CAPITAL MANAGEMENT GROUP, INC.

CMG

Alternative Investment Strategies

CMG 2009 Outlook

2008 Recap

Goodbye 2008. Investors will be trying hard to forget the worst stock market calendar year performance since the Great Depression, but the economic indicators that will dominate the news in 2009 will make it seem like déjà vu. The past 12 months were some of the most turbulent the United States, and the global economy, have faced; not because they marked the onset of a recession, but rather because the very fabric of the global liberal economic order unwound. The United States and Europe emerge from 2008 looking more like state controlled economies than at any time since World War II. The gears of the economy ground to a halt as financial institutions and credit markets stalled, forcing central banks to cobble together makeshift solutions that rely on massive government spending to maintain a working financial system. The year started with a dramatic market sell off - just a taste of what was to come in the second half of the year. Few could have predicted what was to transpire for the balance of the year after those first quarter draw downs. The subsequent volatility across all asset classes reached multi-year highs. Commodity prices spiked to record highs in the first half of the year with oil prices hitting all-time highs while agricultural commodity prices brought about food riots in much of Southeast Asia. For much of 2008, policymakers were concerned about the very real prospects of stagflation. But as quickly as commodity prices shot to record highs, they retreated to unbelievable levels as the fundamentals of the global economy pointed to serious commodity demand destruction.

The environment proved extremely difficult for the Federal Reserve and the U.S. Treasury as both institutions were constantly scrambling to put out fires they could not predict. The credit crisis took a particularly nasty turn in the second half of the year as counterparty risk was such that credit markets simply ceased to function. The main victims were banks as the de-leveraging process quickly became a downward spiral that engulfed Bear Stearns, Lehman Brothers, Indy Mac and Washington Mutual (the largest U.S. bank failure in history). AIG, the world's largest insurer, was bailed out (several times) as it was found to have mismanaged a portfolio of nebulous credit derivatives. Nothing short of massive government injections across the globe would have been sufficient to stop the credit crisis from spreading more rapidly and turning the current recession into a depression. Global markets finished the year on more stable footing as the reality of the current economic condition finally hit home, but not before Bernie Madoff gave hedge funds a black eye after defrauding investors of $50 billion.

Table 1.
2008 Market Returns & Pricing
As of December 31, 2008

	Returns		Pricing
S&P 500	-37.00%	3 Month T-Bill	0.11%
Russell 2000	-34.80%	10 Year Treasury	2.25%
Wilshire 5000	-37.23%	Gold	$869.75
DJIA	-31.93%	Crude Oil	$35.99
NASDAQ Comp.	-40.54%		
MSCI EAFE	-45.09%		
Lehman High Yield	-26.15%		
DJ-AIG Commodity	-36.61%		
Managed Futures	15.59%		

