CAPITAL MANAGEMENT GROUP, INC.

Alternative Investment Strategies

CMG Quarterly Outlook and Performance Update

I remember reading a John Mauldin e-letter in 2007 about the potential for the collapse in the mortgage market and had that "this is a really bad feeling". He talked about Subprime, Residential Mortgage Backed Securities, how the investment banks sliced and diced mortgage pools into Collateralized Debt Obligations, and quoting John from that letter, "Not content with turning lead into gold, we start trying to do the magic on sewage". Here is a link to that February 2, 2007 letter titled ***"A Raging Bull"***. This was not the first time I heard about the potential for a mortgage market blow up yet it was the first time I really got it. John was one of the first to sound the warning alarm.

I remember thinking, how bad can this really get? One of my smartest clients, a consultant on billions of AUM, called asking what kind of subprime / CDO exposure we had in our portfolios. I reported back "none". Yet his call heightened my "really bad" feeling. This was counter to all that was apparent in the world at that time. Remember that the market was in a cyclical bull market move, the economy in good shape, there was a massive amount of liquidity in the system and everything was priced to perfection. To all observers, the world was in a good place. Yet beneath the surface, cracks were beginning to show. While I began to believe that the fallout was going to be bad, I had no idea it would spawn the greatest recession since 1929.

We all know the world broke in 2008 and the subprime bomb nearly destroyed the banking system. We were that close to the brink.

The reason I mention this is that I just read what I believe is one of Mauldin's most important letters last weekend. It is titled ***"The Subprime Debacle: Act 2, Part 2"***. Click here to read the full letter. I think we are all a bit wiser today and as a whole more likely to be a little quicker to react to risk this time around. Be careful. Risk remains significant and portfolios need to be managed in ways far more proactively than 60/40 buy-and-hold.

With this thinking we share our thoughts on the market (attached). Fundamental problems remain both here and abroad, significantly tied to too much debt and the repair needed that will simply take time. Similar to past long-term secular bear market cycles, we see choppy to sideways markets for a number of years to come. Some good rallies, some difficult declines. Deflation now…inflation and higher interest rates to come. As we work through the excesses of the last major bull cycle (that ended in 2000) and work our way through the current secular bear cycle, we believe it is important to stay focused on the bigger picture and not get drawn into a shorter term narrow focused view.

Subprime Part 2 – how bad can it really be? I'm concerned.

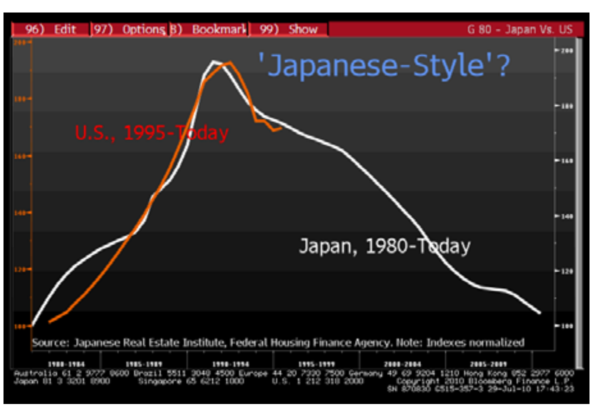
Wishing you the very best,

Steve

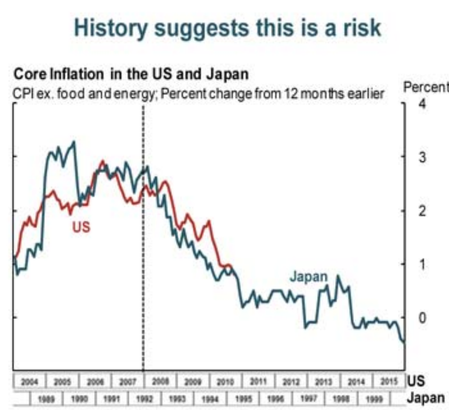
CMG Third Quarter 2010 Update

U.S. equity markets moved higher during an extremely volatile quarter that ended with the best September for equities since 1939. After a strong July, equity markets sold off strongly in August before rallying in September. The DJIA finished the quarter up 11.13%, the S&P 500 rose 11.30% and the NASDAQ Composite finished up 12.30% as technology shares outpaced the broader equity markets. While monthly economic data continues to paint a conflicting picture, particularly with respect to the housing market and unemployment, the announcement of plans for QE2 (Quantitative Easing 2.0) by Federal Reserve Chairman, "Helicopter" Ben Bernanke, sent markets on a double digit rally. It will be interesting to see how much further the market can move on this "sugar high" of liquidity and the effect, if any, it will have on growth.

