

The Advantage Advisor

Volume 11, Issue 7

July, 2007

Market Commentary:

There is a Wall Street observation that states: “the market climbs a wall of worry”. If that is true, then we should be in for some good gains in the second half of 2007. There seems to be no lack of worrying out there. After charging ahead to new all-time highs, the stock market seems to have lost its momentum as interest rates made a sudden upward turn starting mid-May.

Summer is typically a slow time for the markets. Trading volume dries up and the markets tend to move in a lazy sideways pattern. The two charts below illustrate that summer slowdown very clearly. As you can see, on average over the past 18 years, the summer months show low to negative returns for stocks, followed by strong monthly returns in the fall and early winter.

The pullback during June was really a knee-jerk reaction to rising interest rates and fears over hedge fund losses. Both of those things seem to have settled down now as we head into the summer season. In fact, market fundamentals definitely favor a stronger than average market environment both this summer and in the fall.

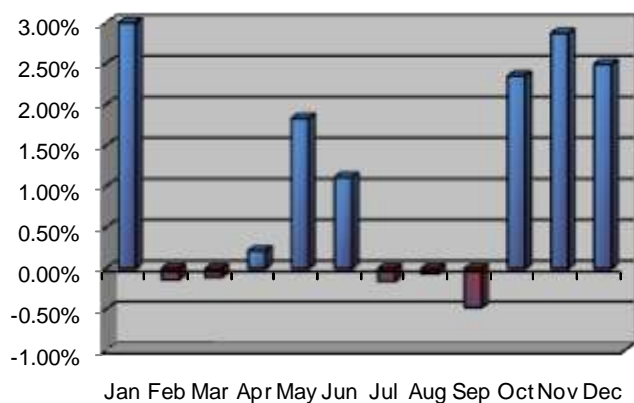
Currently, we are projecting interest rates to trade between 5.2% and 4.8% over the next twelve months. Using that interest rate projection and

Market Index	Closing Price	% Change
Dow Jones Industrial Average	13,409	-1.3%
S&P-500 Stock Index	1,503	-1.8%
Russell 2000 Stock Index	834	-1.6%
Shearson Treasury Bond Index	13,652	-1.3%
Dow Jones World Stock Index	303	-0.6%
Nasdaq Composite Index	2,603	-0.1%

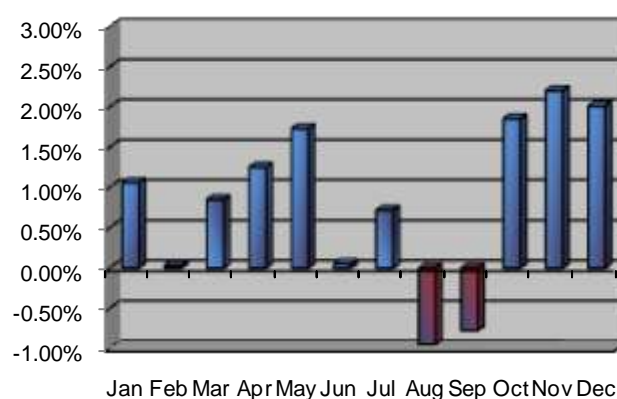
assuming corporate profits will rise by an average of 8.5% over the next twelve months, we can calculate the fair value of the S&P-500 at between 1594 and 1710. This means that given those projections, the S&P-500 is currently undervalued by anywhere from 5.8% to 13.8%.

Those are certainly reasonable assumptions, and are more conservative than the current consensus analyst view. In fact, there are many market strategists who are interpreting the recent upturn in rates as even more positive news for stocks. Their argument is that if interest rates rise without an increase in inflation, then it must be due to a stronger view of economic growth. In addition, the treasury yield curve has finally ended its inverted stance. Historically that has pointed to strong stock markets gains over the ensuing twelve months. Those are certainly some persuasive arguments for a more bullish outlook.

**NASDAQ Composite Index
Average Monthly Returns
1989 - 2006**



**S&P-500 Stock Index
Average Monthly Returns
1989 - 2006**



The Economic Picture

Last month I wrote that we would see the yield on the Ten Year US Treasury Bond trade between 4.8% and 5.2%. At the time, I had no idea we would test that full range within just a couple of weeks, but test it we did. The effect of the sudden upturn in interest rates was that it appears we are now moving into a stage four economic environment.

