CAPITAL MANAGEMENT GROUP, INC.
Alternative Investment Strategies

The Blumenthal Viewpoint

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Extreme Investor Optimism - Risk is high

It seems that everywhere you turn, everyone is bullish. Spend a few minutes watching CNBC and you can feel the constant stream of excitement. Following is the most recent NDR Crowd Sentiment Poll. What concerns me is that Optimism is in the Extreme (Bearish) zone, in fact, it is at the highest level since September 2007 (the S&P 500 was at 1550 that September. It bottomed at 666 a year and a half later).

NDR Crowd Sentiment Poll

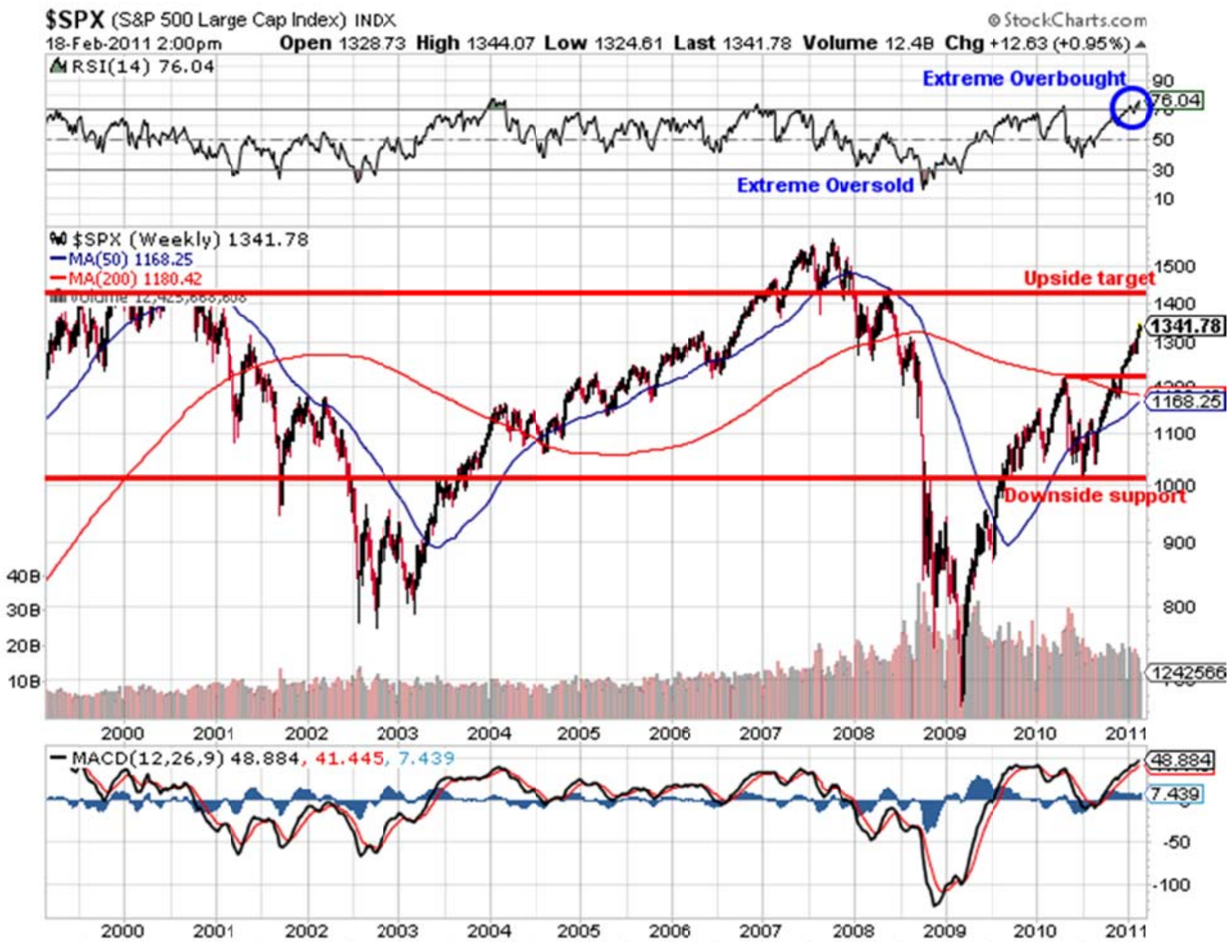
Remember in March 2000, the S&P 500 index reached a record high of 1550. By October 2002, the S&P declined 50% to 770. It then took five years to climb back to challenge 1550 (September 2007). We all know what followed. It seems that it takes years to grow return and seemingly overnight to give it all back. Such are long-term secular bear markets.

