The Blumenthal Viewpoint

June 14, 2012

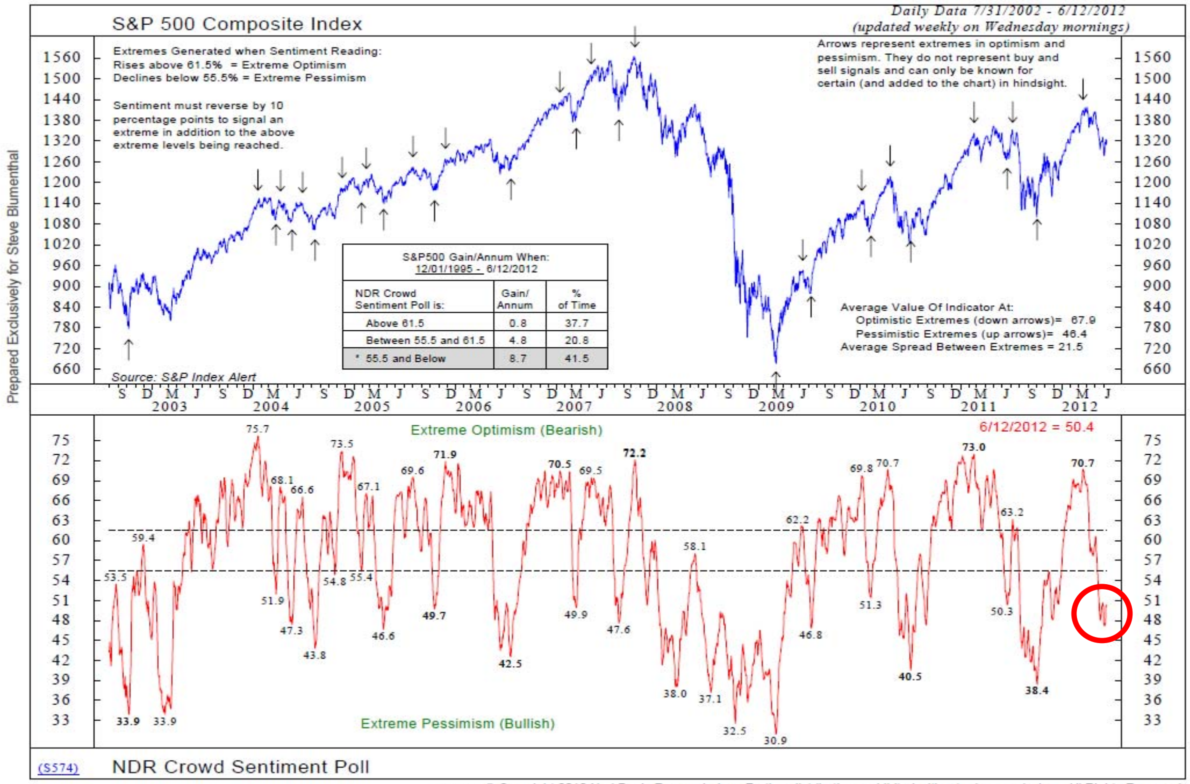
Mid-Year Outlook: A "Risk On" Run

There Sue was, beer in hand, soccer shoes off and sweaty having just lost in the semi-finals of the women's open tournament. My team was up next. Short one player and with the men's tournament about to begin, I felt a tap on my left shoulder. I turned to see this beautiful woman smile and say, "I'll play if you need one." I said, "put those cleats back on." Out of seemingly nowhere I was softly hit right in the heart. We went on to win in the finals and afterwards Sue and I shared a beer. What a beginning.

That was a little more than four years ago and at the end of June, Sue and I are getting married. With a major move, the wedding and a beach vacation to follow, I am extremely excited and looking forward to what we will create ahead.

It is with these upcoming events that I thought I'd share with you my mid-year outlook. My comments are centered on the equity and fixed income markets. I also touch on our four core tactical strategies as well. For now, I believe probabilities favor a "Risk On" run for equities in the second half of 2012. Overall, I feel the keys to success continue to exist within your total portfolio construction (equities, fixed income and tactical/alternatives).

However, into that rally I would be prepared to once again risk protect the equity portion of your portfolio when sentiment becomes extremely optimistic. 2013 looks dangerous. Today, sentiment remains in the pessimism zone supporting a second half rally.



With over 20 years of high yield bond market trading experience, I can tell you that I have learned to trust my CMG Managed HY Bond Program buy and sell signals. Often coming in the face of difficult news (Spain, Greece, Italy, et. al.), my emotions may say sell when my tactical strategy says buy (or vice versa) and I can say with great experience that my disciplined trading approach has consistently proven my emotions wrong. In fact, my greatest trades came at points when I felt great fear. I have learned to like and trust those feelings. Of course, no one indicator is perfect and there is no guarantee that this recent buy signal will prove successful. I can hear Sir John Templeton's sage advice, shared with me in the mid 80s and many others before and since, "the secret to my success is that I buy when everyone else is selling and I sell when everyone else is buying". It is easy to say yet so hard to execute in real life.

