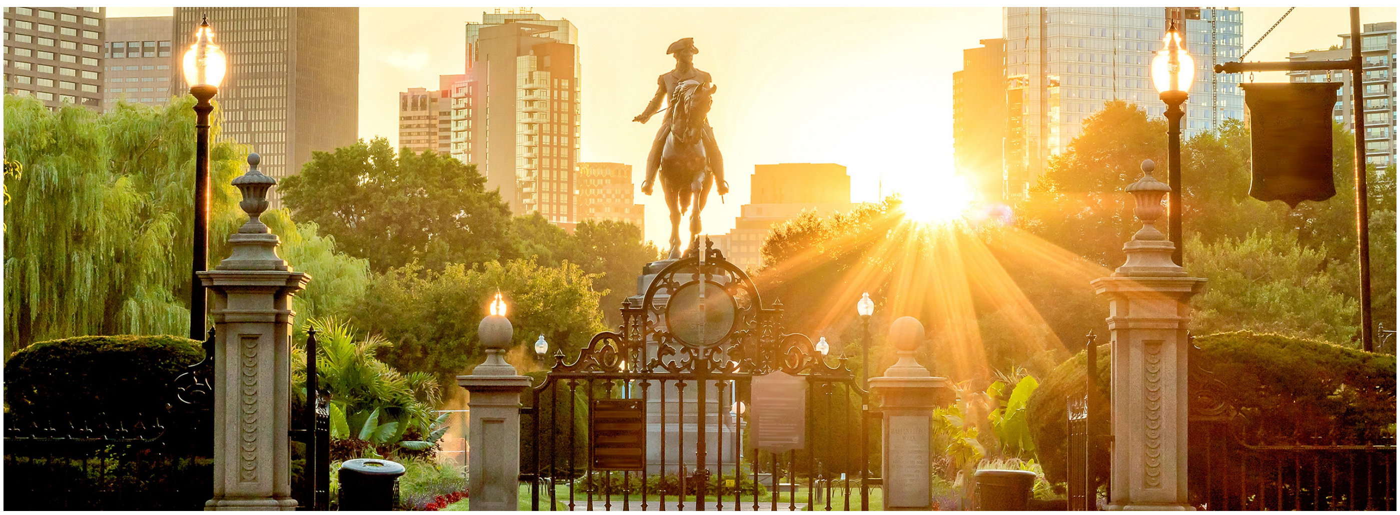
MARKET COMMENTARY

EQUITY RISK PREMIUM: WHAT'S IT ALL ABOUT?



Page through any investment brochure, factsheet, or presentation, and you'll eventually get to the disclosure language claiming "All investing involves risk." For fixed income investors, credit spreads over risk-free U.S. treasuries provide a sense of the interest rate, reinvestment, and credit risk they assume when buying corporate bonds. Along the same lines, stock investors must consider inherent risks in the equity markets when facing investing decisions.

The Equity Risk Premium (ERP) indicates the price of risk in equities and is a key metric in determining the appeal of owning stocks versus bonds or other assets at any given time.

WHAT IS ERP?

Before diving into the significance and implications of ERP, we should define what it is and how it is calculated. In general, the Equity Risk Premium is driven by macroeconomic uncertainty and general investor appetite or aversion for risk. There are several different ways to calculate or extrapolate what the current market ERP is, but for the purposes of this commentary, we aim to keep things simple by subtracting the 10-year Treasury Yield from the S&P 500 12-Month Forward Earnings Yield. In doing so, we get a general sense of what investors expect to be compensated for buying stocks.

WHERE ARE WE TODAY?

The chart on page 3 shows historical Corporate Bond Spreads (blue line) and ERP calculations (orange line) in relation to where the metric stands today. As we can see, the risk premium is close to post-Global Financial Crisis lows, even as recession risks have increased. The ERP is indicating a less attractive stock market where investors are not adequately compensated for taking on additional risk. This can be attributed to a few factors, most notably to the rise in 10-year Treasury Yields and lofty stock market valuations. As government bond yields rise, it becomes harder to justify investment in more risky stock assets. Additionally, as company valuations become richer, investors are less willing to take on the added risks of buying expensive equities.

