Continuum Global Asset Mgt., LLC

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Newsletter

The Debate: Role of Monetary and Fiscal Stimulus during adverse Natural or Man-made Economic Disasters!!!

Our February Newsletter started with **"…DESPITE OUR LONG-TERM BULLISH PERSPECTIVE, WE BELIEVE THAT MARKETS CANNOT MOVE UP IN A STRAIGHT LINE. THEREFORE, WE ARE PLAYING DEVIL'S ADVOCATE AGAINST THE BULLISH SCENARIO IN THIS NEWSLETTER. WE HAVE CONSIDERED SOME MAJOR TECHNICAL PARAMETERS TO INFER WHETHER WE ARE HEADED FOR AN INTERIM CORRECTION…"**

Since, the markets have experienced a correction of approximately 6.5% from mid February followed by a rebound of the same magnitude. We would like to admit the fact that this correction was catalysed by a different set of reasons than we had anticipated but it reinforces our belief in mean reversion, no matter how large or small its magnitude and its correlation with human sentiment maybe.

One of the main events that casued the markets reversal was the tragedy casued by the Japanese earthquake which struck on March 15th. Besides being a great tragedy for the people of Japan, this quake has impacted the rest of the world economically. The Japanese government has already taken extensive measures in an attempt to provide basic necessaties and restore operations in the daily lives of the domestic population. One of the major endeavors by the Japanese government is the infusion of approximately $200 billion to rebuild the stricken infrastructure and industry. Japan being one of the largest economies in the world can undertake this plan with ease. But the question I pose is **"HOW IS ECONOMIC STIMULUS FOR A NATURAL DISASTER DIFFERENT THAN ONE FOR A DISASTER CREATED BY MAN…?"**

Let me explain!

The amount of monetary stimulus Japan has announced after the quake is about $200 billion. In other words the government has a major role to play to resurrect the damage created by a natural calamity. This seems natural and a moral obligation of any authority. This objective will be carried out despite the large Federal deficit Japan has as a percentage of its GDP. Readers are most probably frowning at the mere mention of an argument otherwise especially for a country faced with a tragedy that consists of wreckage on human and economic front. But I would urge readers to hold judgment and read on.

My conjecture starts with comparing the fiscal and monetary stimulus the US Federal government implemented when a man-made (women were also involved) disaster almost brought the US financial infrastructure to its knees during the real estate debacle that began early 2008.

The Federal government, which consists of Mr. Ben Bernanke and party have been berated and condemned for frivolously spending on this economic disaster. A student of the 1929 US depression, Mr. Bernanke favored government intervention in the form of economic stimulus primarily to bolster the distressed banking entities. We believe that this intervention is no different than a venture capitalist inducing a mezzanine debt financing into a distressed company that they already had a stake in. In addition, the Venture Capitalists will utilize their own expertise, experience and professional contacts to support the ailing company in an attempt to stabilize its operations and financials. The difference here is that the monies for the bailout came from the tax payer who may or may not have attributed to the financial debacle directly. The truth is that a financial debacle of this type could have brought about economic havoc of a higher magnitude that a natural disaster like the recent quake has brought to the Japanese economy.

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We believe that the ultimate endeavor of capitalism is to provide a level field for competition, which should lead to a paradigm of improving standard of living for the masses. As governments infuse capital into an economy during adverse economic situations; for reconstruction in case of Japan or to bolster the distressed financial services industry in the US (Banking debacle of 2008), it creates confidence that is desperately needed for moving forward for humans and jobs that creates disposable income that helps overall economic growth. In the latter case, some capitalist empiricists will argue the we as humans denigrade the ability of the system to self correct. We disagree. We as a society have developed a framework (government scrutiny) that either prevents extreme adverse events or follow throughs with the correcting efforts post adverse events.

In our view, both disasters should be treated as comparable and government intervention should not be ruled out as an artificial short term fix. We will leave our readers with a caveat; the scenario of a post event primarily needs confidence infusion. This confidence building exercise can only be undertaken by an entity with enough political clout and financial resources. A public entity shall never have resources large enough to be a major participant in efforts like these as respective governments do not allow any one entity to reach a level of monopolization. Therefore, government intervention in extreme adverse scenarios, whether natural or caused by humans should not be ruled out and considered a solution in unison to capitalism!!!

Current State of Capital Markets in the US

Despite our innate optimism regarding the direction of markets we have reiterated our belief in the importance of investor sentiment as one of the main charecteristic in market movement. Clearly, the markets have performed exceptionally well since the lows of March 2009. Even though capital markets move due to the buying and selling activity of investors, their behaviour is influenced by economic and political fundamentals.

Its is no mystery that the US and global economy have been improving since the economic recession of 2008. Following are important variables that we believe should be considered to view the markets in the intermediate term:

- Earnings potential in the US: Most analysts in the US are predciting a 12% earnings growth year over year for the S&P 500 companies, during Q1, 2011. Despite being a healthy number, this is down from a 31% growth in Q4, 2010. We do not believe that the earnings momentum will continue at the same pace experienced over the last 3-4 quarters. *As mentioned many times in our previous issues, we believe that perception of earnings is more important that earnings itself*. If US corporate sector does not promise greater momentum going forward, the markets can correct. The magnitude of a correction can not be predicted but is obviously a function of actual earnings and future management guidance.
- Margin : Margin is the loan investors avail from their respective brokers based on the net worth of their portfolios. As investors become bullish, they use more margin to invest and vice versa. We believe that this is a contrarian indicator. In other words, when margin as a percentage of aggregate investor portfolio goes up, it is bearish and vice versa. Currently, the margin numbers gathered by the Financial Industry Regulatory Authority are at approximately $350 billion, which are on the higher end relative to a 5 year average.
- Investor Sentiment: Consensus investor sentiment gauged by four different sources (Consensus Inc, American Association of Individual Investors, Market Vane and First coverage) is at relatively high levels. In our view this is also a contrarian indicator. As the aggregate investor sentiment becomes more bullish, the probability of interim market correction moves higher. Therefore, as the market continues to gradually moves higher, it creates bullish attitude which in our view is a self fulfilling bullish activity that ends up being unsustainable and eventually results in market corrections.

Considering the variable stated above, we believe that there is a high probability of market correction despite the interim 6% correction during mid to late March. We still maintian our longer term bullish stance, but are cautious of over bought conditions and in favor of taking profits to circumvent interim corrections.

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

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