MARKET COMMENTARY

ASSESSING INCOMING DATA

Our process for tactical asset allocation involves assessing data. Specifically, we assess month-to-month trends in data. When Russia began a full-scale invasion of Ukraine in late February, most of the trends we follow seemed poised to bounce. Obviously, this is no longer the case. This week we assess how recent data is influencing our outlook.

MARKETS REACT

Global financial markets are now valued at $110 trillion. And while most markets are down for the year, only a fraction of the losses occurred following the Russian's crossing of the Ukrainian border on February 24. So, when does the market's sell-off, which began weeks or months earlier, become a problem?

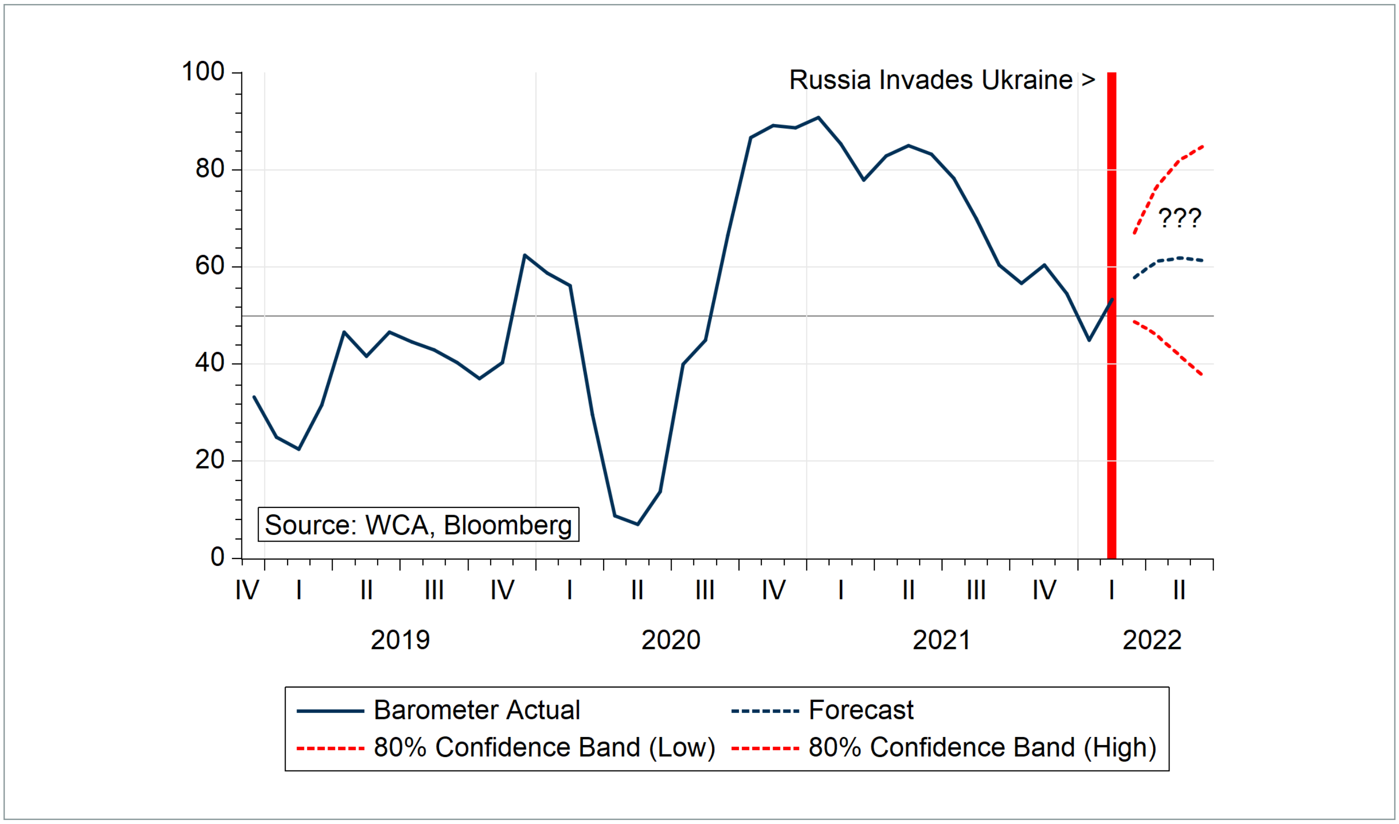
Since the February 24 invasion of Ukraine by Russian forces, the pace of market adjustment has proven reasonably orderly (outside Russia). In most markets, volatility has increased, credit spreads have widened, and inflation expectations have spiked. This is all a completely normal response to a shock. And since the Russian invasion of Ukraine is the most significant conventional military attack on a sovereign state in Europe since World War II, the recent market behavior is appropriate and understandable.