As we discussed in our mid-year update, the Fed is growing increasingly concerned about disinflation: a slowdown in the rate of inflation that could ultimately lead to deflation. It is no surprise that after a credit collapse, a period of balance sheet deleveraging (for consumers and businesses) would create a deflationary environment. However, as government stimulus winds down, the Federal Reserve has continued to lower its growth expectations and has now reached a level of concern that requires further action: Quantitative Easing 2.0 (like Microsoft Windows, there are likely to be more versions to come and just as expensive). There are a number of oscillating economic indicators (i.e. jobless claims, new and existing home sales) that from month to month paint a conflicting picture of the economy, but we imagine that the two charts below are front and center on Mr. Bernanke's desk as he embarks on QE2. The first chart below is a comparison of real estate indices for the U.S. (1995 to the present) and Japan (1980 to the present) showing the massive collapse in housing. Notice the highly correlated trajectory leading us lower. The second chart is a comparison of core inflation, ex: food and energy, in Japan from 1989 to the present versus the U.S. from 2004 to the present. Again, notice the very similar pattern.



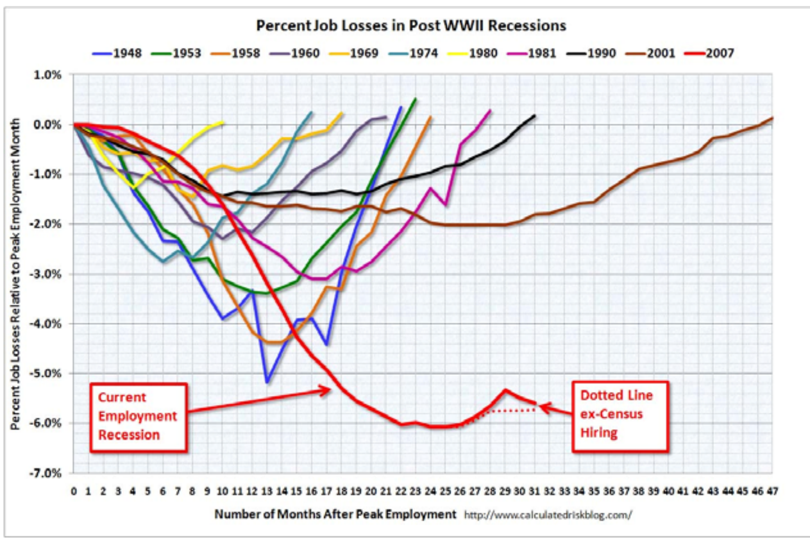
Source: Japanese Real Estate Institute, Federal Housing Finance Agency



Source: Federal Reserve Bank of San Francisco

Looking beyond the Orwellian name of the program, we can see that Bernanke's strategy is simply to throw more money at the problem in the hope that lower interest rates and more liquidity will drive asset prices higher – anything to avoid deflation. In fact, 8 years ago, Ben Bernanke gave one of his more famous speeches titled "Deflation: Making Sure "It" Doesn't Happen Here" in which he discusses his personal views on how to tackle Japanese style deflation. It is an interesting read that gives great insight into the current game plan for the Federal Reserve. It seems that Chairman Bernanke will print any amount of money to avoid being wrong on this one.

A lack of job growth contributed to the Fed's decision. It appears that the recent recession could be a further indication of structural employment changes that will make it a more difficult recovery. Note the bold red line below (specifically the flat trajectory of job growth). Also note the past three recessions have been the three slowest (1990, 2000, 2007) to recover since 1948 (see chart below).



Source: Courtesy of Calculated Risk, data from U.S. Bureau of Labor Statistics

While the trend is modestly up in recent months, it is nowhere near the pace needed for the economy to be running at full capacity and generating an appropriate level of inflation. The Fed's approach is sensible in the short-term but will have many unintended consequences. The dollar index has dropped to a 15 year low against the Yen and the lowest level against the Euro since the Greece sovereign debt crisis earlier in the year, sparking bullish moves in commodities. A weaker dollar should spark export growth but at the risk of antagonizing trade partners, namely China, and other emerging markets like Brazil, who are trying to curb the flow of funds into their markets that could lead to greater inflation. A weaker dollar will also lead to higher commodity prices, namely higher food and energy prices, this at a time when consumers are considerably stretched. Deleveraging trends remain intact as credit growth is nonexistent, the velocity of money is still contained and American households are increasing savings rates towards 10%. None of these trends are supportive of an economy that is still geared towards consumption. We continue to believe GDP growth will be in the 1% to 2% range at best. The coming holiday retail season will check the pulse of the consumer. While sales volumes will likely increase from last year, deep discounting will be necessary for most retailers to meet expectations.

