRATEGIC POSTURE:

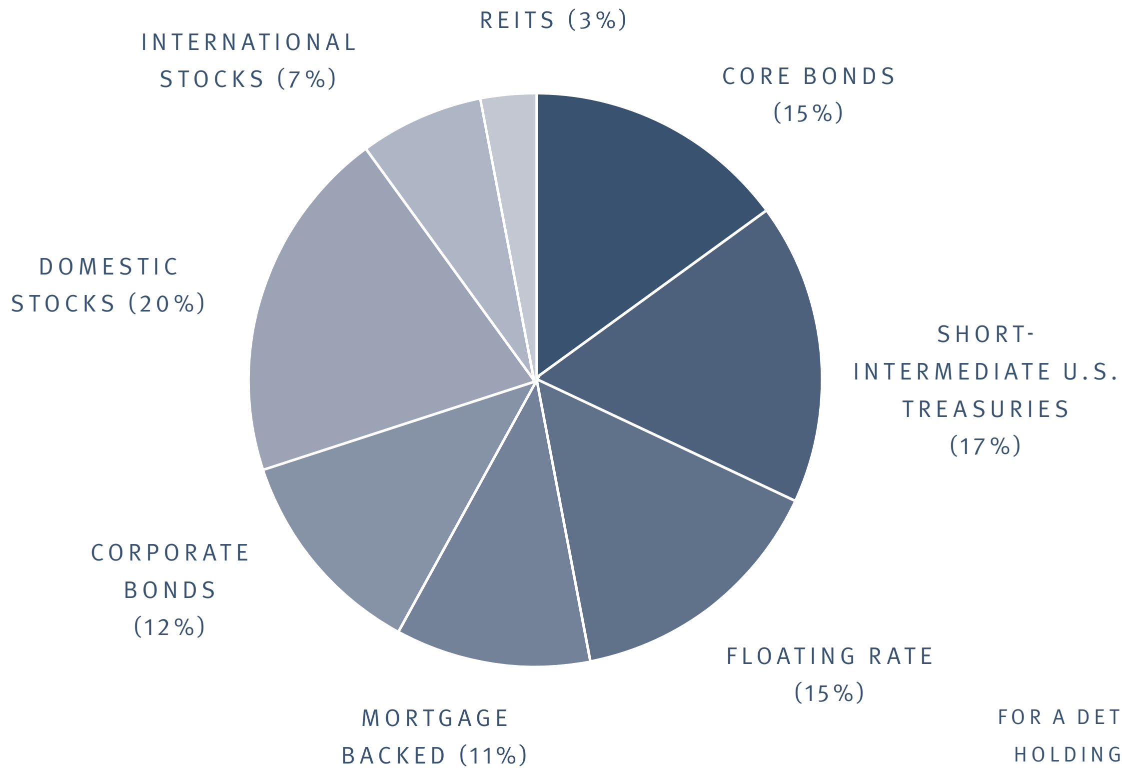
Strategic allocations are set to reflect our long-run forecasts for key asset classes. We expect policy rates to remain low as central banks continue to push lower-for-longer rate strategies. Eventually, rates should rise back to more normal levels, but this is expected to happen gradually and unevenly. Fixed income returns are expected to lag current yields as rates rise. Equity returns will track moderate growth in global GDP with little to no further lift from margin expansion (margins and multiples are already elevated).

NEAR-TERM TACTICAL POSTURE:

The CONQUEST portfolios remain tilted toward equities given continued improvement in fundamentals (GDP expanded near 5% in the third quarter, and our read of incoming data suggests that growth continues throughout our forecast horizon).

We prefer higher-quality credit to lower-quality and shorter-duration bonds to longer. Emerging markets offer better relative valuations (last quarter we increased emerging market weights back to a neutral allocation); domestic small-caps were also reduced to neutral in the second quarter on valuation.

