

CAPITAL MANAGEMENT GROUP, INC.

Alternative Investment Strategies

CMG 2010 Outlook

2009 Recap: The End of a Lost Decade

After a turbulent 2008 and difficult start to the year, the global economy found stability in 2009 as central banks stabilized financial institutions across the globe. Investor confidence was restored and global stock markets staged a remarkable rally (as we anticipated). In the U.S., Congress passed an \$800 billion stimulus plan and the Federal Reserve extended trillions of dollars of liquidity to the financial sector through a myriad of programs. As a result, the U.S. economy, along with most major economies, exited recession in the third quarter. However, the recovery is proving to be slow as third quarter GDP was revised down significantly from 3.5% to 2.8% and then to 2.2%. Despite tepid growth relative to previous recoveries, macroeconomic indicators were indicating some positives as housing is showing a bottom (for the time being) and unemployment looks to be peaking. Inventories of unsold homes have moderated primarily due to government homebuyer credits and home sales while housing starts and home price appreciation indicators showed modest signs of recovery from record lows at the beginning of 2009. Although job losses slowed towards the end of the year showing signs of a peak, it is disturbing that the current unemployment rate will likely exceed the most adverse levels assumed by the Federal Reserve's bank stress test, the Supervisory Capital Assessment Program. The dominant theme of 2009 was by far the expansion of the public sector as the actions of the Federal Reserve, the U.S. Treasury and Congress have provided stability but at the expense of long-term fiscal imbalances. The Federal Reserve's exit strategy in particular will be a key determinant of the recovery's trajectory.

At the end of 2009, global equity market indices were well above their March 2009 lows and have recovered more than 50% of their losses from their 2007 peak. Investor sentiment has run the gamut this past year as extreme bearish sentiment, panic and high cash levels in March gave way to strong bullish sentiment, low cash levels and investor complacency by December. U.S. equity indices finished the year strong as the DJIA returned +22.67% and the S&P 500 returned +26.46%. Technology shares outpaced both indices as the NASDAQ Composite rose 43.89% for the year.

Table 1
2009 Market Returns & Pricing
As of December 31, 2009

	<u>Returns</u>		<u>Pricing</u>
S&P 500	+26.46%	3 Month T-Bill	0.05%
Russell 2000	+25.21%	10 Year Treasury	3.59%
Wilshire 5000	+29.42%	30 Year Treasury	4.49%
DJIA	+22.67%	Gold	\$1,104
NASDAQ Comp.	+43.89%	Crude Oil (WTI)	\$79.39
MSCI EAFE	+27.75%		
Barclays High Yield	+58.21%		
DJ-AIG Commodity	+18.71%		
Credit Suisse Tremont Managed Futures	-3.93%		

Sources: PerTrac Financial Solutions, Federal Reserve, London Bullion Market Association, US Department of Energy

The end of a decade provides a moment of reflection for investors. In 1999, as we entered the new millennium, stock markets were at a peak, valuations were at illogical levels, and, unknowing to the majority of investors, the U.S. economy was about to enter an 8 month recession (March 2001 to November 2001 as measured by the National Bureau of Economic Research (NBER)), and a financially painful bear market decline. During that recession, unemployment, which is a lagging indicator, peaked at 6.3% (June 2003) and the worst quarterly decline in GDP was -1.3% during the first quarter of 2001.

Fast forward to the end of the decade and U.S. equity markets are now recovering from another recession that has proven to be much more severe. Although, the NBER has not announced the trough (typically a year behind), or end of the current recession, it is likely that it ended in the third quarter of 2009, indicating a significantly longer than average recession (as compared with the past 50 year average of 10 months). During this time, the U.S. unemployment rate has exceeded 10% and the worst quarterly decline in GDP of -6.4% in Q1 2009, was considerably more severe than during the prior recession at the start of the decade.

