CMG First Quarter 2010 Update

U.S. equity markets continued to move higher in the first quarter with the major indices reaching levels not seen since the fall of 2008. Despite a 7-8% (peak to trough) correction in January for the major indices, equity markets continued their bullish run on the heels of positive employment data, strong GDP growth in the fourth quarter of 2009 and better than expected retail sales. The quarter was also marked by a further decline in market volatility and lower trading volumes. The DJIA finished the quarter up 4.11% and the S&P 500 closed just short of 1200 (it has since crossed 1200), rising 5.39% since the start of the year. The NASDAQ Composite and the Russell 2000 outpaced both large cap indices with returns of 5.68% and 8.52% for the quarter. The current widespread optimism lies in stark contrast to the depths of the crisis just one year ago when many were calling for the end of the financial world. It is quite remarkable that investors could become so complacent just one year after the Great Recession – yet they have. As we have discussed in several of our communications, this bull market recovery, put in historical perspective, is likely to turn in the coming months. Prior market crashes have shown us that the recovery from the most severe moments of a crisis is quick and dramatic (see **CMG Update: You Will Get The Chance**), but post the recovery what typically follows is a longer, more difficult period when equity markets become more volatile and range bound, trying to consolidate the fundamental and emotional extremes defined the crisis itself. The past two years have been characterized by bailouts and government intervention but the balance of 2010 and beyond will be influenced by the decisions of the Fed, the U.S. Treasury and Congress. We have significant concerns.

Economic indicators continue to paint a very conflicting picture of the market's fundamentals. While equity markets are currently pricing in optimistic growth scenarios, the Federal Reserve has taken a more cautious stance on the current recovery promising to keep interest rates low "for an extended period". Low short-term interest rates are helping banks heal their balance sheets but they are also forcing investors to take more risk, potentially creating new bubbles for the Fed to ignore until a future point in time. With money markets yielding close to nothing, investors are instead choosing to invest in equities despite high valuations and technical indicators showing significant resistance ahead. According to the Shiller P/E ratio, the S&P 500 is overvalued by about 35% with a P/E ratio of 22x compared to the historical average of 16.4x earnings. Corporate balance sheets are healthy and cash levels are high but growth is more likely to come from mergers and acquisitions that consolidate market share than from new capital spending. Consumer confidence remains depressed and businesses remain skeptical of a durable recovery, making them less likely to add workers and further pushing them to squeeze the most out of their current staff. In fact, productivity growth has been robust if not exceptional, growing at 3.8% (non-farm business productivity) in 2009, the highest level in the past five years. Sustained productivity growth at this level is likely to reduce the number of workers firms need to bring back to meet demand when it picks up. If unemployment remains stubbornly high, consumer confidence is likely to deteriorate further thereby muting private demand and economic growth.

Consumption growth, one of the primary drivers of U.S. GDP, will remain restrained for quite some time. Tight credit conditions and fragile confidence tied to weak incomes and a tentative employment recovery will limit consumer spending. Although investment portfolios have rebounded well, real estate markets are still bottoming and consumers are not yet ready to spend. With a backlog of unsold homes already putting downward pressure on home prices, the recent foreclosure statistics indicate there is still more deleveraging to come in the residential real estate market. RealtyTrac Inc., a California based firm that

tracks notices for defaults and home repossessions, recently reported a record number of U.S. homes were lost to foreclosure in the first quarter 2010. The number of foreclosed homes in the first quarter jumped 35% from a year ago. March in particular proved to be a brutal month with foreclosure filings on 367,056 properties, representing a 19% increase from February and almost half of the total, 932,234, which were reported for the quarter. While banks have been encouraged to modify home loans for troubled borrowers, many homeowners are choosing to walk away altogether. Of the 1.2 million homeowners that signed up for the government foreclosure prevention program, 158,000 have dropped out because they stopped making payments or failed to file the appropriate documents. Banks are losing patience and appear ready to realize losses as government support for housing begins to wane. In particular, the termination of the Fed's MBS purchase program and the expiration of the homebuyer tax credit on April 30 is forcing banks to recognize losses as the likelihood of refinancing or a sale is diminishing. The ripple effects of increased foreclosures will be delayed but will impact mortgage backed securities, bank balance sheets and property tax receipts over the coming months.

