CAPITAL MANAGEMENT GROUP, INC.

Alternative Investment Strategies

The Blumenthal Viewpoint

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2011 Outlook: The Good, The Bad and The Ugly

Below I bullet point the probabilities as I see them. In short, I see a better start to 2011 supported by some positive technical patterns; however, I see a much more difficult second half. Today, bullish sentiment has reached levels last seen in 2007 and risk is much higher than most imagine. I continue to believe we are in a long-term secular bear market cycle. Secular bears tend to last a long time (the shortest in the last 113 years lasted 17 years). The current secular bear started in March 2000. Given the fundamental backdrop, I suspect that the current secular bear has another seven to ten years before a bottom is found. I expect a period of choppy to sideways action - some great rallies, some painful declines, with nominal net progress for the traditional buy-and-hold investor. As Bill Gross pointed out in his October letter, "a future of low investment returns, and a heap of trouble for those expecting more, is what lies ahead".

I believe investor sentiment will be a key driver in 2011. It will be important to establish portfolio protection at times of optimistic extremes and take the protection off at pessimistic extremes. There are a number of tools available for you to utilize in this regard. Ask your advisor or send me an email. I'll be happy to give you a few ideas in regards to how to follow sentiment data and better manage your portfolio's tail risk using inverse ETFs and index funds.

Please know that this information is for discussion purposes only and not a specific recommendation for your portfolio. The key take away from what follows is that risk today is elevated. While the Fed has incented the "risk on" trade today, beneath the surface the issues remain large. In my best attempt to cut through the economic noise, my two cents on the probabilities I see them follow.

The Good:

- Third year of a presidential cycle is very bullish (especially into the first half of the year). Traditionally a period of good news/promises from Washington.
- Fed policy supports the risk trade (for now)
- Credit conditions are favorable
- Earnings growth is steady
- Our research supports a continued rally into the first half of 2011 followed by a difficult second half when the next bear cycle returns (I am watching this closely - should our indicators change I won't hesitate to adjust my thinking).
- Economic momentum is now positive yet this is a confusing indicator for many investors, i.e. the market was at a much better buy level when the economy was in distress in late 2008 and 2009, and was at an attractive sell level in 2006 and 2007 and early 2000 when all appeared to be strong (remember the goldilocks economy – not too hot, not too cold, just right). For now a plus.

The Bad:

- Rising interest rate pressures intensify tied to credit issues
- Municipal defaults – underfunded pensions and other fiscal strains at the state and local government levels equals rising interest rate pressures.
- Underfunded pensions
- Commercial real estate debt issues remain large.
- Sovereign Debt – problems resurface as we head towards a reset. More debt on top of unmanageable debt does not fix the problem (a temporary band-aid).
- Valuations – the December Shiller P/E ratio has risen to 22.7. This is a relatively high valuation reading. Assuming corporations can achieve the historical 6% earnings growth rate, a valuation reversion to the historical (non-bubble) Shiller P/E norm of 14 would require seven years of 6% earnings growth and produce zero growth in prices. Source: www.HussmanFunds.com "Current Environment"
- Growth? – Will it be the historical 6% growth or will it be the Bill Gross – Mohamed El-Erian Pimco 2% new normal growth rate?
- Investor sentiment has now reached a new high for 2010 and is at the highest level since 2007, just before the last market high. This is bearish.
- The 2% S&P 500 dividend yield is too low. The last time it was this low was in the summer of 2000. Research from Dr. Christopher Geczy and his team at ForeFront Analytics show that from 1960 to present, when an investor's starting point is at a time of low dividend yield, the following seven year return is nominal. The reverse is true when an investor's starting point is at a time of high dividend yield. This does not paint a pretty picture for achieving the kind of returns many investors are hoping for over the next five to seven years.
- Technical patterns are weakening: We are seeing a number of technical divergences. The number of stocks in the S&P 500 that are making new 52 week highs is declining while the index itself continues to rise. This is a concerning technical pattern.
- Housing: There remains an existing inventory of unsold homes. According to David Rosenberg's December 23, 2010 Breakfast with Dave: "The unsold existing inventory is still 80% above the historical norm, at 3.7 million homes". Low turnover, lower values, lower tax revenues for struggling municipalities and all of this at a time where mortgage rates are at the most attractive level in generations. Little movement, less consumption, very concerning.
- Bush bonus checks in 2008, TARP in 2009, Car Credits, QE2 in 2010, a tax compromise that offers fiscal reassurance near-term, interest rates held forcefully low, and we are just barely squeaking out growth. While there is better economic momentum, it is largely synthetically stimulated momentum at the cost of ever increasing debt.
- Total US Government Debt to GDP peaked at 121% during WWII. It declined to 32% Debt to GDP in 1979. It has reached 93% in 2010. US government debt now totals $13.7 trillion. GDP totals $14.7 trillion. This from John Sica, President of Meridian Capital Partners, Inc.: "Over time, the excess credit currently being pumped into our economy will undoubtedly translate into inflationary expectations and higher future interest rates. The important take away from the decade of the 1940's is that the Federal Reserve can keep interest rates low for very long periods if it is committed to fighting against high unemployment and potential economic contractions. In many ways, what we see in the Fed's QE2 policy in 2010 is similar to the policies utilized in the 1940's. While the timing is unknown, we can be confident that these policies will again result in higher interest rates in the future…Today, while we have significant government stimulus programs, the spending has not provided the intended impact of growth in jobs and increased economic output." I agree.
- Important differences between the 1940's and today: Then, there were negligible Social Security benefits, no Medicare, no 99 week unemployment insurance for 30 million Americans (just under 10% of our population), 41 million Americans were not on food stamps, and one out of seven mortgages were not delinquent or in foreclosure. How do we possibly drive growth while we work our way

through the deleveraging process? I don't believe more debt is the answer.
- Fed policy is ultimately inflationary. Foreign governments are papering away. Inflation is always a monetary phenomenon. As we aggressively ease, so do our competitors. More and more liquidity equals inflation.
- Interest rates are near 50 year lows - yet investors are plowing money into bond funds at exactly the wrong time (tech stock/equity market bubble in the late 1990's, housing bubble in 2006 -2007, bond bubble today). Can interest rates move higher? Look at the following chart – specifically 1962 to 1982. Rates can move higher. I believe most investors have little understanding as to the risk they are taking.