Over the course of the past ten years (January 2000 through December 2009), U.S. equity markets have struggled to break even. The performance numbers are not pretty. The S&P 500 (total return) has generated a cumulative ten year return of -9.09% for an annualized return of negative 0.95% while the DJIA (total return) generated a cumulative return of 13.75% for an annualized return of 1.30%. The NASDAQ Composite (total return) underperformed both indices significantly, losing -44.24% cumulatively for an annualized return of -5.67%. The returns would have been even worse if not for the rally in the second half of the year. For traditional asset allocators and buy and hold investors, it was a difficult decade to say the least. Over the same 10 years, absolute return strategies, in this case measured by the Credit Suisse – Tremont Hedge Fund Index, show a cumulative return of 88.97%, for a respectable annualized return of 6.57%. Looking at 2010 and the decade to come, investors can likely expect more of the same as much uncertainty remains on the trajectory of the U.S. economic recovery. Clearly, a new investment paradigm will be necessary to be successful in the coming years. We believe that alternative investment strategies that seek to generate absolute returns are essential to navigating a secular bear market that is likely to last another seven to ten years.

Table 2
10 Year Cumulative Return, Annualized Return and Growth of \$1,000

	<u>Cumulative Return</u>	<u>Annualized Return</u>	<u>Growth of \$1,000</u>
DJIA	+13.75%	+1.30%	\$1,137
S&P 500	-9.09%	-0.95%	\$909
NASDAQ COMPOSITE	-44.24%	-5.67%	\$558
Credit Suisse Tremont Hedge Fund Index	+88.97%	+6.57%	\$1,890

Sources: PerTrac Financial Solutions

2010 Outlook

The U.S. has systemic macroeconomic problems that will limit earnings growth and mute stock market returns over the coming year and beyond. Furthermore, it is our contention that the 2009 rally is a cyclical (short-term) bull market rally inside of a secular (long-term) bear market. The ability for U.S. companies to grow earnings in the coming year will be hindered as rising unemployment will further push up savings rates, thereby limiting consumption which has been the primary driver of the U.S. economy for the past decade. While banks have recapitalized, credit is unavailable and the deleveraging process continues. With low capacity utilization, it's tough to envision a marked improvement in the unemployment situation. Add to this the coming tax increases and we face many macro headwinds. With equity valuations already at historic extremes (PE ratio at approximately 26 times earnings), it is unlikely U.S. equities will return to the 2007 record highs until 2017. Secular bear markets last a long time. The ongoing contraction of

credit, the fuel for the American consumer over recent years, will temper the effects of the massive liquidity that has been pumped into the system by the Federal Reserve. Despite historically low interest rates, the velocity of money is non-existent, as the banking sector continues to rebuild its capital base as residential and commercial real estate markets, which underpin mortgage backed securities, remain troubled and unlikely to bottom out in the next year. The troubles in the U.S. banking sector now closely resemble the difficulties that have plagued Japanese banks for the past twenty years. The risk of the deflationary, deleveraging cycle extending for several years, despite accommodative monetary policy remains very real.

Government spending, at all levels, has helped buoy the recovery, but budget deficits from federal government down to local municipalities, will limit the public sectors ability to further promote growth. As a result, governments, both domestic and foreign, will need to raise taxes and issue more debt, likely pushing rates up as creditors command higher returns on their capital. If the private sector can not step in once fiscal stimulus is withdrawn, there is a high probability that the U.S. could see a double dip recession (our guess is 2011).

The post crash price recovery pattern has been similar to prior post crash periods. The S&P 500 has gained nearly 70% from its price low of 666 and done so in a historically similar period of 7.5 months. With current PE ratios at 26, valuations are stretched while risk remains high. Equity market returns will be muted and prices more volatile in 2010 and while we expect the S&P 500 could test 1200 in the first or second quarter, we see a sizable correction ahead. The year will be a taste of what the investing climate will look like for many years to come: a lot of oscillation for low returns as is characteristic of secular bear markets. Emerging markets, small cap stocks, energy and commodity based currencies will lead markets higher early in the year. As the Euro and the Yen pullback from multi-year highs against the dollar, their decline will accelerate with the dollar gaining against both currencies by the end of the year, especially if the Fed raises rates and/or a market sell-off creates a flight to quality. We expect the S&P to trade in a range of 1200-1250 on the upside and 950-1000 on the downside. We believe the long-term secular bear will again take hold.

