CAPITAL MANAGEMENT GROUP, INC.

CMG

Alternative Investment Strategies

CMG 2010 Mid-Year Update

The first half of the year has been a fierce battle between bulls and bears. As we anticipated, the market rally that began in March 2009 has come to an end and a more range bound choppy trading environment has taken over equity markets. We believe the balance of the year will continue to be shaped by the ongoing bull and bear battle, likely netting low stock market returns despite trading moves up and down. We expect a slowdown in the global economic expansion. Historically, stock market performance tends to diminish in the second year of a bull market and in the second year of an economic expansion, both of which we are now in. Broader cycles also warn of headwinds by the end of the summer. Bulls will continue to paint the picture of recovery, touting the ability of the US economy to outperform other developed markets despite the uncertain economic backdrop for unemployment and housing. On the other hand, market bears believe the fundamentals point towards a slowing recovery haunted by the specter of deflation. We remain in the bear camp for many reasons that we address below.

After a strong first quarter, US equity markets dropped precipitously in May and June, pushing the major equity indices into negative territory for the year. Although a number of economic indicators weakened during the quarter, the primary catalyst for the sell-off that began on April 23rd was Greece. The fear over Greece quickly spiraled into a broader concern about sovereign debt in Europe and the sustainability of the European Union as a whole. After an initial slow response, the EU pulled out its own "bazooka", à la Hank Paulson, and committed $1 trillion dollars to support the struggling PIIGS. If the idea was to shock and awe the markets into submission, it proved unsuccessful at first as a lack of details only further increased fear of a larger collapse. However, by the end of the quarter, investors had moved on and were looking ahead to earnings season to better gauge how the balance of the year would play out. The Euro crisis appears to have stabilized but the larger impact on the economic and political future of the EU and its constituents is still to be seen. This is far from over and will have an impact on earnings and growth projections well beyond 2010. Caution has returned to the markets and future estimates are being talked down as equity indices hit the lows for the year. The S&P 500 Index lost -11.42% for the quarter and for the first six months of the year, the S&P 500 finished -6.65%, the DJIA finished -5.00% and the NASDAQ Composite returned -7.05%. Small caps outpaced the large cap indices with the Russell 2000 posting a smaller loss of just -2.54%.

Table 1
2010 Market Returns & Pricing
As of June 30,2010

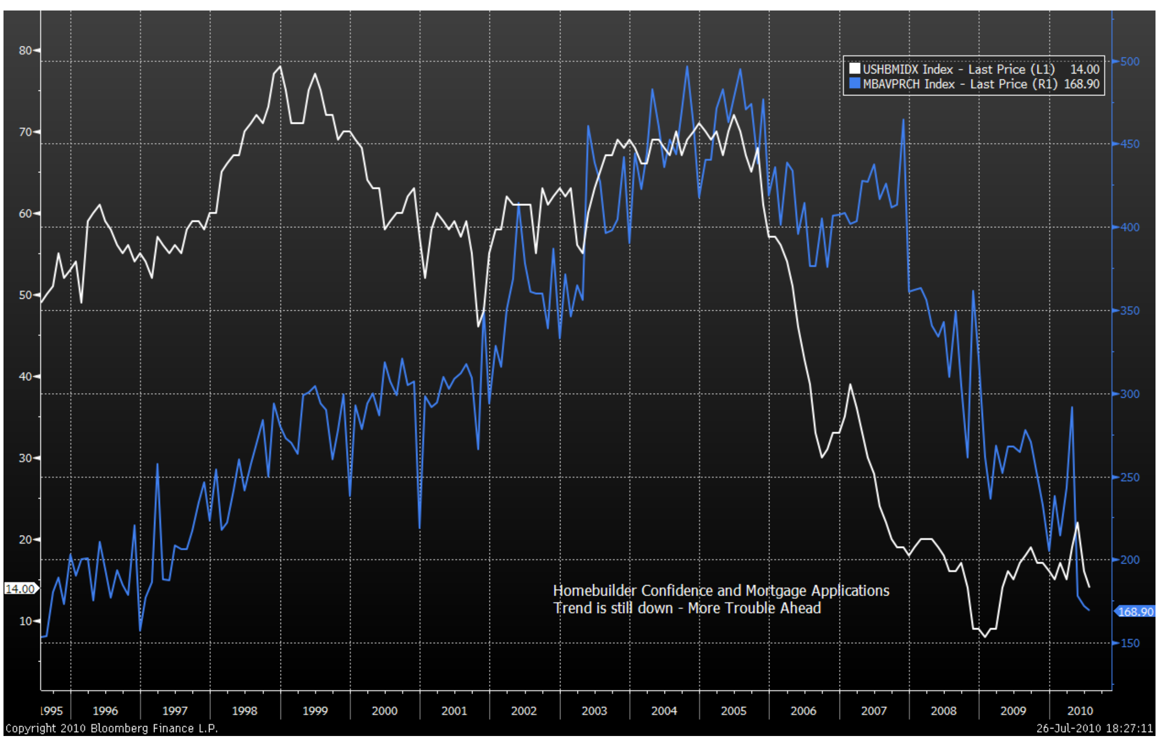
	Returns		Pricing
S&P 500	-6.65%	3 Month T-Bill	0.12%
Russell 2000	-2.54%	10 Year Treasury	3.20%
Wilshire 5000	-5.47%	30 Year Treasury	4.13%
DJIA	-5.00%	Gold	$1,244
NASDAQ Comp.	-7.05%	Crude Oil (WTI)	$75.59
MSCI EAFE	-14.72%		
Barclays High Yield	+4.50%		
DJ-UBS Commodity Index	-9.60%		
Credit Suisse Tremont Managed Futures	+1.79%		