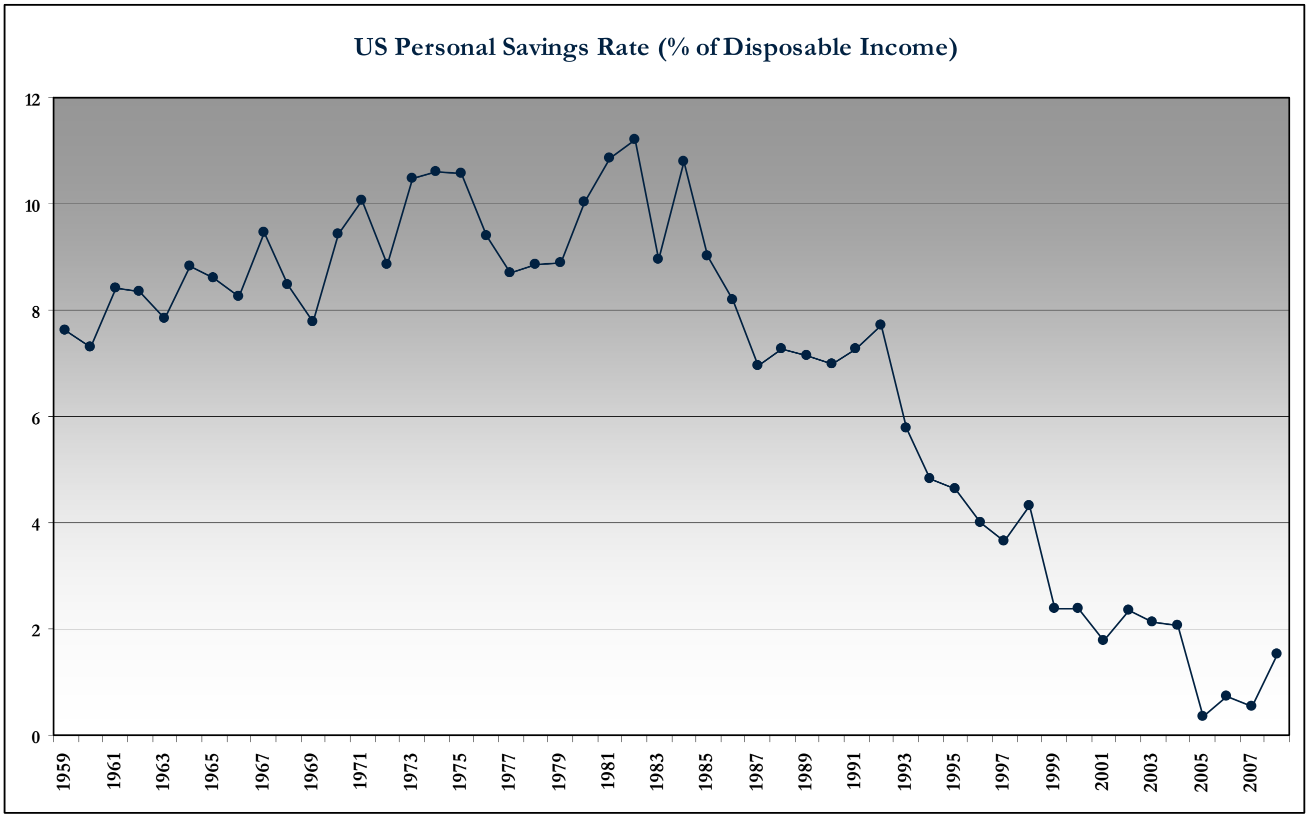
Source: PerTrac Financial Solutions

2009 Outlook

2009 begins with cautious optimism and hope, resonating many of the words President Obama has repeated over the past 2 years of his campaign (which felt like a whole presidential term). But he is inheriting an economy with huge problems. For his words to not end up as pure cliché, his administration's response, specifically, the massive government stimulus plan he is proposing will have to target many industries, distribute funds quickly but prudently and will have to provide tax benefits to the majority of Americans. Piece of cake, right? Not quite. It is more likely that this first stimulus package becomes one of many. The origins of the current recession can be traced to the housing collapse and the sub prime bubble, but aftershocks of that meltdown are now being felt by all sectors of the economy. If the U.S. is to emerge from the current recession sooner rather than later, the Obama administration and policymakers around the world will have to use all of their fiscal and monetary tools to soften the global slowdown. As important as the details of each plan are, so is the coordination of all government policies. To date, the inconsistent application of government programs has added to market volatility. Too many questions remain about who is eligible for which bailout, for what asset, through which government plan.

The government, through Congress, the Fed and the Treasury, will likely continue to refine its two-pronged approach to stimulating the economy in 2009. The Federal Reserve and the Treasury will focus on keeping monetary policy accommodative, maintaining abundant credit market liquidity (keep those printing presses rolling) and making direct investments in banks where necessary. What may change is the implementation of those goals. There is a greater likelihood that an RTC (Resolution Trust Corporation) type approach may be used to take bad assets of bank balance sheets as the current mix of programs has not been as effective as hoped. An accommodative monetary policy was the key policy tool used to slow the bleeding in 2008, but fiscal policy will be the key to getting the economy going again in 2009. President Obama and Congress will focus on stimulus packages, job creation and monitoring the investment of government funds. President Obama comes to office with tremendous public support and his first year will be measured by how effective his economic proposals will be. The immediate effects of the stimulus package will be muted as many of the proposals will take time to enact and work through the system. Infrastructure spending is badly needed in the U.S. and will create jobs, but massive civil engineering projects take time to plan. Tax cuts for the middle class will also take time and most Americans are likely to save most of their stimulus or use it to pay down debt.

