Newsletter

Our December 2013 Newsletter provided an analysis that illustrated a high probability of a 5-7% correction early this year. After a 5% correction late January 2014…

…Our February 2014 Newsletter ended with… "**We believe that the US corporate earnings will continue to show improvement over the next 12-18 months, resulting in fruitful capital market gains. In other words, we expect the broader indexes like the DJI and S&P 500 to gain 10-12% over the next 12 months and believe that this is an opportunity for investors to add to their existing postions and/or initiate new positions in high quality US businesses.**"

Chart 1
Dow Jones Industrial Average Index
12 month Performance
(February 2013-February 3, 2014)

Chart 2
Dow Jones Industrial Average Index
12 month Performance
(March 3, 2013-March 3, 2014)

Source: www.bigcharts.com

Chart 1 and 2, both represent the Dow Jones Industrial Average (DJI) for a 12 month performance period. Chart 1 *(February 3, 2013 to February 3, 2014)* shows a correction denoted by the red arrow, followed by a rebound in the markets shown by the black arrow in Chart 2 *(March 3, 2013 to March 3, 2014)*.

It is important to recognize that the markets have rebounded as quickly as they had retreated in late January 2014. As we write this Newsletter, new events in the form of geo-political tensions between Ukraine and Russia have emerged putting pressure on major market indexes.

Illustrated below are certain variables that we believe have an immediate impact on the markets:

1. **Russian threat towards Ukraine:** The recent tensions caused by Russian military action towards Ukraine can only create uncertainty and worry for the markets. Even though this is an unfortunate event, the total Ukrainian economy is approximately $400-500 million. The ramification of this military threat from Russia could provoke other European regions to get involved resulting in escalating geo-political tensions.
2. **Higher Energy Prices:** These geo-political events have already and will continue to put upward pressure on commodities like oil and energy. Higher energy prices put pressure on not only retail consumers but also businesses. A recent study by Federal Reserve of San Francisco[1] suggested that the US economy is less dependent on oil prices primarily due to the advent in manufacturing productivity and efficiency of energy consumption. We therefore believe that the impact of higher oil prices will be diminished.
3. **Consumer Spending:** Consumers comprise of over 70% of the US economic growth. Consumer spending has experienced healthy growth in tandem to the US economic recovery since the financial and housing bubble of 2008. Healthy gains on Wall Street and the US real estate sector has helped inflate average investor net worth. This phenomenon has resulted in healthy gains in spending.

Despite the importance of the intermediate variables stated above, we at CGAM believe that ultimately, economic fundamentals impact the markets and cut through the short term noise. Therefore, we have presented the updated Market Direction Model to show our 12 month market projection.

CGAM's Proprietary Market Direction Model:

As mentioned in our previous Newsletters, Continuum has developed a market model based on regressing market variables with data spanning over three decades. As always, we have illustrated our proprietary market direction model below. Our endeavor has been to develop a dynamic model that evolves with changing data. It started with a number of variables which were narrowed down to 6 crucial parameters attributing to majority of the movement in the S&P 500 index.

Fundamental Variables (12 month Projections)		**Market Projections** *Based on the regression equation illustrated below*	*As of March 3rd, 2014*
S&P 500 Earnings	$120.00	S&P 500 (Projection) =	1,913.06
S&P 500 Expected PE Ratio	17.00	S&P 500 (**Current, Aug 23, 2013**) =	1,839.28
10 Treasury Bond Rate (%)	2.50%	***S&P 500 (Gain/Loss) =***	**+4.01%**
Inflation Rate (%)	3.00%	***Standard Error***	**+/- 1.88%**
Volatility (VIX) Index	17.00		
Unemployment (%)	6.30%		

NOTE: All variables are projected 12 months in the future with the exception of VIX index that uses current levels.

[1] Source: Federal Reserve of San Francisco

CGAM Market Model Equation[2]

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***

Since the last Newsletter, we have increased the S&P 500 Price/Earnings ratio by about 5%. This is our projectin of a healthy and improving investor sentiment. In addition, we have lowered the Unenployment rate to 6.3% and the 10 year bond rate (cost of capital) to approximately 2.5%.

It can be observed that the model suggests 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 reduced from 8-9% down to 4-5% due to a recent gain of approximately 4% in the markets. Also, it has been observed empirically (Cash:To Raise It Or Not: By Levar Hewlett) that markets underperform during the summer months (May-September). As we move into the summer period, investors can expect subdued movement in the major indexes.

We at CGAM believe that the US Economy is 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.

Despite the rosy outook 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.

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

[2] Source: CGAM's Proprietary Market Direction Model

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