Sources: PerTrac Financial Solutions, Federal Reserve, London Bullion Market Association, US Department of Energy

2nd Half 2010 Outlook

After several quarters of improved macroeconomic data, the US economy is again facing headwinds that will likely lower current growth expectations. Most notably, the housing market is likely to turn down further and unemployment remains stubbornly high. The past several months of housing related data have been nothing short of atrocious. Despite record low mortgage rates, mortgage applications in May dropped to the lowest levels in since 1997 (see the chart below). Since then, applications have dropped further and most applications are for refinancing rather than new purchases. New and existing home sale numbers were equally dismal. New home sales in May plunged 33% to a record low with the seasonally adjusted annual rate dropping to 300,000, the lowest level since records began in 1963. Furthermore, the median home sales price in May was $200,900, down almost 10% from a year earlier and the lowest since December 2003. When you add in the increased number of homes coming on the market as a result of foreclosure, the inventory of unsold homes represents an 8 to 9 month supply. It is no wonder that construction permits dropped further as homebuilders face a massive oversupply and don't see things changing anytime soon. The National Association of Home Builders Confidence Index fell to 14 for July from 16 (any reading below 50 is considered pessimistic) in June to the lowest level since April 2009 (see chart below). It appears that the homebuyer tax credit simply pulled sales forward, but did little to change the longer-term trajectory of the housing market decline. With the expiration of the tax credit and more foreclosures likely, housing is poised for another decline that will further damage the fragile consumer psyche.

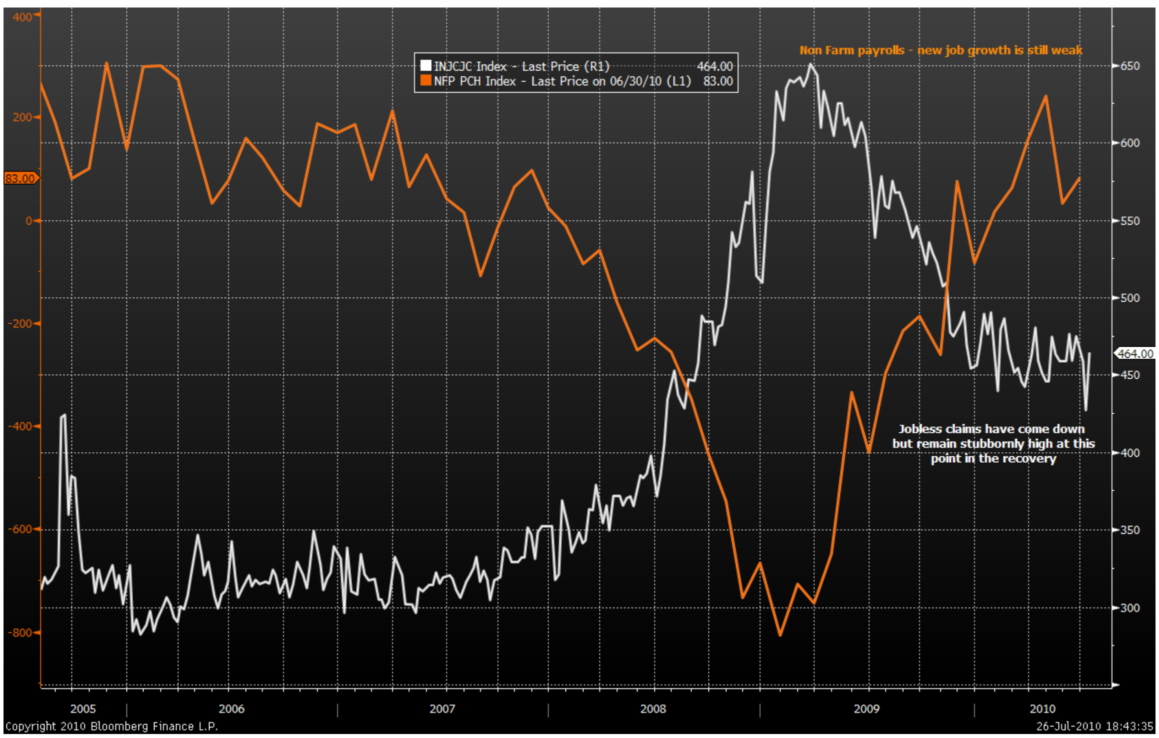
National Association of Homebuilder Confidence Index (White) vs. U.S. Mortgage Applications



