

# The Advantage Advisor

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## Market Commentary:

April was a truly remarkable month for the markets. The Dow shined brightly, jumping by almost 6% in one month and breaking through to all time highs day after day. The S&P-500 was not far behind, but has yet to break out to a new all time high of its own. Small cap stocks however lagged behind their large cap counterparts. Although the Russell 2000 gained a respectable 1.73% for the month, it was well off the pace of the large cap Dow and S&P indices.

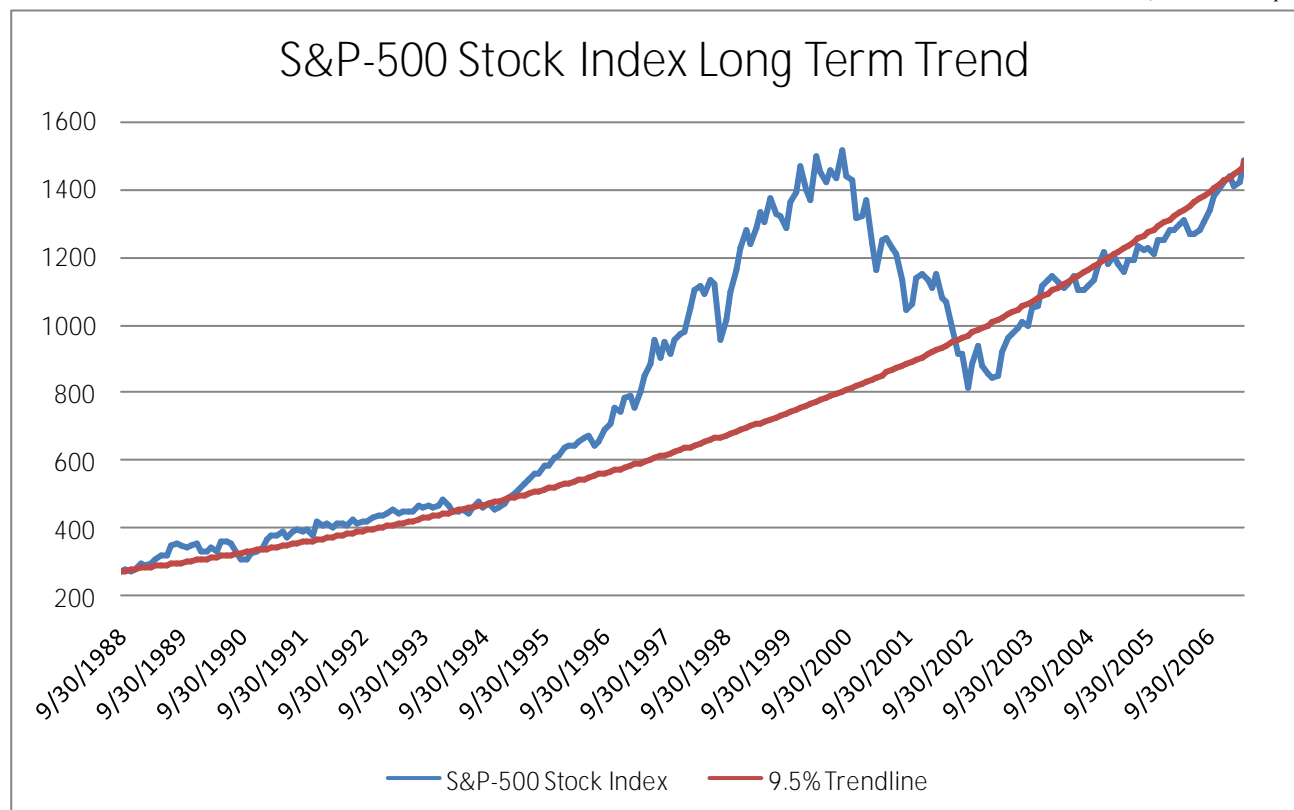
Clearly there is a shift taking place from small cap stocks into large cap, as well as from value stocks toward growth stocks. This is certainly in keeping with our current economic stage and is a transition I have been highlighting for several months now. We have made several adjustments to our investment strategies as the

Market Index	Closing Price	% Change
Dow Jones Industrial Average	13,063	5.74%
S&P-500 Stock Index	1,482	4.33%
Russell 2000 Stock Index	815	1.73%
Shearson Treasury Bond Index	14,092	0.76%
Dow Jones World Stock Index	296	4.13%
Nasdaq Composite Index	2,525	4.27%

market moves through this transition phase, and which are highlighted on page four.

