CYCLICAL INVESTING COMMENT

David L. Smith, Editor

June 8, 2007

As of the close on Thursday, June 7, 2007

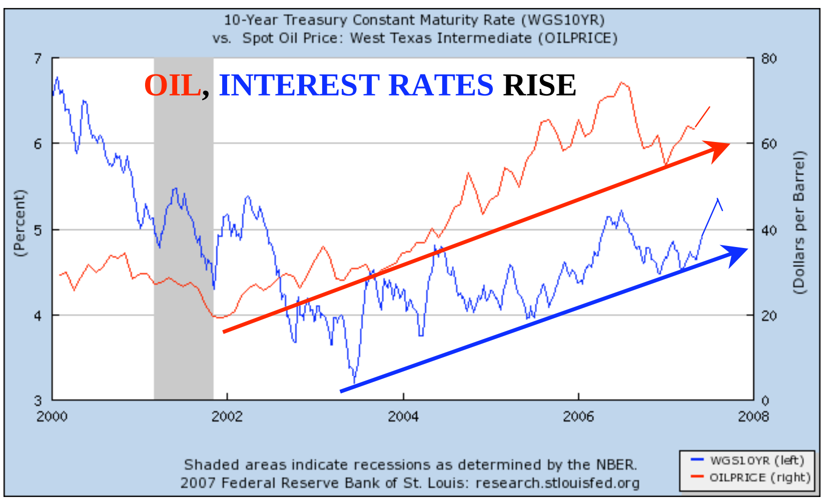
DJIA: 13,266	S&P 500: 1,490	NASDAQ: 2,541	
DIA: 132.53	SPY: 149.10	QQQ: 46.34	
Treasury Yields	2-yr.: 5.04%	10-yr: 5.17 %	30-yr.: 5.21%
¥en: 120.98	€uro: $ 1.343/€	British Pound: $1.977/₤	
Gold: $665/oz.	StreetTRACKS Gold (GLD): $65.26		Oil (Nymex): $66.93
PWE: $35.21	CNE: $15.84	FXB: $197.90	FXE: $134.29

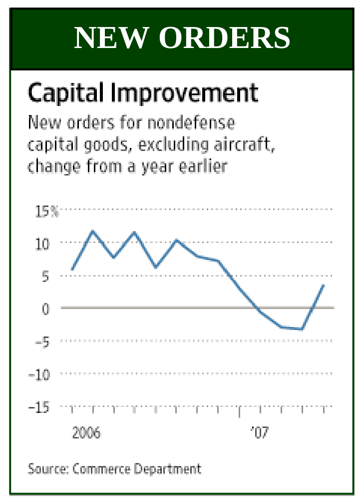
Several cautionary themes I have been warning you about in recent months– notably oil, foreign capital, productivity and money supply -- have resurfaced lately, slapping down stocks and bonds. (Charts will follow the discussion below.) During the past 5 trading days, the Dow, S&P 500 and NASDAQ have retreated about 3% from recent peaks while the yield on the Treasury's benchmark 10-year note has jumped to as high as 5.21% producing a corresponding decline in bond prices to levels not seen since 2002.

