The Advantage Advisor

July, 2013

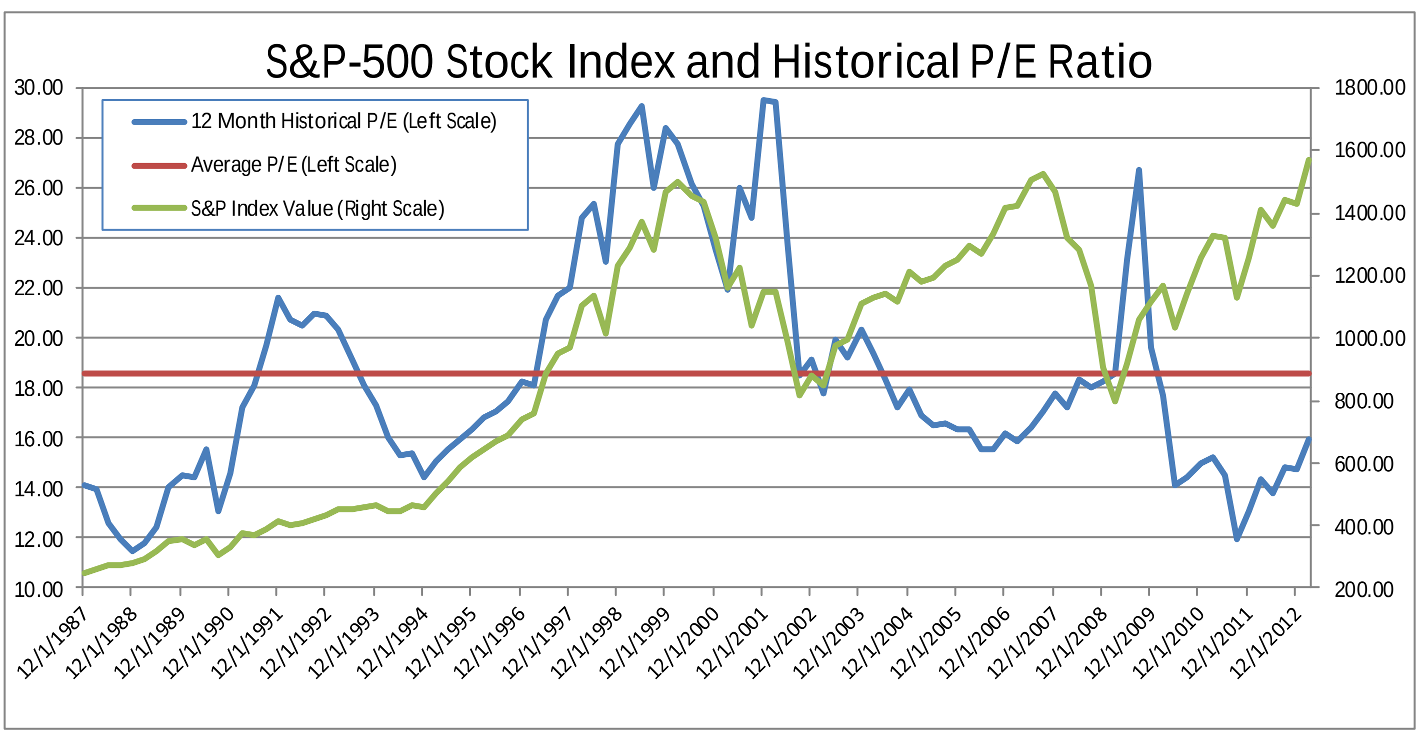
Market Commentary:

If the financial markets today had a theme song, it would have to be "*I'm Only Happy When It Rains*"! Following their June meeting, the Fed released an optimistic but still realistic view of a continuing economic recovery. This was followed by statements from Ben Bernanke to the effect that so long as the recovery stays on course they could start tapering back the Quantitative Easing (QE) program as early as this fall. But, he stressed, this would only happen if growth continued and certain targets were met, such as the unemployment rate at or below 6.5%. And the markets reaction to this positive economic outlook? It was to sell off sharply over a period of just a few days!

