CAPITAL MANAGEMENT GROUP, INC.
Tactical Investment Solutions

The Blumenthal Viewpoint

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Ogres and the Wiley Coyote Moment – It's About Inflation and Rising Interest Rates

I am one of the many millions who like editorial cartoons. I missed out on the family artistic gene though my talented daughter who took AP Art in high school claims that I am pretty good at drawing Sponge Bob. Even lacking technique, I often find myself imagining the cartoons I might have drawn.

Picture an editorial cartoon. Imagine a frightened person, let's say a typical investor, walking down an empty path (you can make it nighttime if you want) when suddenly he comes upon two ogres flanking the way ahead. These are really big, warty, mouth-drooling ogres that go by the names "Inflation" and "Rising Interest Rates". The investor looks anxiously side to side, wondering where and when the beasts will strike.

I can't even begin to draw an accurate picture of how threatening these economic beasts are to your future well being, but I'll give it a shot from the perspective of a fixed income specialist with over 20 years of experience trading bonds.

Let's take a brief look at some of the issues, notably:

1. When interest rates go up, your fixed income positions lose value (I'll illustrate the math in the following charts, which I do have some skill in drawing);
2. Investor behavior hurts returns. Even in good periods for bonds, investors lose money (chart below);
3. Fortunately, there are strategies designed to prosper no matter which way interest rates move. I'll detail one such strategy, our CMG Managed High Yield Bond Strategy.

Let's begin.

Over the years, I've written a great deal about secular bear market tendencies, sub-prime, unmanageable global debt, currency manipulation, cyclical bull and bear market moves, money creation, valuations, investor sentiment, and portfolio construction. My overriding theme has been, and remains, that, from the nation's capital to the smallest town, we are loaded with unmanageable debt. As such, the investment environment remains dysfunctional, out of balance. We can pretend it isn't there and invest accordingly, but we would be kidding ourselves and, in doing so, suffer unpleasant consequences.

I know, you know, we all know that I've said the same thing many times before. In fact, your eyes must glaze over, much like mine when I take my car to a too-talkative mechanic. I have no interest in how an engine works. I'm thinking "Just fix it; don't tell me why it's broken". Perhaps that's how your clients feel about the economy and the markets (if you are an advisor), or how you feel (if you are an individual investor) as you listen to your advisor. With this in mind, I'll get to the point with a minimum of side trips.

The greatest portfolio risks are without doubt the coming growth in inflation and higher interest rates. When these two forces come into play, they will have a direct and more than meaningful impact on the millions of investors and the trillions of dollars that have flown into bond funds (despite historically low yields). How they affect you depends on your asset allocation mix. Get the construction right, and you should be fine. Stay with 60% equities and 40% fixed income and you'll be fine…*in 30 years* (assuming you can stay the course). If your time horizon is a bit more immediate, say the next five to seven years, you have some serious decisions to make.

Here's the problem. In the U.S. we are spending $1 trillion more than we are collecting in gross tax receipts. This deficit has been financed with ease, thanks to the Fed's magical creation of dollars out of thin air and then buying the resulting debt. There was TARP, QE1, and QE2. Cash-for-clunkers, payroll reductions, tax credits, operation twist and every artificial (meaning unfunded) market stimuli available.

Yes, the economy is doing better (nominally, at least), but it is an economy on steroids. We have created over $3 trillion in new money backed by nothing more than political promises and faulty projections, and we all know how comforting these are. Even now, evidence suggests that QE3 has begun. What might come after makes me cringe.

If this inability of our government to get its fiscal house in order isn't enough to turn your stomach, we now owe over $15 trillion. Somebody once told me, wisely, that people tend to lose track of something as immense as one trillion dollars. Not to be pedantic, but think of it as $15,000,000,000,000, divided amongst some 350 million people, more or less, or roughly $42,000 per person. That is more than 100% of our GDP. Add in another $50 trillion in unfunded social security, Medicare and several other entitlement programs and our real debt rises to $65 trillion. Make that roughly $175,000 per person.

As can't be stressed enough, we simply owe too much money now, and in a future of compounding interest payments, it will only increase…even if we stop borrowing right now. The U.S. economic engine, the engine to the world, is still moving along, but did you hear the clank and soon maybe fatal grind the engine is making? We are not alone.