Global Macro Themes

Federal Reserve: The Exit Strategy

The actions of the Federal Reserve will be front and center this year as Chairman Ben Bernanke, (despite recent uncertainty regarding his confirmation, we believe he will ultimately be reappointed) has the difficult task of determining when to raise interest rates and remove many of the liquidity programs that have kept the banking sector afloat. Since the start of the recession, the Fed has narrowed their playbook down to one play: reflate the U.S. economy at all costs. By lowering rates to near 0%, Bernanke has not only helped banks by steepening the yield curve, but has also forced investors to seek higher returns as short-term debt instruments offer paltry returns. This in turn drives investor capital out of safe assets and into riskier assets driving equity prices higher (so far so good as witnessed by a significant drop in portfolio cash to pre-crash levels). He has recapitalized financial institutions and increased profit margins (borrow at near 0% and lend at higher spreads) to give banks time to work through their bad loans (mortgages, commercial mortgages, consumer and business loans, and credit cards, etc.). This is in process today – so far so good. Once healed and consumption returns, the Fed will become concerned with inflation again. They walk a fine line - raise rates too quickly and the economy could sputter causing more banks to fail. Leaving rates at these levels for too long could lead to higher levels of inflation and a further decline in the dollar as international investors search for higher yielding assets.

We believe that if the Fed raises rates at all this year it will likely be towards the end of the year and will not exceed 1%. It is more likely that the Fed closes other short-term liquidity programs earlier in the year, assesses how the market digests these developments and then determines whether to raise rates. In particular, the \$1.25 trillion MBS purchase program that was established in late 2008 is set to conclude by the end of the first quarter. Recent Fed minutes indicate that Fed members are conflicted on whether to extend the program which is designed to help create a floor for prices of MBS that are still a large part of Wall Street bank portfolios. This program is separate and distinct from the Treasury's support of Fannie Mae and Freddie Mac, the beleaguering mortgage giants. In late December, the Treasury said it would provide unlimited support for the companies. Both institutions have spent trillions of dollars to support the mortgage market for two purposes: to support banks who still own large amounts of MBS and to extend credit to homebuyers who otherwise would not be eligible aside from an FHA sponsored loan. With the housing market still vulnerable and bank balance sheets still fragile, it appears that the size and scope of the programs are not enough to get the housing market moving. Median home prices dropped 12% nationally in 2009, the sharpest fall since the Great Depression. We are quickly running out of ammo to support home prices. Perhaps it is time to start looking at the real problem: a massive excess supply of housing in a country where home ownership rates are already 70% (U.S. Census Bureau), one of the highest rates in the world.

While the Keynesian spending spree by the Fed has steadied the banking system, it has not been without costs. Most obviously, the dollar has plummeted as U.S. debt has skyrocketed and foreign investors show concern about how the U.S. plans to return to a more stable fiscal policy and repair its balance sheet. The political cost for the Fed, (which might as well be referred to as the fourth branch of government) may be its independence. With populist sentiment on the rise, Congress is listening to proposals that would curtail the Fed's powers and independence in the future. It is troublesome for Americans to understand how a non-elected official has the power to spend trillions of the dollars on behalf of the government with no accountability. With many Congressmen facing reelection in the coming year, they are hearing the anti-Fed message more clearly as evidenced by the uncertainty concerning Chairman Bernanke's reappointment.

Financial Regulation: Glass-Steagall Redux and Basel 3

As record bonuses are being paid again by Wall Street, a little more than a year after the collapse of Lehman Brothers and Bear Stearns, the call for tougher regulation is reaching a fever pitch on Main Street. The current banking crisis is nothing new. The U.S. has weathered them before and will likely have to weather more crises in the future. It is with that certainty in mind that lawmakers and central bankers should tailor regulation to meet the landscape of a globalised financial system. New regulations are likely to come from two camps and will compliment each other in their implementation. While it is too early to tell what proposals lawmakers (especially given mid-term elections in November) will put forward, it is likely that some legislation in the spirit of Glass Steagall (the Depression era bill that separated banking activities between commercial and investment banking. It is unlikely that a full implementation of the original bill will occur as it would cause most of the major investment banks to split up and put them at a competitive disadvantage globally. However, it appears that limitations on proprietary trading will be part of any proposal that is designed to eliminate excessive risk taking.

