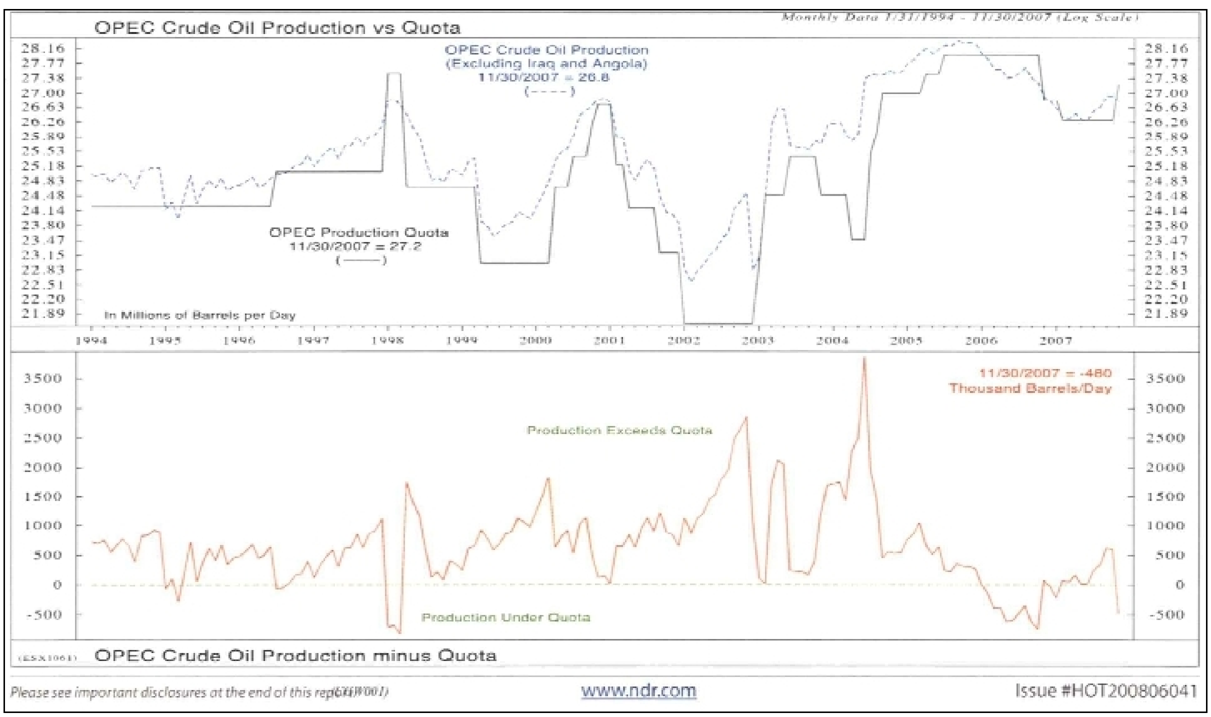
CAPITAL MANAGEMENT GROUP, INC.
CMG
Alternative Investment Strategies

Summer Doldrums

Last month we wrote that investors had become too complacent and that the bull rally was losing steam despite the steady stream of buy ratings on TV. That bullish momentum hit a wall in mid-May as oil prices set record high after record high. Since that high on May 22, oil prices have cooled but are still up 33% (based on May 31 close) since the start of the year. The Bureau of Labor Statistics continues to make adjustments to CPI, excluding food and energy prices, but U.S. consumers are feeling inflationary pressures at the same time as their home value continues to decline. As a result, consumer sentiment, as measured by the University of Michigan sentiment index, dropped to the lowest level in 28 years. As taxpayers receive their economic stimulus checks, they are less likely to make discretionary purchases and more likely to shop at discount stores such as Sam's Club, BJ's Wholesale and Wal-Mart. Consumers are acting like the recession is already here. We believe it started in December or January.

The spike in oil prices even woke Congress from its slumber. Unfortunately, their energy was misguided as they scolded oil executives in public and contemplated a gas tax holiday over the summer to appeal to populist sentiment. Their time would be better spent discussing a coherent energy policy that the U.S. has lacked for quite some time. Specifically, a lack of refining capacity is exacerbating higher crude oil prices. Just recently, South Dakota voters approved zoning for Hyperion Resources to build the first new U.S. refinery since 1976. Unfortunately, it will not come online until 2014. Furthermore, as hurricane season approaches, refineries in the Gulf may have to shut down should a storm come through that region. Forecasters have aggressively increased their oil price estimates with Goldman Sachs saying $200 oil is a real possibility if there was a major disruption in supply. Goldman also increased its average price estimates for 2008, 2009 and 2010 to $95, $105 and $110 per barrel. The supply/demand fundamentals continue to support the bullish case for oil as OPEC's production is below its quota (see chart below).