Stage four in our economic framework is described as late growth. The late growth stage does not mean that a recession is imminent, or even close. It does mean that the economy is maturing, and we need to start watching for signs of overheating in certain areas.

Indicators that will bear closer scrutiny are Capacity Utilization, the Employment Cost Index, and Productivity. As the economy expands and overheats, manufacturing capacity becomes stretched and utilization rates will rise substantially. As those factories reach their capacity, productivity levels will fall and employment costs will rise due to the need to hire more workers to meet the increased demand for goods.

All of that increased demand will mean that corporate profits will grow at higher rates, so we can expect the best returns to come from earnings-driven companies. Most of those companies are large cap, blue chip firms. However, all of that increased demand will have an additional side effect - inflation. When demand rises faster than supply, prices will rise as a result. That is where we expect the Fed to step in and raise interest rates in order to slow the rate of expansion.

But, let's not get ahead of ourselves. We are just now seeing inflation coming down to within the comfort range for

Current Economic Position:
Transition into Stage 4 - Late Growth

Economic Indicators

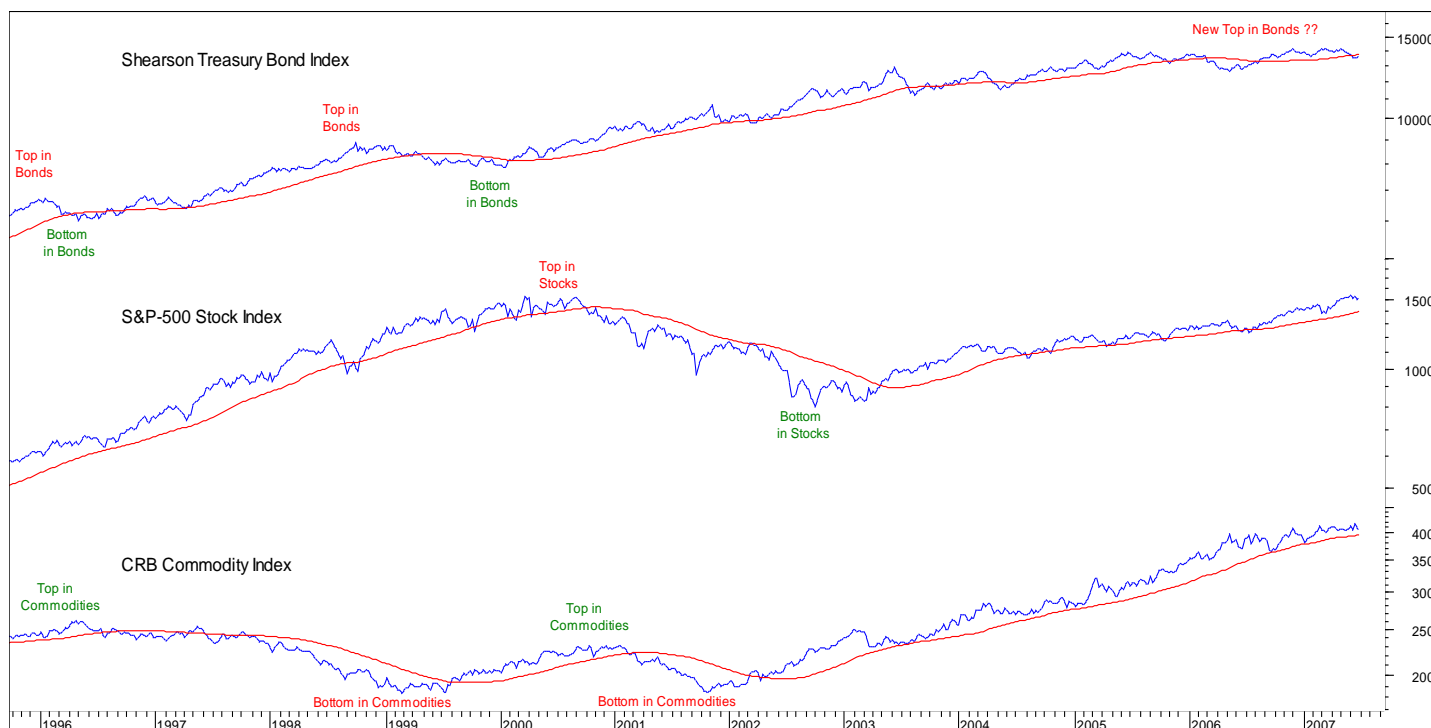
	<u>Latest</u>	<u>Prior</u>
Growth		
GDP	+0.7%	+2.5%
Productivity	+1.0%↓	+2.1%
Employment Cost Index	+0.8%	+0.9%
Capacity Utilization	81.3%	81.5%↓
Inflation		
Consumer Price Index	+0.7%	+0.4%
Core PCE Deflator	+0.1%	+0.1%
Implicit Price Deflator (GDP)	+4.2%↑	+1.6%
Sentiment		
Consumer Confidence Index	103.9	108.5↑
Unemployment Rate	+4.5%	+4.5%
Personal Income	+0.4%	-0.2%↓