CONSERVATIVE PORTFOLIO
EQUITY POLICY RANGE: 0-50%
CURRENT EQUITY EXPOSURE: 30%

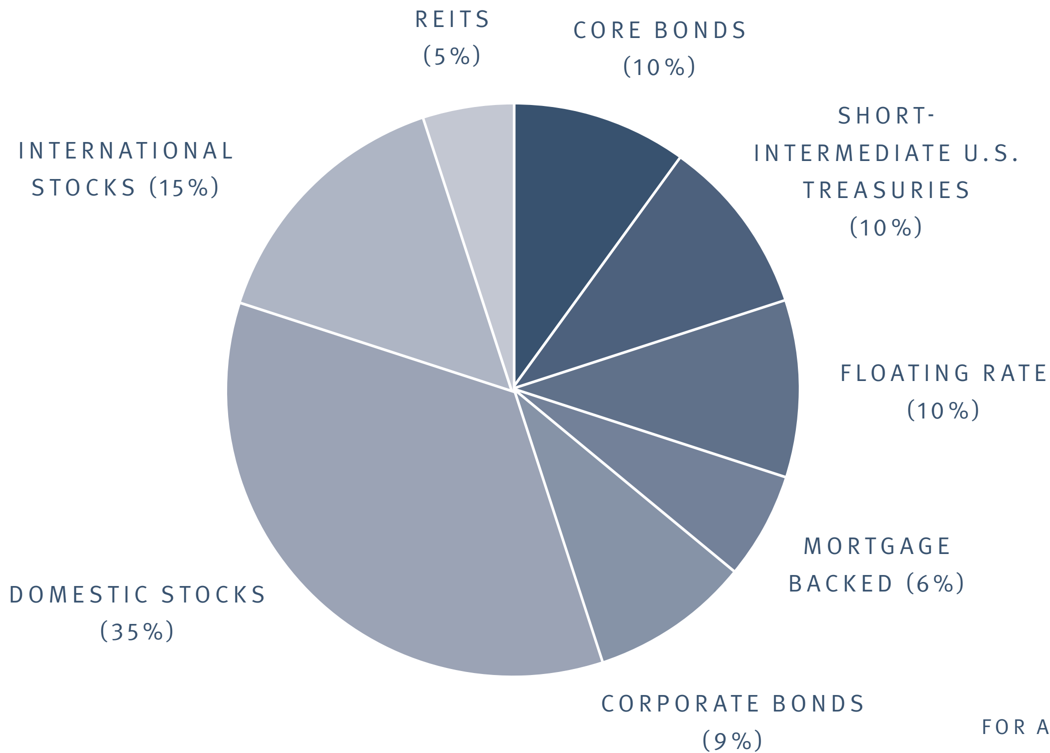


FOR A DETAILED LIST OF HOLDINGS, INCLUDING SUB-ASSET CLASSES, SEE PAGE 5

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.