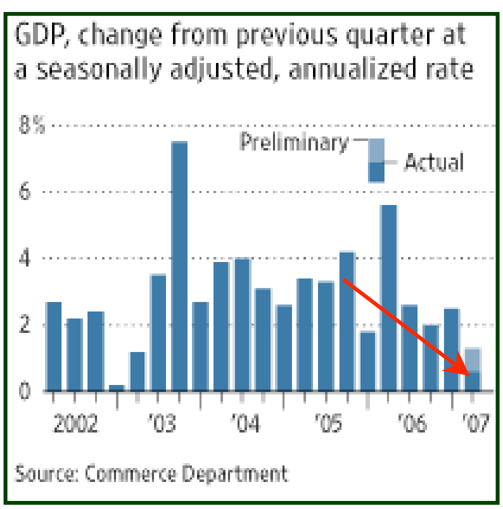
- Oil prices rebounded to $66.93 for domestic crude, raising inflationary fears.
- Productivity growth for the first quarter was revised down to a meager 1% while unit labor costs rose 1.8 percent during the first quarter of 2007, following an 8.9-percent increase in the fourth quarter of 2006, as revised. These data also raise inflationary fears.
- The implicit price deflator for non-farm business output rose by a troubling 3.2 percent in the first quarter of 2007. CPI inflation for the past 12 months stands at 2.4%, above Fed's comfort zone between 1% to 2%.
- Shanghai stocks retreated nearly 18% last week before seeming to find footing in the last few days, resulting in a net loss of around 11% from the peak. As was the case with the previous correction in Chinese stocks earlier this year, financial turmoil in Shanghai may have had an indirect effect on U.S. financial markets by raising fears of an exodus from dollar-denominated securities.
- Gross Domestic Product (GDP) for the first quarter was revised downward from an annual 1.26% rate to 0.6% while weakness in the housing sector persisted, triggering a series of downward revisions in forecasts for the year.
- Concern about weaker future economic growth was allayed to some degree by the report of fairly strong job growth in April (155,000 new jobs were added, nearly double March's disappointing increment of 88,000), an uptick in non-defense capital orders (excluding aircraft) and a modest rebuilding of inventories.
- The Fed slowed the growth rate of the M2 money supply from an 8.1% annual rate between August 2006 and early April 2007 to 4.7% since then. For the past couple of months I have been warning you that the Fed would be forced to do so (or risk reigniting inflation), and that slower monetary growth would deprive the stock market of fuel.

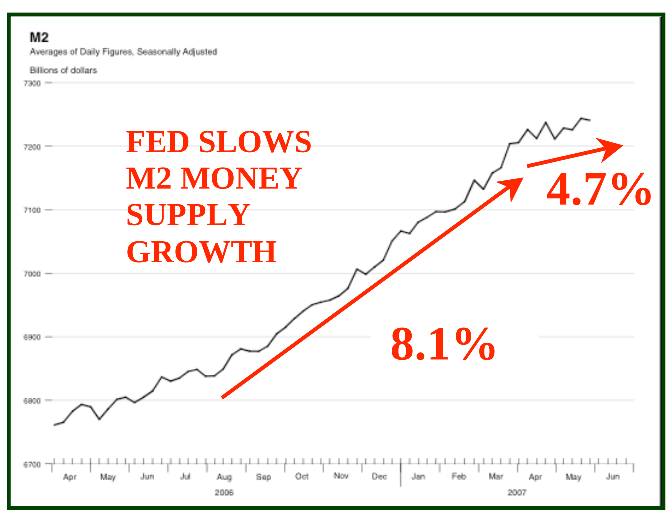
The net effect of these developments, revealing troubling inflation and sluggish growth, has been to alarm the stock and bond markets about the prospect of stagflation and the possibility of a flight from the dollar by international investors. The usual response of the bond market to such an outcome is higher rates (lower bond prices). Accordingly, long-term interest rates popped up by about 30 basis points in recent days, apparently in response to a) concerns about flight from the dollar implicit in the Shanghai swoon and b) the inflationary implications of higher oil prices, lower productivity and troubling increases in unit labor costs. Higher long-term interest rates, firm oil prices and reports of sluggish economic growth in turn unsettled the stock market for several reasons:

- Higher oil prices imply rekindled inflation, which in turn may prevent the Fed from lowering rates and might even prompt them to raise rates. Expensive oil also raises the cost of doing business and discourages consumer spending on non-energy goods and services, thereby eating into corporations' top and bottom lines.
- Higher interest rates also imply a higher cost of doing business, to the detriment of corporate profits, and may tend to discourage mergers and acquisitions, undermining one of the pillars of the bull market in recent years.
- Lower productivity implies higher unit labor costs, forcing business to either raise prices (adding to inflation and corresponding increases in interest rates) or accept lower profits. Either way stock prices suffer.









