Continuum Global Asset Mgt., LLC

July-August 2020

Our May-June 2020 Newsletter concluded with the following inference:

"The capital markets in the US have experienced a significant reversal since the lows seen at the end of March 2020. Using our proprietary market model, we would lean towards a defensive stance for aggressive portfolios. As a long-term investor, it does not pay to time the markets, but the economy will continue to suffer due to the high unemployment rate. Therefore, it makes sense to increase cash and recalibrate respective portfolios. It would be advisable to gravitate towards sectors like Online Retail, Healthcare, Technology and Consumer Staples. In addition, we would avoid Leisure & Tourism, Transportation and Industrials."

In retropsect, we were early in our estimation of the market correction. The S&P 500 index has gained approximately 13% since we shared our views on the May-June 2020 Newsletter.

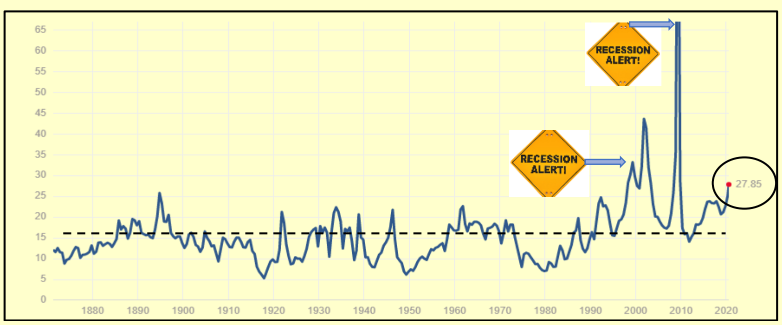
Market Valuation…

We at CGAM, LLC strongly believe that investor psychology supercedes investing methodology, especially in the short and medium term. Having said that, investors, whether institutional or retail are always evaluating numbers to gauge the market psychology and direction. We do believe that certain market parameters are a reasonably good gauge of investor sentiment. One such universally followed variable to gauge whether a market index is over or undervalued is the Price / Earnings ratio.

Price / Earnings Ratio

The Price to Earnings (P/E) ratio of any index or security illustrates its value in relation to its earnings. The value of a particular index or security should increase as it's respective earnings increase and vice versa. Below is a historical perspective of the P/E ratio of the broad based index : S&P 500.

Historical perspective of the US stock market's valuation



[1]

Current S&P 500 PE Ratio: 27.85 -0.06 (-0.22%)
11:00 AM EDT, Fri Jul 31

Mean:	15.81	
Median:	14.83	
Min:	5.31	(Dec 1917)
Max:	123.73	(May 2009)

Observations…

1. The average P/E ratio of the S&P 500 for the last 100+ years, shown above is approximately 15.81.
2. The current P/E of this index is close to 28, which is 75% above this historic average.

[1] Source: https://www.multpl.com/s-p-500-pe-ratio

20419 Cheryl Ln
Santa Clarita, CA 91350

Manu Walia
Email: manuwalia@cgamadvisor.com
www.cgamadvisor.com

Office: 661-299-1920
Mobile: 661-312-2070

3. It can also be clearly observed in the chart on Page 1, that the P/E Ratio of the index was elevated significantly before most major recessions in the last two decades (2000-2003 and 2008-2009).

…putting it all in perspective

- The P/E Ratio of the S&P 500 reached 33 in 1999, before the dot.com recession, which started in 2000.
- In May 2009, the P/E ratio reached an eye-popping 123x. This was the highest ratio in United States history. This was primarily due to the depressed earnings during the "Great Recession" and has been the only instance since 1970 in which the P/E ratio reached triple digits.
- The same ratio reached 23 in 2008, before the banking and real estate crisis creating the recession of 2008-2009.

It would be unwise to rely on one variable like the P/E ratio to evaluate the future of the US capital markets. Then again, it is one of the most reliable variables that has predicted whether the current market environment is over or undervalued, with statistical accuracy.

Charlie Munger, who is Warren Buffett's partner and the Vice Chairman of Berkshire Hathaway said, "Just because one puts numbers on a worksheet, doesn't make them real". Despite agreeing with Charlie whole heartedly, we use our model to keep a fairly unbiased and rational perspective on the market valuation relative to historical measures. We believe that history may not repeat itself, but it surely rhymes.

Market Valuation…

CGAM's Proprietary Market Model:

We have developed our proprietary Market model, which has helped guide us in understanding the direction of the broader markets. We have used the S&P 500 index as the proxy for the US broad based markets. The model was developed on our belief that investor behavior repeats itself based on a combination of economic fundamentals and investor psychology. The model is dynamic, as it constantly reviews the change in the index based on the changes in statistically significant economic variables.

The table below is an illustration of the variables used to project the 12 month target on the S&P 500. Our regression model uses six variables (shown on the extreme left column), which attribute to 93% of the movement in the S&P 500.

Fundamental Variables	**FY 2021 (Estimate)**[2]	**Market Projections**	***As of August 5th, 2020***
S&P 500 Earnings	$155.00	S&P 500 (12 Month Projection) =	3,010.00
S&P 500 Expected PE Ratio	20.00	S&P 500 (August 5th, 2020) =	3,326.00
10 Treasury Bond Rate (%)	0.70%	***S&P 500 Estimated (Gain/Loss) =***	***-9.48%***
Inflation Rate (%)	2.00%	***Standard Error***	**+/- 4.63 %**
Volatility (VIX) Index	23.00		
Unemployment (%)	10%		

2 *Source: CGAM, LLC's proprietary research.*

Changes incorporated to the model parameters…

We have made significant changes to the variables used for the market projection model due to the impact of COVID-19 pandemic. This is based on our proprietary research, especially with respect to the economic trough created by Covid-19 and the expected recovery in terms of US enterprise earnings.

We have increased the projected earnings of the S&P 500 companies by approximately 6.5% for the FY 2021, after a reduction in FY 2020. In addition, we have been accommodative with our P/E ratio of 20. Please note that the average P/E of the index is approximately 15.5. A 20 P/E is a premium of 30%, which translates to a strong investor sentiment. This factors in a healthy economic recovery along with strong investor sentiment. In addition, we have used a 10% unemployment rate, in anticipation of recovering job market.

Conclusion…

It can be observed from the Market Model that we are currently in the overvalued territory. The model suggests a high probability of a correction (-9% to -10%) despite favorable economic and sentiment parameters.

The capital markets have recovered significantly from the March 2020 lows. The S&P 500 has gained approximately 51%, from the March 23rd, 2020 low as of August 5th, 2020. In our view, the Federal government's stimulus package along with the Federal Reserve's accommodative policies have played a significant role on the capital market's recovery. Unfortunately, the Federal government cannot keep printing money limitlessly.

We reiterate and believe that it would be prudent to continue to maintain a reasonable exposure to cash currently, especially for investors with a short / medium term horizon. Sectors we would continue to invest in are: Healthcare, Information Technology and Financials.

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

Please review the following disclaimer

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20419 Cheryl Ln
Santa Clarita, CA 91350

Manu Walia
Email: manuwalia@cgamadvisor.com
www.cgamadvisor.com

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