For the past decade, the U.S. economy has relied heavily on the leveraged consumer. Consumer spending accounts for almost two thirds of economic activity and Americans have saved too little for too long. A shift toward a more reasonable rate of savings is likely. It comes at bad time as the economy is so reliant on consumer spending. Historically, Americans have saved on average approximately 7% of their disposable income (see chart below). Over the past 10 years that savings rate has dropped to 1.6% while over the past 5 years, it barely tops 1%. The numbers do not include other savings such as 401K contributions and home price appreciation. Over the past 10 years 401ks have turned into 201ks and real estate, well, we know what happened to home prices. To make matters worse, no one is getting any younger, especially the baby boomers who in most cases have seen 30-50% of their wealth wiped out in the past year. In light of these events, Americans are likely to save on a level not seen in the past 10 years at the expense of consumption. A coordinated effort to save by all Americans will only exacerbate deflationary pressures.



Despite the significant headwinds facing the global economy, we believe that U.S. equity markets will move higher during the course of 2009, albeit with significant volatility as investors digest ongoing macroeconomic indicators. Investors are wary of committing capital without reasonable earnings guidance. With most industries and companies still trying to assess the full impact of current downturn, few companies are providing guidance beyond 2009. Until earnings guidance is provided, equity markets will continue to be range bound, subject to capital flows and economic news. Fixed income markets are also likely to remain range bound as investors have flocked to Treasuries, pushing yields to historic lows. Yields will return to more reasonable levels with the back end of the yield curve going higher once a recovery is underway. Currently, investors are not being compensated for holding long-term Treasuries as yields are barely over the rate of inflation. Fund flows will move from low yielding Treasuries to equities, which offer comparable yields and greater price appreciation potential. There is a lot of cash on the sidelines and in Treasuries at present. Once the recovery is underway, those funds will rotate into equities, adding upward momentum to the broader equity markets. That momentum will carry markets only so far as it is unlikely the U.S. will break out of the long term secular bear market.

Global Macro Themes

U.S. Recession: First in and first out

The United States remains the focal point of the global economy and prospects for a recovery remain tied to the U.S.'s ability to work its way out of the current recession. Although the recession may turn out to be less severe predicted at the lows of 2008 (it will not be a depression), the recovery will likely be slower and more difficult than recent recessions as the U.S. has many systemic problems to work out. Ultimately, the recovery will be tied to two main factors: the health of the banking sector and a stabilization of the housing market. Banks will continue to be under pressure for most of 2009 as non-sub prime losses, specifically commercial real estate loan portfolios, are marked down and default ratios across all credit qualities rise. More coordination on the part of the government will be needed to accelerate the healing process for banks. The Fed and Treasury did an amicable job of preventing a larger collapse in 2008, but if credit markets are to resume functioning properly, clearer goals and monitoring will be needed to insure that government intervention is effective. Furthermore, as markets recover in the second half of 2009, an exit strategy will be needed to prevent long-term government control of the financial sector. Fortunately, there is light at the end of the tunnel for the housing market. New housing starts plummeted over 30% in 2008 as builders pared construction in hopes of bringing equilibrium to the housing market. Less pressure on the supply side and low interest rates will help bring buyers back into the market to work off excess supply. The banking sector remains a mess and will take another couple quarters before real stability returns.