Over the past several months I have highlighted the dramatic short-term rate of increase in the S&P-500 Stock Index. I have been pointing out that a 25% annual rate of increase is simply not sustainable in the long term. For this newsletter, I took a much longer term look, as can be seen in the chart below. What is most interesting is that even while the current short-term rate of increase is

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# The Economic Picture

The Fed's projection for a "goldilocks economy" continues to play out as hoped for. Economic growth has slowed but remains well into the positive range. Worker productivity gains remain solidly above the increases in the Employment Cost Index. Core inflation rates came in last month unchanged, although headline rates were up due to higher energy and food costs. Finally, consumer sentiment remains high even in the face of increasing energy costs.

The Fed wants to see the economy slow, as it has, in order to bring inflationary pressures under control. This is clearly occurring, and there are other external forces at work that could moderate inflation even further. For example, the fleet of ships that are used to transport oil, coal, and other raw materials is about to have a sudden jump in size. A record number of new vessels are about to join the existing fleet, and futures prices for shipping rates are forecasting a 40% drop in rates charged over the next three years as a result. That kind of a drop in transport costs will most certainly have an effect on raw materials and energy prices at the producer level.

Housing remains the real wildcard in the economic picture. The problems related to the sub-prime lending markets have remained contained and are unlikely to spill over into the prime lending markets.

Current Economic Position:  
Stage 3—Growth

## Economic Indicators

	<u>Latest</u>	<u>Prior</u>
<b>Growth</b>		
<b>GDP</b>	<b>+1.3%</b>	<b>+2.5%</b>
<b>Productivity</b>	<b>+1.7%</b>	<b>+2.1%</b> ↑
<b>Employment Cost Index</b>	<b>+0.8%</b>	<b>+0.9%</b>
<b>Capacity Utilization</b>	<b>81.4%</b>	<b>81.6%</b> ↓
<b>Inflation</b>		
<b>Consumer Price Index</b>	<b>+0.6%</b>	<b>+0.4%</b>
<b>Core PCE Deflator</b>	<b>+0.0%</b>	<b>+0.3%</b>
<b>Implicit Price Deflator (GDP)</b>	<b>+4.0%</b>	<b>+1.6%</b>
<b>Sentiment</b>		
<b>Consumer Confidence Index</b>	<b>104</b>	<b>108.2</b> ↑
<b>Unemployment Rate</b>	<b>+4.4%</b>	<b>+4.5%</b>
<b>Personal Income</b>	<b>+0.3%</b>	<b>+0.7%</b>

