On My Radar

October 18, 2012
By Steve Blumenthal

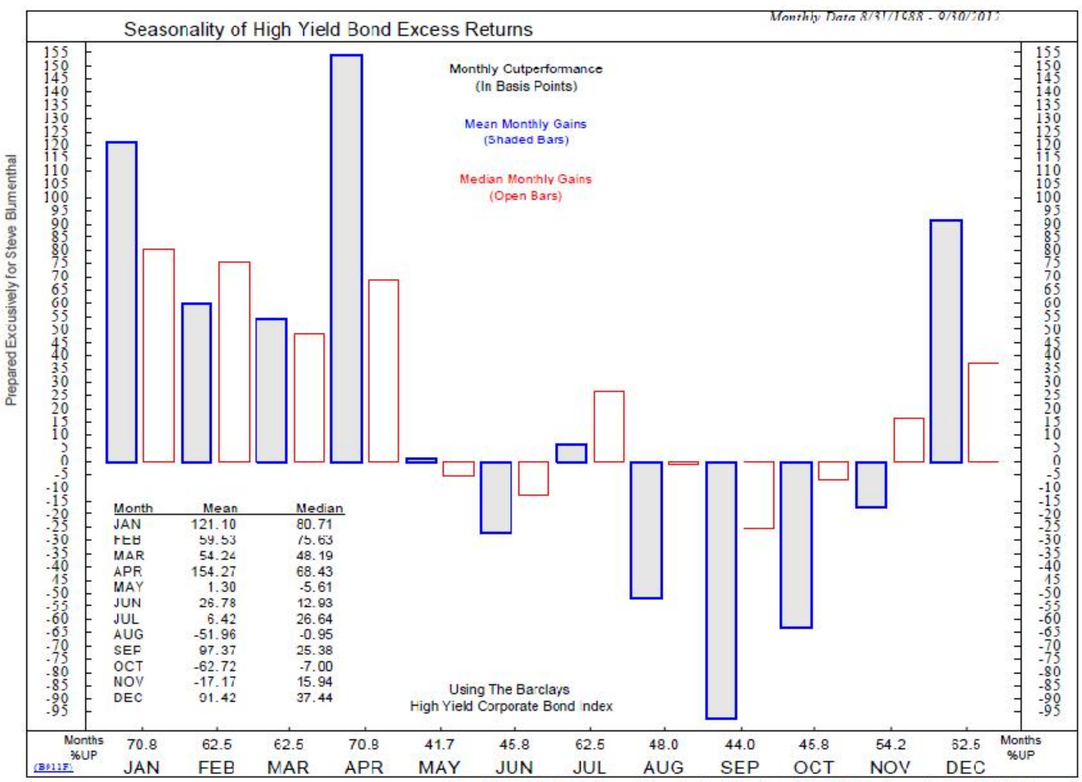
As I dive through a broad range of independent research each week, following are several ***bullet points*** I found important: High Yield Bonds, Tax Harvesting, Treasury Yields, and Investor Sentiment.

- **Seasonality of High Yield Bond Excess Returns**

  CMG Managed HY Bond Program ("CMG HY") remains in a buy signal. I share the following chart below to show the seasonally favorable periods as measured historically since 1988. The best time to invest in high yield bond funds is December through April. The worst is May through November.

  This year has proved to be somewhat of an exception with attractive returns in July, August, September and October (month-to-date). I credit QE3, the ECB and the historically favorable presidential election cycle.

  Interestingly, CMG HY was profitable every month this year with the exception of March and May. June gained 1.99%, July gained 1.00%, August gained 1.17%, September gained 0.87%, and October is looking good to date. I believe it is tied to the chase for yield and the favorable pre-election cycle. Here is the chart:



Looking forward I have some concerns. 1) Investors are pouring so much money into bond funds and underestimate the risk, 2) high yield bond yields have fallen to below 7% - one of the lowest yield levels on record, 3) I believe that a recession is coming if it has not already started (recessions are only know in hindsight), and 4) post election and the fiscal cliff.

