



Wealth through ingenuity.

## Blumenthal Viewpoint

By Steve Blumenthal  
September 2012

It was February 1984 when I first met John Ray, the portfolio manager of the Delaware Fund. John introduced me to the managing director of Merrill Lynch Institutional in Philadelphia and I was lucky to get my start in the business. John became my mentor. We'd talk regularly and I would do everything I could to try to understand what he was saying. He and his good friend, Steven Mittel, took me under their wings.

Today when the phone rings and my assistant, Linda, tells me it's "Uncle Steve", I drop what I'm doing and jump to the phone. I owe him a great deal. When John Ray calls, I clear whatever is on my calendar, grab my pen and notebook and listen to everything he has to say.

Last week, John and I spoke. He said, "we (the U.S.) are buying a reservoir of bad bonds and sending them to the government's balance sheet to die". QE3 was just launched. He was alarmed and continued, "No way the governments balance sheet can take \$40 billion per month... they are buying the worst stuff... tell your friend Mauldin I like most of his work but any notion that we have a couple of years time horizon before working this mess out is garbage." I took my notes as quickly as I could.

There was more and it was concerning. Concerning because it is investors like John Ray, who have significant skin in the game and years of experience that cause me to stand guard. I am fortunate to receive information from some of the brightest minds in the investment business including a number of very large independent and successful hedge fund managers. I like the guys who have skin in the game vs. the Wall Street analysts who are selling their research.

From these various sources I form my own probability way of handicapping the future - what information matters most and what information is non-material noise. As I try my best to cut through the financial and economic fog, I share with you the following Blumenthal Viewpoint. Please know that the views are mine and not necessarily those of my firm.

### **Blumenthal Viewpoint September 28, 2012:**

The Fed is targeting nominal GDP growth. Without growth the U.S. government will not be able to pay off its debts. A weaker dollar is needed to promote U.S. exports and remains the primary goal of our economic policy. The Fed's QE3 or QE Infinity is telling. There is great distress in the system.

QE Infinity is a lifeline to the European banks as we buy the distressed mortgage paper off their books (the same MBS's garbage we sold them in the good old days). QE Infinity is also a firing shot across the Pacific to force China to revalue the Yuan. We are living in interesting times. The battle advances. The unintended consequences are significant.

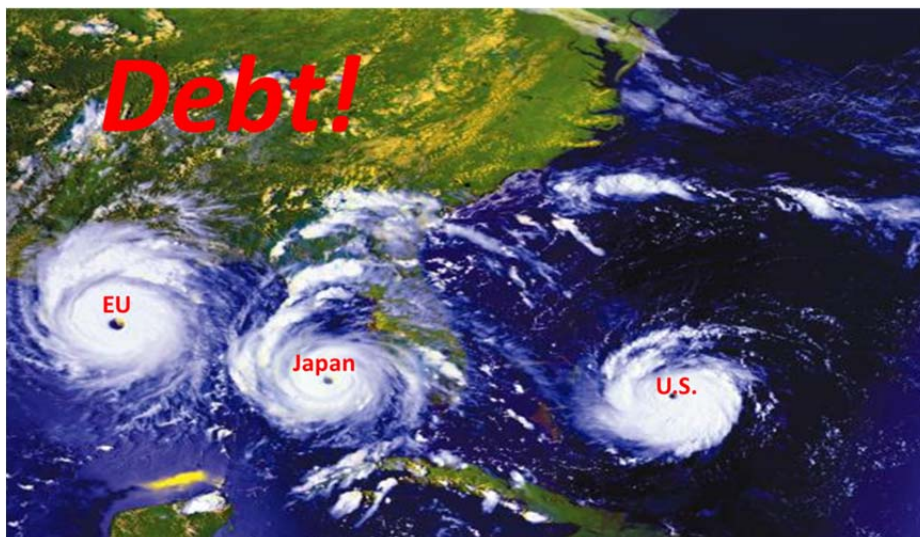
The U.S. is printing, the EU is printing, Japan is printing and China is printing: all at the same time. China, in order to peg their Yuan to the dollar, revs its printing machine into high gear. Beneath the surface, the water is turning, the storm clouds are building and another financial hurricane season is upon us. It is about currency manipulation, trade wars and self preservation. The source of the problem is simply unmanageable debt. We'll deal with it, move through it and we'll heal from it; however, it will be costly.

