

# Newsletter

***Our July 2014 Newsletter concluded with, “Based on the observations illustrated above and the guidance based on our proprietary market direction model, we recommend raising cash (upto 20-25% of the total portfolio). The endeavor is to be pre-emptive and be prepared to take advantage of an interim technical correction.***

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Since the July Newsletter, the markets have been reluctant to plough through new highs and have actually corrected by approximately 3-4% as shown below.

<b>Indexes</b>	<b>Index Highest Level</b>	<b>August 1 2014</b>	<b>Gain / Loss (%)</b>
<b>Dow Jones Average</b>	<b>17,151</b>	<b>16,508</b>	<b>-3.75%</b>
<b>S&amp;P 500</b>	<b>1,991</b>	<b>1,926</b>	<b>-3.26%</b>
<b>NASDAQ</b>	<b>4,485</b>	<b>4,347</b>	<b>-3.08%</b>
<b>Russell 2000</b>	<b>1,213</b>	<b>1,111</b>	<b>-8.41%</b>
<b>Volatility Index<sup>1</sup></b>	<b>10.28</b>	<b>16.8</b>	<b>63.42%</b>

We at Continuum believe that average investor sentiment moves like a pendulum from one extreme to another. As markets are comprised of Fear and Greed, this pendulum is never stable but is constantly being pulled back to a reasonable mean. Therefore, we believe that the markets are experiencing a short-term shift of sentiment, which is resulting in this technical correction.

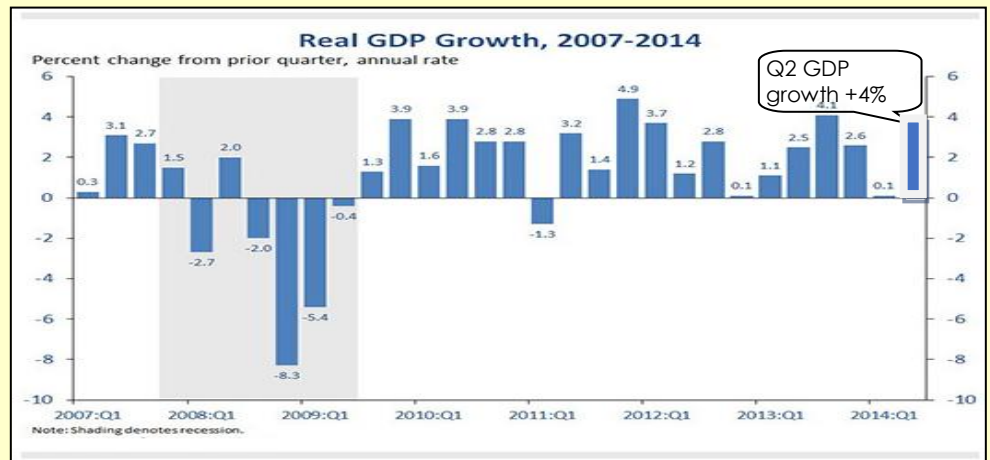
We all know that the cardinal rule of investing is buy low and sell high. As mentioned in the July Newsletter, we believed that the markets were a bit extended and it warranted investors to pre-emptively take profits and raise cash. Again, we also believed that the correction would be a technical one. In other words, the fundamentals of the economy are still intact but the pendulum of sentiment is pulling the markets back.

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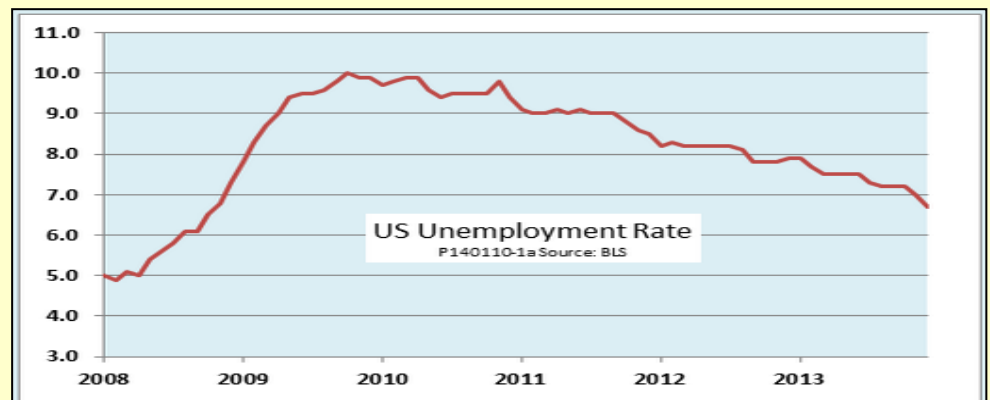
<sup>1</sup> Volatility Index (VIX): The VIX index is calculated using PUTs and CALL options on the S&P 500 index. In layman terminology the VIX index gauges the fear in the markets. It can be clearly observed that this index moves inversely to the major market indexes. Based on empirical evidence, we believe that a value of around 20 on the VIX indicates short term bottoms and therefore an attractive level to re-enter the markets.