THIS HAS TO STOP

While we understand the market reaction, trends must soon start to reverse to avoid longer-lasting damage, however. For example, it would be good to see volatility measures begin to subside. The CBOE's popular volatility index is at 36 versus 15 pre-invasion, a high but far-from-unprecedented level. It would also be helpful to see credit spreads on corporate debt level off. The yield spread on Baa corporate bonds is climbing, but far from very distressed levels. The Moody's Baa to 10-year U.S. Treasury yield spread, for example, is now 230 basis points (2.3%) versus 170 basis points (1.7%) pre-invasion. Lastly, we are anxious to see inflation readings and expectations stop climbing, as these have important implications for policy flexibility. Consumer prices are up 7.5% year-over-year, while oil and gasoline prices are also near records, and bonds reflect surging inflation expectations ahead. Indeed, policymakers at the Federal Reserve (and politicians) are also paying very close attention to these numbers.

To reiterate, we do not view a temporary spike higher in these factors to be a significant permanent threat to the markets or the U.S. economy. We would, however, see continued upward movement in these measures to be problematic. Thus, we are monitoring the situation closely. Rising volatility, tightening credit, and a pop in inflation are ok for now. Still, for growth to continue, this will soon have to stop.

WCA FUNDAMENTAL CONDITIONS BAROMETER



WCA BAROMETER UPDATE

Given recent events, we must exercise judgment in interpreting new and rapidly changing data. Our monthly WCA Barometer (chart, above) seemed poised for a slight bounce at the end of February. Alas, recent events make it very unlikely that next month's update will track to the upside of the forecast range. Suppose we were to factor in the post-invasion information flow, including heavy sanctions, soaring oil prices, and volatility. What would our forecast look like then? It would almost certainly be looking to track the lower bound of the forecast path you see above.

TACTICAL POSTURE

We exercise caution since new data strongly suggests conditions are likely to track the lower end of the forecast range below. Accordingly, we now adopt a neutral tactical allocation to equities rather than the more aggressive posture that might have made sense before Russia invaded Ukraine. We will continue to monitor and adjust tactically as more information becomes available.

WCA Fundamental Conditions Barometer Description: We regularly assess changes in fundamental conditions to help guide near-term asset allocation decisions. The 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 three 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 three underlying categories into a single summary measure. This measure can be thought of as a "barometer" for changes in fundamental conditions.

FOR MORE INFORMATION, PLEASE CONTACT US:

Washington Crossing Advisors
- **Kevin R. Caron, CFA,** Senior Portfolio Manager | (973) 549-4051
- **Chad Morganlander,** Senior Portfolio Manager | (973) 549-4052
- **Matthew Battipaglia,** Portfolio Manager | (973) 549-4047
- **Steve Lerit, CFA,** Senior Risk Manager | (973) 549-4028
- **Suzanne Ashley,** Internal Relationship Manager | (973) 549-4168

Sales and Marketing
- **Eric Needham, Director,** External Sales and Marketing | (312) 771-6010
- **Jeffrey Battipaglia,** External Sales and Marketing | (973) 549-4031

Municipal Fixed Income
- **Paul B. Clark, CFA,** Senior Portfolio Manager | (415) 364-2635
- **Richard K. Marrone,** Senior Portfolio Manager | (415) 364-2917
- **Daniel W. Urbanowicz,** Senior Portfolio Manager | (973) 549-4335

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