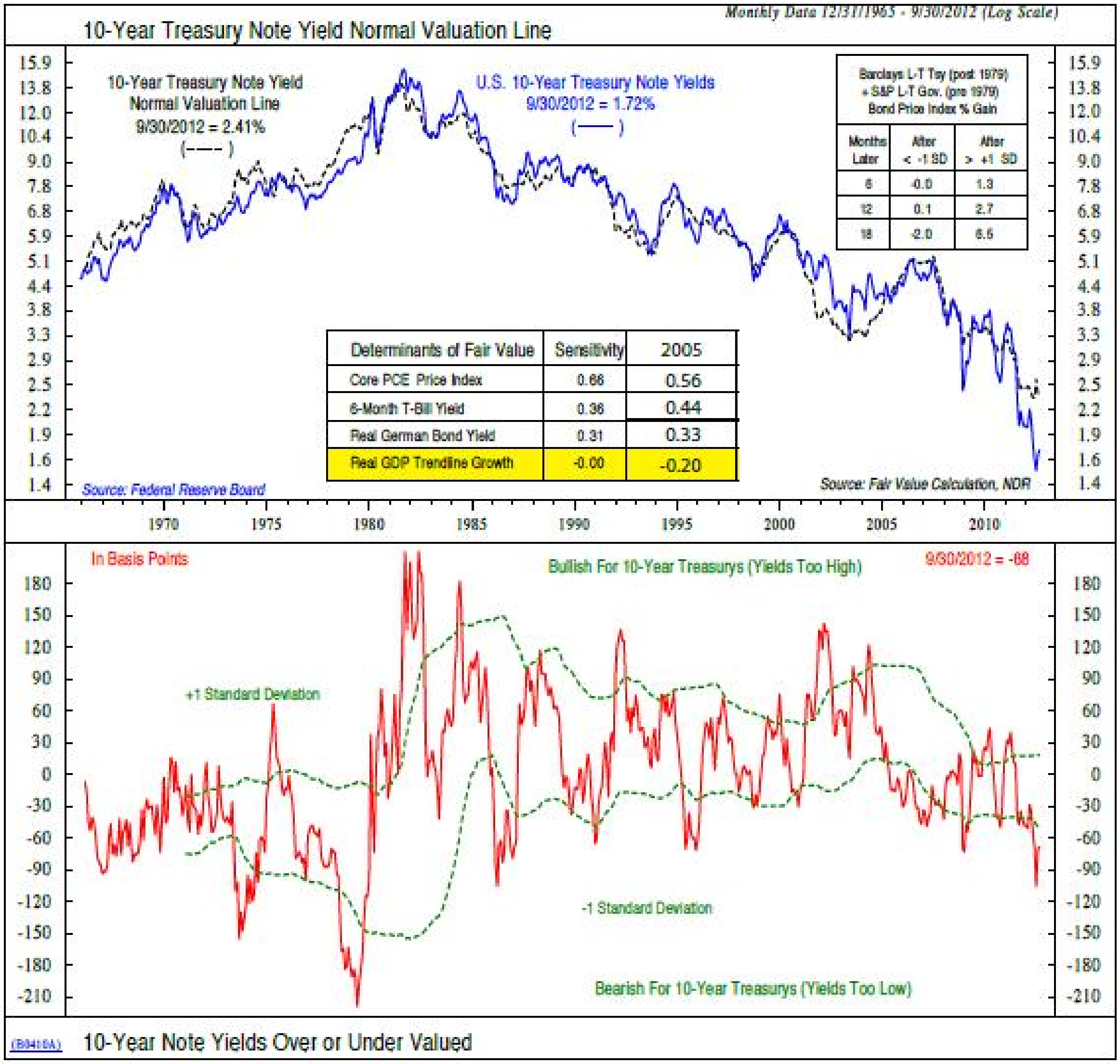
We'll continue to trade according to our defined risk disciplined trading process, just as we have for the last 20 years.

- **Tax Harvesting**
  If the Bush tax cuts are allowed to expire as part of the fiscal cliff, then the long-term capital gains tax rate is poised to rise from 15% to 20%, while short-term capital gains will see more modest increases in rates (although lower bracket thresholds will also push many Americans into higher brackets). Dividends are also set to increase from 15% to as high as 39.6% based on their treatment as ordinary income.

  Depending on the outcome of the election (Romney favoring upholding the Bush tax cuts and President Obama not in favor), I believe we will see an increase in selling pressure with the intention on harvesting the current favorable long-term capital gains treatment.

  Beyond this of course is the very large fiscal cliff issue.

- **10-year Treasury Yields are 70 bps below Normal Valuation – Ned Davis Research**

