CAPITAL MANAGEMENT GROUP, INC.

Tactical Investment Solutions

The Blumenthal Viewpoint

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Deep within the Atlantic, on the silent ocean floor, you hear a click where no sound sounded before.

It grows and in growing unsettles the sediment of ages. Tectonic plates grind through the earth's crust and as they do, the liquid center of the earth erupts in fire. Ashes spew and fall, layer upon layer, until a pause ensues and a dome of burning rock settles over all.

The waiting begins.

Okay, so I'm being a little, just a little, hyperbolic.

It doesn't take a volcanologist, or an economist, to decipher this metaphor. All we need do is look to Washington, to New York, to London, Athens, and Lisbon, Madrid and, lately, perhaps to Rome to see that the global economy is in very real trouble.

In the U.S., everyone who is up on such things knows that unsustainable pressures have been building for some time. Unfunded entitlements. Uncontrolled spending. A rising national debt. Hardening unemployment numbers. Increasingly fractious politicos of all stripes. Deeply unhappy citizens. A not-recession recession with no end in sight.

The latest eruption came in the form of a bitter fight over how to address the national debt and keep the "full faith and credit" of the United States in "AAA" territory. A dome, of sorts, was created with the literally last minute agreement to fund the government to the tune of an immediate infusion of $2.5 trillion in debt (albeit with roughly matching cuts over a 10-year period).

But, as any volcanologist can tell you, a dome such as this can contain the pressure for just long. Only two things can happen. The pressure can build and build until this temporary bandage breaks apart and it explodes with massive force. Think Krakatau. Or, side vents can open, one by one, relieving the pressure and thereby averting catastrophe.

Well, enough about doom and gloom. I am, by nature, an optimist. This is not the optimism of the blindly hopeful, but the optimism of experience. The money, the value, the investment does not simply vanish, although day-to-day market movements sometime make it appear otherwise. It just moves around from one place to another, as investors seek value in a turbulent universe.

Look at our various crises of the recent past…housing, financial, tech, etc. People who started out in roughly the same shape often ended up far differently. Some bought beach houses and others had trouble with their mortgages. It just moves around.

Certainly, this is the simplistic view, yet one grounded in very hard reality. The very hard part comes in deciding how to move it around as market dynamics ebb and flow.

First, the Badder News

Okay, so we've barely touched upon some of the broad problems facing investors in today's marketplace. Let's get a little more specific. Some highlights.

From John Mauldin, "There is no way to spin the GDP report that came out recently as anything but very bad. It was just last May that consensus second-quarter GDP growth stood at 3.3%. Subsequently, this was revised downward to 2.7%, *but the final number came in at just 1.3%*. Normally, at this time in a recovery we are growing at close to three times that number, or 3.6% (you can see the data at http://www.bea.gov/newsreleases/national/gdp/gdpnewsrelease.htm).

Even worse, the first-quarter number was revised down from 1.90% to an anemic 0.36%. For new readers, note that the first estimate of a quarter's growth is just that, an estimate. Three monthly revisions follow, and after a few years, it is revised yet again with the aid of hindsight. With this in mind, 4th quarter of 2010 GDP declined from 3.1% to 2.35%, with further revisions yet ahead!

And it gets worse. The Bureau of Economic Analysis went back and revised the numbers for the recession. It might surprise you to learn that the recently "ended" recession was worse than we thought at the time. The peak-to-trough decline was 5.1% instead of 4.1%. That means that in real terms the economy has not yet recovered to pre-recession levels."

David Rosenberg (via Mauldin) notes that "going back to 1947 and never before have we seen this dynamic of the level of overall economic activity lower on the second birthday of the recovery than it was at the prior cycle peak. Typically two years into a recovery, real GDP is already 9.5% *above* (emphasis mine) the pre-recession high."

This is just ugly. Now, notice the direction of the revisions. Care to wager the over/under on where the revisions will go when the BEA revises second quarter further still? Might it be not simply a decline in the positive, but a step into the negative?"

And we are not alone. Europe's financing needs over in the next several years (namely Italy and Spain) are massive. Unfortunately, Europe's political and economic structures are not built to deal with this kind of crisis. At stake is not just the solvency of several countries, but the future of the European integration experiment. A favorable growth environment? Doubtful.

I Believe There is a Recession in Our Future – Target 2012

Rich Yamarone, Chief Economist at Bloomberg sent an email to Mauldin saying that if year-over-year GDP growth dips below 2%, a recession always follows. It is now at 2.3%, with the second quarter already revised downward to 1.3%, or well below Rich's recession threshold.