Sometimes the marketplace can appear completely irrational, just like this. In fact, all of that good news should have spurred us on to even higher levels. So what happened? Probably the easiest explanation is the unwinding of complex trades by large institutions and hedge funds that were based upon a continuation of the Fed's QE program. An example of these trades would be that a hedge fund would sell US Dollars while using the proceeds to buy Gold. This obviously has worked well so long as the cost of borrowing was near zero and the dollar continued to remain weak. The effects of the unwinding of that kind of trade have been particularly strong as the Dollar shot up in value while Gold has plunged to below $1,230 an ounce.

While it is not enjoyable to watch this kind of volatile disruption in the markets, it is almost certainly a temporary situation. The chart below helps to illustrate why. The Price to Earnings ratio (P/E) is a measure of the relative value of stocks or in this case the S&P-500 Index. As you can see by the blue line, that measure is significantly below the long-term average. This is a very different situation than what we experienced back in the late 90's when stocks were clearly overvalued and about to fall precipitously. In fact, our situation now is more akin to what we saw back in the late 80's which was prior to a very long bull market.

So, how are we managing our client's portfolios through all of this volatility? We have raised the cash levels in each of our strategies in order to reduce the short-term impact of the price swings. Our intent moving forward is to reinvest that cash and do some significant re-allocating within each strategy based on our forecast for a continuation in the US economic recovery.



Source: Standard & Poor's

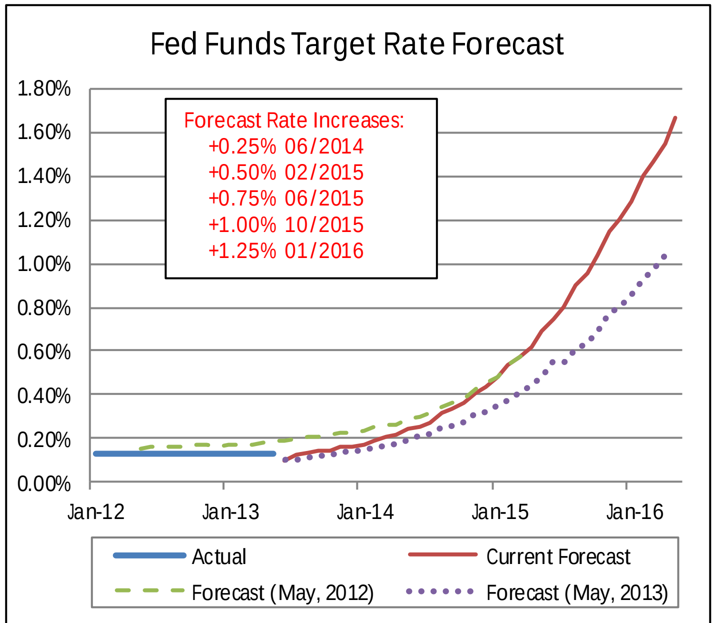
The Economic Picture

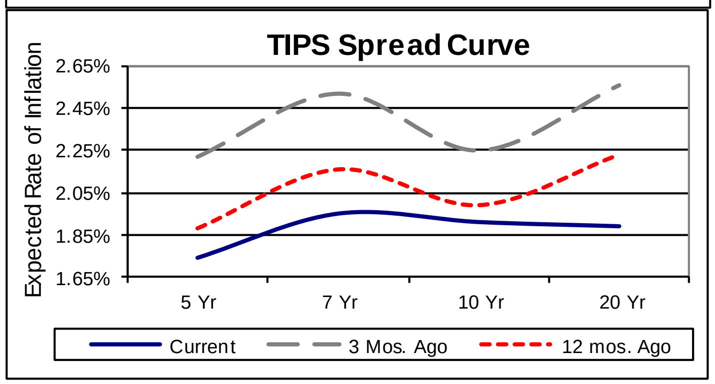
The US economy continues to expand at a slow but steady pace. The **Conference Board Index Series** below shows that all three indicators are in positive territory, indicating a continuing expansion. In it's recent statement, the Federal Reserve's Open Market Committee shared their expectation of slow but steady improvement with moderate acceleration in the recovery. This would in turn lead the FOMC to taper back their buying of US Treasuries and Mortgage bonds on the open market, and at some future date even begin to increase interest rates.