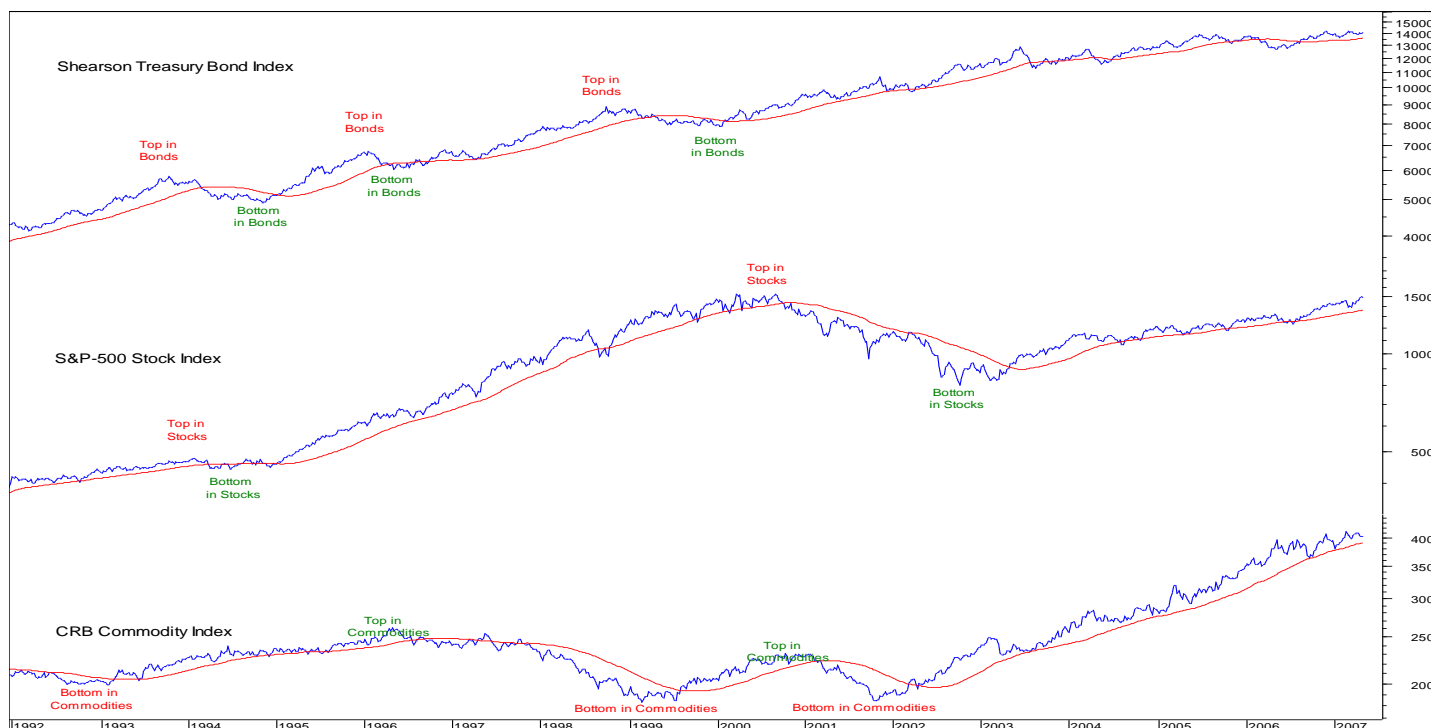
↑=revised up, ↓=revised down

Source: Moody's Economy.com

However, other issues related to the housing slowdown have yet to truly work through the system. The good news is that even though sales of homes have slowed considerably, prices have been affected by a much smaller amount.

The median sales prices for existing homes fell by 0.9% nationwide over the past 12 months. But in the South, prices actually rose by 0.3%. In all regions, the low in prices appears to have occurred back in January, when the median sales price was 2.8% lower than in March. The low in total homes sold also occurred in the

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Source for Data: Investor's Fast Track

*(The Economic Picture, Continued from page 2)*

January/February timeframe - even in spite of nicer weather. I'd hate to jump the gun here, but it may be that we have seen the low in both measures for now. That does not mean that I expect things to just take off from here. I anticipate that the market will trade in this range for quite a long time as excess inventories work their way out of the system.

One other positive sign in housing is the recovery in the Housing Affordability Index published by the National Association of Realtors. According to that measure, housing is now more affordable than it was on average in 2005 even though interest rates are currently 1/2% higher than they were then. For this index, the low seems to have occurred in July of 2006. Serious problems do still remain in the West region as the qualifying income for the median priced home remains 34% higher than the median family income for that region.

*(Market Commentary, Continued from page 1)*

running around 25%, on a long-term basis we are right back at the trend that we saw from the late '80s through the mid '90s (prior to the market bubble that developed). What this shows is that even though the current rate of increase does need to slow, values have not gotten out of hand as yet, and the bull market still has room to run.

April was also a big month for corporate earnings announcements. It was widely expected that earnings growth would slow considerably as the economy slowed. However, to the surprise of many almost 2/3 of reporting companies beat their earnings estimates, and average earnings posted yet another double digit increase for the 1st quarter. The majority of the upside surprises occurred in the large cap segment, which certainly explains the incredible performance of the Dow Industrials for the period.

There is an interesting market force that is taking form which is likely to provide support for those earnings for many quarters to come. What is that force? The supply of stock available to be purchased is actually shrinking at record rates.