Included in this viewpoint are a number of charts I found interesting. I believe we are ultimately moving from a period of credit expansion that drove attractive stock and bond market returns to a new period of inflation that typically proves to be a major headwind to traditional stock and bond investing. I believe that if you can get the asset allocation right, you'll be pleased in the period ahead. If you stay stuck in 60/40, like 98% of the investment portfolios out there, you'll be disappointed.

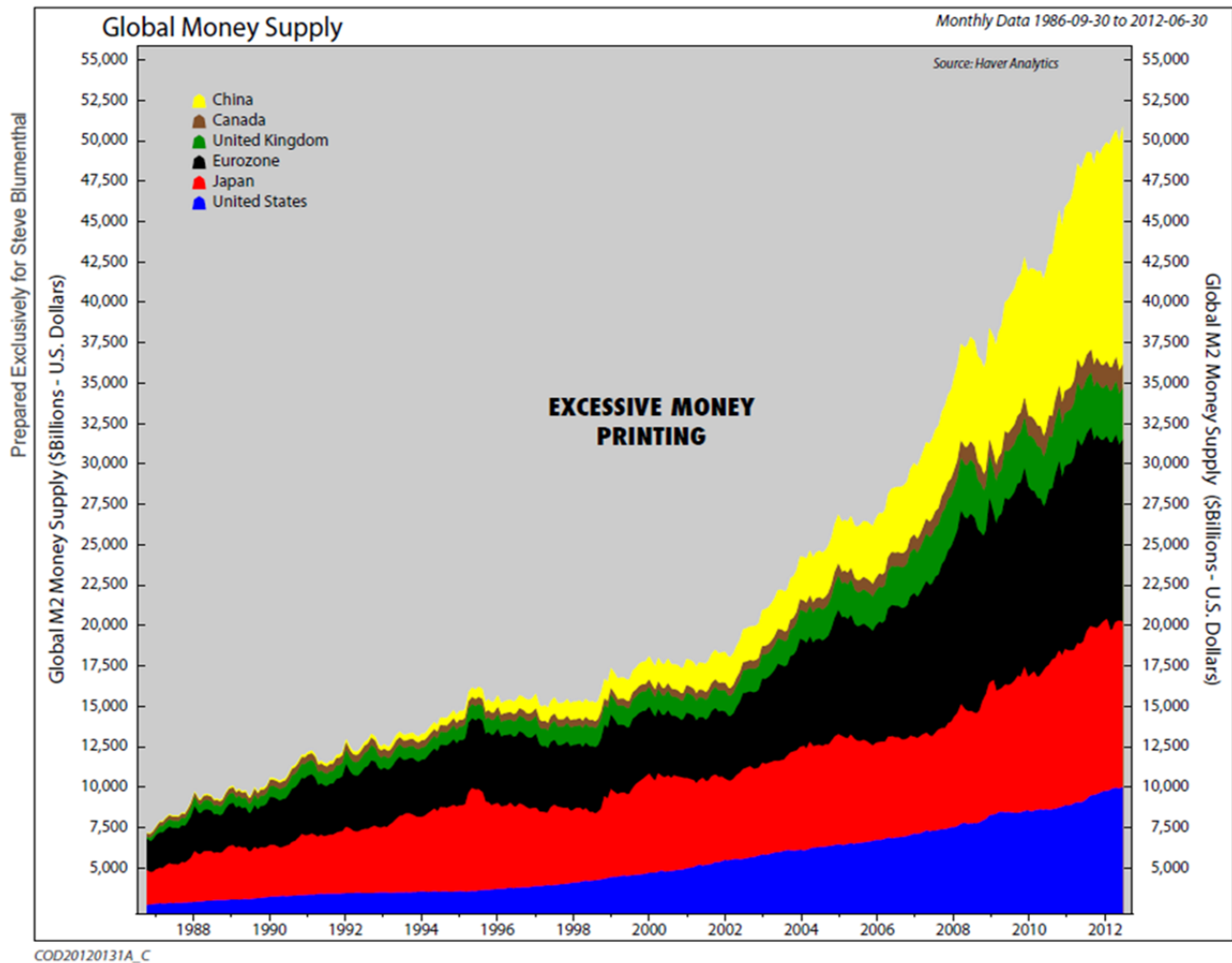
Game plan: Include non-correlating risk diversifiers into you portfolio. These are strategies designed to profit in rising and falling stock and bond market environments. Hedge your equity exposure at times of Excessive Investor Optimism, think more tactically about your bond exposure tied to rising interest rate risk, and add trading strategies into your portfolios (find those that may profit in rising and falling market periods). If I'm completely wrong in my view, I believe your portfolio can perform inline with a traditional 60/40 investment mix. If I'm correct in my view, you'll be among the very few that were prepared for the storm.

