Continuum Global Asset Mgt., LLC

NOVEMBER 2014

# Newsletter

***Our October Newsletter and the follow-up write-up carried a bullish message. We believed that the markets were in for a bullish move, for the longer term after the September 7-9% correction. We ended our October Newsletter Follow-up with…***

***"We reiterate…***
We believe that the current market correction is not based on fundamentals. It can be attributed to exogenous factors like geo-politics, a changing stance of the US Federal government and to a certain extent; profit taking. As a contrarian manager, we believe that this is an opportunity to invest in the market selectively, as the US economy continues to improve." **The S&P 500 has gained approximately 5-6% since this correction.**

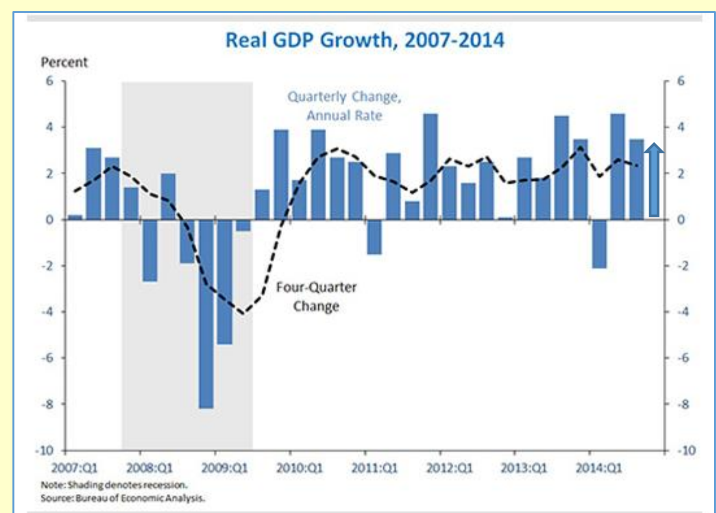
I recently read a book written by Howard Marks, a Wall Street veteran who is revered and sometimes compared to Warren Buffet. Marks, succinctly mentions the fine line between a lucky idiot and an astute investor. Both can be sussessful in the markets for entirely different reasons. Marks then goes on to explain the importance of recognizing the reasons that a successful investor basis his/her investment thesis on, and whether those variables come to frution in the final outcome.

We therefore, would like to revisit the variables mentioned in our October Newsletter which were used to guide us in developing our market direction model.

Following are the variables highlighted in our previous Newsletter:

1. **Stable growth in US Gross Domestic Product (GDP):**

   **US GDP grew approximately 2%, 4.6% and 3.5% in Q1, Q2 and Q3, 2014 respectively.** A 3% average growth for a $16 trillion US economy is healthy from an empirical point of view. In other words, the US stock market value has doubled every decade on an average for the last 100 years with a 3% annual GDP growth rate. If history is a prudent guide for the future, then a 3% GDP growth number is rather favorable.





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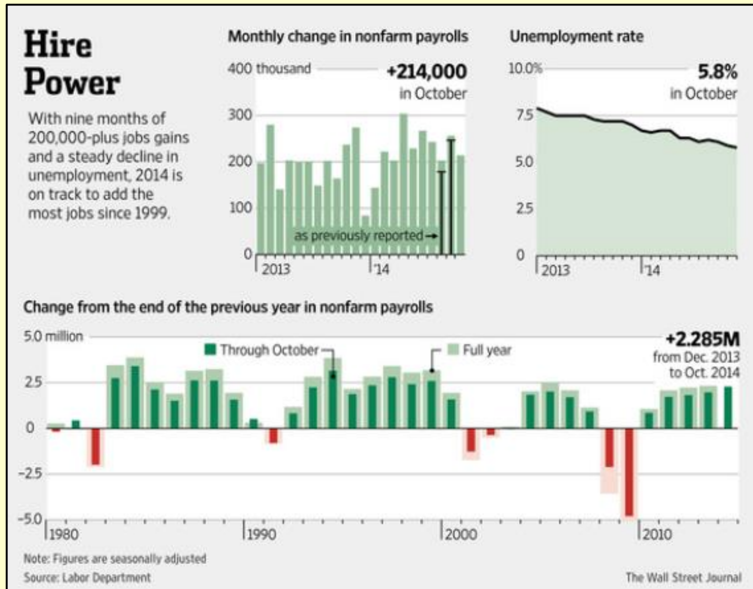
## 2. Unemployment has improved from over 10% in 2008 to 5.8%[1] currently.




**The Wall Street Journal reported on Nov 7th :** "U.S. employers, which added 214,000 jobs to payrolls last month, are on pace to post the best yearly gain in employment since 1999. The steady job growth has pushed the nation's unemployment rate down to 5.8% last month, closer to a level many economists consider healthy."

It can be clearly observed in the adjacent chart that the employment scenario in the US has improved considerably over the last two years. This situation looks better if we consider that the unemployment rate has fallen from approximately 10% in 2008 to 5.8% currently. More jobs mean higher disposable income which should propel the US economy as consumers comprise of two thirds of the US ecnonomy.

## 3. Improvement in housing market. Prices in Real Estate are somewhat elevated and may see flat to decelerating growth going forward:

As the housing market improves, it positively impacts home owners sentiment regarding their overall networth. This element will further continue to add to consumer spending which can only augment the economic activity.

## 4. Energy prices have declined almost 10% from the beginning of September 2014:

The decine in the per gallon price of gas over the last 2-3 months is clearly shown in the adjacent chart. The significant deline in the cost of a major monthly expense in the US would save approximately $20-25 billion per quarter. In other words favorable energy prices could add approximately 0.5% to annual US GDP growth.

Source: U.S. Energy Information Agency, http://www.eia.gov

[1] Source: US Labor Department

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**Our proprietary Market Direction Model illustrated below shows a favorable capital market growth over the next 12 months:** CGAM's proprietary market model has been developed to project the S&P 500 index over the next 12 months. The model uses fundamental parameters of the economy to project the market movement. We have also illustrated the regression equation developed based on 4 decades of historical data.

Table 2

| **Fundamental Variables** (12 month Projections) | | **Market Projections** ***Based on the regression equation illustrated below*** | ***As of Nov 7th, 2014*** |
|---|---|---|---|
| S&P 500 Earnings | $125.00 | S&P 500 (12 Month Projection) = | 2,133.00 |
| S&P 500 Expected PE Ratio | 18.00 | S&P 500 (**Current, Nov 9th, 2014**) = | 2,032.00 |
| 10 Treasury Bond Rate (%) | 2.30% | **S&P 500 (Gain/Loss) =** | **+4.99%** |
| Inflation Rate (%) | 2.50% | ***Standard Error*** | **+/- 6.26%** |
| Volatility (VIX) Index | 21.00 | | |
| 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**

As mentioned before, we strongly believe that corporate earnings is the major variable that determines the long term movement of the capital markets. We have kept our 12 month S&P 500 earnings estimate at $125.00. We repeat our belief in the improvement in investor sentiment in tandem to the US economic recovery. Due to this phenomenon, it is warranted that the Price Earnings ratio ( a measure of investor sentiment and how much they are willing to pay for earnings) should expand. Therefore, we have used P/E of 18 in our model; a 6-7% expansion.

Keeping the fundamental observations in mind, It can be observed that the model infers a gain of approximately 5% in the S&P 500 index for the next 12 months. The total return expectation of the broader market indexes has been reduced to 5% from 10% (Since October Newsletter). This is primarily due to the fact the the markets have gained approximately 5-6% since our last write-up (depending in the index one considers: S&P 500 has gained approximately 9% after a 4.5% decline in September).

***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.***

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

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

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