BALANCED PORTFOLIO
EQUITY POLICY RANGE: 25-75%
CURRENT EQUITY EXPOSURE: 55%

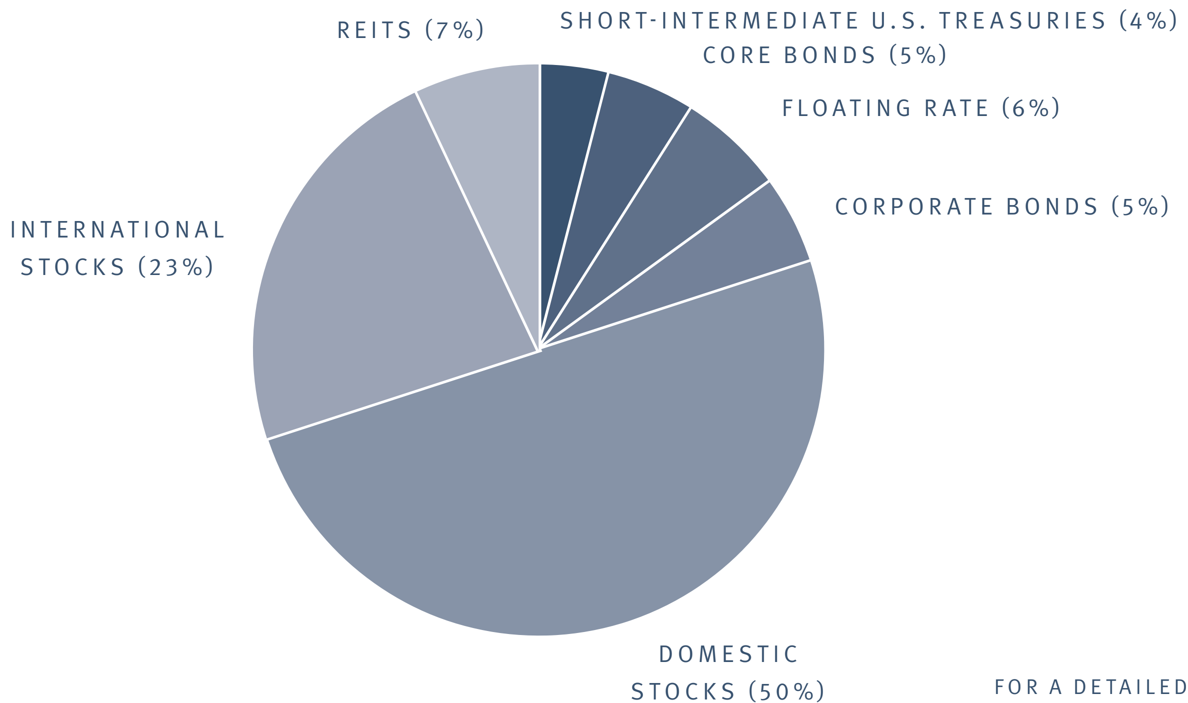


FOR A DETAILED LIST OF HOLDINGS, INCLUDING SUB-ASSET CLASSES, SEE PAGE 5

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.

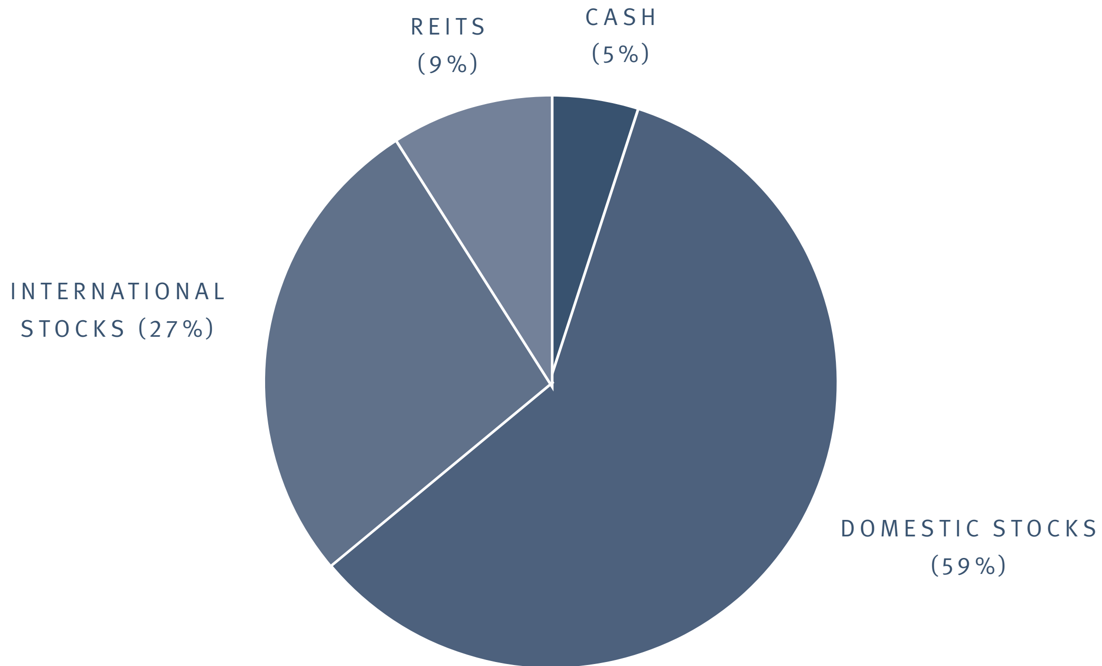
MODERATE GROWTH PORTFOLIO
EQUITY POLICY RANGE: 50-100%
CURRENT EQUITY EXPOSURE: 80%



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.



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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

	2011 (Actual)	2012 (Actual)	2013 (Actual)	2014 (Estimate)	2013 Growth	2014 Growth
Real Gross Domestic Product	15,021	15,369	15,710	16,025	2.2%	2.0%
Gross Domestic Product	15,518	16,163	16,768	17,321	3.7%	3.3%
Consumption	10,689	11,083	11,484	11,880	3.6%	3.4%
% GDP	69%	69%	69%	68.6%		
Investment	2,240	2,479	2,648	2,875	6.8%	8.6%
% GDP	14%	15%	16%	16.6%		
Government Spending	3,169	3,169	3,144	3,135	-0.8%	-0.3%
% GDP	20%	20%	19%	18.1%		
Exports	2,106	2,194	2,262	2,338	3.1%	3.4%
% GDP	14%	14%	14%	13.5%		
Imports	(2,686)	(2,763)	(2,770)	2,910	0.3%	-205.0%
% GDP	-17%	-17%	-18%	-16.8%		
Government Deficit	(981)	(816)	(368)	(520)		
% GDP	-6%	-5%	-2%	-3%		
Total Private Saving	3,416	3,641	3,815	3,291	4.8%	-13.7%
% GDP	22%	23%	23%	19%		
Households & Institution	1,109	1,301	1,035	1,143	-20.4%	10.4%
% GDP	7%	8%	9%	6.6%		
Business Saving / Profits	2,307	2,341	2,368	2,148	1.2%	-9.3%
% GDP	15%	14%	14%	12%		
Employment (Nonfarm Payroll)	132,828	135,064	137,395	140,143	1.7%	2.0%
Employment (Private Sector)	110,882	113,176	115,541	117,852	2.1%	2.0%
S&P 500 Operating EPS	$96.48	$103.08	$108.44	$115.00	5.2%	6.0%
Inflation Index (GDP Deflator)	103.3	105.2	106.7	108.2	1.5%	1.3%