INVESTMENT STRATEGY:

BONDS: The recent surge in long-term interest rates confirms the profitability of my longstanding recommendation to avoid bonds in favor of debt instruments at the short end of the yield curve. Bonds have been depreciating for the past 4 years in tandem with rising oil prices and accompanying inflation (see graph above of rising long-term yields, implying declining bond prices). There is no change in my negative outlook for bonds since the May 23, 2007 CIQR. The bond market will turn around only after the inflationary threat posed by rising oil prices ends, the eventuality of a massive exodus from the U.S. bond market by international investors plays out and the U.S. economy slides into recession (dampening the demand for credit). Accordingly, I continue to advise avoiding long-term bonds.

STOCKS: Whether the recent weakness in the stock market portends a bull market peak remains to be seen. However, recent events have tended to confirm my expectations of stagflation rather than a "soft landing" as the next economic stage, boding ill for stocks. In particular, rising long-term rates have rattled stock investors on three counts:

1) The prospect of stunted economic growth and higher debt-service costs, squeezing corporate profits
2) Higher cost of capital inhibiting mergers and acquisitions, which have bolstered stock prices in recent years
3) Higher bond yields luring investors away from stocks into bonds

In addition, the stock market is now laboring under the following burdens:

- Firming oil prices (which also tend to squeeze both the top and bottom lines of corporate income statements), and the trimming of monetary growth by the Fed (which reduces liquidity available for stock purchases)
- Flagging growth in productivity, cutting into profit margins
- The threat of a flight from dollar-denominated investments by international investors, not only reducing foreign demand for U.S. stocks, but also aggravating the effects of higher interest rates by reducing demand for U.S. bonds

Yesterday, the S&P 500 and the NASDAQ, fell slightly below my lines-in-the-sand for traders – those with quick reflexes and a willingness to step into and out of the market on short notice based on technical signals. The S&P 500 corresponding market-surrogate exchange-traded fund (SPY) also fell below my line-in-the-sand at $150, NASDAQ's corresponding ETF, QQQ did not, nor did the Dow and the Dow's ETF, DIA. As this is written, (around noon on June 8, 2007) stocks seem to be rebounding in response to a $2/bbl drop in oil prices and relative calm in the bond pits. The NASDAQ bounced back above my May 23, 2007 line-in-the-sand, the S&P 500 is just below it, and the Dow is 95 points above and QQQ is 56 cents above (see table below). None of the indices has come close to breaking below my lines in the sand for long-term investors.