We continue to believe the markets will be choppy to sideways for some time to come. A long-term secular bear environment with increased volatility: uncertainty over taxes and regulations, political gridlock and monetary experiments by the Federal Reserve. The additional uncertainty regarding the foreclosure crisis will only further hamper the nascent recovery. What has become evident in recent weeks is that the Wild West of sub-prime mortgages that we have read about for the past several years is actually more wild than anyone could have expected. We won't go into great detail as our friend, John

Mauldin has already done that job for us with a fascinating and infuriating piece on the foreclosure mess in the past week that is available on our website: ***The Subprime Debacle: Act 2, Part 2***. The investigations in 50 states will slow foreclosure proceedings and stall a real estate market that is already wobbling and likely to fall further. Recent home sales and home price data points to lower prices. The bigger issue is the allegations of fraud that have lead to large pension funds and institutional investors (i.e. PIMCO) suing major banks for knowingly selling MBS and CDOs that had mortgages with numerous problems. Most pensions are required to invest in AAA rated investment securities and if Wall Street bought, packaged and sold mortgages to these investors while intentionally misrepresenting their composition, banks could face another massive crisis as they are forced to buy back loans and mortgage pools. Despite tepid assurances from major bank CEOs, none of this is good news for the recovery. For investors, it again creates doubt that the financial sector can be counted on to grease the gears of commerce. For consumers, it increases their distaste for debt of all forms, further supporting the secular move up in the savings rate.

Markets are poised to challenge the highs of the year as we move through the fourth quarter of the year. There are several tailwinds including the prospects of QE2 and a Republican victory in the mid-term elections that could move markets higher into year end. However, markets may have gotten ahead of themselves and we expect short term weakness tied to an overbought market/excessive investor optimism. Our intermediate term outlook remains positive through year-end and into early next year, however, we see the potential for much greater risks as 2011 progresses. There remain significant structural issues lurking below the surface. Watch the Fed as they attempt to print our way to prosperity. All in, double down, a big bet with significant risks.

The Fed's game plan? In 2002, Bernanke discussed a number of remedies for deflation that could be prescribed by the Fed, a number of preventative measures that could be undertaken and several key characteristics that made the U.S. economy unlikely to face the same crippling effects of deflation as Japan. Since 2002, many of the strengths of the U.S. economy that Bernanke touted, such as a well capitalized banks and smoothly functioning capital markets, have since turned into question marks. Some of the other tools that could be used to prevent deflation, including monetary (lower interest rates) and fiscal (lower taxes, more government spending) stimulus have already been used. As he moves deeper through his monetary playbook, Bernanke is confident that there is always a "Hail Mary" he can throw: currency devaluation.

Under a fiat money system, the Federal Reserve along with the US Treasury can always print more money, creating inflation. This is a blunt tool, one that will work only if everyone at the global financial party continues to play this game. At extreme – unlikely. The risks are big and we face hard choices. First, if we print like crazy and lose our currency, all of our savings will be confiscated by either inflation or a collapsed currency (or both). Second, foreign holders of our dollars are getting little interest on their treasury holdings and are taking a beating from our falling dollar. They own over 50% of our debt. At some point, they will no longer buy our bonds. That will end the Fed's power. We are at the early stages of currency warfare.

At the recent G20 meeting, the non-U.S. members gave a tacit approval to the recent dollar decline and further quantitative easing. A modest decline could help move global trade imbalances towards more stable levels and spur growth in the U.S., thereby keeping the global recovery on track. There is, however, a great risk that a deeper devaluation will spark currency and trade wars, as exporting countries like Japan and Germany try to stay competitive despite their surging currencies. Taken as a whole, the macroeconomic factors driving recent market activity will continue to create stock market volatility, driving more investors out of equities and into fixed income (the next big bubble) at precisely the wrong time.

The whip-saw movements that investors have experienced over the past two years are nothing new. They are the defining characteristics of a bear market. Bear markets test investors discipline and patience at every turn. There are no quick fixes; the economy must work off its excess debt, allow uncompetitive business to fail and create fertile ground for new long-term bullish trends to begin. While short fixes like QE2 can calm investors in the short-term, they are likely to put off the inevitable for a later date.

On September 20, the National Bureau of Economic Research officially called an end to the recession, the deepest and longest since the Great Depression. The final tally is not pretty: 7.3 million jobs lost, a 4.1% decline in GDP and a 21% drop in household net worth. There is still more deleveraging to be done before the bear goes back into hibernation.

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