### **The coming storm:**

I believe it is important to have a keen understanding of probable human behavior. The issues remain large, difficult, challenging and extremely emotional. Each country is separately dealing with internal political infighting; each dealing with unmanageable debt. The EU is front and center, Japan is in trouble and the U.S. is not too far behind.



The global monetary response, as we can see in the next Money Supply Chart, is telling:



The printing presses are out of control. The inflation seeds are planted. The unintended consequences will follow. Frankly, I don't see it this year or even next but the genie is out of the bottle - it is going to be hard to put her back in. It is hard to avoid history. Each country is more concerned about the home team. At points of inflection it becomes we vs. them. Where does our loyalty fall? Who votes whom into office? Do we really know what we are doing?

This from Dallas Fed President, Richard Fisher, "I believe that with each program we undertake to venture further in that direction, we are sailing deeper into uncharted waters. We are blessed at the Fed with sophisticated econometric models and superb analysts. We can easily conjure up plausible theories as to what we will do when it comes to our next tack or eventually reversing course. The truth, however, is that nobody on the committee, nor on our staffs at the Board of Governors and the 12 Banks, really knows what is holding back the economy. Nobody really knows what will work to get the economy back on course. And nobody – in fact, no central bank anywhere on the planet – has the experience of

successfully navigating a return home from the place in which we now find ourselves. No central bank – not, at least, the Federal Reserve – has ever been on this cruise before.”

Some additional bullet points on QEs:

- History is littered with paper money failures.
- Issuing new paper devalues the existing paper stock. It makes our stocks and bonds worth less to foreign investors and is ultimately inflationary.
- It’s a race to the bottom. Right now the U.S. dollar is the best looking character in the global money printing ugly contest.
- “The age of credit expansion which led to double digit portfolio returns is over and the age of inflation is upon us” Bill Gross, Pimco.
- Stocks and bonds do not do well in inflationary environments. Gold, on the other hand, has been a good hedge historically when governments allow you to own it. Today, governments allow ownership. In the long term, the debasing of currencies is positive for gold.
- During QE2 the Fed acted alone in printing money. This time all of the countries are printing at the same time.