In addition, non-OPEC members are also near peak supply output while the commodity appetite of China and other emerging markets is as strong as ever. The level of excessive bullish sentiment gives us reason to believe a pullback is in order before another leg up in prices. However, the inability of OPEC members to meet the quota and production levels of 2005 and 2006 serves as a strong tailwind for oil prices and could push bullish sentiment even higher. Is OPEC running out of oil or are they playing oil politics?

It will be interesting to see what the impact of recent price spikes will be on earnings moving forward. The two industries most visibly impacted are automobiles and airlines. The big three (GM, Ford and Chrysler) are struggling due to a dramatic drop in SUV sales and now face the difficult task of restructuring their business as consumer behaviour is changing, perhaps permanently. Chrysler, which was bought by private equity firm Cerberus, will have a difficult time servicing their debt payments as their sales are expected to decline more than the industry wide estimate of -7%. Cerberus has already taken a write-down of over $200 million and according to Reuters, one of the deal's underwriters (the underwriters include Citigroup, Goldman Sachs, Morgan Stanley, JP Morgan Chase and Bear Stearns), has sold millions of dollars of Chrysler loans at 61 cents on the dollar. There is a strong likelihood that further losses are on the way as banks continue to de-lever and sell off riskier assets. Airlines are the other headline sector to be dramatically effected by higher fuel costs. The International Air Transport Association expects the industry to lose over $2 billion dollars this year primarily because of jet fuel costs. As a result, the airlines are scrambling to cut flights, jobs and retire inefficient planes. Consolidation within the sector may be the only option for most carriers should fuel prices remain at current levels or go higher. If consolidation can't solve some of the industry's problems, airlines could be the next industry looking for a government bailout.

In addition to autos and airlines, many other sectors will be impacted by higher oil prices as petroleum based products are used throughout the global economy. Petrochemicals are used in almost every industry including drink bottles, food packaging, appliances and various industrial lubricants. At some point these and other industries that utilize petrochemicals will pass along their cost increases to the consumer, further straining their budget. Stagflation (slow growth combined with rising inflation) is alive and will certainly weigh down US equity markets and create a choppy trading environment. In this type of environment it is important to monitor levels of market resistance to trade the investor sentiment extremes.

The increase in oil prices, which has dominated news the past several weeks, has overshadowed the continuing problems in the housing and credit markets. Although credit markets have stabilized post the Bear Stearns bailout, the problems in the mortgage markets will continue to force write downs for holders of mortgage backed securities, likely forcing banks and insurance companies to raise more capital. In the first quarter 2008, delinquency rates on mortgage loans rose to a record high of 6.35%, up over 1.51% from a year ago. Furthermore, seriously delinquent mortgages (loans 90 days or more past due and loans in foreclosure) are now above 4% for the first time ever. Sub-prime mortgages are rapidly approaching a delinquency rate of 20%. If such a large percentage of homeowners can't pay for their mortgage, they, in all likelihood, can't make their car and credit card payments as well. It is only a matter of time before other asset-backed securities, backed by auto loans or credit card receivables suffer losses and force write-downs for investors holding those assets. By most estimates, the US real estate market is about half way through its projected peak-to-trough decline of 25%. Prices need to fall another 10% before the market returns to pre-bubble levels. The housing and credit crises are not over yet, but there are signs of light at the end of the tunnel.

Although we are bearish long-term, we believe the prospects for a recovery in the second half of the year have some supporting fundamentals. For example, markets tend to rally in the second half of an election year. More significantly, markets tend to rally and perform better than average for 3 to 12 months after the final Fed rate cut. What the Fed's next move will be is still up for debate, but the probabilities point to a pause and a potential rate hike later in the year if inflation should persist. If the magnitude of a recession is greater than expected, the slowdown in growth could help cool commodity prices. Higher interest rates could help strengthen the dollar and help it break its current trading range, eventually helping to bring down oil prices. Last month's complacency has quickly been replaced by uncertainty and as we approach the "Summer Doldrums", when the financial industry slows down, the current volatility in the markets will likely be exacerbated during a slow trading environment.