CAPITAL MANAGEMENT GROUP, INC.
CMG
Tactical Investment Solutions

The Blumenthal Viewpoint

October 11, 2011

The Coming Recession, S&P 500 Index Targets, Investor Sentiment, High Yield Bond Market Opportunity Ahead

Coming Recession:

I highlighted the probability of recession in last month's piece. Specifically, "when the GDP year-over-year growth drops by more than 2%, we have always had a recession". The most recent year-over-year GDP growth is just 1.50%.

"It's Going to Get a Lot Worse" according to Economic Cycle Research Institute co-founder, Lakshman Achuthan. Weakness in leading economic indicators has become so pervasive that the Economic Cycle Research Institute now predicts a new recession is unavoidable. Here is a link to that interview if you are interested: http://finance.yahoo.com/blogs/daily-ticker/going-lot-worse-ecri-achuthan-says-recession-unavoidable-141929160.html

DJIA recession performance statistics - Recessions and Top 12 Bear Markets 1916 – 2011:

Bear Market Dates*	DJIA % Change
11/21/1916 - 12/19/1917	-40.1
11/03/1919 - 08/24/1921	-46.6
09/03/1929 - 11/13/1929	-47.9
04/17/1930 - 07/08/1932	-86.0
09/07/1932 - 02/27/1933	-37.2
03/10/1937 - 03/31/1938	-49.1
09/12/1939 - 04/28/1942	-40.4
12/03/1968 - 05/26/1970	-35.9
01/11/1973 - 12/06/1974	-45.1
08/25/1987 - 10/19/1987	-36.1
03/19/2002 - 10/09/2002	-31.5
10/09/2007 - 03/09/2009	-53.8
Mean	-45.8

* The 12 NDR-defined bear markets with the greatest declines.
NED DAVIS RESEARCH, INC. *see important disclosures below

S&P 500 Index Targets:

The market remains in a trading range with 1200 on the upside and 1000 on the downside. Below is a monthly chart of the S&P 500 index chart dating back to the beginning of the secular bear in 2000. Within all long-term secular bear periods are shorter term cyclical bull and bear periods. The tendency is for the markets to stay above the middle dotted line in cyclical bull markets and below the line in cyclical bear markets. This chart can be helpful in identifying periods to reduce risk (or hedge) long equity exposure.

From a trader's perspective, I look for rallies towards levels of logical overhead resistance tied to optimistic investor sentiment. The idea is to establish put option positions to protect your long equity exposure or raise cash at logical levels of resistance. I see overhead resistance at 1200 (dotted line). I believe we are in a new cyclical bear period as I previously identified in my April letter. Nothing has happened to change that view. Cyclical bull and bear trends last several years.

I'm often asked where I think the market will bottom. It's a guess but technical analysis can give some clues. Below are three technical downside support targets. Resistance (think of it as an overhead ceiling that is tough to penetrate) is marked by the blue line at the top of the yellow highlighted trading range box. The lows in March 2011 of 1249 and June 2011 of 1258, once broken, become the overhead resistance. The 1250 level marks major resistance. A break above 1250 would be a positive for those with a bullish view. I see the 1200 – 1250 range as a good spot to again get defense; especially tied to a spike in investor optimism. That spike has not yet happened. More below.