↑=revised up, ↓=revised down

Source: Moody's Economy.com

the Fed. It is still very likely that the next move on interest rates will be down. In fact, Paul Kasriel of Northern Trust expects that we will see a full 1% decrease in rates finishing up in the first quarter of 2008. This is based on a forecast of lower than expected economic growth due mainly to the housing slowdown and lack of action thus far by the Fed.

While I believe he may be overstating things a bit, I would certainly agree with his premise that the Fed will need to lower rates in order to sustain growth. Barriers to that action are continuing to fall. For example, core PCE inflation has grown at a mere 0.8% annual rate over the past three months. With inflationary pressures out of the way, the Fed will soon feel justified in lowering those rates.



Source for Data: Investor's Fast Track

Advantage Investing, Inc.
Investment Strategy Composite Annualized Returns
For The Period Ending 6/30/2007

<u>Investment Strategy</u>	<u>2007 YTD</u>	<u>1 Year</u>	<u>3 Year</u>	<u>5 Year</u>
Bond Strategy	3.0%	10.5%	6.8%	11.0%
Current Income Strategy	1.8%	14.3%	7.1%	6.3%
Stock Strategy	7.7%	12.4%	8.1%	7.9%
Strategic Allocation Strategy	7.1%	13.5%	18.6%	18.7%
<u>Comparison Indices</u>				
S&P-500 Stock Index	6.0%	18.4%	9.6%	8.7%
Dow Jones Corporate Bond Index	0.9%	7.3%	4.2%	6.6%
US T-Bill Index	2.5%	5.2%	3.7%	2.8%
Shearson Treasury Bond Index	-1.3%	6.0%	4.7%	5.6%

Notes:

Composite returns are time weighted returns that include all client accounts invested within the respective strategy. Returns greater than one year in length are annualized. All strategy returns are shown net of 2% annual asset management fee, as well as all other trading expenses incurred. Past performance cannot guarantee future results.

Investment Strategy Performance Review

Our investment management strategies are performing very well this year, with each of them well ahead of their respective market benchmarks. The investing environment is becoming more and more selective, and so we are continually making adjustments to be certain we remain ahead of the curve. Stocks do still appear to have value left in them, and the global economy remains solid, so we will remain fully invested in order to capture those returns.

Bond Strategy

In the first half of 2007 this strategy outperformed its benchmark (the Dow Jones Corporate Bond Index) by more than three fold. In addition, the long term performance continues to be stellar, turning in a 11% five year average annualized return. This is significantly above benchmark return of 6.6%.

The large swing interest rates this month caused us to do a bit of trading in this strategy. We reduced our exposure to bonds early in the month by a little over 1/4. We intend to get those funds reinvested back into the high yield sector as soon as the volatility and valuations come back into line.

