Continuum Global Asset Mgt., LLC

April 2014

Newsletter

Our March 2014 Newsletter concluded with, ***<u>"Despite the rosy outlook for the next 2-3 years, we do not diminish the importance of crucial variables our Market Model exhibits and therefore recommend that investors take a defensive stance under the current circumstances. We would only invest opportunistically once the geo-political tensions alleviate and the fear gauge reach critical levels according to our model. …"</u>***

As mentioned in our previous issue (March 2014), we believed that the markets had gained too much too quickly. Despite showing no apparent signs of any fundamental problems with the economy or the capital markets, we believed that a technical (a word I use when I can't really explain WHY!!!) correction was imminent. It can be observed from the adjacent charts, that the major US broad based indexes have pulled back in the last 2-3 weeks. **<u>(Dow Jones =-3% , S&P 500 = -3.5% and Nasdaq = -7.2%)</u>**

We believe that one of the main reasons for any technical correction is reversion to mean. If an asset class, a sector or a security moves further from its reasonable valuation, (again, there are umpteen ways to define reasonable) the probability of reverting back to the longer term mean value continues to rise. In other words, when a security moves significantly above its reasonable value, investors will then start digesting good news with less enthusiasm and similarly bad news with greater trepidation and vice versa. This phenomenon continues and gains momentum till aggregate investor sentiment based on fear and greed helps the security value to gravitate towards it's reasonable mean.

<u>The question on everyone's mind now is whether the indexes have corrected enough to take advantage and start investing in the markets or is this a beginning of a larger correction and therefore wait…</u>

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We have listed important fundamental and technical variables below to put the current market situation in perspective. In addition, we have included our proprietary Market Direction model to evaluate a fair market value. Subsequently, we conclude with our inferences whether this is a good time to start investing or add to existing positions with the cash we generated in the recent bullish phase.

1. **US Gross Domestic Product (GDP):** US GDP has been firming up since the recession we faced in 2008-09. The International Monetary Fund (IMF) reently projected 2.8% GDP growth for the US for the next 12 months. This is a very favorable variable.
2. **US Corporate Earnings growth:** US companies comprising of the S&P 500 index have been consistently growing since 2008. We believe that their earnings power continue to grow at approximately 7-10% per annum; a favorable fundamental indicator for capital markets.
3. **Price to Earnings Ratio (PE Ratio):** PE ratio is a statistical measure of investor sentiment. This variable gauges how much investors are willing to pay for the earnings of respective companies or sectors. The current S&P 500 PE is approximately 16, which is in line with the average for the last 30 years. In other words, markets do not seem to be in bubble territory according to this measure; another favorable indicator.
4. **Inflation and Cost of Capital:** Inflation is at approximately 2.1-2.2%; a relatively benign number. This allows the Federal government to keep interest rates low, which in turn keeps the cost of capital low. A lower borrowing cost suppports growth for small to medium companies in addition to favorable mortgage rates for home buyers.
5. **US Corporate Balance Sheets:** Currently, the US corporations have over $2 trillion in cash reserves. These corporations should help augment employment as the economy stabilizes and confidence in poillital policies continues to gain strength.
6. **Equity Vs. Bonds:** We believe that equities provide a better opportunity relative to bonds. With the economy stabilizing and employment conditions improving, the federal government will be compelled to raise rates at some point in the future. In this paradigm, equities should flourish relative to bonds
7. **Margin Balance:** Margin balance signifies the borrowed funds that investors use to leverage their portfolios. Usually, margin balances rise during bullish periods. Margin balances are currently at all time high and have breached the levels experienced in October 2007 (prelude to the 2008 recession/market correction). The current elevated margin level indicate market froth and we can see some more pain in the markets if investors decide to reduce their leverage which would result in increased selling pressure.
8. **Volitility Index (VIX):** The VIX index is based on Puts and Calls being bought and sold on the S&P 500 index. In other words, the VIX index illustrates and gauges the fear in the markets. We believe that this is a contrarion indicator. This index is currently tradiing at 16 and we believe that a level of approximately 20 is opportune for investors to start investing. It has also been observed that this index can gain or loose 10-15% intraday and hence we do not recommend that investors wait for exact values but use this index as a guide.
9. **Stochasic Variable:** We have included a technical variable known as the Stochastic indicator in the charts (Page 1 & 2) exhibitng the market indexes. This variable uses the average of the money flowing in and out of the respective index. Empirical evidence suggests that when this indicator touches or breaches 20-25 on the downside, the respective index is in an oversold region an vice versa. It can be observed that most times the Stochastic variable has touched 20-25 during the previous market corrections, it has created opportunities to invest. This variable is currently at very low levels which in our view is flashing signs to buy and add to existing positions.

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Illustrated below is CGAM's proprietary market model which has been developed to project the potential gain or loss in the S&P 500 index over the next 12 months. The model uses fundamental growth and strength of the economy to project the market movement. We have also illustrated the regression equation developed based on 4 decades of historical data.

Table 1[1]

Fundamental Variables (12 month Projections)		**Market Projections** *Based on the regression equation illustrated below*	*As of April 10th, 2014*
S&P 500 Earnings	$120.00	S&P 500 (Projection) =	1,943.00
S&P 500 Expected PE Ratio	17.00	S&P 500 (**Current, Aug 23, 2013**) =	1,833.00
10 Treasury Bond Rate (%)	2.50%	***S&P 500 (Gain/Loss) =***	***+6.00%***
Inflation Rate (%)	2.50%	***Standard Error***	**+/- 1.88%**
Volatility (VIX) Index	17.00		
Unemployment (%)	6.50%		

S&P 500 ***(12 Month Estimate) = 927.80+10.77 x (S&P Earnings)+20.68 x (S&P Price Earnings Ratio)-35.90 x (Treasury Bond Rate{10 yr})-44.68 x (Consumer Price Index)- 9.89 x (VIX; Volatility Index)-95.77 x (Unemployment Rate)+St. Error***

It can be observed that the model suggests a gain of approximately 6% in the S&P 500 index with an error rate of about 1-2% for the next 12 months. The total return expectation has been increased from 4-5% down to 6% due to the recent correction in the markets.

We at CGAM believe that the US Economy is currently on sound fundamental footing. Most US Corporations have positioned themselves to be much more efficient since the 2008 recession. Not only has US enterprise become relatively efficient but also far more solvent with over $2 trillion on their balance sheets.

We believe that the recent decline in the market is a normal technical correction. We cannot accurately predict the magnitude of the correction but believe that this is an opportune time to start investing and adding to current core positions.

PLEASE REMEMBER: Each investor is unique and should invest to compliment their respective financial conditions and objectives.

[1] Data Source: Various Analyst estimates, CGAM's estimates

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