The impact of this outlook has been dramatic as market participants shifted their expectations of exactly when those rate increases might occur. In the chart of the **Fed Funds Target Rate Forecast**, one can clearly see an upward shift from the dotted line, which was the forecast in May, to the solid red line, which is the current forecast. The table inset in the chart provides the dates when the Fed Funds Rate is expected to rise to specific levels. It is important to note that even with this shift in expectations, the forecast rate of increase remains moderate—not rising to 1% until October of 2015.

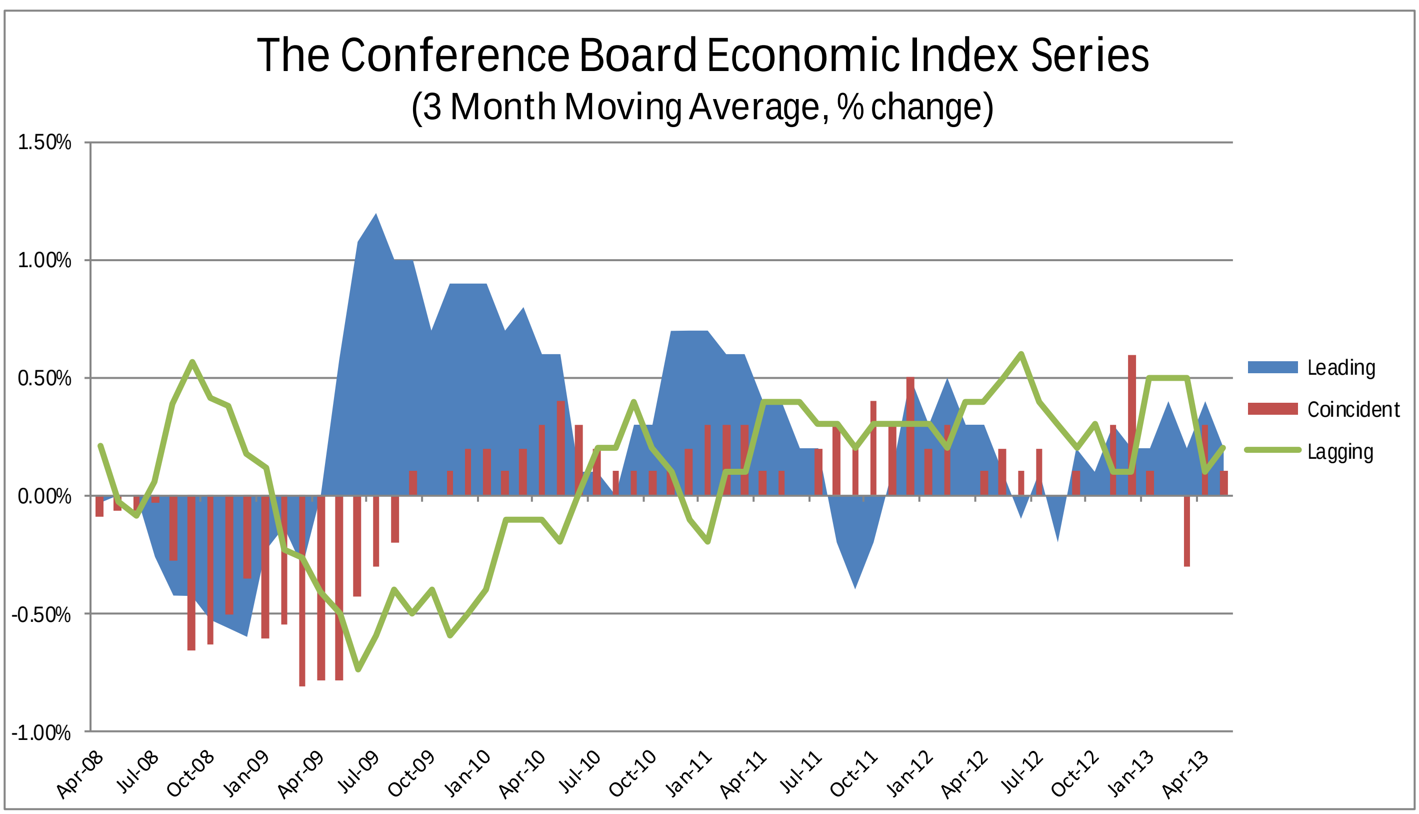
One other important shift in sentiment has taken place, and that is in terms of inflation expectations. The **TIPS Spread Curve** shows how inflation expectations have fallen over the past three months. Current expectations are for inflation to average less than 2% for the next 20 years!