10-year Treasury Yield 1962 to Present

- Investor sentiment is alarming bullish. It is currently at levels last seen near the last cyclical bull peak in 2007. The little guy is beginning to buy back into the market. Fear and greed. Greed is back on. Yet insiders are going the other way (see next bullet). My money is on the smart money.
- From Rosenberg – November 12, 2010 Breakfast with Dave: "Insiders sold a record $4.5 billion of their stock last week. Just as the big boys are taking chips off the table, the retail investor is back, having plowed money back into equity funds in three of the past four weeks (with inflows of $729 million last week). $4.5 billion is the biggest weekly number ever recorded by tracking company InsiderScore.com. No other week ever had more than $2 billion in net selling."
- The average short-term cyclical bear correction within a long-term secular bear cycle is -34% (according to Ned Davis Research). I believe we'll see the decline begin in 2011 and run into 2012.

The Ugly:

- December 29, 1989: It has been 21 years since the Japanese market reached its bull market high. The NIKKEI 225 Index peaked at 38,915. It closed December 29, 2010 at 10,344. Still 74% below its bull market high.
- In March 2000, most investor portfolios were heavily overweighted Technology. Nearly 75% of the assets at Fidelity Funds were allocated to their technology oriented funds. The NASDAQ peaked on March 10, 2000 at 5,048. It closed December 29, 2010 at 2,667. Still 47% below its bull market high.
- September 2010 turned out to be the best September for the stock market since 1939 and the best monthly performance for the S&P in ten years. So is it time to get excited about the stock market? The last time the S&P was up roughly 10% in one month was March of 2000. That was followed by a 50% decline in the market over the following three years. After September 1939's performance, it took ten years before we entered a secular bull market. Be careful not to get overly drawn in by the excitement of a short term cyclical bull market move. Secular bear markets last a long time.

- US Secular Bear Markets: 1966-1982: The bear market started with the DJIA at 969 and a PE Ratio of 21. It ended with the DJIA at 875 and a PE Ration of 7.
- This past October marked the three year anniversary of the 2007 S&P 500 peak (it hit 1,565 on October 9, 2007). As a historical guide, it took 15 years for investors to recover from the Crash of 1929 if they had reinvested their dividends. The S&P 500 closed December 29, 2010 at 1,260. Still 19% below its 2007 high.

In summary, the market has some favorable technical winds at its back and the short-term benefits of an out of control Fed creating unheard of amounts of liquidity. Valuations are reasonable yet not attractive relative to potential growth rates. I believe the risk trade will drive the markets higher into the first quarter of next year and I personally have plans to get defensive by the end of April. How much higher? As a pure guess, I think the S&P 500 could cross 1,400. Ned Davis Research sees Median Fair Value at 1,152. A 1% standard deviation to the upside puts an overvalued extreme at 1,535. I don't think we get there. A 1% standard deviation to the downside, from Median Fair Value, puts the market at an undervalued extreme of 766. I don't think we get there either. On the downside, I see a 34% correction beginning in the second half of the year and running into 2012. A 34% correction from 1,400 puts the market at 924. I think 900 to 1,400 is a reasonable range over the next three to five years. Bear markets are long-term choppy to sideways periods. They have some very good gains and some painful declines. It is an environment that is difficult for traditional buy-and-hold. It is an environment that needs to be navigated differently.

I spend a great deal of my time reading market research. This research, from independent research firms like Ned Davis Research to monthly investment letters from several of the brightest hedge fund managers in the business (who have their and their investors' money on the line), helps to form our outlook. A lot of great information is available to you for free. I have great respect for John Mauldin, Bill Gross and Mohamed El-Erian at Pimco, Jeremy Grantham, David Rosenberg and John Hussman.

In conclusion, caution is advised as the post crash recovery rally comes to an end. As expressed clearly by Jeremy Grantham: "You (the Fed) can drive a market higher yet eventually, of its sheer overpricing, it will eventually pop. Be aware that the ice is thin. It's a dangerous game. Don't believe that it's somehow justified. It is not justified by anything except the crazy behavior of the Fed. The problem is in the not too distant future, stocks will be too expensive and they'll crack again. Fixed income will be too expensive and that will crack again."

CMG Investment Forum:
On February 3-4, 2011, CMG will be hosting an Investment Forum in Las Vegas. John Mauldin will be presenting his thoughts on the economy and opportunities he sees ahead. Dr. Christopher Geczy, Adj. Associate Professor of Finance at the Wharton School, will share his insights on the investment landscape and show you how you can construct a liquid multi-generation portfolio. Chris consults on a $6.3 billion endowment-style portfolio for a major US financial institution. Jim Ruff, retired President of Oppenheimer Funds, will discuss how he invests his personal retirement portfolio. Jim has pretty much seen it all and will give an industry insider's view to investing. To view the invitation, click here. For more information, please send an email to Linda@CMGFunds.net or call her at 610-989-9090 x140.

Wishing you a happy, healthy and safe new year!

Steve

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