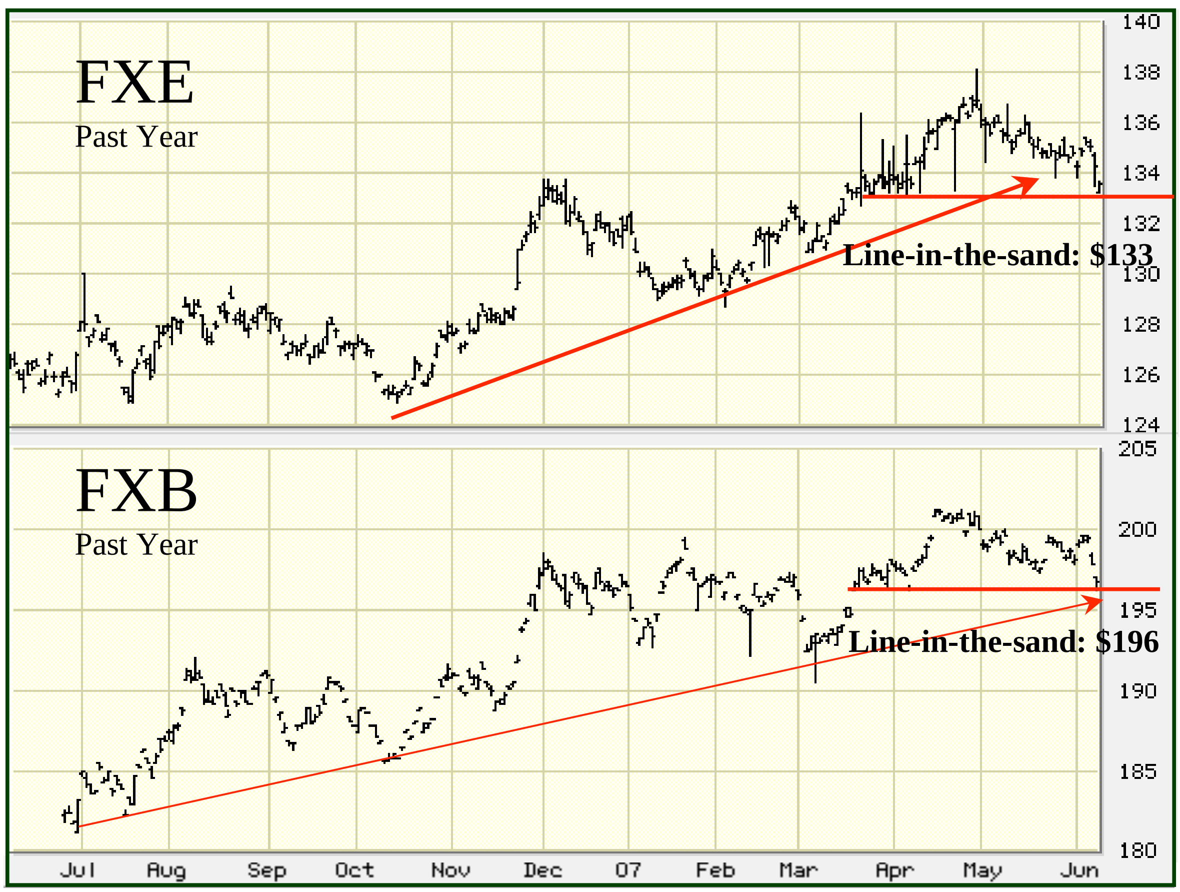
Accordingly, I am writing this *Comment* to alert traders that they are on the knife's edge of a short-term technical breakdown. Any significant weakness below current levels would suggest a defensive sidestep to the sidelines with a readiness to jump back in at short notice if the markets reverse course. Long-term traders should hold current long positions in stocks as long as they remain above the "Investors" lines-in-the-sand displayed in the table below.

INDEX/ETF	JUNE 7, 2007	L-I-T-S TRADERS	L-I-T-S INVESTORS
DJIA	13,266	13,200	12,500
NASDAQ	2,541	2,550	2,450
S&P 500	1,490	1,500	1,425
DIA	132.53	131	124
SPY	149.10	150	143
QQQ	46.34	46	44.50

Here are the corresponding graphs for DIA, SPY and QQQ as of noon June 8, 2007:

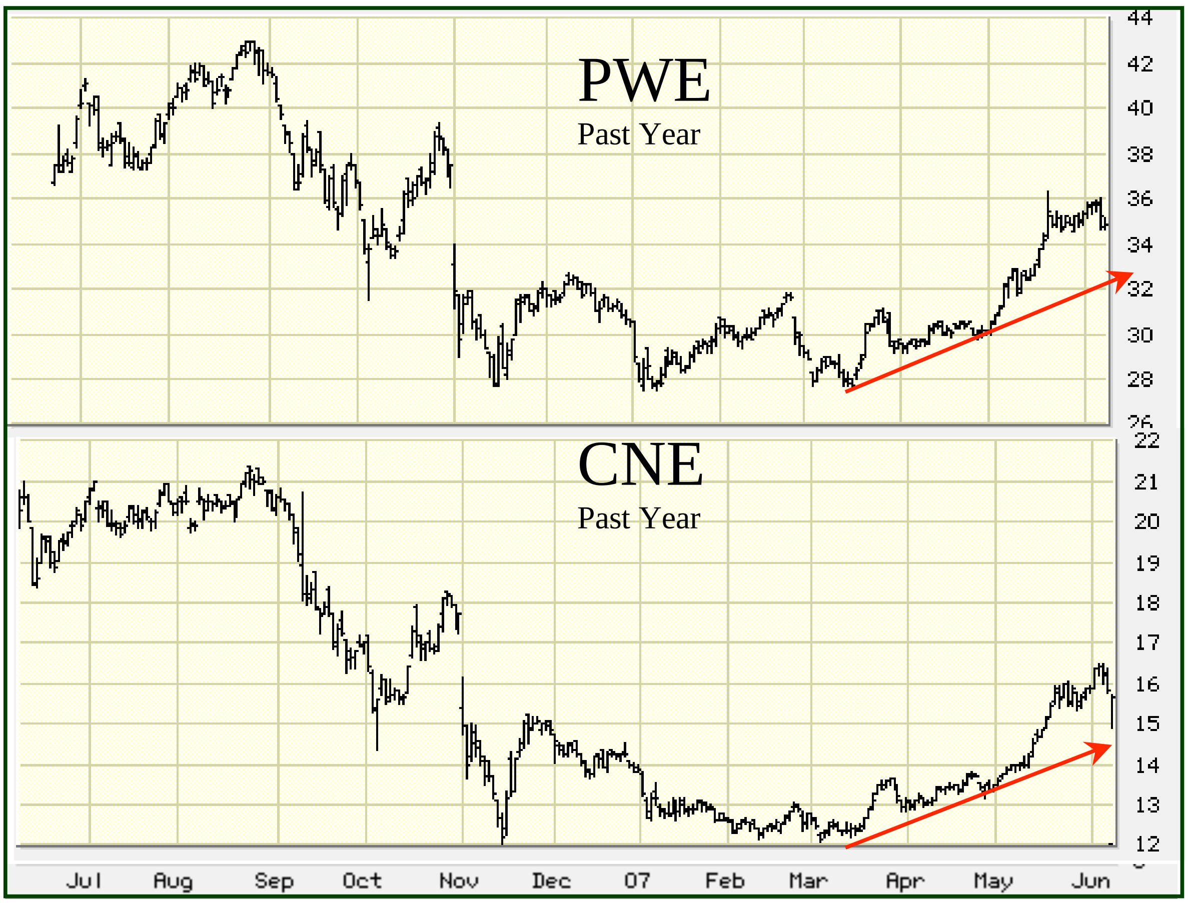
GOLD: Gold has had some rough sledding in the past few days, and today in particular, because rising long-term rates have tended to attract interest in short-term U.S. debt instruments, driving up the dollar relative to other major currencies. A $2/barrel slump in oil prices today has also contributed to gold's weakness. Accordingly, with Gold trading at $651/oz. and streetTRACKS Gold (GLD) trading at just over $64, gold is also on a knife's edge. In my last newsletter, I drew lines-in-the-sand for GLD (out below, in above) at $65 for traders and $63 for investors. Accordingly, with GLD trading at $64.12 as this is written, traders may want to consider selling the recommended 10% allocation for growth-oriented, liquid portfolios if GLD closes below $65. Investors, however, should hold their long positions as long as GLD holds above $63.

CURRENCIES: As previously mentioned, the euro and the British pound have been under pressure in recent days due to the rise in U.S. long-term interest rates.



Presently the ETF's both currencies (FXE and FXB) are on the knife's edge of a technical breakdown below support at $133 and $196. *Any further weakness below these lines in the sand would warrant a precautionary sidestep to the sidelines in the interests of preservation of capital.*

OIL: Oil prices have fallen by more than $2/barrel today for several reasons. Prices had risen in recent days because of fears that cyclone Gonu would interrupt shipments of oil through the Straits of Hormuz. Gonu weakened to a tropical storm, easing that fear. They also rose because of worries that the current spat between the U.S. and Russia over a proposed missile defense system to be located in central Europe might prompt Russia to play the energy card, curtailing oil and gas shipments to Europe. That crisis seems to be easing following discussions between Presidents Bush and Putin at the G-9 meeting in Germany recently. The threat of rising U.S. interest rates depressing effects on economic growth and, therefore, demand for oil has also weighed on the market. So far, these gyrations in the global oil market appear to be short-term-oriented. Consequently, my long-term expectations for firm oil prices in the vicinity of $65 a barrel remain unchanged. Consequently, I advise holding long positions in oil, and specifically in the two Canadian oil Trusts, Penn West Energy Trust (PWE) and Canetic Resources Trust (CNE), both of which have rebounded nicely from recent lows.