Current Economic Position: Stage 2 - Early Growth

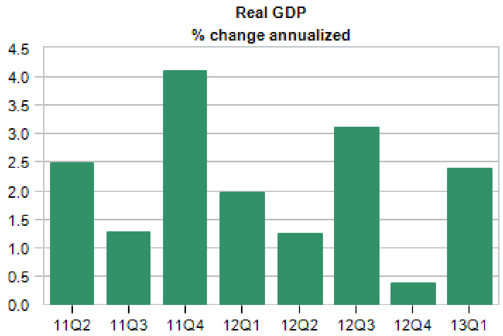


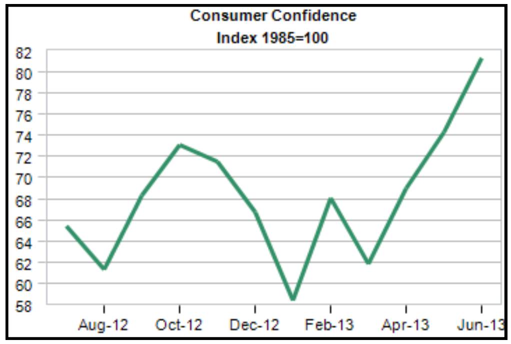


Source: US Federal Reserve, CBOT

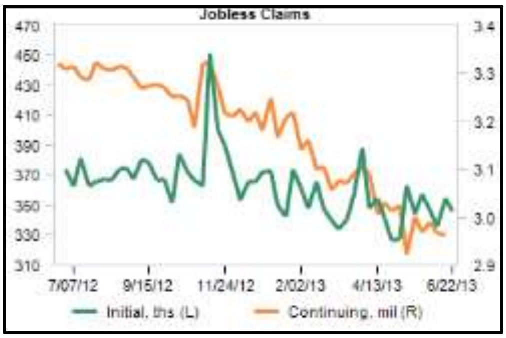


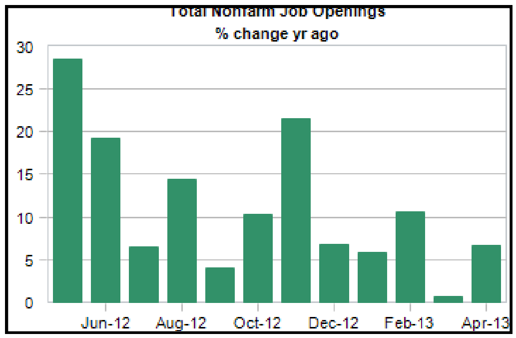
Source: The Conference Board

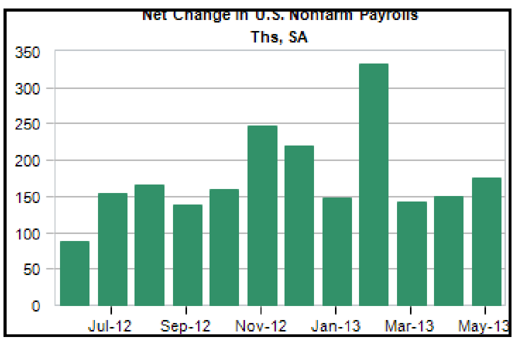


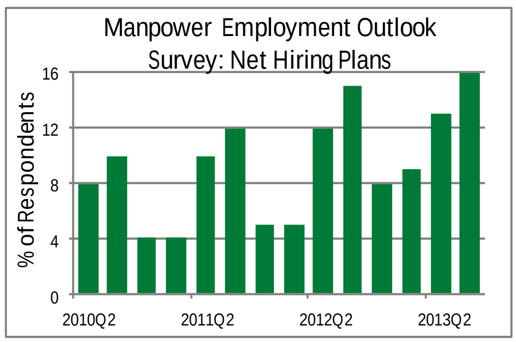


Economic Growth: The US economy, as measured by **Real GDP**, grew at a rate of 1.8% in the first quarter of 2013. Growth below a 2.5% pace is simply not strong enough to become self sustaining. However, there are reasons to believe that growth will improve later this year. As you can see, **Consumer Confidence** has picked up dramatically over the past several months to a new recovery high, and is a good indication that GDP will pick up as well.