As for the rally call, favoring a risk on run are the following:

1) The high yield bond market appears to have bottomed and is trending up. CMG HY "Buy"
2) Sentiment is pessimistic enough to support a rally (chart above)
3) Favorable election year technicals. The equity markets tend to bottom out at the end of the second quarter and rally in the second half of the year in election years. This year has followed the historical script closely to date.
4) The average cyclical bear market decline is -10%. The S&P 500 Index declined -9.9% from its early April high.
5) The cyclical bull trend began in October 2011 after an almost 20% decline. Cyclical bulls don't tend to last any more than 1 to 1.5 years (according to NDR Research). This combines well with the end of the election cycle statistics and a 2012 second half rally.
6) Risk indices are beginning to show early signs of bullish strength: Energy, HY, commodities, and commodity currencies.

I realize that there are some major issues in the world and I remain in the long-term secular bear market camp, yet the extreme level of pessimism is supporting a rally period ahead. Put me in the Jim Rogers camp of let the banks fail, file for bankruptcy and let this mess find a necessary bottom; however, I continue to believe the hand to be played is one of continued money creation, which buys time but creates an even more painful bottom down the road.

"Taxmageddon" is approaching at year end (the expiration of the Bush tax cuts and payroll tax cuts). If the tax cuts are not extended, there will be a significant drag on growth. Estimates range from a -1% to -4% hit to GDP that is optimistically expected to grow at 2 to 2.5% this year. That means negative GDP growth. Can our politicians come together post election? Don't know. I sure hope so.

Money supply continues to expand but the velocity remains low. Does the world continue to print? I lean strongly in this direction. Imagine a bunch of skilled politicians elected to run your business. They have a short-term agenda and a strong desire to be re-elected. They have little to no business skill yet are asked to solve your financial crisis and turn your business around.

Will they cut spending, pay down debt or will they borrow more money or raise your prices or run down your office stairs to the printing press in your basement and print new money? You issue new bonds and use the freshly printed cash to buy your newly issued bonds (the greatest of all Ponzi scams) and use that money to fund your excess spending and inefficient business ways. Are the most experienced people making the right decisions? Great political skills; however, little to zero business skills. I believe we will continue to borrow and print. The EU prints. Japan prints. China prints.

The problem is that there will be unintended consequences for us to deal with and yes, eventually we'll get through those as well. The most probable future issue that I see is stagflation (low growth and high inflation), but not yet. My best guess is that the secular bear cycle ends at higher interest rates, higher inflation and lower equity valuations to support a period of much higher returns for your portfolios. I think the 10-year Treasury yield can rise to 7%+ in five years (it is at 1.63% today).

I would guess we are in the 7th inning of the secular bear cycle and that a very attractive investment period presents itself soon. For now, continue to overweight tactical trading strategies.

For now, I believe it is "risk on" tied to another round of QE (global QEs). I'm concerned about 2013. I believe a recession is highly probable and markets correct nearly 40% in a recession. A coming cyclical bear within the long-term secular bear cycle. We'll see how it plays out. Risk management remains important.

From a positioning standpoint, I encourage you to take a good look at our CMG Managed HY Bond Strategy. It has been performing well and is again in a buy signal. The yields are more attractive than when we exited a month ago and we hope to capture those high yields and price appreciation before the next sell signal. Disappointingly, Scotia Partners Growth S&P Plus Program is in one of its larger drawdowns; however, I continue to favor the strategy and have found that it is best to buy when it is in a larger than normal drawdown. If it is sized correctly in your portfolio, I believe it will help as the strategy has zero correlation to the equity and fixed income markets and has a solid performance history dating back to 2004 (+22% annualized return net of fees). System Research Treasury Bond Program is having a very strong year and the CMG Opportunistic All Asset Strategy is performing well. Of course, past performance cannot predict or guarantee future returns. Risk exists in every investment, even cash.

For the long-term equity positions in a portfolio, I continue to favor removing hedges tied to the high level of investor pessimism (buy when everyone else is selling) and expect a second half of the year rally. I recommend re-establishing hedges into the rally tied to excessive investor optimism. I will provide more color on that when we get there.

Gold:
I'm often asked what I think about gold. In short, I hold a very bullish view. I believe the fundamentals supporting gold are strong, world money supply is increasing, and the technical picture is strong. Last year China bought what amounts to half of the gold mines in the world. At the same time, only 1.4% of foreign reserves are in gold. With all of the FIAT currency creation in the world, backed by nothing but a promise, I believe strongly that governments will be forced to back some portion of their currency with a combination of physical commodity assets. Gold is at the top of that list.

I'm rushing out to meet the movers. What a purge of old toys, clothes and trash. A trip to Goodwill is planned, then days of unloading boxes. Surprisingly, I'm not too stressed, just excited. My daughter, Brianna, is going to get an overdose of testosterone as it is she and five boys. Sue has three boys and I have two. I bet she will be especially looking forward to getting back to Penn State where she will be a sophomore in the fall. I'm very lucky and grateful.

With kindest regards,

Steve

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