The UK has created over $3 trillion in new money; the EU has created the LTRO, which can now print new money to bail out Greece, Portugal and Spain and who knows who else (Italy? France?). China is printing merrily along, as is Japan. In all these places and others, the issue is too much debt to be anywhere near sustainable. The combined response – print new money and by doing so devalue the investments many people have spent lifetimes accumulating. Use this hidden "tax" to finance even more debt. The unintended consequence of this behavior is inflation. Like the directionally challenged cartoon character, Wiley Coyote, I can see us running off the cliff before we think to look down.

Never before in history have all the developed countries printed so much money AT THE SAME TIME. Each country has its own set of issues. Can they pull their collective hands back from the cookie jar (take the liquidity out of the system) all at the correct time? Can any one of them, or even a small group, pull on the reins? Do their politicians even want to, or are they simply going to avoid confrontation in favor of their prospects in upcoming election cycles? I may be wrong, but experience suggests they won't.

This financially irresponsible behavior simply mucks up the economic engine in a very big way. John Maynard Keynes said it best, "There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency (by a continuing process of inflation)". In the early stages, the newly created money is a stimulant and the economy responds. No immediate sign of inflation and a growing complacency sets in (just like today). Then inflation begins to show; slow at first then it spirals out of control. We did it in the 1970s and we did it in the 1930s. Talk to Germany about what currency printing did to them in the 1920s, Argentina, Mexico… and many more examples in history. I hope I'm wrong, yet historical evidence is significant. With interest rates so low today, is the risk of rising inflation and rising interest rates worth it? The risk looms large for those who are unprepared.

I carefully watch for evidence of inflation and yes we are seeing considerable commodity inflation and weak currencies relative to gold. Ok – back to plain English. If we have higher inflation, we will have higher interest rates. More to the point, take a look at just how much risk may come into play within the fixed income portion of your portfolio.

1) **The negative impact of rising interest rates.**

Here is what happens to your bond portfolio:

First, let's look at the impact on a 10-year Treasury Bond currently yielding 2.30% (top section of below chart). If interest rates move up 1% from the current 10-year bond yield of 2.30%, your bond will decline by 8.56% in value. If interest rates move up 3% to 5.3%, your bond will decline in value by 23.32%. If you own the bond outright, then you can always hold it to maturity and earn your 2.3%. The problem is that most investors have poured money into bond mutual funds and ETFs and those funds have no fixed maturity. If you do own the bond, the question also remains as to the ability to hold a 2.3% bond to maturity when inflation is at 5% and then current interest rates are near 7%. Locking in at 2.3% makes little sense to me.

Next, look at the impact on a 30-year Treasury Bond currently yielding 3.40%. If rates move up by 1%, the decline in value on the bond is 16.98%. If rates move higher by 3%, the decline is 40.66%. The impact is more penal on longer maturity bonds and bond funds (as bond funds in general have no fixed maturity date).

Impact of Rising Interest Rates on Bond Prices:

10 Year Treasury Bond assuming a 2% Coupon with a 2.30% yield to maturity						
Yield to maturity	**2.30%**	**3.30%**	**4.30%**	**5.30%**	**6.30%**	**7.30%**
Price	97.334	89.004	81.465	74.639	68.453	62.843
Change in Price		**-8.56%**	**-16.30%**	**-23.32%**	**-29.67%**	**-35.44%**
30 Year Treasury Bond assuming a 3% Coupon with a 3.40% yield to maturity						
Yield to maturity	**3.40%**	**4.40%**	**5.40%**	**6.40%**	**7.40%**	**8.40%**
Price	92.514	76.804	64.542	54.901	47.262	41.160
Change in Price		**-16.98%**	**-30.24%**	**-40.66%**	**-48.91%**	**-55.51%**