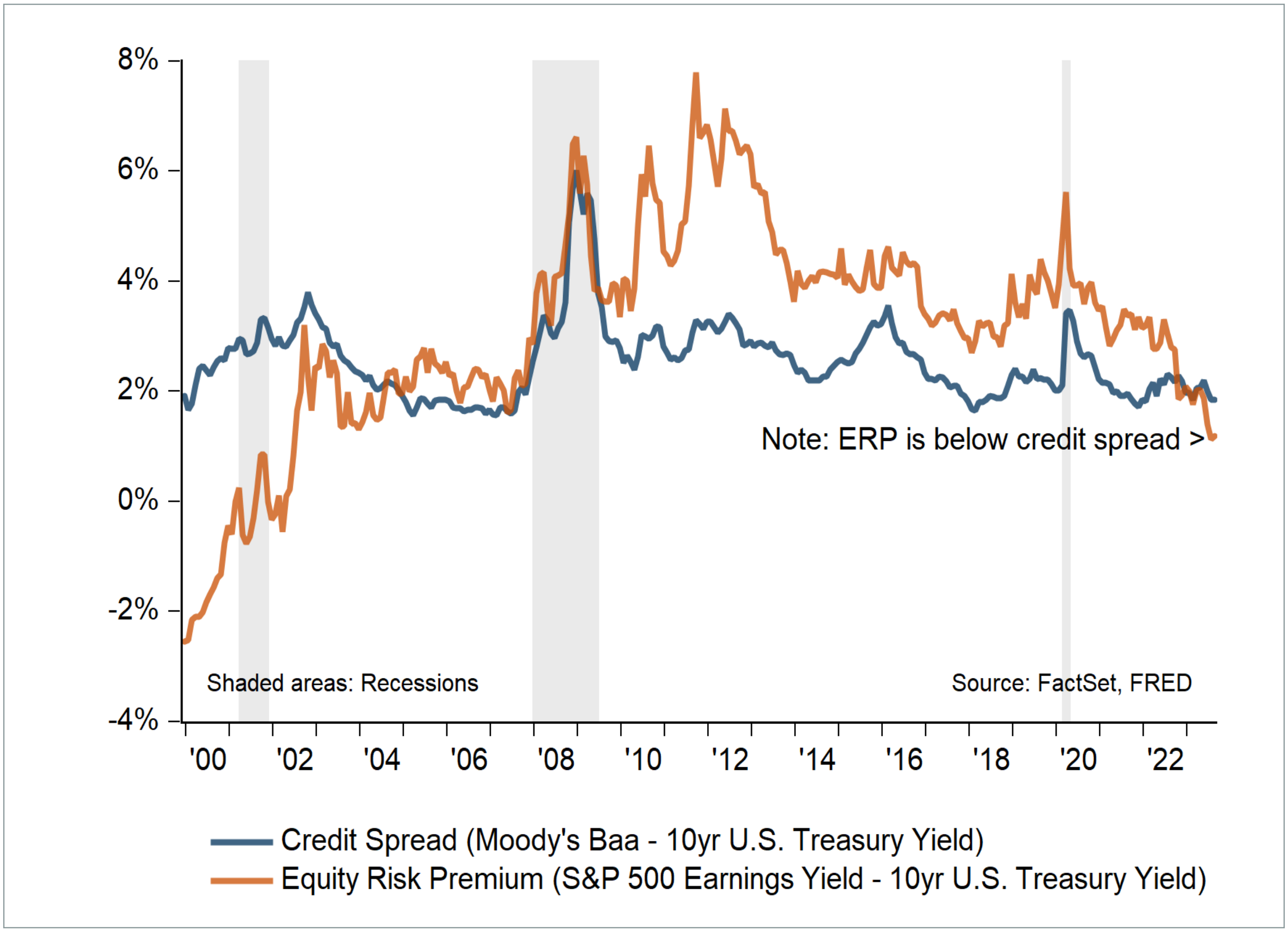
EQUITY RISK PREMIUM AND CORPORATE BOND SPREADS (BAA-UST)

One of the most interesting observations of today's Equity Risk Premium relates to the bond market. As previously mentioned, the ERP is at a historically low level – so much so, that it is less than investment grade credit spreads over Treasuries. Effectively, investors are being paid a bigger premium to invest in bonds over stocks. If that seems odd, it's because it is . . . the relationship is typically reversed.

PORTFOLIO IMPLICATIONS

At Washington Crossing Advisors, we spend a lot of time assessing investment risk across our portfolios. In particular, our Conquest Asset Allocation ETF models make monthly tactical tilts based on macroeconomic inputs, including risk premiums, valuations, and corporate spreads. With the ERP at relative historic lows and high valuations, our tilts have remained neutral, favoring neither stocks nor bonds. As always, we remain vigilant to market conditions and the associated risk premiums that investors have assigned to stocks and bonds.

CHART A | HISTORICAL CORPORATE BOND SPREADS AND ERP CALCULATIONS Source: FactSet, FRED



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.

Index Descriptions: WCA Quality Indices are based on Washington Crossing Advisors' quantitative analysis of firms along three dimensions: asset profitability, consistency, and leverage. Higher quality companies are defined as those which fall in the top quintile of largest-cap U.S. companies and tend to have higher average profitability, greater than normal consistency, and low leverage. Lower quality companies are defined as those which fall in the lowest quintile based on the same criteria. Indices are reconstituted annually, continuously rebalanced, and presented on a total return basis, as calculated by Bloomberg. Indices are unmanaged and do not represent performance of any actual portfolio or portfolio strategy offered by Washington Crossing Advisors, LLC.

Standard & Poor's 500 Index (S&P 500) is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. S&P 500 Growth Index and S&P 500 Value Indices are designed to provide a comprehensive measure of global equity growth and value performance.
S&P High Beta Total Return Index is designed to measure the performance of the constituents of the S&P 500 that are most sensitive to changes in market returns.
S&P Low Beta Total Return Index is designed to measure the performance of the constituents of the S&P 500 that are least sensitive to changes in market returns.

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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.

All investments involve risk, including loss of principal, and there is no guarantee that investment objectives will be met. It is important to review your investment objectives, risk tolerance and liquidity needs before choosing an investment style or manager. Equity investments are subject generally to market, market sector, market liquidity, issuer, and investment style risks, among other factors to varying degrees. Fixed Income investments are subject to market, market liquidity, issuer, investment style, interest rate, credit quality, and call risks, among other factors to varying degrees.

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