Historic data provided by Bureau of Economic Analysis (NIPA Tables 1.1.5 / 5.1) for GDP, Bureau of Labor Statistics for employment, and Standard & Poor's for S&P 500 earnings. Forecasts and assumptions provided by Washington Crossing Advisors. Government deficit includes Federal, State, and Local.

FOUNDATIONAL ASSUMPTIONS

	2011 (Actual)	2012 (Actual)	2013 (Actual)	2014 (Estimate)	2015 (Estimate)	Long-Run Growth Forecast
Population (Millions)	311.9	313.9	316.1	318.3	320.5	1.0%
Labor Force Participation Rate	64.0%	63.6%	62.8%	63.0%	63.4%	0.0%
Average Weekly Hours	34.4	34.4	34.5	34.6	34.7	0.0%
Productivity Growth	1.08%	1.09%	1.10%	1.11%	1.12	1.5%
Forecast Inflation (Long-Term)	2.0%	2.5%	2.25%	2.0%	1.75%	2.0%

	2011 (Actual)	2012 (Actual)	2013 (Actual)	2014 (Estimate)	2015 (Estimate)	2015 Growth Est.
S&P 500 Sales	1,052.8	1,092.4	1,099.4	1,164.9	1,200	3.0%
S&P 500 Diluted Earnings	86.95	86.51	100.20	105.00	112.00	7.0%
S&P 500 Normalized Earnings	79.71	86.56	93.12	94.81	104.00	9.7%
S&P 500 Dividends	26.43	31.24	34.99	38.62	43.00	11.0%
Dividends (% Market Cap)	2.1%	2.3%	2.1%	2.1%		
Net Buybacks (% Market Cap)	1.8%	0.5%	-0.3%	-1.0%		

DOMESTIC SECTOR ALLOCATION

	Weighting	Notes
Consumer Discretionary	12%	Recent relative price weakness to fade as employment gains continue
Consumer Staples	9%	Steady final core demand masked by recent dollar strength
Energy	13%	Valuations attractive despite near-term commodity price pressure
Financials	16%	Attractive valuations from a long-run perspective
Healthcare	13%	Solid recent performance reflects fading uncertainty over legislation
Industrials	9%	Uneven global production masks solid domestic demand for factory orders and capital goods
Technology	22%	Legacy technology companies offer solid valuations, but growth is slowing
Materials	3%	China slowdown pressures demand near-term; longer-term valuations more attractive
Utilities	3%	Risk-on equity environment limits desirability; slow growth; relative valuations attractive
	=====	
Total	100%	

DEFINITIONS AND DISCLOSURES

The Standard & Poor's 500 Index is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. The MSCI EAFE Index (Europe, Australasia, and the Far East) 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. The MSCI Emerging Markets Index is a free float-adjusted market capitalization-weighted index that is designed to measure the equity market performance of emerging markets. The Russell 1000 Index measures the performance of the 1,000 largest companies in the Russell 3000 Index, which measures the performance of the 3,000 largest U.S. companies based on total market capitalization. The average market capitalization is approximately $11 billion, and the median market capitalization is approximately $3.5 billion. The Russell 2000 Index measures the performance of the 2,000 smallest companies in the broader Russell 3000 Index. The average market capitalization is approximately $490 million, and the median market capitalization is approximately $395 million. The Russell 3000 Value Index measures the performance of those Russell 3000 Index companies with lower price-to-book ratios and lower forecasted growth values. The Russell 3000 Growth Index measures the performance of those Russell 3000 Index companies with higher price-to-book ratios and higher forecasted growth values.

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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.