I argue that it is not the economy that drives the market but supply and demand and investor sentiment. The market valuation at the point in which you begin investing is what matters most over the years to follow. Start at low valuations and a lot of the risk is taken out of the equation. It is not the economy. Note that the economy grew about the same pace from 1966 to 1982 (a long-term secular bear market) as it did from 1982 to 2000 (a long-term secular bull market). One experience led to flat returns over 17 years and the other led to the greatest bull market move in history. Earnings growth and economic growth were roughly the same.

I have trouble buying into the hype that "the economy is now OK" as a reason to buy the market. The economy was strong in September 2007 and it was weak in March 2009. It was best to be a buyer in March 2009 when the economy was bad and it was best to be seller in September 2007 when the economy appeared invincible. It's not about the economy. I believe investors have it backwards - thus data reflecting buying and selling at the wrong times. Following is a link to Crestmont Research's valuation chart: Crestmont Research: Secular Bull & Bear Markets Profile - 2010

Today valuations are at a level that I believe will produce nominal net returns over the next five to seven years (at least if history is any guide). I continue to believe we are in a long-term secular bear market environment with significant issues beneath the surface (e.g. sovereign debt, municipal debt, required deleveraging, and inflation pressures/higher interest rates in the years ahead). Shorter-term I believe a new cyclical bear market lies ahead. Data from Ned Davis Research reflects that the average short-term "cyclical" bear market correction within a long-term secular bear environment is -34%. Risk exists.

Here are the probabilities as I see them: Several months ago the S&P 500 Median PE Ratio was 17.3 (based on actual earnings). Then, based on earnings, that put the Median Fair Value at approximately 1152. Perhaps today the fair value on the S&P is 1225. As of January 31, 2011, the S&P 500 Median PE Ratio was 16.7 (based on actual earnings). Not too bad. Based on the recent PE low of 15 and actual 12 months S&P 500 earnings of approximately $77 (through December 31, 2010) and giving the benefit of the doubt to some pretty good recent earnings reports, let's call the most recent actual 12 months' earnings $80; my best guess is that the fair value of the market is somewhere just north of 1200. A one standard deviation move higher would put the S&P 500 at an overvalued level of 1550. I don't think we get there. A one standard deviation move lower would put the S&P 500 at an undervalued level of 800. I don't think we get there either. I believe we see a range of 1000 to just north of 1400 (see below chart). Note that historically the first two quarters provide most of the third year presidential cycle gains. This cycle is no different as the markets have experienced significant moves. The market is up 13% since the beginning of the cycle in November 2010. I believe most of the presidential cycle move is baked in and now is the time to get defensive (unfortunately now is the time that far to many investors feel it is safe to get back in).



Risk is high. My best guess is that there is 5% upside potential and 34% downside risk. I don't like the odds – especially tied to today's extreme optimism. I think it is a "sell by May and go away" type of year. Cyclical rallies within long-term secular bear periods have historically averaged 26 months (source: NDR DJIA Median Performance After Cyclical Bottoms Within Secular Bears). The bear market low was 666 on March 6, 2009. 26 months gets us to May 6, 2011. I remain long in my 401k, giving the upside the benefit of doubt. I'm happy but getting ready to get defensive again. Opportunities always present themselves. There are a number of strategies one can employ to position a portfolio more defensively. Please know that this information is for discussion purposes only and is not a recommendation to by or sell any security.

[Click here to link to my 2011 outlook commentary]

Please speak with your Investment Advisor Representative for specific advice.

With kind regards,

Steve

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