The economy has stabilized but remains fragile. The Fed knows this and has become more cautious with its communication, particularly in regards to the federal budget deficit and the real estate market. The financial system has been saved but the cost has been put on the government's tab. That tab will keep growing as the Treasury has written a blank check for the GSEs, Fannie and Freddie. In addition, lower tax receipts and uncertain revenue projections tied to lower GDP growth will likely mean budget deficits will be 4-5% of GDP until 2020 (per the Congressional Budget Office). Under this projection, Federal Debt to GDP would be approximately 70%. That is the baseline scenario. Under an alternative scenario, that number could be much higher, where the federal debt would balloon to more than 100% of GDP. That would be an unsustainable amount, one that would impact the U.S.'s ability to finance its debt moving forward at reasonable rates. There are difficult choices ahead and the current political climate is not conducive to finding a solution. At some point the U.S. will have to take some pain, whether it is in the form of higher taxes, cuts to entitlements (Social Security and Medicare) or a higher retirement age. For a congress that can't agree on some reasonable derivatives legislation (this should be a slam dunk for both parties), tackling the growing deficits is a mammoth task.

We are a year removed from staring at financial armageddon and the debate concerning financial reform has become a political battlefield. Brushing politics and the weak SEC case against Goldman Sachs, there is a need for serious regulation that prevents a crisis of the magnitude we have just witnessed. The major issues at the heart of this debate are Too Big To Fail (TBTF), regulation of shadow banking (primarily derivatives) and consumer protection. TBTF has become the most political aspects of the debate as no tax paying voter wants to see a replay of what happened in the recent crisis. The current regulation is pushing for resolution authority to wind down systemically significant firms, such as Lehman and AIG, where in the recent crisis the government did not have the authority to wind down failing companies. Critics of the proposal favor utilizing bankruptcy. Unfortunately, Congress and the Fed lack the nerve to allow a business to fail, especially after watching the credit markets implode after the collapse of Lehman. In a perfect laissez faire market, bankruptcy would be the resolution, but for a financial system built around mega banks like Citigroup and Bank of America, this is not an option. Unfortunately, re-implementation of Glass Steagall is unlikely but some resolution authority that would facilitate an orderly wind down of a failing firm is likely to pass. When investment banks, like Goldman Sachs, generate an overwhelming majority of their revenue from trading ($7.7 billion of the $12.8 billion of revenue this quarter was from trading), there is no reason to give them the Federal Reserve safety net that comes with being a bank. The recent crisis also informed us that there are aspects of the financial system that were invisible to the regulatory framework that currently exists, namely the credit default swaps that took down AIG. Bringing the shadow banking system into the light of day is necessary if regulators and investors are to have any confidence in companies' balance sheets. Financial firms are lobbying hard against any regulation, threatening that the derivatives business will simply move offshore, most likely to London. A

justified fear, but they could also take the approach that an exchange for the transparent trading of derivatives might actually attract more investors, if done effectively in the U.S.. Consumer protection is also on the agenda with the Federal Reserve likely to house an agency charged with protecting consumers from predatory lenders and other evil bankers. How ironic that the agency, the Fed, that has encouraged reckless risk taking through its adoption of accommodative monetary policy, will now monitor how consumers get access to credit. Given the opacity of the Fed and its cozy relationships with the banking sector, how effective will a consumer protection agency really be? A more effective, more capitalist approach would be to stop pushing risk down artificially through lower interest rates. The recent housing crisis showed that abundant liquidity at a cheap price creates bubbles. There is still no reason to believe that this approach to pricing risk will yield different results in the future. Ultimately, markets get it right and price risk appropriately – just ask the Greeks.

