Continuum Global Asset Mgt., LLC

May-June 2011

Newsletter

"Bubbles burst much faster than they are made; this illustrates the emotional irrational dominance of fear as opposed to greed in investor sentiment…" CGAM's Observation, May 8th, 2011

Our March-April Newsletter ended with **"…**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**…"**

Since the beginning of April 2011, markets have gained approximately 1%. After two years of great market gains, the question is whether to continue pursuing the path of bullish expectation or to sell in May and go away. At CGAM we believe that aggregate investor sentiment drives -markets which are driven by an amalgam of economic fundamentals and information dissemination via various media sources.

Despite improving economic situation, robust earnings and global growth, markets have an uncanny ability to surprise the best analysts and economists. Despite our belief in the importance of random variables, and the fragility of projections, we have ventured into developing a model that evaluates where markets are currently and the future.

	Fed Fund Rate (%) (1954-2011)	CPI (1980-2010)	S&P 500 P/E (2000-2011)	S&P 500 Value (2000-2011)	Unemployment (1980-2011)	Consumer Sentiment (1978-2010)
Max	19.10	218.06	29.21	1,468.36	9.71%	112.00
Min	0.11	82.40	15.40	879.82	3.97%	51.70
Average	5.39	151.61	19.80	1,201.85	6.39%	86.19
St. Deviation	3.44	40.46	4.06	182.83	1.67%	13.10
Current	0.25	217.5	16.00	1,340.00	9.00%	69.6
%age from Average	-5.14%	65.89	-3.80	138.15	2.61%	-16.59

The table above comprises of parameters that we believe are extremely important in understanding the current fundamentals of the capital markets and get a perspective on what the future might hold.

We have calculated the maximum, minimum, average and standard deviation for each variable. Most varaible are self explainatory but we have defined them below for clarity.

1. Federal Fund Rate: This is the interest rate that the federal government charges major banks on loans.
2. Consumer Price Index (CPI): This is the basic measure of Inflation.
3. S&P 500 P/E: This variable denotes the Price to Earnings ratio for the S&P 500 companies. As a rule of thumb, the lower the ratio, the better.
4. S&P 500 Value: Actual value of the broad based S&P 500 index.
5. Unemployment: Percentage unemployment rate.
6. Consumer Sentiment: Consumer sentiment attempts to evaluate consumer expectation of the future using sample data by using telephone surveys.

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It can be seen from the table above that these variables are mixed at best. For example, rates are at exteme lows which is great for the economy but when these rates revert to the mean, it would impact the markets adversly. On the other hand, S&P 500 price earnings ratio is well below the 20 year mean, which is a favorable indicator. If corporate earnings keep pace, we could expect the markets to gain stronger results over the next 12 months.

Table 2[1]

S&P 500 Earnings (2011)	$87.00
S&P 500 Earnings 2012 (Estimate)	$95.70[2]
S&P 500 Index Value as of April 30th, 2011	1,363.61

	P/E Minimum	P/E Average
Average P/E	15.8	17
Projected S&P 500 Valuation	1,512.06	1,626.90
Expected %age Gain based on projected earnings	9.82%	16.18%

It can be observed in Table 2 that even at a conservative P/E of approximately 16, the markets can experience a gain of approximately 10% over the next 12 months. At an average P/E of 17 we can expect the markets to gain 17%. That is all good but the problem with an assumption is that it assumes.

As we mentioned before, earnings are if not the most, one of the most important variables viewed by investors to value a security or collectively the direction of the market. Earnings have improved from a low of approximately $47 for the S&P500 companies to $87 in the Fiscal year 2011. This is an 85% increase in about two years. In addition, the economist are expecting another 10% increase in earnings going forward another 12 months.

The following section portrays our projections on the markets which is verbatim to our previous newsteller:

Investor behaviour plays an important part in the direction of the market. We believe that **Bubbles burst faster than they are built which illustrates the emotional dominance of FEAR over GREED in investor sentiment**.

