Continuum Global Asset Mgt., LLC

MARCH-APRIL 2015

Newsletter

Our January 2015 Newsletter ended with…

<u>"We believe that the current economic conditions, especially in the United States, which include a growing economy, improving unemployment situation and low inflation will boost corporate earnings and consumer sentiment. The culmination of strong fundamentals should compel domestic and international investors to feel confident in the US capital markets."</u>

Chart 1

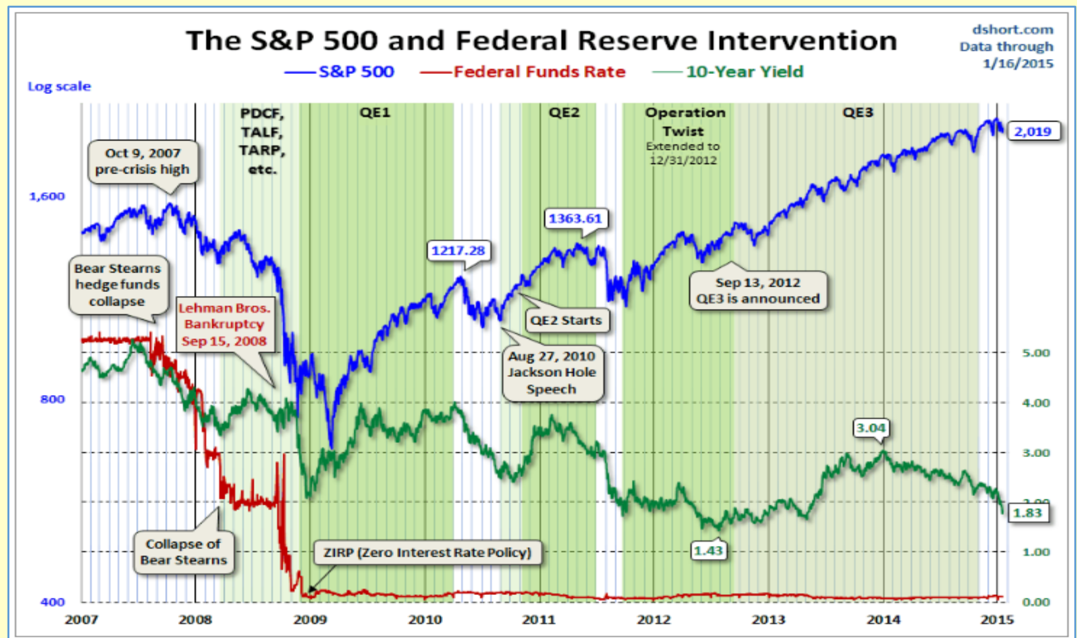


Chart 1 clearly shows how well the markets have performed over the last five years (S&P 500 represented by the **BLUE** line).

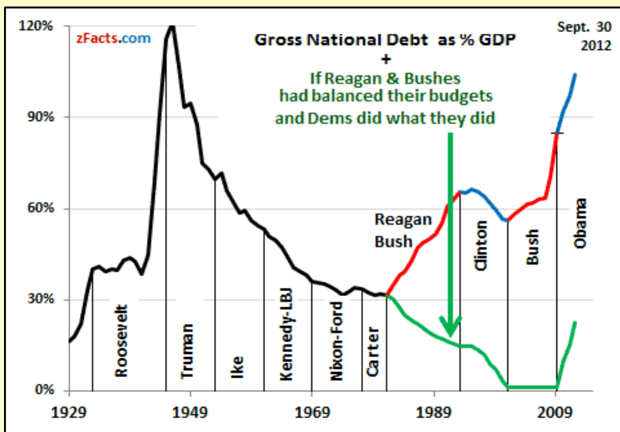
In our view, the post 2008-09 recession market gain was fueled primarily by a highly accommodative monetary and fiscal policy by the Federal government.

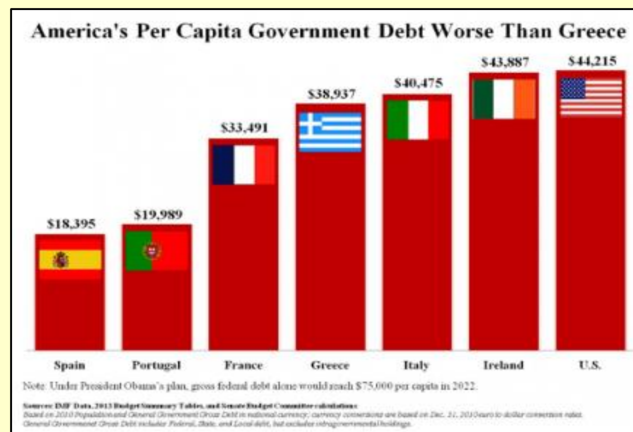
Another name for this fiscal policy is <u>"Quantitative Easing" or QE</u>. It can also be observed in Chart 1 that there have been three distinct phases of QE (represented in shades of green). Each phase has proved fruitful for the capital markets. This is great for the fortunate investors invested in the US markets. Having said that, it's critical to understand the impact of QE in conjunction to other accommodative monetary and fiscal policies the US Federal Open Market Committee (FOMC) has adopted post 2008-09 recession.