Unemployment, while stable, remains stubbornly high at this point in the recovery. The headline unemployment rate may have dropped below 10% but it has been primarily a result of workers no longer looking for employment and their withdrawal from the data rather than due to the creation of jobs themselves. Digging deeper into the recent reports from the BLS (Bureau of Labor Statistics) shows a more disturbing picture than the headline decrease in the unemployment rate. For example, in June, the number of long-term unemployed, those looking for jobs for 27 weeks or more, remained unchanged at

6.8 million, representing 45.5 % of unemployed persons. Furthermore, the number of discouraged workers (those no longer looking for work because they believe no jobs are available), has increased by 414,000 from a year ago. For the year, total private-sector employment has increased just 593,000 and remains below its December 2007 level. If not for the B/D model (the birth death model that is designed to make up for the lag between new firms forming and when they get counted), the numbers would be even worse. The model has accounted for the creation of 301,000 jobs this year and strong gains in construction and leisure over the past several months. It is likely that those numbers will be revised down at year-end showing even fewer jobs created. Below is a chart of non-farm payrolls, the headline employment number from the BLS and jobless claims. As you can see over time, when jobs are lost, jobless claims go up, and when jobs are created, claims go down. It appears we have reached a point of stagnation.

Jobless Claims (White) vs. Non-Farm Payrolls (New Jobs)



Both housing and unemployment are likely to worsen by year-end, for a number of reasons, impacting growth expectations and ultimately earnings. In the recent minutes from the June FOMC meetings, the Fed has already revised down its estimates (from April) for growth and inflation while modestly increasing estimates for the unemployment rate. Growth estimates, given as a range, for 2010 were revised down from a range of 3.2%-3.7% to 3.0%-3.5% and estimates for 2011 were also cut from 3.4%-4.5% to 3.5% to 4.2%. The Fed did not alter their growth projections for 2012, keeping estimates at 3.5%-4.5% growth. With respect to unemployment, projections were revised up, suggesting job growth will remain sluggish for the next two years. Although the current earnings season has been respectable, primarily due to cost cutting measures, top line revenue numbers have disappointed and the outlook for many companies is negative as businesses believe the economy is set for slower growth.

Global Macro Themes

Deleveraging and Deflation

One of the primary functions of a central bank, including our Federal Reserve, is to fight inflation. In fact as part of the Federal Reserve's charter, the FOMC should seek "to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates". Since the Great Depression, the goal of promoting stable prices has focused almost exclusively on taming inflation, keeping core CPI in the 1-2% range. The Fed, particularly Paul Volcker, has had a lot of experience fighting inflation. But what about deflation? What happens when we can't grow the economy and create stable inflation? Severe asset price deterioration was instrumental in the credit crash of the past recession. The Fed and US Treasury helped to stabilize prices for bank assets in 2009, but the recent CPI releases are telling us that in the short- to intermediate-term, it is deflation that is again the biggest threat. After declines in April and May, June showed another decline of -0.1% in consumer prices, a 1 in 40 event. The 12-month change in prices remained at 0.9% (less food and energy), for the third month in row.