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 the rest of 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 shall correct. The magnitude of a correction can not be predicted but is obviously a function of actual earnings and future management guidance in regards to corporate growth.
- 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

[1] Data Source: Various Analyst estimates, CGAM's estimates
[2] *Source: Average Projected S&P 500 earnings based on CGAM projections. Information gathered from various analyst's projections*

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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.

Volitility Index as a Hedge:

We all know with some certainty that markets do not go up or down in a straight line. Having said that, what can investors do protect themselves from an unpredictable interim correction(s) of 5-7%.

Chart 1[3]

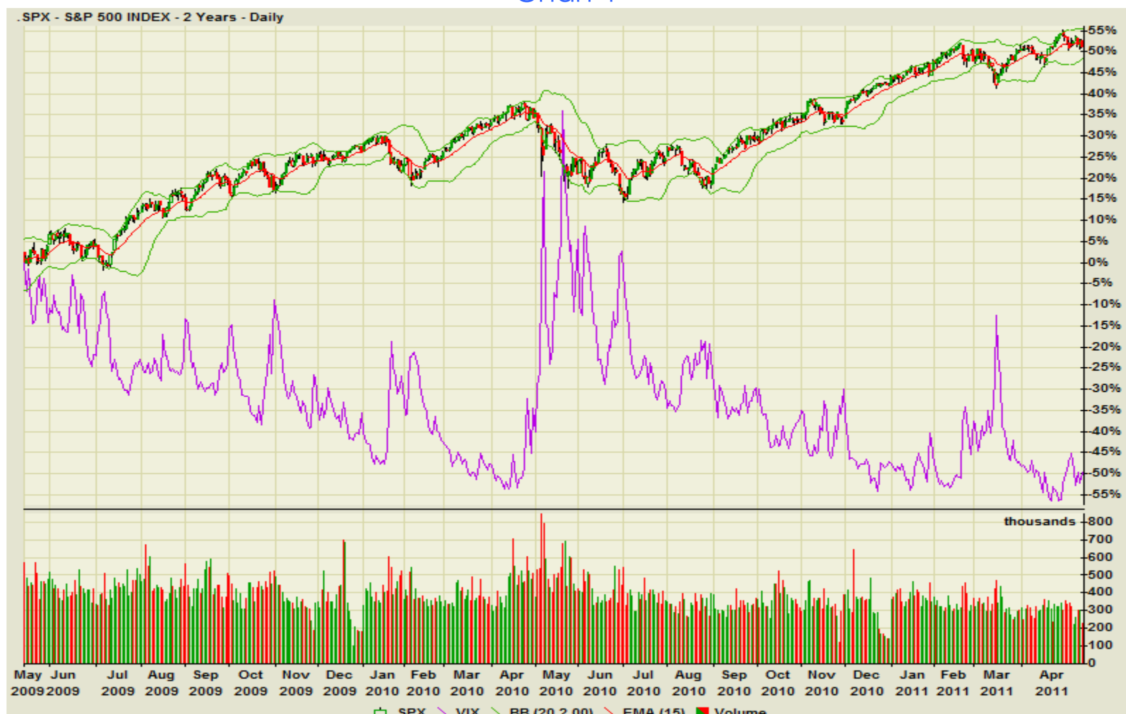

Chart 1 illustrates the Volitility Index (VIX), a measure of market fear relative to the S&P 500 index. It can be seen that this index has a negative correlation with S&P 500 or in other words, it moves in the opposite direction to the S&P 500 index. The VIX index is calculated using the Puts and Calls being bought on various exchanges. As investors become more fearful due to market decline, more puts are bought for portfolio protection hence pusing the index north. This provides an estimation of investors sentiment for the near and intermediate future.

We believe that an investor can not effectively trade this index around their respective portfolios but can defnitely include it in their portfolios in times of uncertainty. There are risks involved with this index and readers should contact their advisors before acting on this recommentation.

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

[3] Chart Source: www.fidelity.com

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