We would like our readers to focus on the following factors to gauge the direction and magnitude of the market direction going forward:

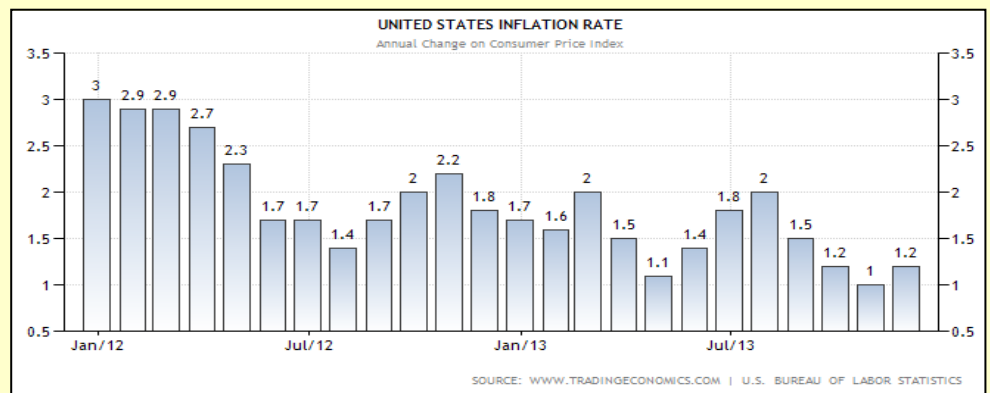
1. **Gross Domestic Product (GDP) Growth**<sup>2</sup>: The GDP growth for the second quarter of 2014 in the US clocked a gain of +4% relative to an expectation of +3%. Economists are projecting that the second half of 2014 could experience +3% GDP growth.



2. **Unemployment Rate**<sup>3</sup>: The US economy has experienced growth since 2008 along with an improved employment scenario. Unemployment rate has declined to approximately 6% from a high of 10% in 2009.



3. **Inflation**: US Consumer Price Index or inflation is currently contained at about 1.5%-1.7%. This is well within the US Federal government's mandate range. We believe that the Federal government will likely keep the interest rates low for the next 12 months, which in turn helps corporate growth.



4. **Geo-Political Tensions**: We can not diminish the importance of geo-political problems, particularly in Russia-Ukraine. The US and European economic sanctions could have real impact on the global economy which would disrupt the US markets in the intermediate term.

<sup>2</sup> Source: <http://www.whitehouse.gov>

<sup>3</sup> Source: <http://www.economonitor.com/>

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 4

<b>Fundamental Variables</b> (12 month Projections)		<b>Market Projections</b> <i>Based on the regression equation illustrated below</i>	<i>As of August 1<sup>st</sup>, 2014</i>
S&P 500 Earnings	\$125.00	S&P 500 (12 Month Projection) =	2,055.00
S&P 500 Expected PE Ratio	17.00	S&P 500 (Current, July 2, 2014) =	1,930.00
10 Treasury Bond Rate (%)	2.30%	<b>S&amp;P 500 (Gain/Loss) =</b>	<b>+6.50%</b>
Inflation Rate (%)	2.50%	<b>Standard Error</b>	<b>+/- 6.50%</b>
Volatility (VIX) Index	20.00		
Unemployment (%)	6.00%		

**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**

The major change in the model has been the gain in the **Volatility Index (We have used a value of 20, which factors another 2-3% decline in the indexes)**. The Volatility index has been trading at very subdued levels since February of this year but have experienced a spike during this correction (Table 1). We believe that a level of approximately 20 on the VIX would exhibit a good entry point for the equity markets. At 20, the VIX would have climbed almost 8 points or approximately 60% from its low this year. This is a contrarian indicator which influences us to believe that the markets could gain 6-8% in the near term.

In addition, we have kept the 12 month S&P 500 companies earnings at the higher end; \$125. The **Price Earnings ratio** (a measure of investor sentiment) is trading at 17 which is about 9% above the long term average of approximately 15.50.

It can be observed that the model infers a gain of approximately 6-7% in the S&P 500 index with an error rate of about 6% for the next 12 months. The total return expectation of the broader market indexes has increased from 1-2% up to 6-7% (Since July Newsletter).

***We had been anticipating a technical correction that was clearly stated in our July Newsletter. This recent market correction has presented investors with an opportunity to reinvest. Investors should be cognizant that our target interim correction called for a 5-7% decline, which means that major indexes could loose another 3-4% before a short term bottom.***

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

<sup>4</sup> Data Source: Various Analyst estimates, CGAM's estimates

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