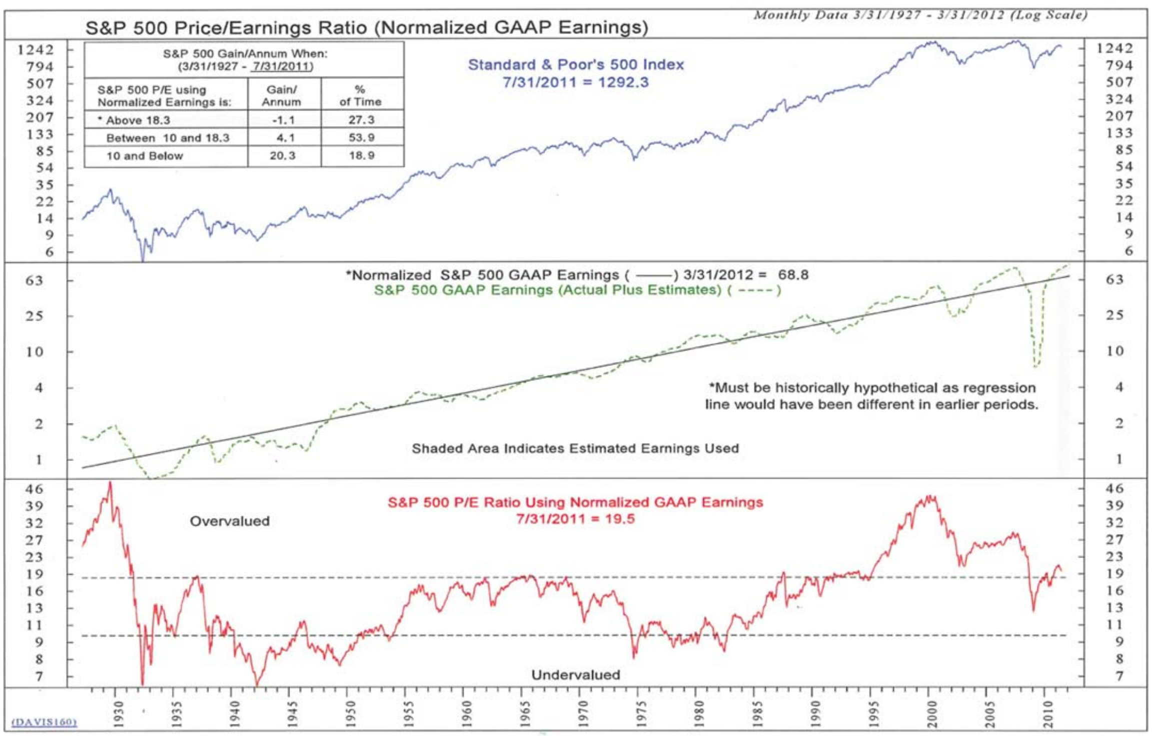
The long and short of it is that the economy is stalled, if not receding. It will not take much to push us into an outright and painfully acknowledged recession.

Enough about GDP. More importantly, keep in mind that the stock market historically drops about 30-40% on average in a recession.

What to Do About It

I could spend more of your time and my own delineating all the many and variable indicators that suggest that rough times have arrived. You might say we've already experienced them. Can get back to where we were, now that the worst is behind us? Yes, but think choppy to sideways similar to the 1970's. Is the worse behind us? More is likely to come. We are in an environment that favors trading strategies and punishes buy-and-hold.

In the period 2000 to 2002, when P/E's on the DJIA were at 42 on average, the market declined 50%. As I write, the S&P 500 P/E Ratio (Normalized GAAP Earnings) is at 19.5* and falling. *source: Ned Davis Research as of 7/31/11.



So, I don't have to step very far out on a limb to suggest that we are in a secular bear market. Studies show that secular bear markets last many years. Of the four secular bear's in the last 113 years, the shortest lasted 17 years. They typically end with P/E's below 10. In secular bears interest rates start low and move higher. This is where we are today. In secular bull markets interest rates start from high levels and move lower. A 17 year secular bear would target 2017 as the year we might exit from the bear market that currently persists. It could be sooner, but maybe not, and maybe much later. If you are traditionally positioned 60% equities 40% bonds (buy-and-hold), you need to change your thinking. These are deleveraging times.

How to Position Your Portfolio in Either Case?

It is important to protect long equity exposure by putting portfolio protection in place during periods of excessive investor optimism and unwind that protection during periods of excessive pessimism. Think of it as insurance protection against loss. It is cheapest at points of extreme optimism and richly priced at points of extreme pessimism. An intelligent strategy in long-term secular bear periods.

My point today is to focus on the big picture. Look at the probabilities ahead and position accordingly. For my part, I see a balanced portfolio today consisting of 30% equity (hedged as I suggested), 30% tactically managed fixed income and 40% to various Alternative-Tactical investment strategies.

This is very different from the 60% equities and 40% fixed income recommended by traditionalists. News flash: that long approved mix has not worked for 10 ½ years! If you are more bullish then me, overweight equities and low interest yielding bonds. If you are more bearish, consider a mix of 20%, 20%, and 60%.
Importantly, there are many Tactical strategies that allow you to profit in up and down periods. We have a number of attractive Tactical Investment Solutions, and we would be happy to discuss them with you.

In sum, we are sheltering under a pressure dome of quick fixes and Band-Aids that sooner or later will have to be vented and/or replaced with fortified adamantium.

As a passing note for those who don't know me and the overall accuracy of my prognostications, I will gladly send you past issues of this letter which project major market trends and inflection points going back to the 1990s, along with the follow-up market results.

I sincerely hope I am wrong about the wrongness of the U.S. and global economies. Recessions are painful and bear markets are costly if your portfolio is not properly positioned. There are investment solutions that may work for you in this environment, regardless of whether I am accurate as to its future progression. Find them!

With kindest regards,

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