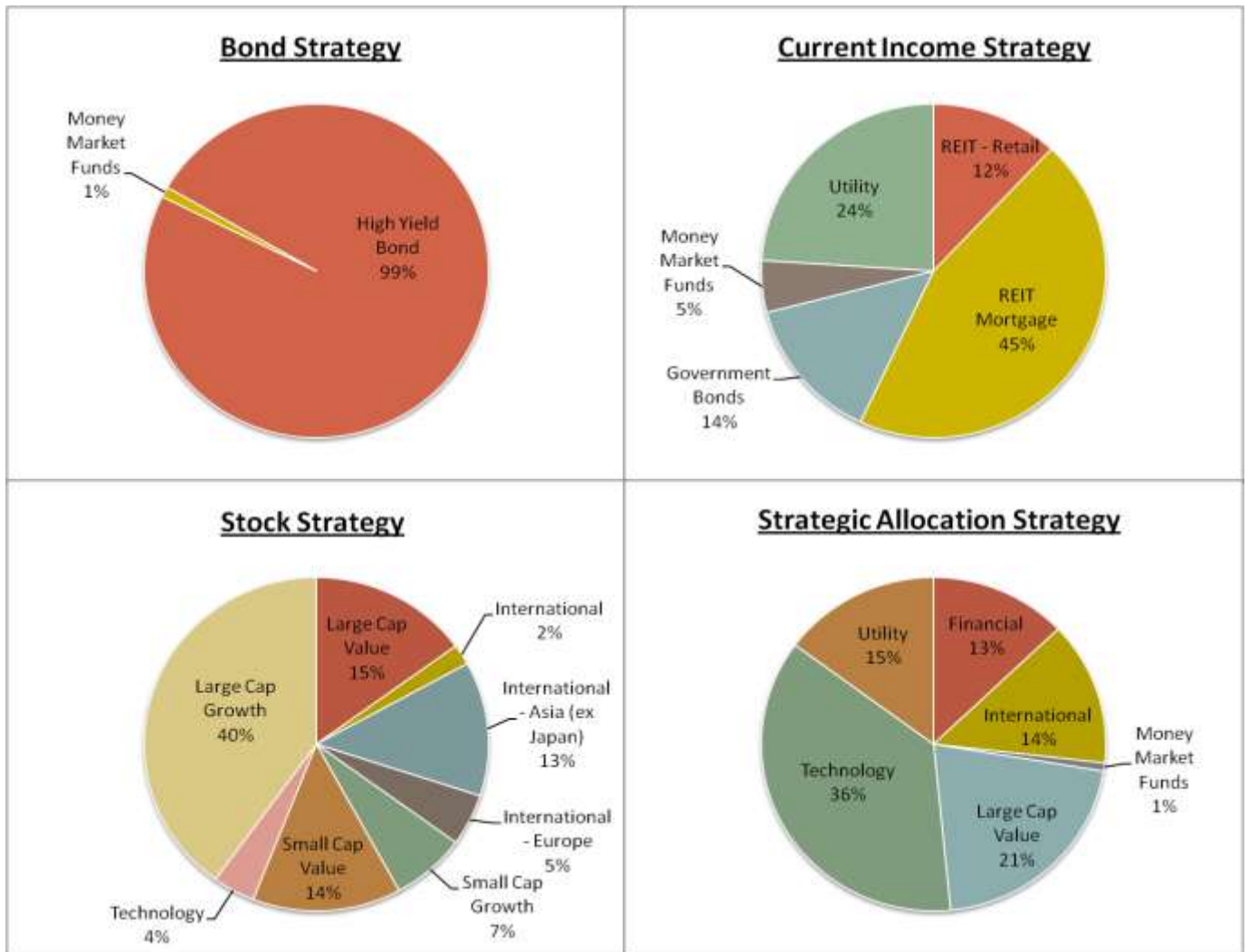
There has been a boom in what is known as the "Private Equity" markets. These are firms or consortiums that buy public companies, effectively removing their shares from the marketplace. Corporations have also been buying back their own shares at record rates, which again reduces the outstanding supply.

I'm sure you will recall from basic economics that when supply is reduced yet demand remains constant, prices will rise. Another, more hidden effect of this change is that earnings per share will increase even if the earnings themselves do not. Taking things one step further, market value measures such as the P/E (Price to Earnings) ratio will also decline simply as a result of fewer shares in the marketplace. A lower P/E ratio means that a stock has more value, and therefore more room to grow.

So what does that mean for investors? It provides yet another support to stock prices and a continuation of the bull market. Even if corporate profits were not growing, this supply/demand shift would provide strength for stock prices. Remember that even though it is earnings and profits that give a stock value, it is trading in the marketplace that sets the price. If a stock becomes more sought-after, then its price will rise as a result. And so long as we are careful to be certain stocks are trading based on actual earnings, then we will avoid the excesses that we saw back in 1997 to 1999.

Looking ahead, we will continue to monitor the transitions occurring in the marketplace and adjust our portfolio allocations accordingly. The summer months are typically slower for the markets, particularly for technology companies. We expect to see the rate of gains slow considerably over the next few months, but plan to use that time to position everything for the push ahead during the fall. With a high likelihood of a decrease in interest rates during the second half and earnings continuing to support prices, we should see a strong close for 2007.

# Current Investment Management Strategy Allocations



Our investment management strategies have seen several changes over the past month due to the transition in the markets from small cap to large cap and from value toward growth styles. The charts above show the current allocations in each strategy by investment type.

## Bond Strategy

This strategy remains 100% invested in high yield bonds. This continues to provide superior returns while keeping risk to a minimum.

## Current Income Strategy

This strategy has benefitted greatly from its positions in both Utilities and REITs. In particular, the mortgage REITs hold only higher quality loans within their portfolios and have no exposure to the sub-prime loans that have been so problematic. These loans have increased

in value as a result of their much higher quality holdings.

## Stock Strategy

This strategy had the most trading occur during the month. We have shifted to an allocation that includes 55% large cap stocks and 20% international stocks. The small cap holdings were reduced significantly and have begun a shift toward growth versus value. Finally, we are adding some additional exposure to technology sector stocks.

## Strategic Allocation Strategy

This strategy now holds 36% tech stocks, 35% diversified stocks, and 29% in financial stocks. Back in February we added utilities into the financial allocation. Those utilities shares have enjoyed some excellent performance since that change.