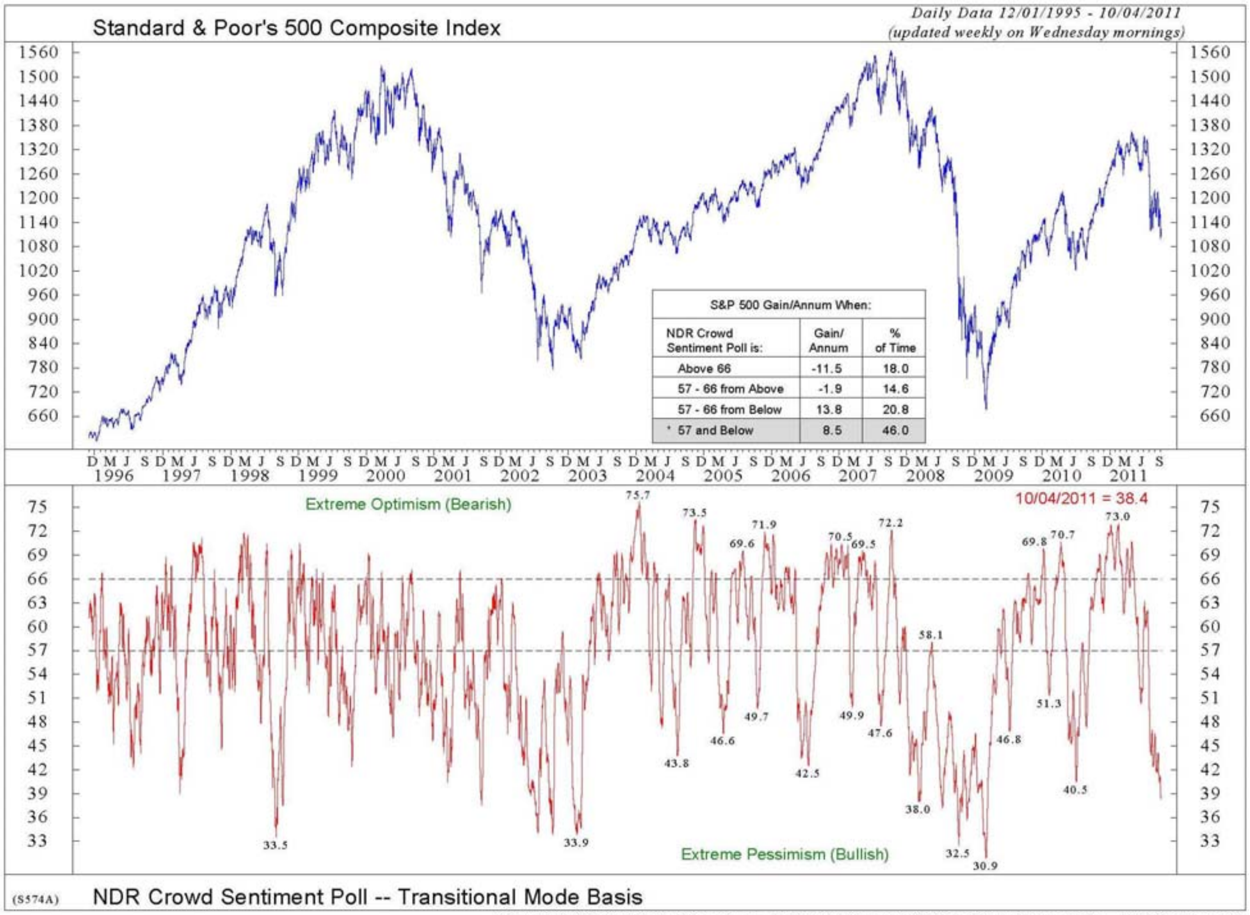
I believe the cyclical bear market started on 4-29-11. According to Ned Davis Research (NDR), since 1901, the mean return in NDR-defined cyclical bear markets was -31.5% and lasted 410 days. I believe the most logical downside target is first 1017 then 934 on the S&P. Looking at the DJIA performance in the past recessions listed above, a 40% decline from 1370 drops the S&P to 822; a 31.5% decline drops the S&P to 938.   My best guess is we see Target 3 achieved by June 15, 2012 (410 days approximately from the 4-29-11 cyclical bear start).

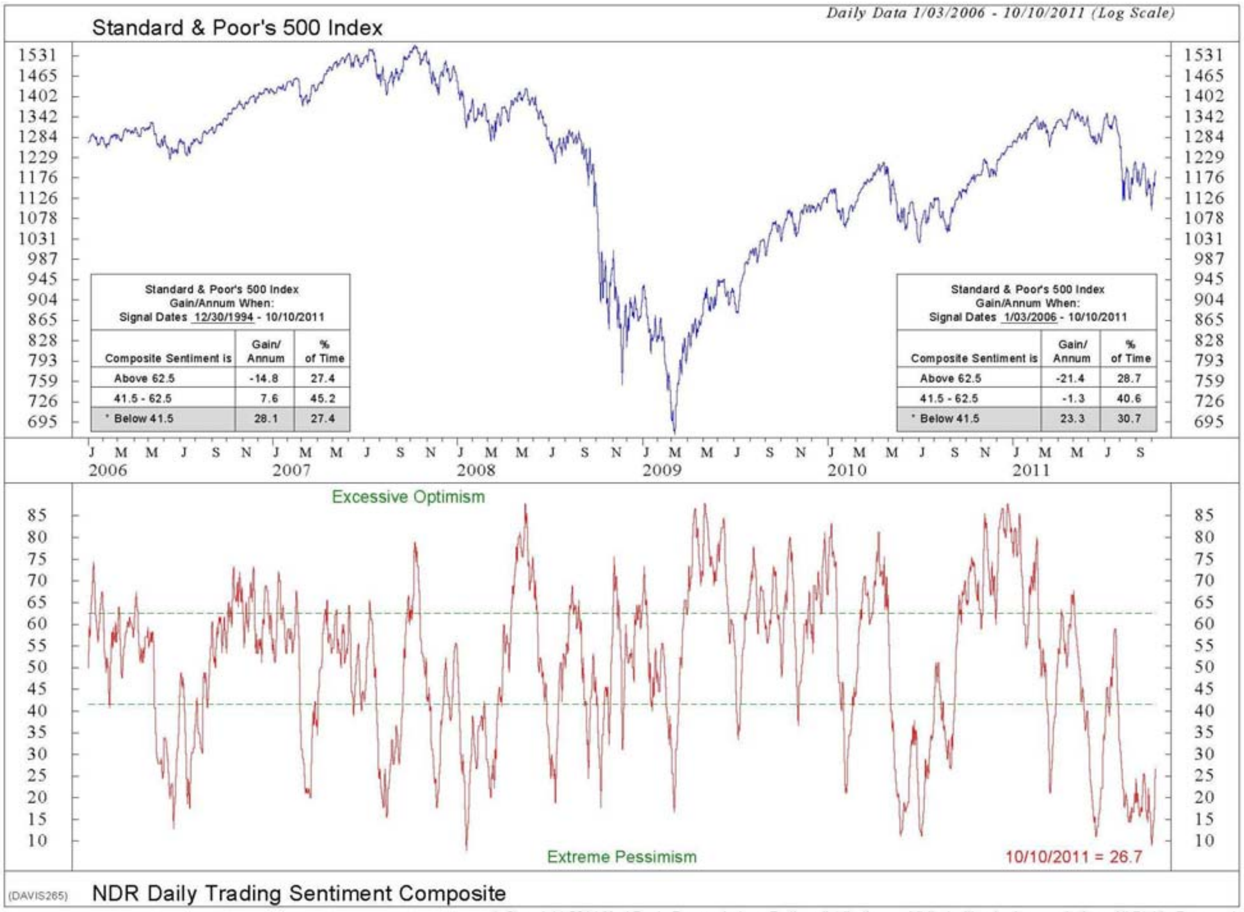
I'm not in the 'market crash' camp but I am in the 'cyclical bear within a long-term secular bear' camp. Fundaments/valuations are better and corporations are in a better financial position but I believe the world's debt and forced spending cuts will drive lower growth. Rising taxes, slower growth, increasing debt and spending issues are not bull market drivers. It's not sub-prime this time but something much bigger - Europe. We've got issues. It is tough for me to want to get aggressive with long-term equity exposure in front of the odds I see.