Source: CMG Research

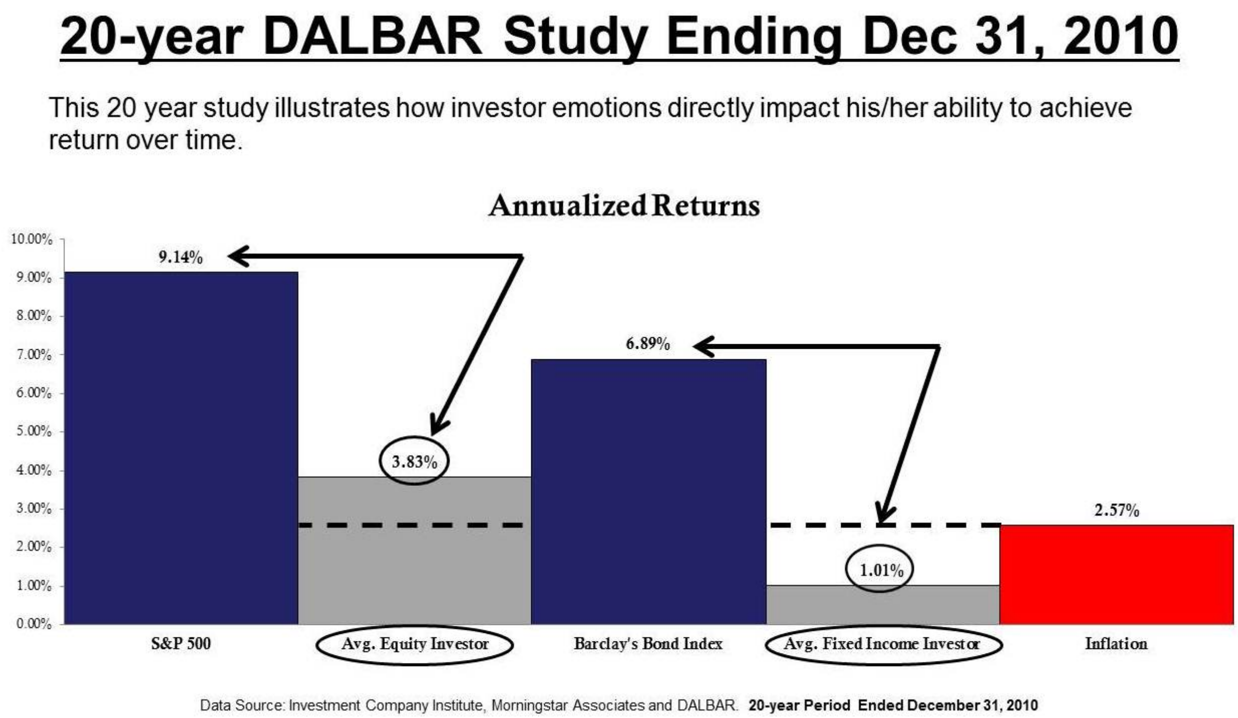
Finally, it is worth noting that risk is significantly greater when your starting point is when yields are low. For example, if the starting yield to maturity on a 10-year Treasury Bond was 7.30% (it is not that high, of course) and rates rose 3% to 10.30%, your loss in value would be *18.59%* vs. *23.32%* if rates rise 3% from current levels. For the 30-year, a 3% increase from a 7.40% starting yield, the loss in value is *27.66%* vs. the *40.66%* above. Mathematically, risk is much larger when rates are low than when rates are high. I don't believe that most investors understand what can happen. There is a bubble in bonds, yet investors are flocking into bonds and bond funds.

1) **Investor behavior:**

I've touched on one of my points from the beginning of this piece, that rising inflation and higher interest rates will hurt many bond investors. I could go on, but you get the grim picture.

Now, what impact will investor behavior have on such investments as these inevitable market forces make their respective marks?

In the following chart, I have circled the "Average Fixed Income Investor" and the "Average Equity Investor". Note the return of the Average Fixed Income Investor in comparison to the Barclay's Aggregate Bond Index over the 20 year period ended in 2010. This from a study published annually by DALBAR, one of the nation's leading financial services market research firms:



The Average Fixed Income Investor earned just 1.01% annualized on their fixed income investments over the last 20 years, compared to the Barclays Aggregate Bond Index return of 6.89%. Simply put, investors are buying and selling at the wrong time. This occurred during a period of declining interest rates and low inflation (a favorable period for bond investors). Imagine the returns in a rising interest rate, rising inflation period. We typically see 40% allocated to fixed income (bonds and bond funds) in most investor portfolios. For those who maintain this allocation, like the mechanic telling me more than I want to know, I see trouble ahead without shortening the maturity exposure and adding risk managed fixed income solutions into the mix.

What will investors do in a rising interest rate period? Hold those bonds to maturity? I seriously doubt it. Instead, they will tend to panic and sell. As you can see from the above math on interest rate movements, selling these bonds will lead to very large losses. Also take a look at the poor behavior of the Average Equity Investor. The Average Investor appears to be emotionally programed to buy and sell at exactly the wrong time (DALBAR chart).

This is why I believe strongly in an enhanced view of Modern Portfolio Theory; portfolio construction that includes a number of non-correlating risk diversifiers. I am talking about strategies that can make money in up trending AND down trending environments. One such strategy for your consideration, with a 20 year performance history, is our tactical high yield strategy. Here is the story that led to me creating CMG in 1992:

1) **CMG Managed High Yield Bond Program:**

In 1985, I was a young Merrill Lynch broker in Philadelphia. I read an article in *Barron's* about two Drexel Burnham analysts who left their firm to set up an advisory business focused on trading high yield bond funds. Interesting, I thought. Drexel had a big presence in Philadelphia and I was a fan. I had spent some time working on Merrill's options arbitrage desk (the concept of arbitrage is to drive risk free returns – though free doesn't really exist) and found this high yield trading idea fascinating.