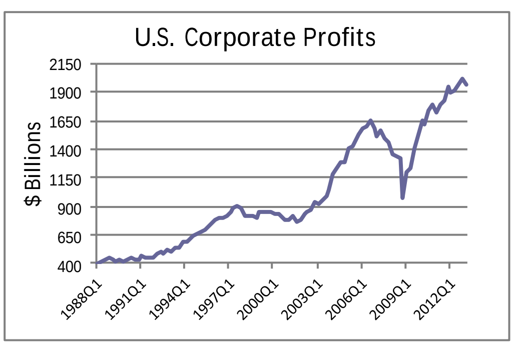


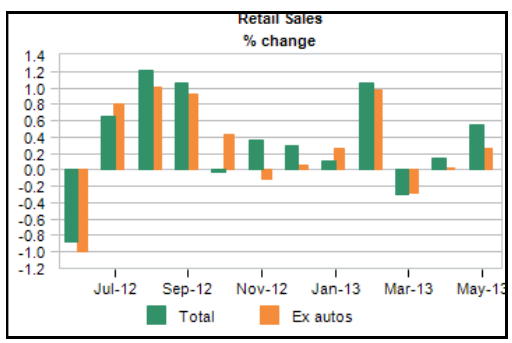




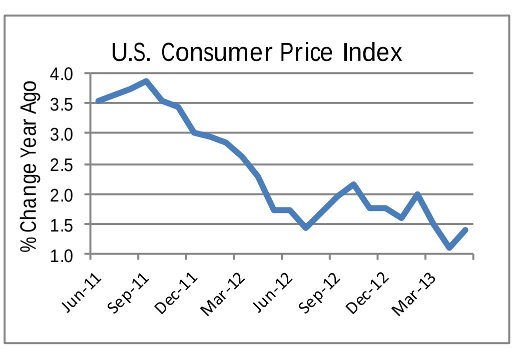


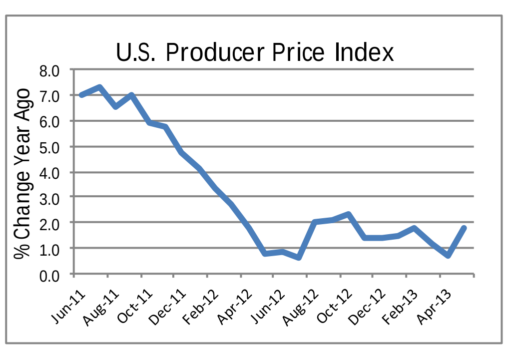
Employment: **Jobless Claims** in the US, both initial and continuing, are clearly trending down. Generally speaking, our economy hits a break-even point for unemployment at around 420 to 450 thousand jobless claims per week. Below that level the unemployment rate declines, while above that level the unemployment rate will rise. Not only do we see a drop in the number of jobless claims, but we are also beginning to see a pickup in the expectation for new jobs. This can be seen in the **Manpower Employment Outlook Survey**, which shows an increasing number of companies expressing plans to expand their workforces.