Simultaneously, the Basel Committee on Banking Supervision is working on a new set of banking laws and regulations, dubbed Basel III (yes, we've been here before). The new proposals will focus on capital ratios and liquidity buffers as the primary mechanisms to allow banks to weather bigger losses and longer credit seizures in another crisis. The trend over the past century has been to lower capital ratios and to increase leverage across the banking sector. While this trend was briefly reversed after banks collapsed during the Great Depression, it quickly reversed course to such an extreme that bank capital ratios were barely above

5% coming into the current crisis. With the average U.S. bank losing about 5% in this crisis, the need for higher capital ratios is quite evident. The big question is how much? Based on analysis of the current crisis and prior episodes globally, it would appear that number should be approximately 8-9% at a minimum: 5% to allow for losses of the magnitude we have seen recently and another 4-5% that would remain to insure investor confidence. If we are to avoid putting taxpayer money at risk in the next crisis, an increase from the current levels is a must. More importantly, any increase in capital requirements will limit the velocity of money (even less money available to lend), thereby lowering overall economic growth prospects.

International Outlook: BRI-C, Europe and Old Man Japan

International markets will continue to be fragmented in regards to growth prospects in 2010. The BRIC nations, and emerging markets in general, we believe will continue to show resilient growth, but the Eurozone and Japan will lag not only emerging markets, but also the U.S. The BRIC acronym was first coined in 2001 by Goldman Sachs on the premise that these four countries (Brazil, Russia, India and China) had the potential to eclipse the combined economies of the current richest countries in the world. Although these countries just recently organized their first summit in 2009, their growth prospects are likely to differ moving forward. Most notably, Brazil and China, in particular, have pulled ahead of the other two constituents in terms of global economic clout, foreign investment and political stability. Decoupling, the concept that these economies could be less dependent and therefore less correlated to the U.S., has been debated heavily over recent years. The downturn in 2008 across global markets showed decoupling was unlikely in the near term – providing little true diversification we believe high correlation will remain. However, as the recovery in the U.S. continues, domestic demand in emerging markets has proven to be robust and despite the worst global recession in recent memory, these countries continue to post positive growth that is likely to accelerate in 2010.

China, without a doubt has grown out of the BRIC acronym and is rapidly becoming the global political and economic power that will challenge the U.S. for global economic primacy. China started the global rally in 2009 on the back of a massive and highly effective stimulus. The insatiable appetite for commodities and raw materials has returned, underpinning strong growth in many of its supplier countries, namely Brazil and Australia. China's growth and share of global GDP will continue to rise as Western economies work through much larger systemic problems. The Chinese renminbi (aka the yuan) will appreciate further against many of the developed currencies including the dollar, especially in light of China's desire to diversify their reserves away from U.S. Treasuries. That is not to say that the Chinese will not be a buyer of U.S. Treasuries, but they will look to diversify, possibly into gold, especially if domestic demand remains strong.

While there is reason for optimism in Brazil and China, there is reason for real concern in Europe and Japan. Both economies face many of the same structural issues (aging population, entitlements, troubled banking system) that the U.S. does but must also deal with extremely strong currencies that make their exports less competitive globally. For Europe, it will be hard to keep the EU from bursting at the seams as fiscally weak countries such as Greece, Ireland, Spain and Italy will be a drag on any economic rebound in Germany and France. Japan has struggled for 20 years with deflation and with interest rates effectively at 0%, the economy is still struggling to grow. The strength of the Yen, which is near all time highs, will hurt Japanese exports, especially relative to the more dynamic and emerging Asian countries. A massive demographic transition and weak political leadership will further curb growth potential in Japan.

Conclusion

With many macroeconomic headwinds facing the U.S. economy, we believe 2010 will prove to be a much different market than 2009 – the post crash recovery rally is largely over. The housing market has yet to show a definitive bottom, unemployment has yet to peak and the consumer, the primary driver of the economy, will not be in a position to contribute significantly to growth. Taken in tandem with the ongoing contraction in total system-wide credit, our belief is that GDP growth is likely to be on the lower side of consensus estimates, currently ranging from 2.3% on the bearish side and 2.8% on the bullish side. Much depends on continued stimulation, and the timing of higher taxes, yet with the equity markets at high valuation levels, capacity utilization at low levels, unemployment probably closer to a real number of 17% (not 10%) and the lack of available credit, it is tough to project an optimistic view for the equity markets and the buy-and-hold investor. Sell the rallies, look to tactical trading strategies, shorten up fixed income maturities, add tax free bonds and diversify between multiple absolute return strategies that can tactically trade the markets. The short-term bull move is largely over and the long-term secular bear market will again take hold.

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