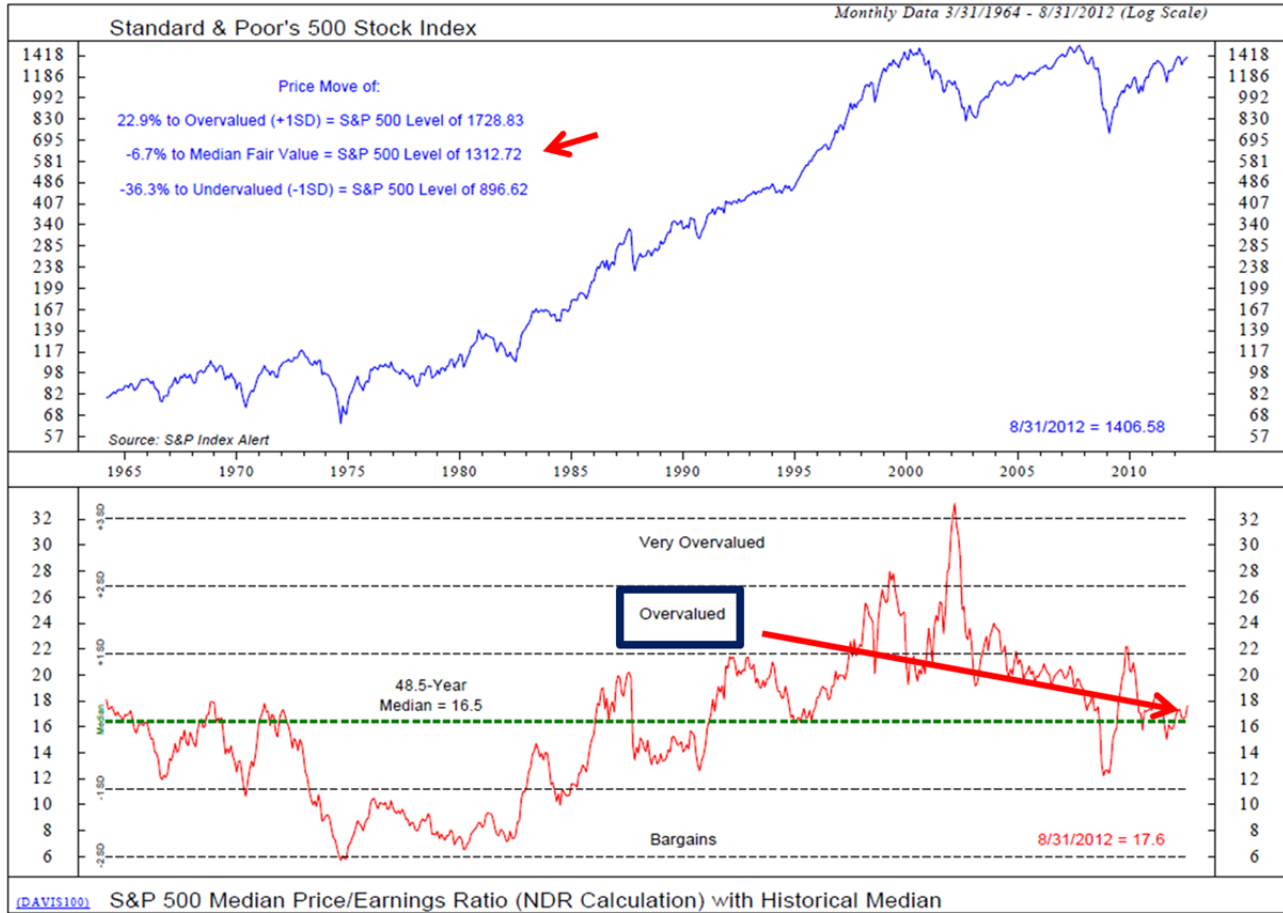
Then there is the “Fiscal Cliff” and the impact of higher taxes on GDP growth. We are spending \$1 trillion more per year than we are taking in and in a crazy dysfunctional way the Fed is buying 61% of the newly issued U.S. Government bonds.

I hear John Ray in my head, “... China is not pulling the plug now as they deal with their own internal problems, but they will”. “Steve, the fat is in the fire right now”. Not to be ignored.

Over the immediate short-term, perhaps it is, as they say, tough to fight the Fed. This market can be influenced and there is the historically favorable Election Year Cycle. It is with this thinking that I next take a look at valuations to see if we can get a sense of how far down the downside may be. Frankly, I’d be less concerned if PE valuations were in the single digits as is typically found at secular bear market lows; however, current market valuation is a hair on the rich end.