Defensive sectors such as healthcare and consumer staples should outperform early in the year as equity markets continue their bottoming process. Once a bottom has been found (and tested several times) equity markets will focus on earnings guidance and the cyclical trough in earnings growth. Equity markets should show renewed strength by Spring 2009 as the stimulus package takes hold and earnings guidance is more clear. An optimistic view points to the second quarter being the end of the current recession (of course we won't know that until later in the year). Should government action fall short of expectations the recession is likely to last into the third quarter of 2009. Industrials, materials and technology sectors should outperform during this period, with infrastructure spending creating a huge tailwind. As the recession concludes, consumer discretionary and technology should continue to perform as businesses gain confidence in the outlook and invest in fixed assets and inventory for the subsequent expansion. While always unpleasant, the current recession reminds us that there is no avoiding the natural course of a business cycle.

Europe & the UK: Worse than the U.S.

The UK and the EU will experience a more difficult economic environment than the U.S. in 2009 with a recovery more likely in 2010. Economic growth has been lackluster coming into the current recession and will only get worse as Europe suffers from many of the same structural problems (namely an aging population, a weak banking sector and declining exports) as the U.S., but lacks the ability to recalibrate and affect policy as quickly as the US. Demand for exports, particularly in Germany, will continue to drop as European goods are expensive on a relative basis globally. Bank lending will remain tight, further hindering a potential recovery. Housing markets still look overvalued in the UK and Spain in particular. Real estate in Eastern Europe is still attractive as there is less speculation and real demand for housing. Unemployment, already high in many EU countries will rise more than in 2008 and consumer spending will suffer as a result. Fortunately, inflation has been controlled leaving room for the ECB (European Central Bank) to cut rates aggressively. Fiscal stimulus will also be necessary across most of Europe and will test the EMU's (European Monetary Union) GDP deficit limit. Since the Euro's adoption, most monetary union countries have been able maintain their target of 3% budget to GDP ratio. Issuance of government debt will push deficits to the highest levels since the introduction of the Euro with France potentially being the largest country to breach such limits. On a relative basis, Germany is better positioned to weather the current downturn than France, Spain and Italy. The Nordic countries will battle through their own recessions with the exception of Norway, which is better fiscally positioned to weather the storm. The UK is facing a grim outlook with the potential for a more severe recession than most of its European counterparts. This is due in part to a weaker banking system and the pricking of a larger asset bubble than in most of Europe. The Bank of England will continue to cut rates and may have to nationalize several large institutions as the recession is likely to get worse. The pound sterling should continue to weaken against both the Euro and the Dollar.

BRIC – Reading the tealeaves of Emerging Markets

BRIC, the acronym given to the four largest emerging markets (Brazil, Russia, India and China), needs to be broken down in 2009 as the prospects of each of the four economies will diverge. China in particular is far more important to the global economy than the other three countries combined. In 2009, China will celebrate the 30 year anniversary of the market reforms brought about by Deng Xiaoping in late 1978. That Communist Party conference is generally viewed as the official starting point of China's economic reforms. Those first 15 years brought few reforms, but the past 15 years have brought about huge economic changes in China that have made it an economic powerhouse. So much so, that there is talk of China setting an economic example for other emerging countries to follow that has been coined the "Beijing Consensus", an alternative economic philosophy that rivals the liberal economic philosophy of the "Washington Consensus". There is no doubt, that China's growth has led credence to this view, but the integration of China into the global economic order has made is more susceptible to the normal business cycles of the West. However, to label it a free market would be premature. The state sector still contributes the majority of fixed asset investment and state owned banks still account for more than half of total banking assets. The state's involvement will help to fortify weak private demand, but that same culture allows it hide many of the problems the country will face in the coming years, namely defaulting loan portfolios and bankruptcies.