The departing Drexel guys shared with Barron's readers a deeper understanding of the behavior of high yield price tendencies and added two important pieces of data: 1) high yield prices trend in a predictable way and 2) the higher yields help to enhance return and minimize risk. These novel observations were contrary to how most investors viewed the high yield bond market of that time.

I dove deep into researching price trends, yield levels, yield spreads (how much greater high yield bonds yield vs. Treasury bonds, high grade corporate bonds, muni bonds, mortgage bonds, etc.) and default history. When the stock market crashed in 1987, I was on a Merrill Lynch award trip in Maui. I was up all night, as the crisis unfolded, speaking with one panicked client after another. Forget the efficient market mantra, human emotion, as we see in the DALBAR study, influences returns. The experience was important to me and led to my focus on finding ways to drive return while preserving my clients' money during times of distress.

The idea within the trading process was and is to capture the high yield and also to capture price gains during periods of rising prices. When the price trend changes and moves lower, the strategy risk protects by moving to cash/money market funds. When it bottoms and begins to move higher, the strategy buys into high yield bond funds.

I was hooked and in the early 1990s created the tactical trading strategy to take full advantage of these price trend movements. The result is a time-tested approach to investing that has the potential to produce good results regardless of movements in inflation or interest rates (whether higher in trend or lower in trend) and is relatively immune to gross currency manipulations and debt overload. Of course, past performance cannot guarantee future returns.

I would suggest you consider placing a portion of your fixed income allocation in this risk managed and liquid high yield bond tactical trading strategy.

The risk I see is for interest rates to move higher than one might expect. I believe the 10-year Treasury yield may move to 8%+ in three to five years. Such a move will hurt the billions of dollars that have flown into bond funds, locking them into record low yields. The move will be in spurts, starting out slow at first, then perhaps two years from now (my best guess), rates will move rapidly higher, seemingly overnight. If I am wrong and rates stay the same or move lower, I expect our high yield strategy to perform well (no guarantees). If I'm correct, then I expect even higher returns for our strategy as the trade gets reset at higher yields (again, no guarantees).

As a trader, I'm excited about the positive impact moves in inflation and interest rates can have on our strategy. However, I am equally happy collecting a 7% yield if we were to move back into a buy signal today. Importantly, our high yield trading strategy has the ability to side step the price loss and be in a position to tactically trade back in at lower prices and higher yields - trading defensively and patiently waiting for the next opportunity.

Of course, not every trade wins. It is about risk management, capturing rising prices and high yields and avoiding major declines. There are no guarantees in this business. There are no guarantees that the performance will be as good as it has been for the last 20 years. The idea is to be forward looking within your portfolio construction.

Finally, we use the same mathematical decision process I created in the early 1990s. It is a straightforward and relatively simple process yet having the discipline to trade the process is what is most important. If you have the time, patience and trading discipline, you may be able to successfully trade this strategy on your own. It does require time and you need to have absolute and total belief in your investment process.

Most importantly, you must learn to become a skillful trader. There are hundreds of books about great traders. It's about balance, self awareness, probabilities, process, discipline and guts. It is a skill that is learned and mastered over a number of years and not over a number of days. We have such skill.

Given record low bond yields, why are so many investors loading up on bond funds? Blind to risk? Bubble? What if you do nothing with your bond investment? Look back not long ago to the bursting of the equity bubble and the housing bubble. All the money was flowing into technology funds at the market peak in 1999/2000. The NASDAQ Composite Index peaked at 5132, bottomed at 1108 and is now just over 3000. Then the housing market bubble that was supposed to never bubble? Minus 40% on that one. Now the bond bubble. The seeds are planted – I can hear the great Sir John Templeton screaming, "sell when everyone else is buying!"

The economic engine is bogged down with unmanageable debt and scary currency manipulation. Be aware, be wary, be forward looking and know that you can shape your portfolio in such a way to be more defensive and remain positioned to drive profitable returns.

Fortunately, there are a number of intelligent strategies that have the ability to enhance your returns and protect your capital. To learn more about our CMG Managed High Yield Bond Program please call us at 800-891-9092.

With kindest regards,

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