Business Growth: **U.S. Corporate Profits** continue to trend up toward new all-time high levels. These higher profits have also led to all-time high cash levels on corporate balance sheets. On the consumer side, **Retail Sales** appear to have recovered from their recent weakness. With consumer confidence rising it is likely we will see even stronger numbers over the remainder of the year.





Inflation: Both headline **Consumer Prices** as well as **Producer Prices** are growing at a significantly slower pace than they were two years ago. Clearly the Fed's stimulus programs have added little if any to inflationary pressures. This gives the Fed more flexibility in determining when to begin tapering off their stimulus.

Source for charts and data: Moody's Economy.com

U.S. Housing Market

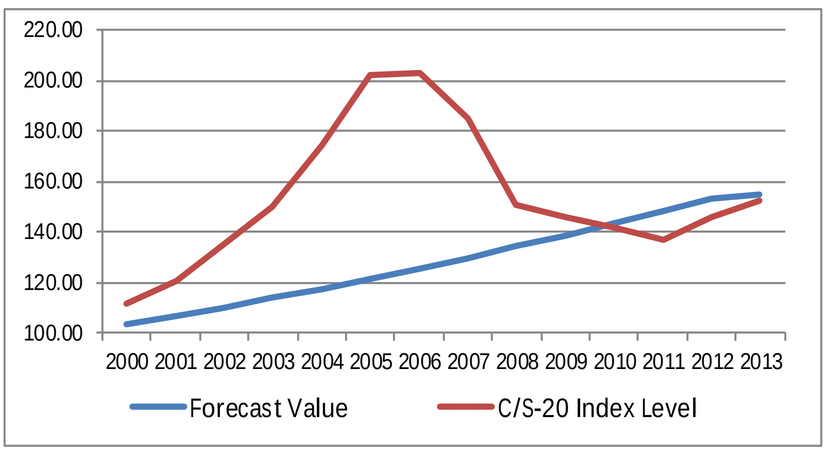
The US housing market has certainly taken on a new look. Mortgage delinquency rates and foreclosure starts are down, sales of existing homes are rising, and prices are going up as well! The S&P/Case-Schiller Home Price Index (C/S-20) has made a decisive leap forward, showing an improvement of 12% in home prices nationwide versus a year ago. In some metro markets, the one year gains were even reminiscent of the housing market boom. In San Francisco, for example, prices rose almost 24%. Atlanta, Las Vegas, and Phoenix all posted twelve month gains in excess of 20% as well.

The chart in the middle of the page shows the results of our own model which compares the value of the Case-Schiller index to a long run home price index. The long run index value is based upon the average nominal (not inflation adjusted) gain in home prices going back over 115 years. The fact that home prices were terribly overextended is obvious in retrospect as we see the C/S-20 index climb to nearly double the long run forecast price. Since then, the C/S-20 index has fallen to below the long run level, has stabilized, and is now moving back up to meet it once again.

Our model also forecasts the time it will take for prices to climb back up to where they stood at the peak of the housing boom. Based on prices gaining at the long run average pace of 3.3% per year, it would take until August of 2021 for house prices to hit that peak once again. While that may not be particularly comforting, it is important to remember that what we experienced in terms of price appreciation during the boom was most definitely an aberration.

There is some concern that this upturn in prices will lead to a flood of homes for sale, which would then push prices back down and could stall the recovery. The truth is, however, that negative home equity is constraining existing home sales and thereby reducing available inventory as home owners who are underwater cannot sell their homes at current prices. This is a self-correcting mechanism that should keep the price recovery moving forward at a sustainable rate.

