Continuum Global Asset Mgt., LLC

June 2014

Newsletter

Our April 2014 Newsletter concluded with, ***"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. …"*** Since we published this statement (mid April), the major broad based markets have gained 2-3%.

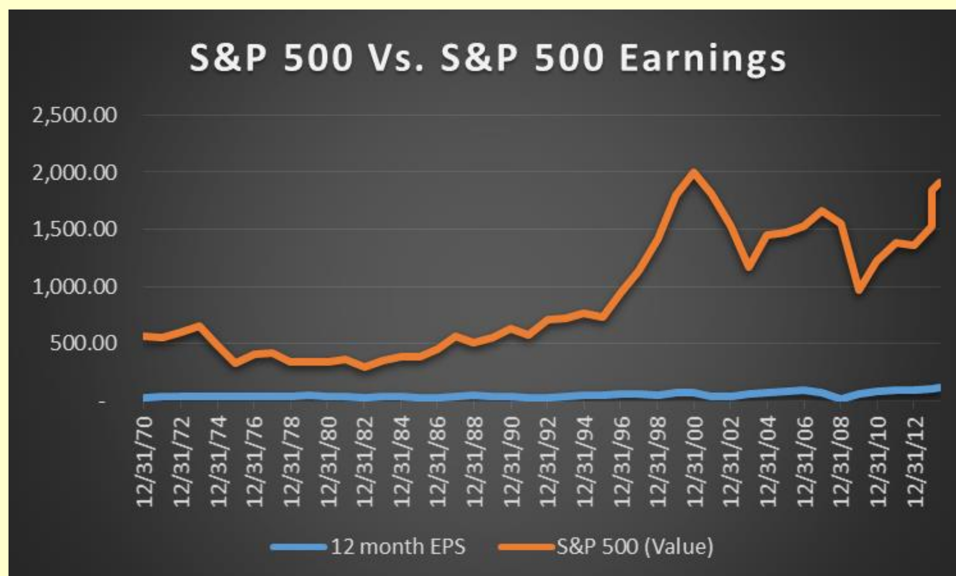
"Only a fool would deny that it's a fool's errand to predict the movement of the markets…" Having said that, we still attempt to understand investor psychology in order to gauge how much, if any, would repeat itself. As the late Barton Biggs (a very reputable and revered investor) said, "History may not repeat itself but it rhymes…".

We have illustrated three variables, that we have used in our propriatary market direction model. We believe that these variables provide a reasonable perspective for investors who believe that the fundamental growth of the economy and companies ultimately drive value.

Following are the variables used:

1. S&P 500 earnings.
2. Interest Rates or Cost of Capital.
3. S&P 500 Price / Earnings Ratio or Investor Sentiment.

S&P 500 Earnings:



It may be a bit difficult to observe in the adjacent chart, but there is a distinct positive correlation between earnings and the movement of the underlying index.

It can be observed that the S&P 500 (orange line) declined precipitously in 2008, as earnings declined almost 50% (blue line) from the 2007 high. Since the 2008 lows, corporate earnings have doubled and so has the index.

We believe that the earnings momentun in the US is intact and despite a relatively diminished growth rate, earnings will not dissapoint the markets for the next 12-18 months.

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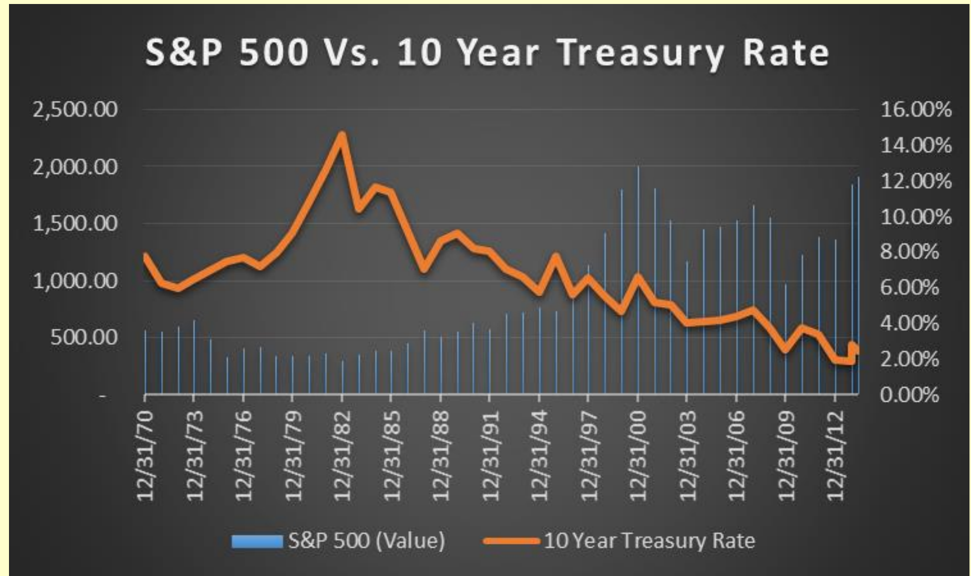
Interest Rates or Cost of Capital:

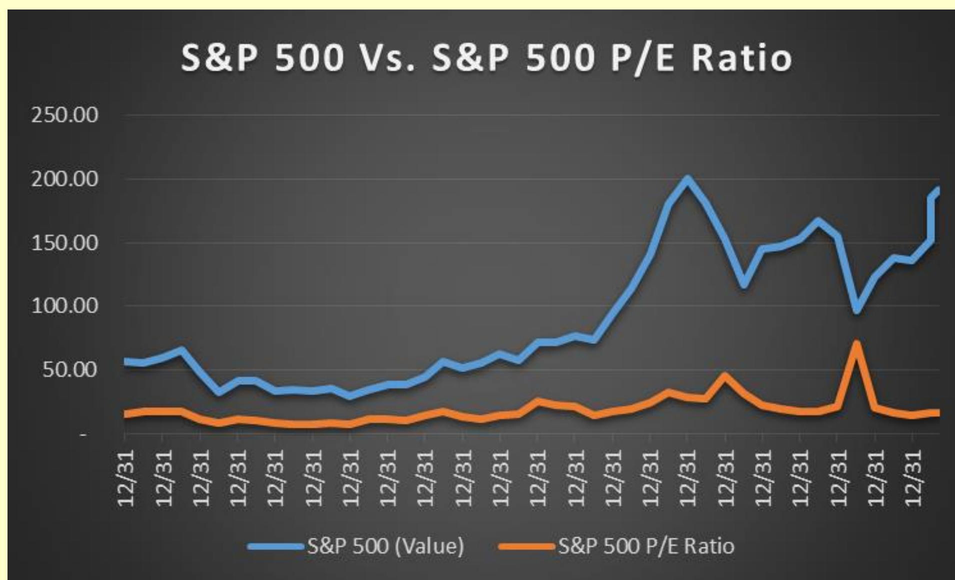


The adjacent chart provides a representation of the correlation between the US 10 year treasury rate (a proxy for the cost of capital) and the S&P 500 index. We can clearly observe that there is a negative correlation between the interest rates and the direction of the underlying index.

Rates have been on a decline over the last three decades. The Federal Government has indicated that the rate environment is expected to stay relatively benign for the foreseeable future. This is primarily because the easy monetary and fiscal policy have helped the economy recover from one of the most severe recessions this country experienced in 2008-09.

We believe that the Federal Open Market Committee (committee responsible for managing the interest rate movement with and endeavor to control inflation and in an indirect way help the economy) will continue with its accommodative monetary policy (keep rates low) and let the economy recover so that it can self sustain.

S&P 500 Price / Earnings Ratio or Investor Sentiment:



We can observe from the Chart on the left that the S&P 500 index moves inversely with the movement of the Price to Earnings ratio.

In other words, as investors become more confident and euphoric, they are willing to pay a higher multiple for the earnings of an underlyinng security or index.

Empirically, this should indicate that we are in a dangerous situation and may be ready for a significant correction. On the other hand, it is also true that P/E ratios are governed by the expectation of the growth in earnings. As mentioned above, we believe that the US corporate environment is healthy and will experience decent growth. In addition, the current P/E of the S&P 500 is in the range of 16-17, which is close to an

average of about 15 for the last 30 years. We would be concerned if the P/E starts to infringe on the 20 level and earnings start to deteriorate.

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 11

Fundamental Variables (12 month Projections)		**Market Projections** *Based on the regression equation illustrated below*	*As of May 29th, 2014*
S&P 500 Earnings	$125.00	S&P 500 (Projection) =	2,006.00
S&P 500 Expected PE Ratio	17.00	S&P 500 (**Current, May 29, 2014**) =	1,920.00
10 Treasury Bond Rate (%)	2.30%	***S&P 500 (Gain/Loss) =***	***+4.50%***
Inflation Rate (%)	2.50%	***Standard Error***	**+/- 1.68%**
Volatility (VIX) Index	15.00		
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

It can be observed that the model infers a gain of approximately 4-5% 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 decreased from 6% down to 4-5% (Since April Newsletter) due to the recent assent in the markets.

We believe that due to the accommodative policies adopted by the FOMC two major developments have taken place over the last six years:

1. Cost of Capital is at extremely low levels. This has a favorable consequence on business growth.
2. Treasury yields are at low levels which means that investors have graviated towards government bonds.

We believe that as the US economy continues to show resilience, the FOMC will gravitate towards unwinding its accommodative policy. Once this becomes the market perception, a reasonably significant number of bond investors will start to liquidate their holdings. Under these circumstances, this newly released asset base will start to gravitate towards the equity markets.

Based on this paradigm, we believe that the equities are a favorable area to be invested in currently.

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

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

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conditions and objectives.

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