The Greek tragedy unfolding every week, like a bad case of déjà vu, may ultimately prove to be the catalyst that triggers a widening of credit spreads across global fixed income markets. While Greece's finances are abysmal and its reputation as a serial defaulter is well documented, their case is not unique and will not take down the Euro by itself. However, the PIIGS, the acronym for the troubled countries of the EU (Portugal, Ireland, Italy, Greece and Spain), collectively are testing the validity of the European Monetary Union. Unfortunately, Western Europe, Japan and the U.S. face many of the same budget deficit and high debt problems as the PIIGS. Recent deficit data for Europe showed that Greece is not alone. Ireland was at the top of the list with a 14.1% deficit (as a percent of GDP), followed by Greece 13.6% (and going higher after revisions), Spain at 11.1% and Portugal at 9.4%. Italy has a lower deficit for this year than the other PIIGS, at 5.3%, but it also has the highest debt to GDP ratio at 115.8%. Deficits in France and the UK were also high with France's deficit rising from 3.3% in 2008 to 7.5% in 2009 and the UK reaching 11.5%. Many of these deficits are the result of government stimulus that was used to limit the depth of the recent recession, but underneath the short-term spending, Europe faces many of the same long-term structural challenges as the U.S. and Japan: namely an aging population, lower growth and massive entitlement spending. Japan's debt is under pressure from ratings agencies as its debt to GDP ratio has skyrocketed to approximately 200% of GDP. It has been able to finance its debt at cheap levels as 90% of its debt is held domestically. However, that is likely to change as an aging population starts spending in retirement rather than saving. A strong currency, weak exports, slow growth and rising costs of capital will prove to be a dangerous cocktail for Japan. Finally, back to the U.S. where debt to GDP is expected to exceed 100% in the next couple of years. Although crossing the 100% mark is not a scarlet letter, it does create serious cause for concern. In particular, the U.S. relies heavily on foreigners (China) to finance its debt and it will have to pay a higher price (interest rate) moving forward as supply of sovereign debt will greatly exceed demand over the coming years.

So what does this all mean to investors? U.S. equity markets have returned more in the past 12 months than in the past decade, PE ratios are well above historical levels and interest rates have nowhere to go but up. Consumer confidence remains weak, employment is stagnant and the real estate market is likely to further weaken. While corporate balance sheets are healthy, government balance sheets are a mess. A period of fiscal austerity is ahead of us and it will not be pretty. For investors, it is time to take chips off the table: take some profits and wait for a period where risk and reward are more attractive. Much like in poker, after a "bad beat", the tendency is to try and make that loss back on the next hand. The result is usually not good as discipline and risk management take a back seat to emotion. For investors, the desire to recover all of the losses from the crash is sometimes too much to overcome and they cannot see that the game has changed and their odds are not good. Stay patient, wait for a better hand and avoid another "bad beat".

CMG Capital Management Group, Inc.
150 North Radnor Chester Road – Suite A150
Radnor, PA 19087
610-989-9090

IMPORTANT DISCLOSURE INFORMATION

CMG Capital Management Group, Inc. ("CMG") is a Registered Investment Advisor located in Radnor, Pennsylvania. CMG and its representatives are in compliance with the current filing requirements imposed upon SEC registered investment advisors by those states in which CMG maintains clients. Accordingly, this publication should not be construed by any consumer and/or prospective client as CMG's solicitation to effect, or attempt to effect transactions in securities, or the rendering of personalized investment advice for compensation. Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product made reference to directly or indirectly in this document will be profitable, equal any corresponding indicated historical performance level(s), or be suitable for your portfolio. Due to various factors, including changing market conditions, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained herein serves as the receipt of, or as a substitute for, personalized investment advice from CMG (or any of its related entities), or from any other investment professional. To the extent that a reader has any questions regarding the applicability of any of the content to his/her individual situation, he/she is encouraged to consult with the professional advisor of his/her choosing. A copy of CMG's current written disclosure statement discussing our advisory services and fees is available for review upon request.