Forecast Long Run Index Level: 153.09 (+3.3% per year)
Current C/S-20 Index Level: 152.37 (1.6% undervalued)

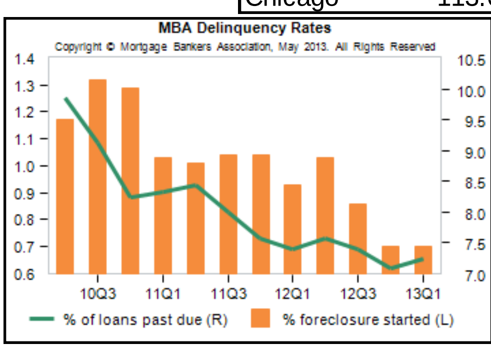


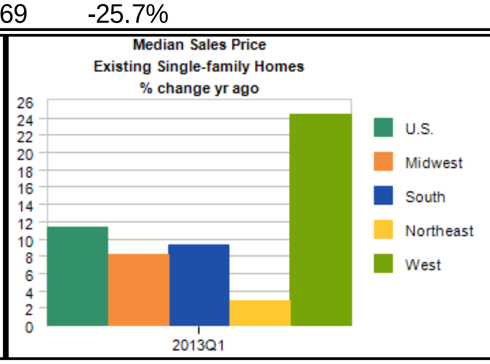
Most Undervalued Metro Areas:

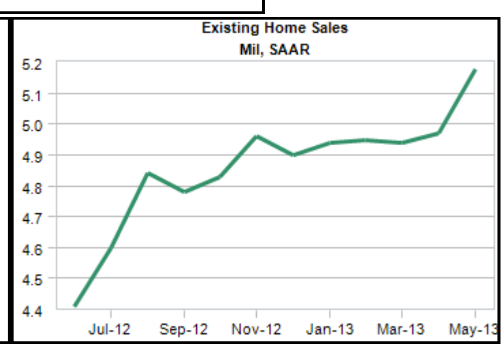
Area	Index	% Diff.
Detroit	81.28	-46.9%
Cleveland	101.74	-33.5%
Atlanta	102.06	-33.3%
Las Vegas	111.06	-27.5%
Chicago	113.69	-25.7%

Most Overvalued Metro Areas:

Area	Index	% Diff.
Washington	194.16	26.8%
Los Angeles	192.58	25.8%
San Diego	174.08	13.7%
New York	163.05	6.5%