The primary concern of the ruling Communist Party is social order and to insure their own political viability. This stability has come through economic growth and the massive migration of peasants to urban manufacturing jobs. It is commonly quoted that China needs an 8% growth rate to avoid social unrest. With the most recent GDP figures showing growth of only 6.8%, half of what it was in 2007, the potential for social unrest is great. There is reason for optimism, but not without risks. China's leaders have done well adapting the free market system to their economy, but to navigate the current slowdown, China will have to prescribe precisely the right remedies. The massive $585 billion government stimulus announced in late 2008, representing over 16% of 2007 GDP, is a step in the right direction. The stimulus is focused on infrastructure and designed to be spent in key areas including, railways, rural utilities, low rent housing as more socialist programs that subsidize agriculture and provide minimum income support. More importantly, the Chinese leadership is introducing programs designed to help boost domestic consumption. There is an emerging middle class that could drive domestic demand (to make up for the loss of US consumer demand), but many Chinese prefer to save their money, fearing that they will not have the adequate healthcare and retirement provided to them by the government. To alleviate these fears, China has already announced spending of an extra 850 billion Yuan on healthcare over three years and from February on, rural residents will receive a 13% rebate on purchases of consumer goods. Interest rates have been cut five times since September, bank lending is being heavily promoted by the government and down payments on real estate have been lowered. Taken together, these measure should bring about a soft landing for the Chinese economy but do not address any long-term imbalances caused by an artificially weak currency.

The other members of BRIC have many difficulties of their own. Russia, heavily dependent on commodity exports (80% of all exports), will see demand drop significantly. The banking sector and real estate are in crisis mode, forcing the Russian government to announce a fiscal stimulus package of $400 billion, 25% of GDP. Brazil, also a big commodity exporter, is better positioned for the current downturn. Growth will slow from over 5% to 3% or lower as foreign investment into the country slows. The economic reforms over the past several years have put Lula's government in a stronger position than in prior emerging markets downturns. India, a big commodity importer will benefit from the recent decline in commodity prices, but it will not be enough to offset the domestic slowdown. As with China, India will likely look to increase investments in commodity rich countries as prices are particularly attractive relative to the past couple years. India will likely rely on monetary policy to stimulate the economy. Fiscal stimulus is more difficult to implement in the world's largest democracy, especially ahead of general elections in May. India's service economy took a reputation hit as Satyam Computer Services, once the fourth largest software/services firm in the country, became the countries largest fraud in history. In what is already being called India's "Enron", Satyam's CEO confessed to inflating cash balances by over $1 billion. For India, the timing couldn't be worse, as investors will be put off by a lack of corporate governance during a time when risk aversion to emerging markets is already running high.

Conclusion

We believe there is reason for optimism in 2009. 2008 proved to be one of the most turbulent and difficult investment environments in history. It is exactly at times of great fear that the greatest investment opportunities present themselves for those with the fortitude to commit capital. Valuations across global equities look significantly more attractive than a year ago, particularly in emerging markets and energy, where both look to be considerably oversold. Long term, we remain strong believers in long term commodity bull cycle and convergence of emerging markets. Fixed income, especially U.S. Treasuries are overvalued. Yields, as shown on the chart below, are at historically low levels. As of the end of 2008, the 30 year Treasury yield was below that of the S&P 500 and is not sustainable at this level. As the magnitude of the U.S. budget deficit hits home, Treasuries should sell off as investors demand more reasonable compensation for the risk they are taking.

Table 3.
U.S. Treasury Yield Curves
Year End %

	2007	2008
3 Month	3.36%	0.11%
6 Month	3.49%	0.27%
2 Year	3.05%	0.76%
5 Year	3.45%	1.55%
10 Year	4.04%	2.25%
30 Year	4.45%	2.69%

Source: U.S. Federal Reserve

The U.S. is poised to lead the rebound in developed markets while Europe could see things get worse before they get better. China, despite working through its own slowdown, should benefit the most from the current crisis, as its global economic position is stronger on a relative basis than a year ago. Looking beyond 2009, China's continued integration in the global economic system remains the biggest challenge. Will the Chinese revalue their currency? Can China create real sustainable domestic demand? Will China continue to finance the spending habits of the west? We will likely see the U.S.-China relationship change in the next couple years as the terms of their co-dependence shift with the new realities of the global economy.

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