Our April-May 2016 Newsletter concluded with:

> ***"Markets have recovered impressively since the 10%+ correction experienced in January-February this year. We believe that the markets are still in a bullish mode and could continue their assent if corporate earnings show promise. Having said that, the volatility index is indicating complacency in the markets. CGAM's proprietary model is projecting a 5-6% gains over the next 12 months if earnings grow by 5-7%. The US economic growth may well accomplish this task, but the contrarian fabric in us at CGAM believes that this is not the time to buy. We would be inclined to raise cash in growth portfolios to approximately 10% and continue to hold onto quality companies. Investors will be served well by waiting for an interim correction to add to their portfolios."*** *April-May 2016.*

The capital markets currently remind me of an athlete running on a treadmill. He is working hard but going nowhere. The market has been full of major events this year, without actually having any direction. As mentioned in our previous Newsletter, some of the reasons for the worry in the markets have been; decelerating Chinese economy, the extremely low commodity prices, the uncertainty of the interest rate direction created by the US Federal Reserve and the apprehension whether the English will opt to exit the European Union (in other words; Brexit).

A sideways market has induced doubts in investors, whether we are being set up for another correction. Despite the worries that investors harbor, it is always a prudent process to review critical variables that have historically and will continue to impact markets in terms of investor sentiment that ultimately drives values.

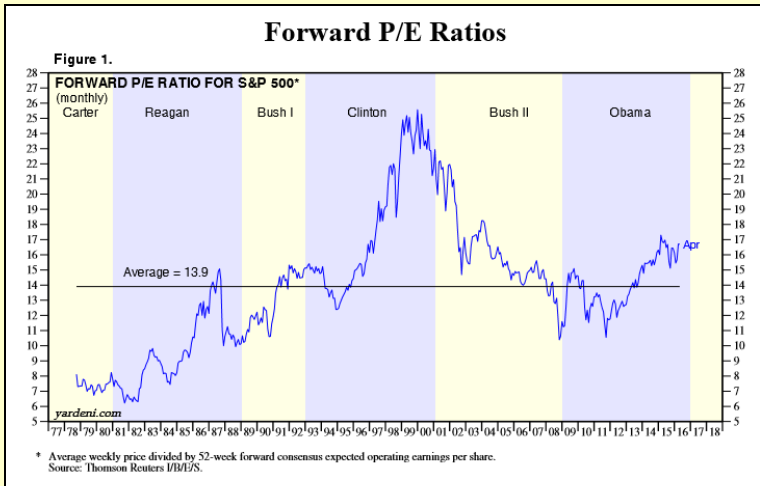
Following are critical variables that provide a sense of direction for the markets over the next 12-18 months. In addition, we have included our proprietary market model which also provides market direction using parameters that have consistently impacted the market valuations.

1. **Stock Valuations[1]:** Stock market indexes are a leading indicator that suggest the future of an economy. As a leading indicator the market expectations attempt to predict the level of future economic activity. In addition, it is obviously a great measure for investor to recalibrate their portfolios. Following are two charts that provide a historical perspective on US stock market valuation. These charts use the

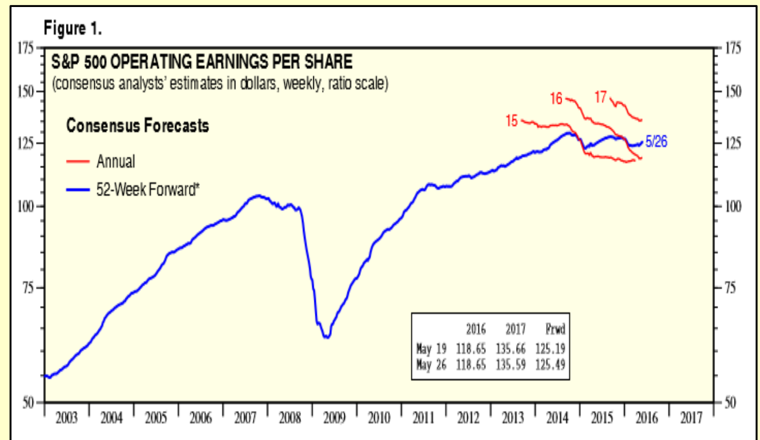
[1] Source: Yardeni Research, www.yardeni.com