Furthermore, retail sales declined for a second straight month in June, down 0.5%, after May showed a decline of 1.1%. The last time there was a sequential decline in retail sales was in the midst of the recession when February and March posted back-to-back losing months. Retailers are trying everything possible to lure in shoppers, including "Christmas in July" sales modeled after the Black Friday stampedes, which will only further compress already tight margins and move demand up. How much more can the US consumer take? Their largest asset (home) is still declining in value, retirement portfolios have not recovered, wage growth is non existent with an oversupply of labor and credit is still tight. It's no wonder that Americans are continuing to save and repair their balance sheets. Consumer confidence numbers reflect this concern as the University of Michigan dropped 9.5 points to 66.5 in July, the lowest level since August 2009 and the worst one month drop since the Lehman collapse in October 2008.

For the time being, deflation remains the biggest concern for the Fed and they are likely to keep rates unchanged for longer than expected. An economic recovery that looked robust last year is now more tepid. A recovery from a credit – deleveraging crisis takes several years and is likely to impact growth much more severely than in the last several recessions. Short-term interest rates can't go much lower and the Fed will have to lower interest rates further out on the yield curve to stimulate growth if this deflationary environment persists. The Fed would likely have to purchase Treasury securities 2 to even 5 years out to lower intermediate-term interest rates and stimulate aggregate demand across the economy. The FOMC doesn't believe that the deflation of Japanese variety is possible. Let's hope that's the case.

Financial Regulation: Better, but not done yet

The Wall Street Reform and Consumer Protection Act is the most important financial reform legislation since the Glass- Steagall Act of the Great Depression. At least that's what we're being told. The truth is that the recent reform bill is not perfect but is better than what we had. However, much still depends on how regulators implement many of the bill's provisions. The lead-time before some of the changes take effect, in some cases several years, gives Wall Street lobbyists plenty of time to water down the more subjective aspects of the new regulations. The new law will face criticism from all sides, with some Democrats unhappy about the watering down of the Volcker Rule and Republicans suggesting the new regulations are overreaching and will force business overseas. The law does however provide the government with new powers to break up companies that are failing and are systemically significant, in theory, too big too fail. Although the government now has the ability to facilitate an orderly wind down of an AIG or Lehman Brothers, there are no specific criteria in the bill by which such a wind down should proceed. That discretion is left in the hands of the Fed Chairman who will have to objectively decide who fails and who survives. In addition, the bill creates a new Consumer Protection Bureau that will consolidate a number of functions now carried out by a plethora of agencies. The Bureau is charged with protecting consumers from predatory lenders and policing the financial institutions in the name of the consumer. Unfortunately, the law will likely have the unintended effect of limiting access to credit rather than making that access more fair and equal as financial institutions tighten lending standards. The Bureau may protect consumers from evil lenders and fraudulent financiers, but who will protect consumers from themselves? Although banks were eager to lend and take a large share of the blame for the sub-prime meltdown, Americans were equally content to leverage themselves for homes they could not afford.

As large as the new legislation is, there is one particularly glaring hole: a lack of resolution to the time bombs that are Freddie and Fannie. The recent delisting of both companies may give the companies some cover by excusing them from filing quarterly reports, but Congress will not be able to hide its head in the sand forever. At present, the two firms own or guarantee more than $5 trillion worth of mortgages, approximately half of all mortgages in America. Furthermore, 9 in 10 mortgages in the first quarter 2010 in the US were government backed. The CBO (Congressional Budget Office) estimates taxpayers could lose $400 billion on the two entities. The reality is likely to be worse as housing remains weak, credit worthy buyers are scarce and homeownership is still near record high levels. Unfortunately, there is no political will to face the problem head on, especially in an election year. Democrats have no appetite for further change as they face a referendum on Healthcare and Financial Reform in November while Republicans won't risk addressing the problem for fear of actually having to do something about it if they get elected. Unfortunately, the longer we stick our collective heads in the sand, the greater the risk of the US looking like Japan, or worse yet, Greece. There will come a time when global investors will assess the liabilities of the GSEs for what they are: US public debt. The addition of those liabilities to the $13 trillion of national debt may prove to be the tipping point. It's no wonder everyone is choosing to look the other way.

International Outlook: Austerity

International markets remain a mixed bag: emerging market growth remains robust while Japan and Europe are likely to remain stagnant for some time to come. In contrast to prior credit crisis, emerging markets have performed exceptionally well and are now counted on as the primary drivers of global growth. We believe the European and US consumer retrenchment will continue to impact China's export economy and while there is an emerging middle class in China that is expected to help drive consumer spending it may be too soon to expect them to buffer the soft consumer spending of the Eurozone and the US. Austerity is the policy du jour in Europe and cutting the deficit may soon become the national pastime in the US. Neither of these developments is good for China. Furthermore, talk of a property bubble in China grows louder by the day and the Baltic Dry Index, a measurement of shipping rates of various dry cargos (a great proxy for what is really happening with exports), has collapsed since the start of the year. Growth in China remains strong, especially relative to the US and Europe, but there are growing concerns about how sustainable China's growth trajectory is.