Post the Bear and Lehman collapse, there is less leverage in terms of margin and leveraged structured trades in the system. I don't think we will see anything like the margin call/investment leverage unwind that we saw during the 2008 crash. Margin calls and forced selling puts would be buyers on the sidelines and a trap door opens. I don't believe we have the same dynamics in place but I could be wrong (i.e.: flash crash). Currently, we are seeing a good rally from Target 1 support at 1100. We were so oversold with extreme pessimism that the move is to be expected.

Investor Sentiment:

Below are two sentiment charts. My favorite is the NDR Crowd Sentiment followed by the NDR Daily Trading Sentiment Composite. Note the Extreme Pessimism in both charts. Think about putting protection on tied to logical overhead resistance in the 1200-1250 area or raise cash tied to an Investor Sentiment move towards the Excessive Optimism zone and subsequently taking it off tied to logical support levels (combined with Excessive Pessimism).





<u>High Yield Opportunity Ahead:</u>
The High Yield (HY) bond market has been in a steep decline. I have been running a HY tactical strategy since the early 1990's. This is a more defensive way to add equity-like exposure within your portfolio. We traded to cash nearly two months ago near the top of the last up trend. I get excited when prices decline and yields expand. The re-entry at lower prices/higher yields sets up the next future opportunities.

The Merrill Lynch High Yield Master II Index's option-adjusted spread is approximately 801 basis points. In English, that is 8% higher than 5-7 year Treasury bond yields. My favorite HY analyst is Martin Fridson, Global Credit Strategist for BNP Paribas Investment Partners. Martin's model sees fair value at 368 basis points. This means the HY market is pricing in a great deal of recession fear. Martin forecasts a default rate of 5.1%. The high yield market currently yields around 9% with a yield spread of nearly 8% over safer treasuries. It is getting more attractive.

In my opinion, the odds favor a recession by 2012. Europe's a mess with estimates of a $2 trillion to $6 trillion fix required. Who's going to provide that money? From where? I'm not sure anyone really knows. The EU is positioning to put a defensive ring around its banks. The great debt unwind continues. These are not normal times.

There will be tradable market rallies and I believe a 4th quarter rally lies ahead. No guarantees, we'll see. November through January is historically a seasonally positive period for HY's and the equity markets in general. That should make for a good HY trade but I remain concerned about the coming recession so a strong defense is important. Frankly, as bad as recession sounds, if you are positioned correctly there is great opportunity. Post recessions, HY's are a great asset class. Stay tuned.

1/3rd, 1/3rd, 1/3rd – Equities, Fixed Income and Tactical/Alternative Investment Solutions:
Finally, I believe it is important to remain tactical, risk protected and balanced. Fortunately there are a number of liquid strategies and mutual funds available for you to broadly diversify your portfolios. Bear markets favor an over-weighted allocation to tactical and other alternative strategies. To me, today a balanced portfolio is 1/3 rd, 1/3rd, 1/3rd.

I hope you find this information helpful. Past viewpoints are posted on our website. Additionally, I'm often asked if there is a way for me to provide more frequent "Investor Sentiment" charts. I'm going to add the most recent charts under our CMG Insight page weekly. Click here to go directly to CMG Insight's. See "Sentiment Charts 10-10-11".

With kindest regards,

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