17991 Lost Canyon Rd., Suite 138
Canyon Country, CA 91387
Manu Walia
Email: manuwalia@cgamadvisor.com
www.cgamadvisor.com
Office: 661-299-1920
Mobile: 661-312-2070

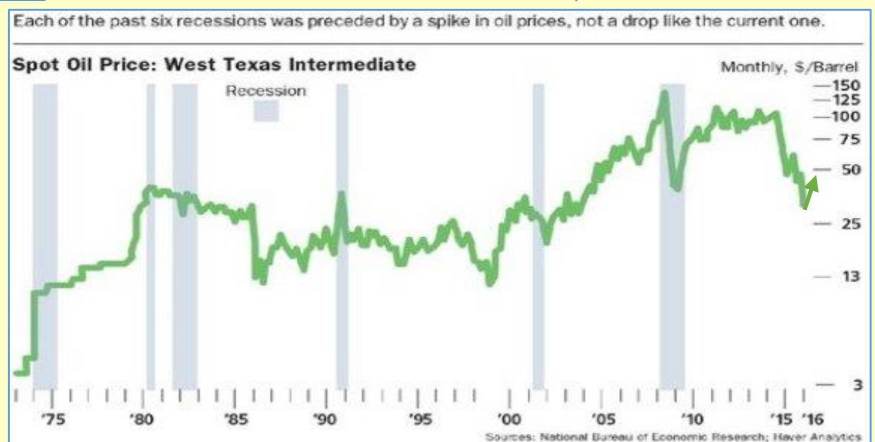
forward price to earnings ratio (P/E) for the S&P 500. This measure exhibits how the market values relate to the earnings of the companies under review.



It can be observed in the adjacent chart that the Forward P/E Ratio, is approximately 16-17. The average P/E for the last four decades has been approximately 13-14. The P/E during the end of 2007 (before the US economy dove into recession) was approximately 17, about where it is now. The major difference is that leading up to 2007, the US banks and financial institutions had realized inflated earnings due to the artificially exploding housing prices. The financial sector experienced the biggest decline in earnings subsequently. Currently, we have had depressed earnings in the entire S&P 500 index due to the decline in the energy sector. We currently have a relatively healthy US financial sector and energy prices have recovered to about $50/barrel from low $20s early this year. The coupled effect could boost earnings beyond our estimate of $130 for the fiscal year 2016, giving the needed boost to investor sentiment.



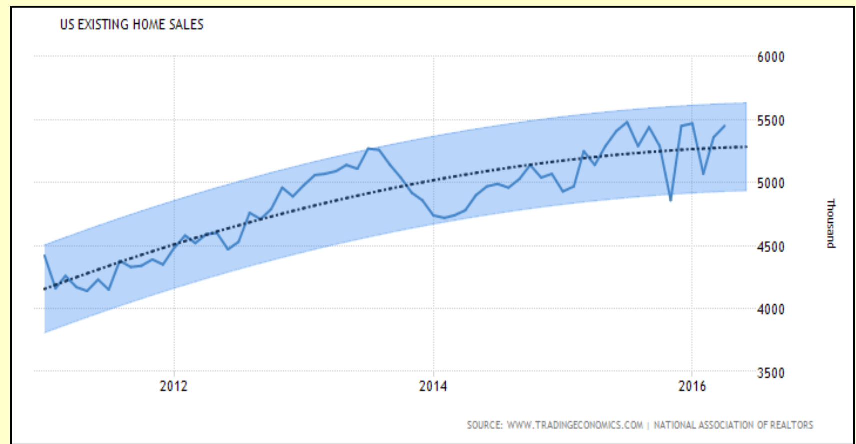
2. **Oil Prices :Impact on Markets**[2]: The Chart below shows that the past 6 recessions in the US happened in conjunction with relatively higher oil prices. **This is not the case currently**. We believe that low gas and energy prices have resulted in higher disposable income for US consumers, which would propel the US growth over the next 12-18 months.