We now illustrate crucial fundamental economic parameters that impact Main Street and in essence Wall Street. In addition, we have included technical variables that influence short term market volatility. Finally, we depict our proprietary Market Direction model to gauge the general direction of the capital markets for the next twelve months.

1. **US Gross Domestic Product (GDP):** US GDP has been improving since the recession of 2008-09. It has grown at an average rate of over 3% for the last 3-4 qtrs; a bullish sign.
2. **US Corporate Earning's Growth:** US companies comprising of the S&P 500 index have been consistently growing since the 2008-09 recession. We believe that earnings will continue to grow at approximately 4-6% per annum; a favorable economic indicator.
3. **Unemployment:** US unemployment has improved dramatically since the lows of 2009. The current unemployment rate is approximately 5.5-5.6%, down from 10% in 2009.
4. **Commoditiy Prices**: Commodity prices, especially oil and energy are currently at realtively low levels. Even though the impact of lower oil on the economy is not significant empirically or statistically, we believe that this would prove favorable for retail consumption and hence economic growth.
5. **Inflation and Cost of Capital:** Inflation is at approximately 2.1-2.2%; a relatively benign number. This allows the Federal government to keep interest rates low, which in turn keeps the cost of capital low. A lower borrowing cost suppports growth for small to medium companies in addition to favorable mortgage rates for home buyers.
6. **US Corporate Balance Sheets:** Currently, the US corporations have over $2 trillion in cash reserves. These corporations should help augment employment as the economy stabilizes and confidence in poillital policies continues to gain strength.
7. **Equity Vs. Bonds:** We believe that current valuations provide a better opportunity in equities relative to bonds. With the economy stabilizing and employment conditions improving, the Federal government will be compelled to raise rates at some point in the future. In this paradigm, equities should perform better than bonds. Also, since 2008-09, bond funds have experienced $1.6 trillion[1] inflow as opposed to a $430 billion outflow in equity funds.

Fundamentally, we believe that the US economy is in great shape with an exception of a large US Federal deficit. Illustrated below is the Gross National Debt as a percentage of the US Gross Domestic Product. In addition, the bottom right chart shows a comparitive measure of the US per capita government debt relative to other debt laden countries. This is an issue that the US will have to address sooner rather than later.