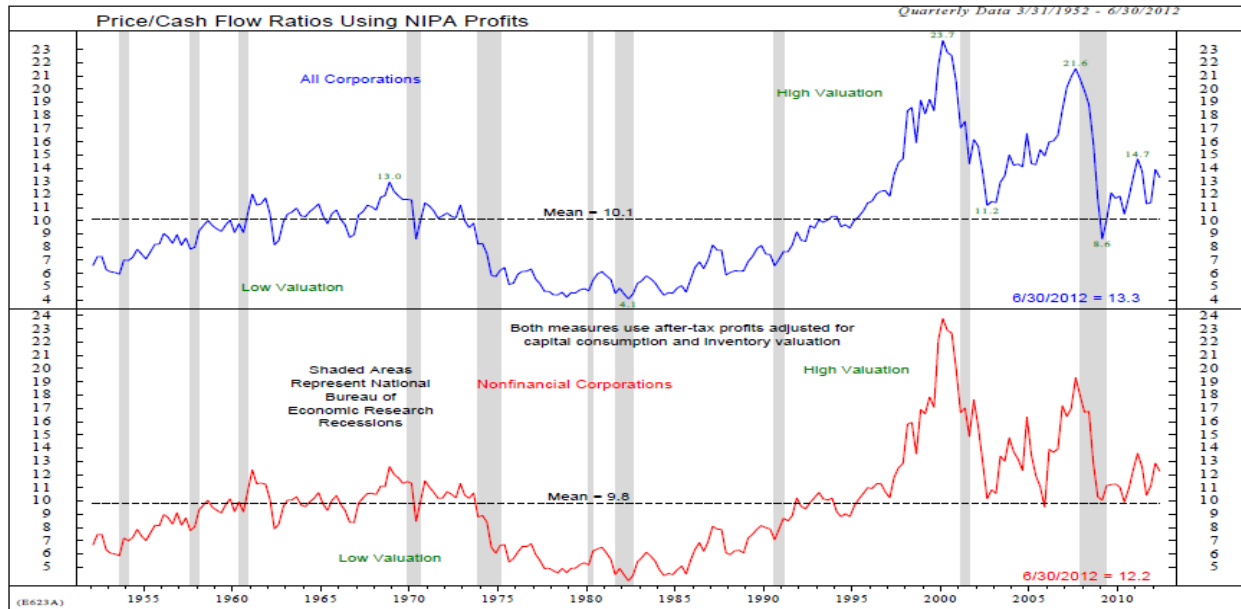
The next few charts take a look at two valuation measures: PE and Cash Flow. With the S&P 500 Index near 1440, the median fair value is approximately 125 points lower at 1313 (see arrow on NDR chart). Again, that doesn’t mean that QE can’t drive the market higher, it simply means the fall will be that much greater. I favor hedging long equity at periods of Excessive Optimism (like today – sentiment charts below).

S&P 500 Median PE:



As for my best downside guess, I believe we could see a 1 standard deviation move to approximately 900 on the S&P 500 Index if the fat in the fire hits the fan. It typically takes three recessions to end a secular bear market cycle. Perhaps the next recession gets us there. Also note the 1 standard deviation move to the upside to 1728. Bernanke is trying hard to push asset prices. Could we somehow get there first, maybe - but at this point I'd rate that probability on the low side.

CASH FLOW – a different look at valuation:

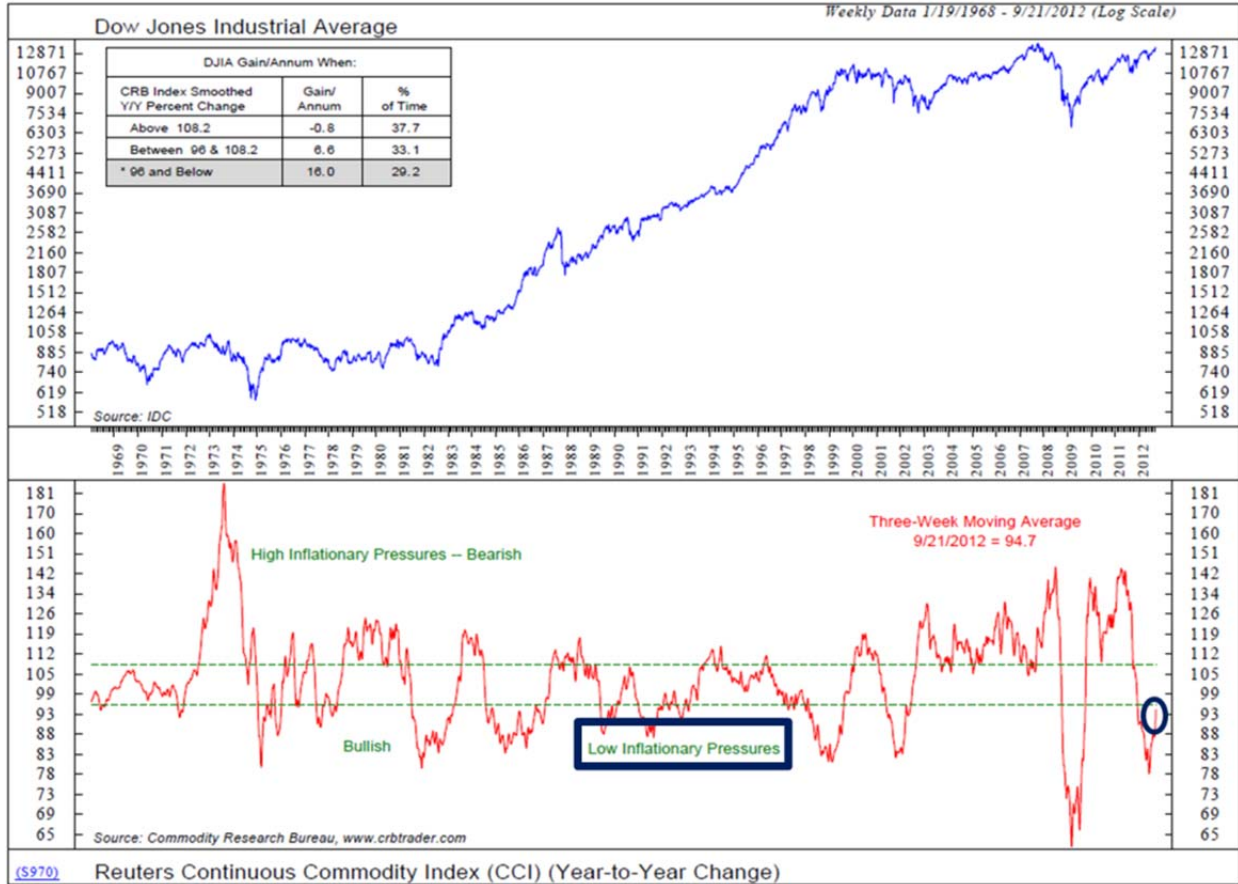


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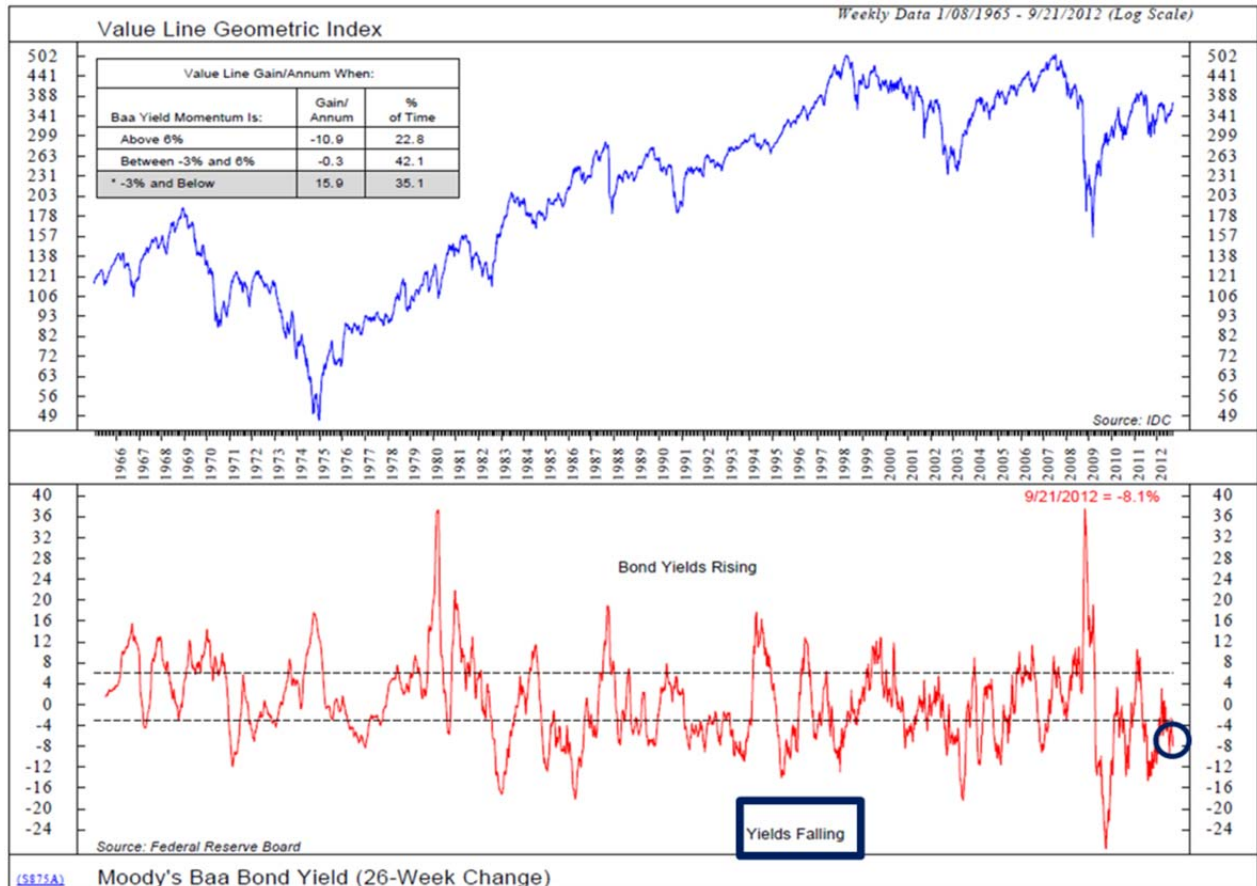
This chart says to me that stocks are overvalued relative to cash flows. The price/cash flow ratio of 13.3 on 6-30-12 was well above the 10.1 mean since 1952. In short, both valuation measures show that stocks at modestly high valuations vs. low. Inflation matters as it historically proves a major headwind to both stock and bond prices so let's go there next. What to watch?