[2] Source: http://www.calamos.com/campaign/2015/Q1/outlook

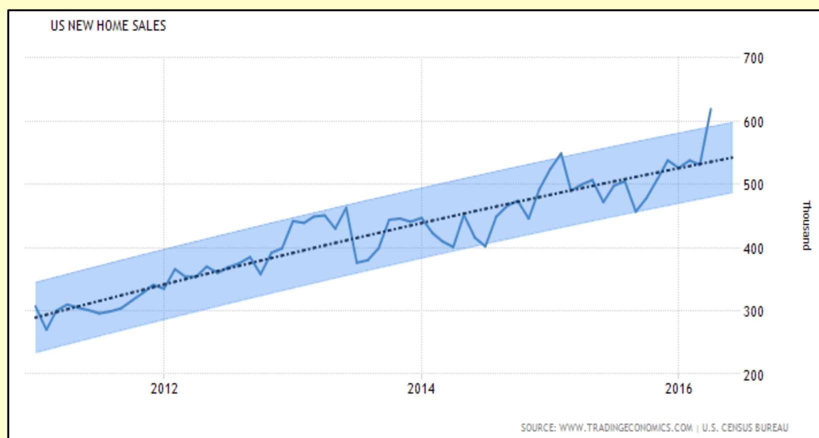
3. **US GDP:** The International Monetary Fund (IMF) and the United Nations expects the global growth to be in the 2-2.4% range respectively. We believe that the US economy should grow at about 2.2-2.3% for the next 12 months as well. This would be a great accomplishment considering that the US is approximately $16 trillion. In addition, most other economies including the high growth emerging economies are showing signs of decelerating growth. This makes the US a favorable destination from a global investment perspective.

4. **Housing Prices:** Real estate markets have a wide spread impact on the overall economy. There are umpteen allied products and services that are related to housing.

   The adjacent two charts represent US Existing and New Home sales. The blue line represents the actual houses being sold for the last 5 years. The dotted line is the forecast for the respective category.

   In addition to consistent growth in the real estate market, the most important difference between the housing bubble of 2007 and today is that the average home price in 2007 was $260,000 vs $232,000 today. In addition, lending criteria is a lot more stringent today compared to 2007.

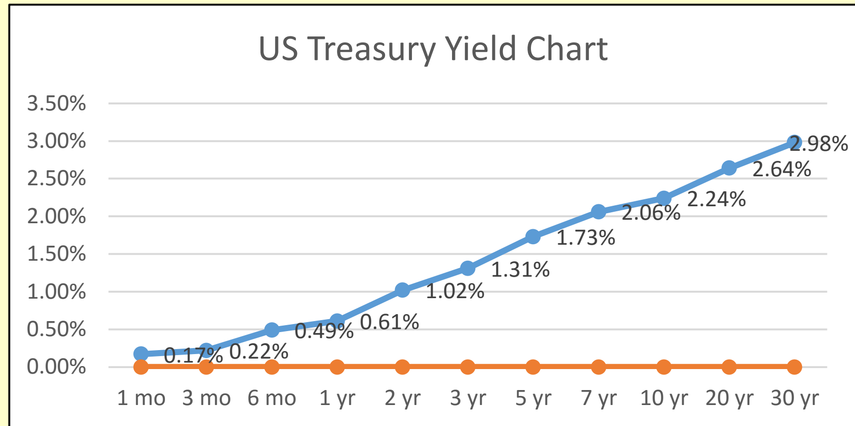
   With unemployment low (~5%) and wages growing, we believe that housing should continue to be healthy and in turn fueling US economy.

5. **US Interest Rate Yield Curve[3]:** The chart below "US Treasury Yield Curve" is an illustration of the interest rates corresponding to the continuum of the time horizon, starting at a month and going to 30 years. Empirical evidence shows that a steep yield curve (short term interest rates are lower than the longer term interest rates) indicates a healthy rate environment which helps economic growth. The steep yield curve suggests that

[3] Source: http://www.tradingeconomics.com/united-states/interest-rate

17991 Lost Canyon Rd., Suite 138
Canyon Country, CA 91387
Manu Walia
Email: manuwalia@cgamadvisor.com
www.cgamadvisor.com
Office: 661-299-1920
Mobile: 661-312-2070

banks can borrow at lower rates and lend monies at higher rates. This helps with their profitability and also injects adequate flow of assets in the economy for growth in other sectors.