We have enough of a rising trendline presently to draw lines-in-the-sand at $32 and $14.50, respectively, for PWE and CNE.

ASSET ALLOCATION: Your personal asset allocation will depend on your particular risk tolerance and investment objectives. Here are some suggested guidelines, for a balanced asset allocation targets for both aggressive, growth-oriented and conservative, income-oriented liquid portfolios *based on current cyclical conditions.*

Aggressive, long-term, growth-oriented liquid portfolios:

- Hold 35% allocation to stocks but be ready to exit to money market (pending further redeployment) if trendlines of support are broken (see table in "Stocks" above.)
    - Hold: 10% Diamonds Trust (DIA) recommended most recently on September 1, 2006 at $114.70, now trading at $132.53. Lines-in-the sand at $131 (traders) and 124 (investors).
    - Hold: 10% S&P Depositary Receipts (SPY) recommended most recently on 9/1/06 at $131.42, now trading at $149.10. Lines-in-the-sand at $150 (traders) and $143 (investors).
    - Hold: 15% NASDAQ 100 Trust (QQQ or QQQQ) recommended at $39.08 on 9/1/06, now trading at $46.34. Lines-in-the-sand at $46 (traders) $44.50 (investors).
- Hold 10% oil-related investments
    - Hold: up to 5% Penn West Energy Trust (PWE) most recently purchased October 30, 2006 $37, current price $35.21 yielding about 10.58%. Line-in-the-sand $32.
    - Hold: up to 5% Canetic Resources Trust (CNE) purchased October 30, 2006 at $17.50, current price $15.84 yielding about 13.01 %. Line-in-the-sand $14.50
- Hold 20% position in short-term sovereign debt denominated in euros, originally recommended April 28, 2006 at $1.26/€, presently selling at $134.63. Consider Euro Currency Trust (FXE) a NYSE exchange-traded fund as a market surrogate, presently trading at $134.29 yielding 3.19%. Originally recommended July 24, 2006 at $126.45 yielding 2.24% at the time. Line-in-the-sand: $133.
- Hold: 20% in short-term sovereign debt in British pounds, most recently recommended for growth-oriented portfolios at $1.86/£, currently trading at $1.977/£ yielding around 5.5% for bills maturing in 3 months. Can use British Pound Sterling Trust (FXB) a NYSE exchange-traded fund as a market surrogate, presently trading at $197.9 and yielding 4.5%, originally recommended on July 24, 2006 at $185.50 with a yield of 3.9% around the time when it first began trading. Line-in-the-sand at $196.
- Hold: 5% physical gold (non-numismatic gold coins) originally recommended around $300/oz. after 9/11/01. Spot gold presently $665.
- Hold 10% position in streetTRACKS Gold (GLD). Presently selling at $65.26. Lines-in-the-sand: $65 (traders), $63 (investors) (in above, out below).

Conservative, risk-averse, long-term, income-oriented liquid portfolios

- Hold: 40% in 90-day Treasurys currently yielding 4.89 % and/or investment grade corporate obligations of the similar maturities yielding 5.22% while awaiting higher long-term bond yields.

- Hold: 20% in short-term sovereign debt in British pounds, most recently recommended for growth-oriented portfolios at $1.86/£, currently trading at $1.977/£ yielding around 5.5% for bills maturing in 3 months. Can use British Pound Sterling Trust (FXB) a NYSE exchange-traded fund as a market surrogate, presently trading at $197.9 and yielding 4.5%, originally recommended on July 24, 2006 at $185.50 with a yield of 3.9% around the time when it first began trading. Line-in-the-sand at $196.
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Illiquid portfolios/Direct Investments/Commodities/Special Situations:
Direct ownership of oil and gas reserves. These are illiquid, and, therefore, long-term holdings, purchased back when oil was selling between $20-$30 a barrel.

That's a wrap.

I welcome your questions, suggestions or comments: davidlsmith@iname.com or call (713) 532-6090 during normal business hours. . I will be out of the country until May 5 with limited access to the Internet. Therefore, please be patient if there is a delay in responding to your communication.

Kind regards,

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