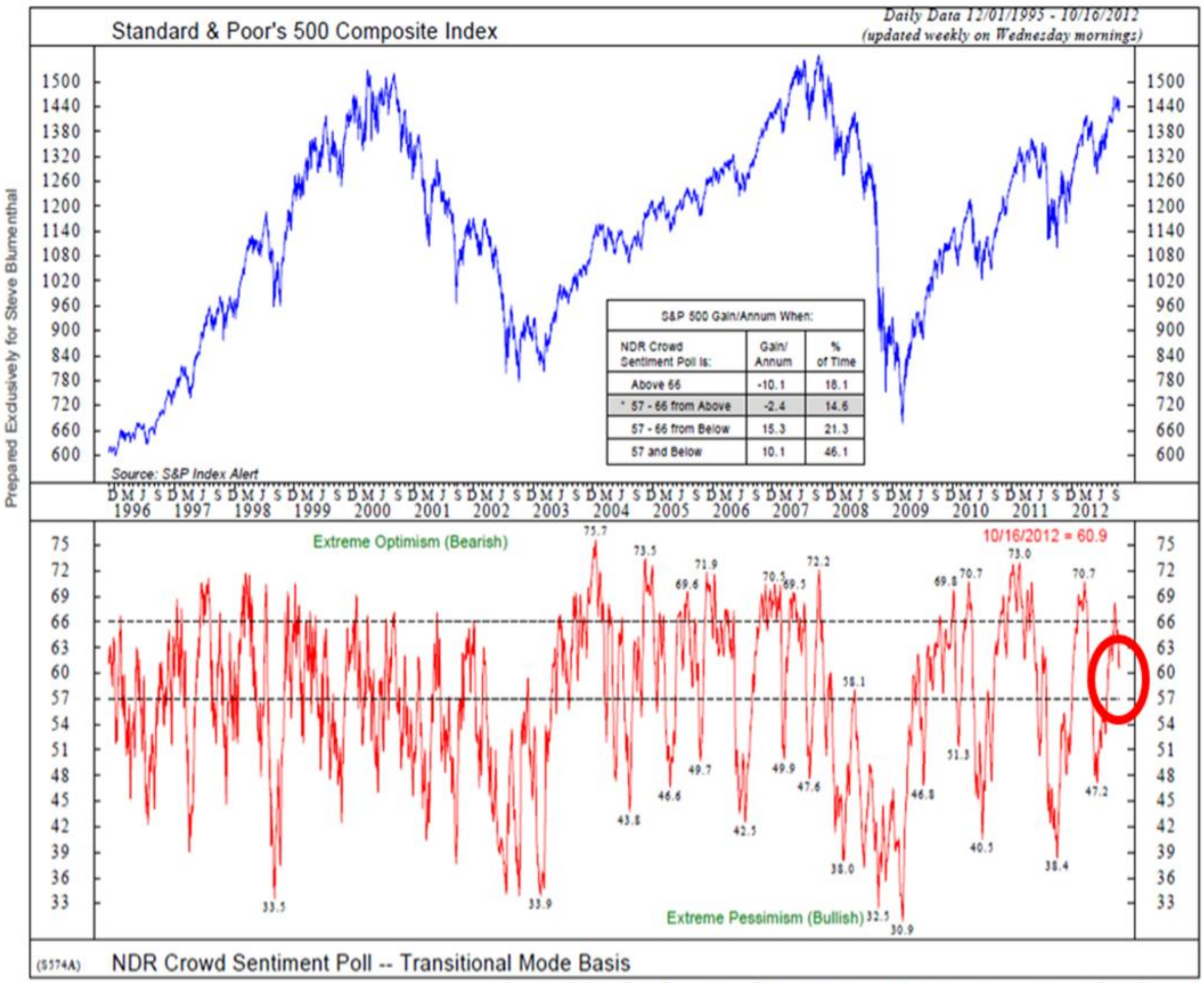


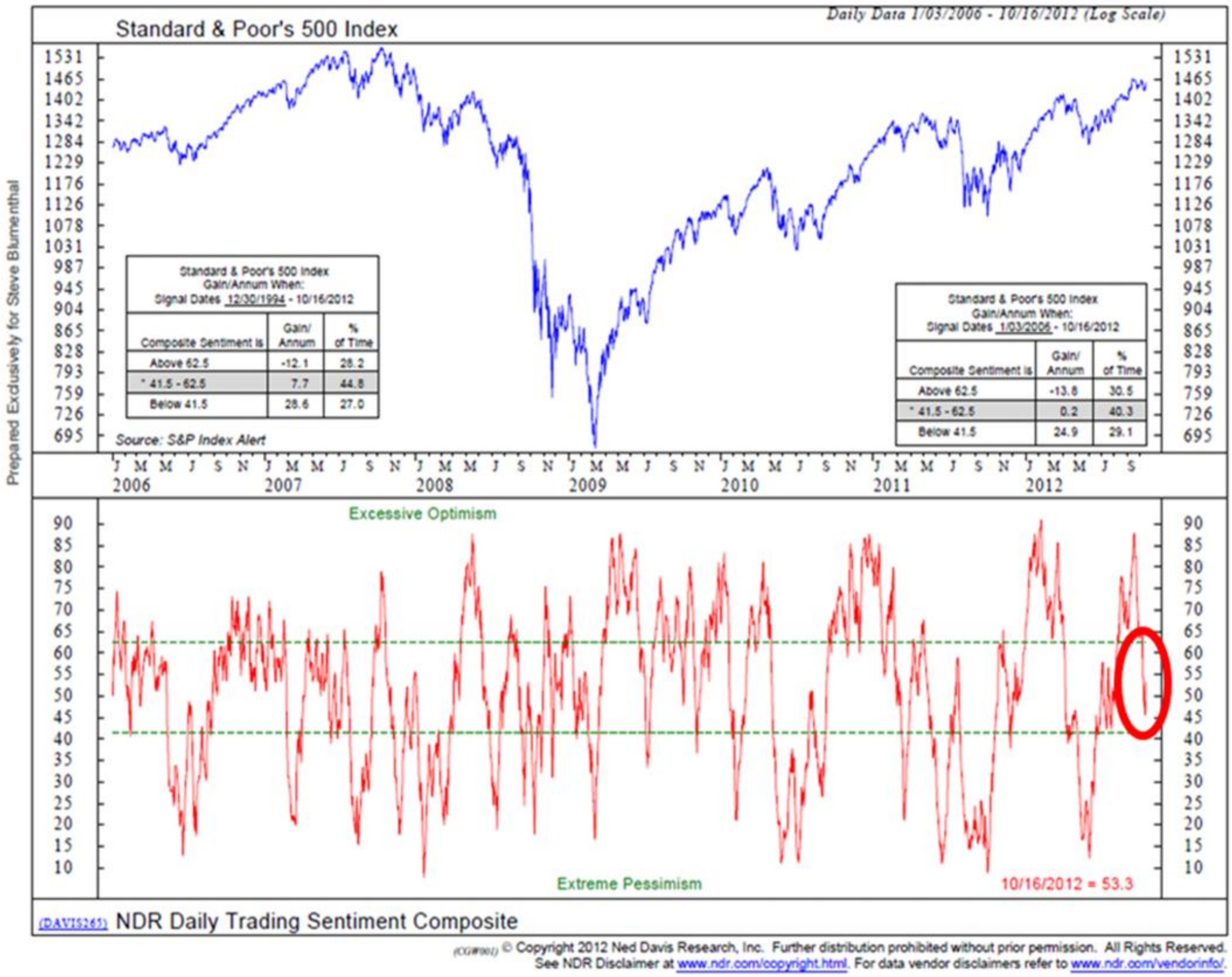
I believe this is largely due to Fed policy (zero interest, QE3 and Operation twist). From a risk perspective, it is important to understand downside exposure. A 1.00% rise in yield (from 1.70% to 2.70%) equates to approximately 8.50% in loss of value on a 10-year bond investment. The loss on a 30-year bond, given the same 1% up move in rates, is approximately 17%. Today the 10-year Treasury yields just 1.70%. It yielded over 5% in 2008. The Fed Funds rate has dropped from 6% to 0.25% over the same period.

The biggest risk I see today is in the fixed income portion of a client's portfolio. I believe most individual investors are unaware that they can lose money in their bond investments. I see deflation and low rate pressures today giving way to a new period of higher interest rates and higher inflation in the years ahead. Frankly, I think the Fed is out of control (as are the EU, Japan and China).

- **Sentiment is improving**

  On sentiment and risk management, my thinking is that long-term equity exposure should be hedged at points of Extreme Optimism and removed at points of Extreme Pessimism. Currently, sentiment has moved from the Extreme Optimism (Bearish) zone into the neutral zone. Following are my two favorite sentiment charts.





You can access sentiment charts in the piece I publish every Wednesday on our website called "Trade Signals" www.cmgwealth.com or here.

I hope you find this information helpful.

With warm regards,

Steve

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PS: When I look at the world, I try my best to view it from a probability perspective. I read endlessly and have access to some outstanding hedge fund and independent investment research. Fortunately, if you dig deep enough you too have access to a great deal of information on the internet. This certainly wasn't the way it was in 1984 when I started in the business.

I believe we are in a challenging low return environment and that most individual investors hold higher return expectations; those expectations will not be met and investors will seek a better solution. I see an unprecedented opportunity for you to grow your advisory business.

With this piece I try to share some information that I have found to be important. To me the evidence is clear, but I most certainly could be wrong.

Whether I am correct or incorrect in my thinking, my overriding belief is that you can create and manage successful portfolios for the period ahead. This environment requires more work (mixing a diverse set of risk drivers and more active beta hedging) than exists in a secular bull market cycle, but also offers you the ability to separate yourself from the 98+% of your competition that is heavily weighted in the old 60/40 stock/bond construction model.

The good news is that the investment opportunity set has been greatly expanded and solutions exist. While risk is an inescapable companion in the investment process, I believe it can be quantified and minimized by expanding the asset classes you include in your portfolios.

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