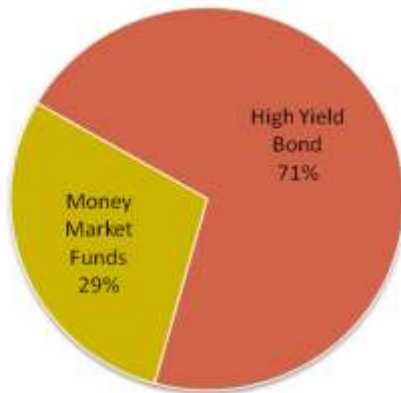
Current Income Strategy

The Current Income strategy took a bit of a hit this month due to the swing in interest rates. Both our bond and utility positions pulled back as a result. We were ready to put in some protective hedges if conditions continued to deteriorate; but things did finally firm up again at month-end. However, even in spite of that weakness, the 14.3% one year return is more than double the Shearson Treasury Bond Index benchmark return of 6.0%. This is because the pullback in the utility sector was really not large in comparison to the tremendous gains from that sector over the past year.

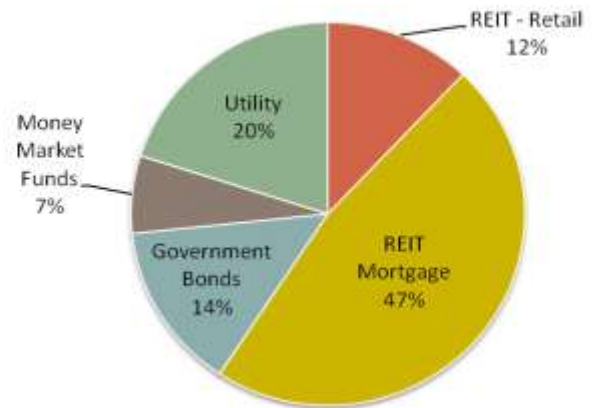
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Current Investment Management Strategy Allocations

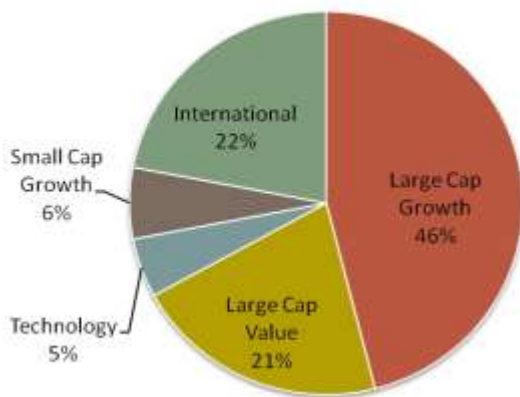
Bond Strategy



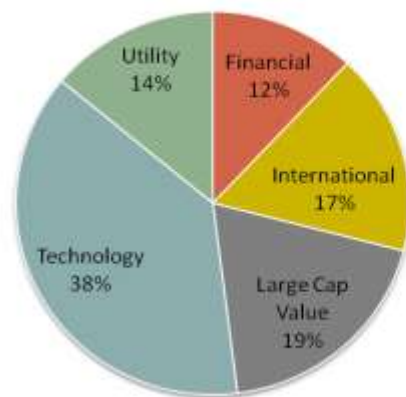
Current Income Strategy



Stock Strategy



Strategic Allocation Strategy



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Stock Strategy

After a rough summer in 2006, this strategy is definitely back on target. The performance year to date is well above that of the S&P-500 benchmark, besting it by 1.7%. This is no small feat given the strong performance of the index over the past year. We anticipate holding the current asset mix for most of the summer months as the market trades in a generally sideways pattern. However, we do anticipate increasing the allocation to technology stocks as we head into fall and winter to take advantage of the seasonally positive period for that sector. We also anticipate large cap stocks will continue to pull ahead of the small cap sector as the economic environment continues to mature.

Strategic Allocation Strategy

This strategy also struggled through last summer, which put a bit of a damper on its one year performance. Year to date, it is a little more than 1% ahead of the benchmark, so things are definitely picking up once again. Over the past five years, this strategy has turned in more than double the performance of the benchmark S&P-500 stock index. With an almost 40% allocation to technology, this strategy is positioned for a strong market later in the year. In the mean time, the positions in financials, utilities, and internationals should provide good returns over the summer months.

Please note: A current copy of Advantage Investing's form ADV (registration statement) is available at no cost upon request. Please contact us at the address or phone number below if you would like to request a copy for your own records.