Continuum Global Asset Mgt., LLC
November-December 2015

# Market Correction!!!

### *We concluded our September 2015 Market Correction article with the following:*

> ***"We believe that investors are worried about the Chinese economic slowdown and the uncertainty of interest rates introduced by the recent rhetoric from the Federal Open Market Committee (FOMC).***
>
> ***Markets have shown immense resillience in the face of bearish sentiment, especially during times of good economic fundamentals.***
>
> ***We believe that these are testing times that bring a tug of war between bulls and bears. Our belief is on the side of patience. History shows that steep corrections, that are created by fear and panic are followed by more than normal gains in the markets". September 2015.***

Major market indexes had lost over 10% on an average for the August-September time frame. Subsequently, the same indexes have gained approximately 8-9%, making October the biggest monthly gain since 2011.

As investors, if we had decided to not pay attention to the markets for the last three months, we wouldn't have detected the volatility or have endured the pain of the interim correction. Unfortunately, the ubiquity of media and our innate emotions pertaining to fear and greed compel us to react incessantly to market headlines.

Having said that, we at Continuum have always paid immense attention to economic fundamentals that we believe ultimately drive the markets in the long-term. As mentioned umpteen times this year in our previous Newsletters, we believe that the US economy is on strong footing relative to other developed nations. In addition, we also believe that the US economy will benefit greatly from the burgeoning economies like India and China. As these economies grow, the average population will experience a rise in their disposable income fueling domestic consumption. The phenomenon of wants and desires, influences people to look for products and services beyond utility and into desires. Products like the iphones, Starbucks coffee, Levi's jeans, Mcdonald's burgers, GM and Ford vehicles etc., will definitely experience continuing growth from these areas of the world.

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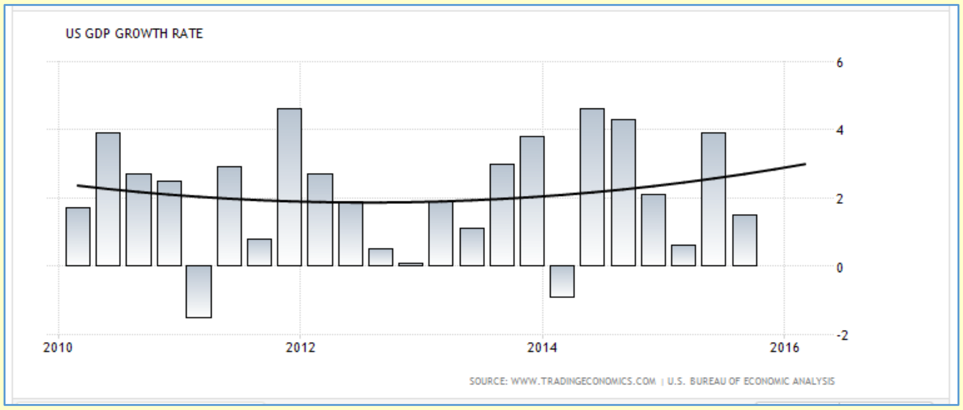
Following are crucial economic fundamentals that impact the US economy with a relatively long term perspective.

[1]**US Gross Domestic Product (US GDP):** US GDP has been growing consistently since the great recession of 2008-09. The black line on the adjacent chart clearly shows the positive trajectory in the GDP growth since 2010. In addition, the US GDP has grown at an average of 2.5% for 2015 and is projected to grow at approximately 2.5-3% over the next 12-18 months.




**Dow Jone Industrial Average (DJI; 1970-2015):** The chart below illustrates the growth in DJI index. Despite the major corrections that this much followed index has experienced, it has doubled approximately every decade since the 1930s recession. The major variable that has driven this index is the average GDP growth of approximately 3% per year.


If the US GDP grows at 3% going forward, the DJI should be at approximately 20,000 in the next 12-18 months. This would translate to about 10-12% higher than the current levels.

**Government 10-Year Bond Yield (1970-2015):** Interest rates have been declining since the last three decades. This fundamental variable that commands the cost of capital certainly impacts the growth of an economy. We believe that rates at some point, sooner rather than later, will start to move up.


[1] Source: All charts are obtained from www.tradingeconomics.com

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Despite our belief of this interest rate reversal, we don't envision it adversely impacting the US economy in the near term. Even if the Federal government starts to raise rates, they should do it in a more prolonged and uniform manner. Our belief is primarily based on benign inflation. As long as inflation remains tame, the Federal government would be comfortable keeping rates fairly low.

**Unemployment Rate (1971-2015):** The US economy depends mostly on retail consumption. In other words, the US population's spending comprises of over 70% of the US GDP. This is obviously a function of the employment situation we experience. It can be seen in the chart below, that the current unemployment rate is on the lower end in over three decades.


We strongly believe that unemplyment will remain low for the forseeable future which should help the economic growth in the US.

## CGAM's Proprietary Market Model:

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

**Table 1**[2]

| **Fundamental Variables** (12 month Projections) | | **Market Projections** ***Based on the regression equation illustrated below*** | ***As of November 9th, 2015*** |
|---|---|---|---|
| S&P 500 Earnings | $135.00 | S&P 500 (12 Month Projection) = | 2,232.00 |
| S&P 500 Expected PE Ratio | 17.00 | S&P 500 (November 9th, 2015) = | 2,074.00 |
| 10 Treasury Bond Rate (%) | 2.20% | ***S&P 500 (Gain/Loss) =*** | ***+7.60%*** |
| Inflation Rate (%) | 2.50% | ***Standard Error*** | **+/- 5.98%** |
| Volatility (VIX) Index | 17.00 | | |
| Unemployment (%) | 5.00% | | |

**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.**

Following are the changes followed by the inference of our model based on the recent developments in the capital markets:

1. The 12 month earnings expectation of the companies comprising of the S&P 500 remains the same; $135.
2. VIX index: the previous Newsletter used a value of 29 vs the current value of 17. Our model is showing increasing correlation of the market indexes with the VIX index. It should be noted that the correlation is primarily for shorter term trading and not long term forecasts.
3. Our projections guides us to believe that markets could gain another 7-8% over the next 12 months.

**The 9-10% correction experienced by the US domestic markets during August-September was followed by 8-9% gains in October. We believe that this volatility was created by technical variables and not economic fundamentals. We believe that the markets could gain another 7-8% over the next 12 months. Despite this bullish prediction, we also believe that investors should wait for an interim correction to enter the markets. We expect an interim 5-7% correction based on lower levels of the VIX index currently experienced by the 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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