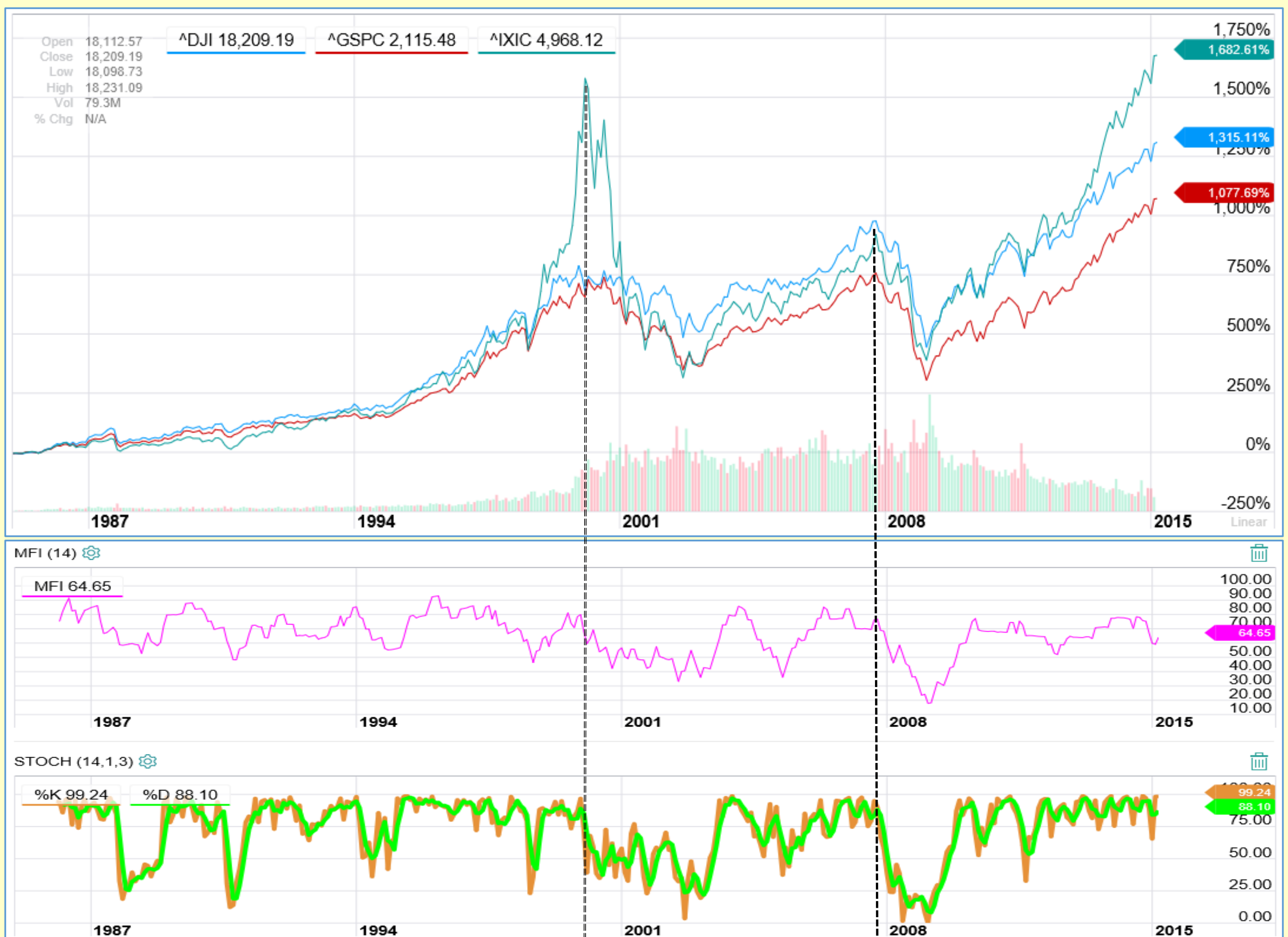




[1] Source: Barron's Weekly (2/21/2015)

In addition to fundamental parameters, we would like to focus on certain technical variables that illustrate the impact of human psychology impacting the short-term direction and volatility of market indexes. The classic definition of technical analysis is: **Technical analysis** is a security analysis methodology for forecasting the direction of prices through the study of past market data, primarily price and volume.

1. **Money Flow Index** – MFI: A momentum indicator that uses a stock's price and volume to predict the reliability of the current trend.
2. **Stochastic Oscillator**: A technical momentum indicator that compares a security's closing price to its price range over a given time period.



Based on the chart above, we can clearly observe that the previous two peaks in the markets; 2000-01 and 2008, coincided with the peaks in the two main technical indicators mentioned above. Again, technical analysis is predicated on the paradigm that human behavior repeats itself. We believe that the markets have performed exceptionally well in the light of improving economic variables. Despite the strength of the economy, we should not ignore the technical indications which can impact short term corrections in the markets.

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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's behavior repeats itself based on certain fundamental parameters of the economy and human sentiment. The model constantly reviews the changes in the index based on the change in statistically significant economic variables. We have attempted to quantify these variables into a regression equation developed based on four decades of historical data. The combination of these variables explains almost 93-94% movement in the S&P 500 index.

Table 2

Fundamental Variables (12 month Projections)		**Market Projections** *Based on the regression equation illustrated below*	*As of February 26th, 2015*
S&P 500 Earnings	$135.00	S&P 500 (12 Month Projection) =	2,179.00
S&P 500 Expected PE Ratio	18.00	S&P 500 (**Current, Feb 26th, 2015**) =	2,115.00
10 Treasury Bond Rate (%)	2.00%	***S&P 500 (Gain/Loss) =***	***+3.00%***
Inflation Rate (%)	2.50%	***Standard Error***	**+/- 6.13%**
Volatility (VIX) Index	14.00		
Unemployment (%)	5.50%		

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

The major change in the model since our January 2015 Newsletter has been the decline in the Volatility Index (VIX) from 21 down to 14 currently. We still believe that the S&P 500 companies will earn approximately $135.00 (aggregate per share) over the next 12 months. We repeat our belief in the improvement of investor sentiment in tandem to the US economic recovery.

It can be observed that the model infers a gain of approximately 3% in the S&P 500 index for the next 12 months. The substantial decline in our projection of the S&P 500 from 11% in January 2015 down to 3% is primarily due to the significant 4%+ gain in the month of February 2015. The decline in the VIX index signifies complacency in the markets. In addition, we are entering (May-October) a phase of the year which is statistically a subdued time for capital markets.

We continue to believe that the current economic conditions, especially in the United States are strong and continue to improve. Improving economic conditions, low unemployment and low inflation should bode well for the capital markets for the next few years. Having said that, we believe that the markets could and will experience a technical correction (5-7%) in the short term. We recommend that investors raise 10-15% cash in order to position themselves to take advantage of any short term correction we may encouter.

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

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

Please review the following disclaimer

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