## Inflation and Interest Rates:

I'm keeping a close eye on commodity prices and interest rates. Following are two charts I watch weekly that I believe will help us see inflation pressures rise. You can see that the Reuters Continuous Commodity Index (CCI) is currently in the "Low Inflationary Pressures" zone.



Here you can see that yields are in the Moody's Baa Bond Yield is in the "Yields Falling" zone.

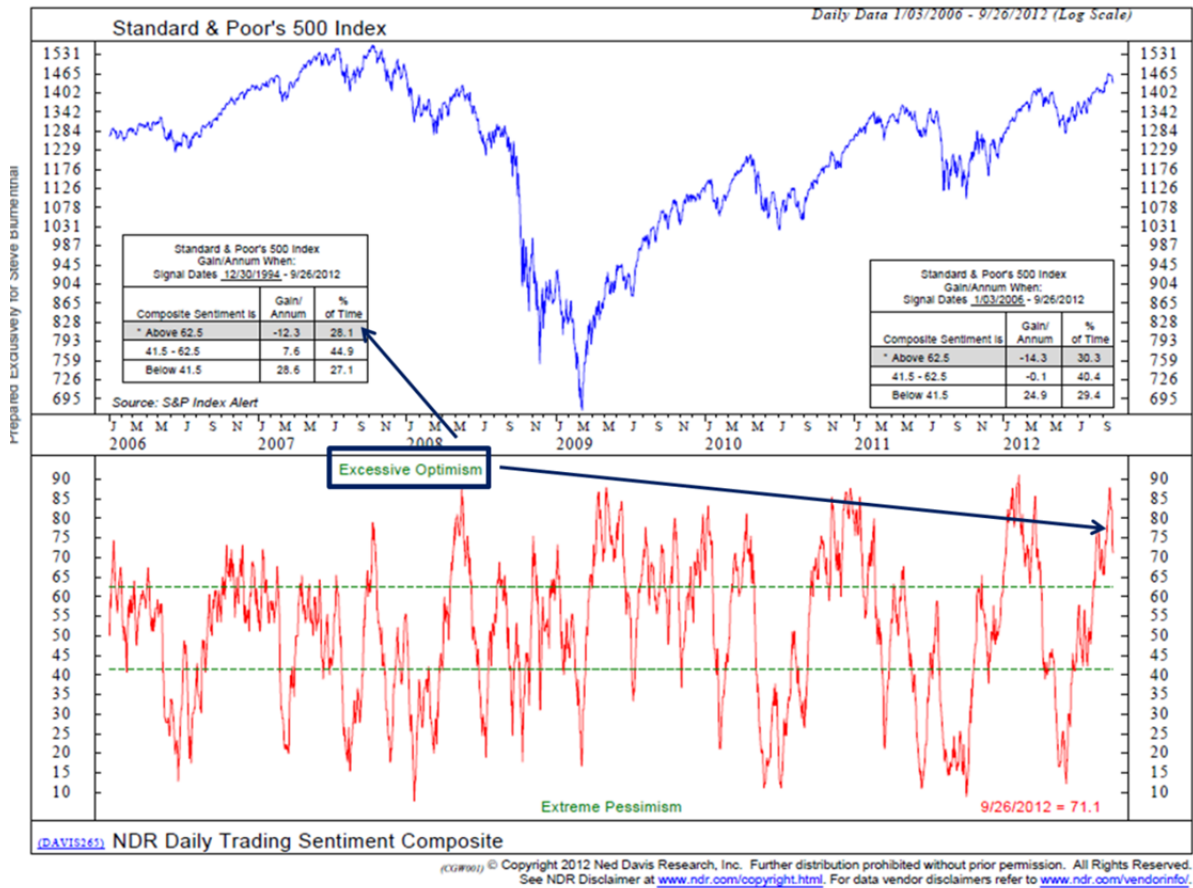


Conclusion: no sign yet of immediate warning.

Next, as I do each week, let's take a look at Investor Sentiment. I feel this is a useful tool to help know when to put hedges in place for your long-term equity holdings. When everyone is bullish and buying, risk protection is less expensive. Remove the hedges when Pessimism builds (everyone is selling).



## Investor Sentiment remains Excessively Optimistic.



### What to do:

Build broadly diversified portfolios. The tools exist and liquid strategies are available. Learn more about the tactical investment space. Include as many non-correlating risk diversifiers as you can into your portfolio. Find investments that have the potential to generate return in both rising and falling stock and bond market periods. Consider a move towards a new 60/40. 30% Stocks (hedged at times), 30% Bonds, and 40% Tactical or a balanced 1/3, 1/3, 1/3.

Just what does Tactical mean? In an effort to introduce this concept, I share just one idea with you today; my CMG Managed High Yield Bond Program.

### CMG Managed High Yield Bond Program:

I have traded this relatively simple high yield bond trend-following strategy for over 20 years. When HYs begin to move higher in price, I trade in and capture the high yield bond mutual fund dividend yield as well as price gain (of course, we hope the price gains). When HYs begin to trend lower from any high price peak, we tactically trade to money market instruments (our intent is to be risk focused and avoid price decline, preserving principal and patiently waiting to trade back in at a lower price and a higher yield).

If you can follow the rules, you can do this yourself. It takes discipline to trade when the model says trade and while that sounds easy to do on paper, I can tell you it is very hard to do in real life. For example, can you buy back into HYs when the world appears to be breaking down or exit when the news looks seemingly positive? Then there is the matter of your busy day life, interruptions, vacations and missed trades. The easy part is tracking the model signals; the hard part is getting the execution right. If you are a do it yourselfer, go for it. If you are a delegator, find someone who has years of experience, great balance, deep passion and trading discipline. Apply this thinking to all the managers you hire.

The message here is that there are strategies that may do well in the period ahead. No guarantees I'm right about the challenges and how it plays itself out but I personally wouldn't take the unhedged 60/40 bet.

The CMG Managed High Yield Bond Program looks only at the intermediate period ahead. It is designed to make money whether I am correct or incorrect with my personal market and interest rate views. Year-to-date through September 2012, the strategy is up approximately 8.68% net of fees (please note this is an estimate). It is just one of a few select strategies for you to learn about.

Talk to one of our CMG Advisor Representatives. Ask him about our Core 4 strategies. He'll take a helpful non-sales approach and you can learn more at our website: [www.cmgwealth.com](http://www.cmgwealth.com) or by emailing [info@cmgwealth.com](mailto:info@cmgwealth.com).

With warm regards,

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