As stable as China has been throughout the recent financial crisis, the other Asian titan, the Japanese economy looks more and more vulnerable. The country is simply facing too many headwinds for growth: an aging population with little appetite for immigrant workers, an export economy with a strong currency and a lack of political will to bring about structural reforms. The Japanese stock market has been on a downward trajectory for close to 2 decades and there is little to suggest that its prospects will improve. During this period the Japanese government has been able to finance its debt at very attractive low rates, primarily due to its own citizen's appetite for JGBs. They believe, despite the low yields, it is still a better option than Japanese equities for most Japanese retirement portfolios. However, as retirees begin to draw on their accounts for income, the government will have to look elsewhere for buyers of its debt. This will put upward pressure on their interest rates as Japan's debt is approximately 200% of their GDP and growing at 10% per year. Tougher to finance and frankly unsustainable. Should interest rates rise as we expect, the cost to finance their debt pushes Japan far closer to the reset button.

Fortunately there is no need for concern about the state of the European banks (right). The stress test results announced last week appear to have achieved their goal of increasing confidence in the banking sector through increased transparency. Three of the main assumptions for the stress tests were realistic: a rise of 6 percent in unemployment, economic contraction of 3% on average and a 6% hike in market interest rates. There were, however, several shortcomings of the tests including, the biggie, mild or no haircuts to sovereign debt positions. For a crisis of confidence that began with fears about sovereign default, the fact that a sovereign default was not factored into the stress tests seems absurd. If those assumptions regarding growth and unemployment prove to be optimistic, banks will likely have to raise capital again. The call for austerity is loud and clear and Greece has done a nice job of cutting spending quickly in response to market concerns but it is not clear how the Greeks can make such deep cuts to avoid a default, while still having a realistic chance at growth. It is simply not possible. That is the challenge for most of Europe: cut spending while creating jobs and generating growth. If the stress tests are to be seen as anything but a PR scheme, European governments will have to work hard to get their finances in order and shore up their financial systems. We have our doubts.

Conclusion

We continue to see a bumpy road ahead. We expect 1% to 2% GDP growth as stimulus fades and worldwide delevering continues. We believe that the post crash cyclical bull market recovery move ended in April and that the market has entered a choppy higher volatility period. This schizophrenia is characteristic of a bear market and will continue through 2010 and beyond. However, the short-term trend is still down as we expect several hard sell offs through the summer and early fall. Typical bear market behavior. The reason for that is that the recession that likely ended in June of last year is worse than anything we have seen in our lifetime. The severity of the housing collapse and credit crisis will be felt for several years. Recovery will be slower than most expect and we continue to believe that growth expectations will be revised down. Most market commentators believe there is no chance of a double dip recession; it is a black swan, like the idea of housing prices going down or major investment banks collapsing overnight. These things don't happen. At least that is what we are told to believe. Let's see what happens should taxes rise significantly as scheduled to occur in 2011.

Whether the US economy double dips or not, Americans are feeling like it already has. A recent Pew Research Center Survey shows just how Americans feel 30 months after the recession. More than half of all workers have spent some time unemployed (on average for about six months), cut back on hours or have been forced to go part-time. Home prices and investments have lost almost a quarter of their value and about a fifth of Americans are underwater on their mortgage. New graduates face one of the worst job markets ever and one in four between the age of 18 and 29 are moving back in with their parents. Consumer sentiment reflects all of these trends and supports a rising savings rate and weak consumption, neither of which supports strong growth. Recent commentary from the Fed shows a serious concern about the recovery and we believe the current estimates for GDP growth by the Fed are optimistic and could be revised lower yet again.

On a more optimistic note, to be clear, all bear markets have periods of shorter term bull market moves. Looking ahead into the fourth quarter, both the four year election cycle and the 10 year market cycle point to a potential rally in 2011. Should a 3rd quarter decline take valuations to better levels combined with a postponement of the coming 2011 tax increases (likely necessary given a dire economic backdrop), the potential exists for a gain in 2011. Much like the long-term secular bear markets of the past, we believe there are at least 7 years to go before valuations reach a level that will mark this bear market bottom. Until then, passive management investment returns will be similar to the returns of the last ten years.

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IMPORTANT DISCLOSURE INFORMATION