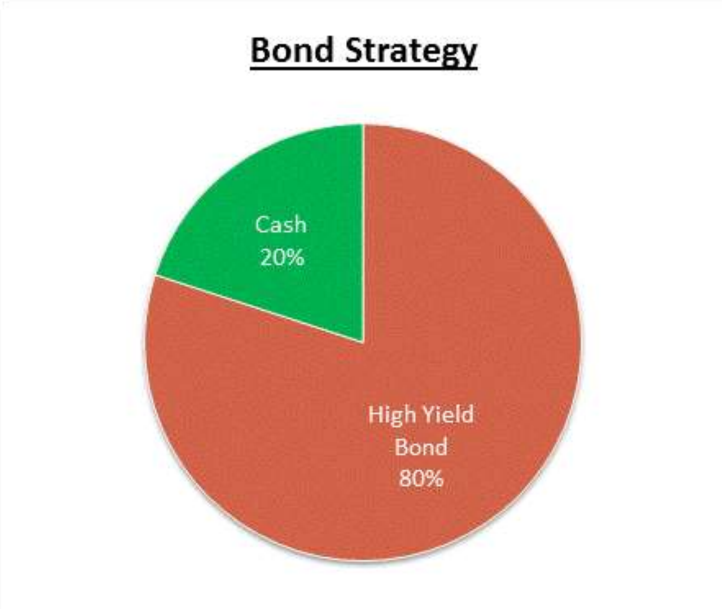


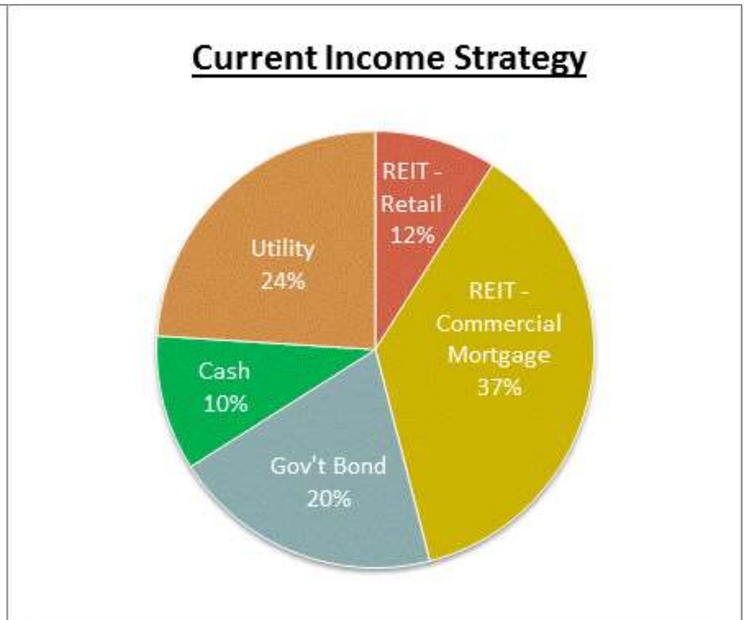


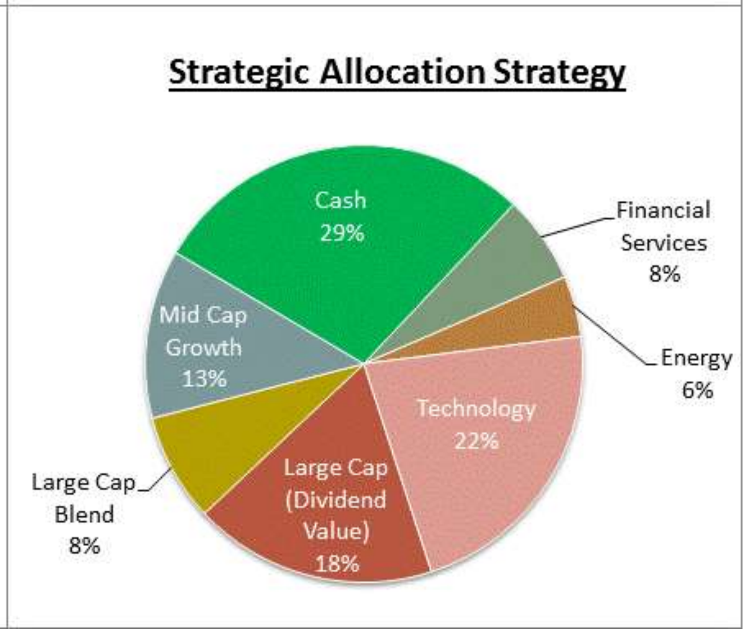


Source for data: Standard & Poor's Indices and Fiserv, Moody's Economy.com

Current Investment Management Strategy Target Allocations







The recent increase in market volatility has led to quite a bit of movement within our investment management strategies. In all but the Current Income Strategy we raised the allocation to cash in order to take on a more conservative posture and to take some profits off the table. In doing so we realized gains of as much as 30% (HYG) in our Bond Strategy, 26% (VBK) in our Stock Strategy and even 43% (QLD) in our Strategic Allocation Strategy.

Moving forward, we expect to begin making some additional changes to the allocations and positions within each of our investment strategies. We recently upgraded to a new portfolio management platform which allows us to leverage our own economic models with the detailed data and research from Morningstar Investments. This, along with some new and very sophisticated quantitative tools has allowed us to fine tune our strategy models. These enhancements should allow us to further reduce risk (volatility) while at the same time increasing the returns for our clients on a portfolio level.

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