There has been a lot of talk about rising interest rates. There are two most important points that we would like to make. One; The Fed Fund Rates (the rates which major US banks pay the Federal Government to borrow) are still at very low levels (0.25%). Second; even if the Federal government starts to raise rates, they have made it clear that their actions would be data dependent. In other words, the Federal Open Market Committee (FOMC) is aware and cognizant of the impact of their actions, especially in the current global environment. The FOMC's rhetoric validates patience, understanding and cooperation for a sustained economic expansion.

CGAM's Proprietary Market Model:

We now turn towards CGAM's proprietary market model that has been developed to project the S&P 500 index over the next 12 months. The model is based on the concept that investor behavior repeats itself based on certain fundamental parameters of the economy and human psychology. The model constantly reviews the change in the index based on the changes in statistically significant economic variables. The objective is to quantify these variables into a regression equation based on four decades of historical data. The combination of these variables explains almost 93-94% movement in the S&P 500 index.

Fundamental Variables (12 month Projections)		**Market Projections** ***Based on the regression equation illustrated below***	***As of: May 31st, 2016***
S&P 500 Earnings	$130.00	S&P 500 (12 Month Projection) =	2,235.00
S&P 500 Expected PE Ratio	17.00	S&P 500 (May 31st, 2016) =	2,088.00
10 Treasury Bond Rate (%)	1.80%	***S&P 500 Expected (Gain/Loss) =***	**+6.90%**
Inflation Rate (%)	2.10%	***Standard Error***	**+/- 5.73%**
Volatility (VIX) Index	15.00		
Unemployment (%)	5.00%		

<u>S&P 500 (12 Month Estimate) =</u> 888.017+11.34 x (S&P Earnings) +21.18 x (S&P Price Earnings Ratio)-32.98 x (Treasury Bond Rate{10 yr})-47.60 x (Consumer Price Index)+9.50 x (VIX; Volatility Index)-94.50 x (Unemployment Rate)+St. Error.

17991 Lost Canyon Rd., Suite 138 *Manu Walia* *Office: 661-299-1920*
Canyon Country, CA 91387 *Email: manuwalia@cgamadvisor.com* *Mobile: 661-312-2070*
www.cgamadvisor.com

Following are the changes and the inference of our model based on the recent developments in the capital markets:

1. 12 month earnings expectation for the S&P 500 companies is $130[4]. We believe that the energy and financial sector is in recovery and will benefit the entire index from an earnings perspective.
2. The Volatility Index (VIX) is a fear gauge for the markets. It is calculated using PUTs and CALLs on the S&P 500 index and indicates how concerned investors are in the short to intermediate term about the market volatility. VIX has declined from about 25 during the hight of the market correction (mid February) to about 15 currently. Our model has shown increasing negative correlation of the market indexes with the VIX. In addition, empirical evidence shows that the VIX level of 25 and above indicates a buying signal and sell signals below 11-12, from a contrarian perspective.
3. Our projections guide us to believe that markets could gain another 6-7% over the next 12 months with an error rate of 5-6% for our model.

CONCLUSION

We believe that the markets are attempting to find a direction under the presence of improving US economic fundamentals. Fortunately, the markets have experienced great gains over the last 7 years since the great recession of 2008-09. We believe that the markets should break out on the upside and reward patient investor. We do not see an interim correction based on the parameters described in this Newsletter and would encourage investors to maintain their portfolio positions; especially in the Financial and energy sectors.

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

[4] Source: CGAM, LLC estimates.

17991 Lost Canyon Rd., Suite 138
Canyon Country, CA 91387
Manu Walia
Email: manuwalia@cgamadvisor.com
www.cgamadvisor.com
Office: 661-299-1920
Mobile: 661-312-2070

This page is left blank intentionally

Please review the following disclaimer

This Newsletter has been prepared by Continuum Global Asset Management, LLC (CGAM), an independent Registered Investment Advisor. CGAM believes that the data contained is from reliable sources but cannot guarantee the accuracy of the data. None of the information provided constitutes a recommendation or solicitation of an offer to buy or sell any particular security. The investment strategies and or securities may not be suitable to all investors and past performance is not indicative, nor a guarantee, of future results. It should not be assumed that recommendations made in this Newsletter and in the future will be profitable or will equal the performance of the securities mentioned in this or previous Newsletters.

17991 Lost Canyon Rd., Suite 138
Canyon Country, CA 91387

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

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