Newsletter

Our September 2014 Newsletter concluded with, ***"Markets have shown immense resillience in the face of bearish sentiment. We currently believe that the US economic recovery has actually stabilized major fundamental variables like earnings, unemployment and inflation.***

We believe that the aggregate investor sentiment maybe entering a tipping point based on the six plus years of US economic recovery. From a sentiment of reminiscing the two greatest bear markets of 2000-2002 and 2008-2009, we maybe entering a phaze of prolonged bull market that could extend the market gains significantly.

The markets have lost approximately 3% over the last 2-3 weeks. As of October 1, 2014 the Dow Jones Industrial Average has wiped out all the gains for the year.

Without getting too technical, we would like to point out a few crucial fundamental variables that we believe would help support the markets over the forseeable future:

1. **Stable growth in US Gross Domestic Product: (GDP grew approx. 2% and 4%+ in Q1 and Q2, 2014 respectively).**
2. **Unemployment has improved from over 10% in 2008 to 6.1% currently. More jobs mean higher disposable income which should propel the US economy.**
3. **Improvement in housing market. Prices in Real Estate are somewhat elevated and may see flat to decelerating growth going forward.**
4. **Energy prices have declined almost 10% from the beginning of September 2014. The US would save approximately $20-25 billion per quarter. In other words favorable energy prices could add approximately 0.5% to annual GDP growth.**
5. **Our proprietary Market Direction Model illustrated below shows a favorable capital market growth over the next 12 months.**

Illustrated below is CGAM's proprietary market model which has been developed to project the potential gain or loss in the S&P 500 index over the next 12 months. The model uses fundamental growth and strength of the economy to project the market movement. We have also illustrated the regression equation developed based on 4 decades of historical data.

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Table 1

Fundamental Variables (12 month Projections)		**Market Projections** *Based on the regression equation illustrated below*	*As of October 1st, 2014*
S&P 500 Earnings	$125.00	S&P 500 (12 Month Projection) =	2,093.00
S&P 500 Expected PE Ratio	18.00	S&P 500 (**Current, October 1st, 2014**) =	1946.00
10 Treasury Bond Rate (%)	2.30%	**S&P 500 (Gain/Loss) =**	**+7.58%**
Inflation Rate (%)	2.50%	***Standard Error***	**+/- 6.38%**
Volatility (VIX) Index	17.00		
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 $125.00for the next 12 months. We had mentioned in the past that we believe 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. We have used P/E of 18 in our model. This is approximately 5-6% higher than the current P/E of 17 on the S&P 500. In addition, we have seen a spike in the Volatility Index (VIX) from 12 to 17 currently; a 40% increase in three weeks. We feel that this index can increase to approximately 20 or another 17-20%, based on empirical evidence. This could result in another 2-3% decline in the markets in the short term.

Keeping the fundamental observations in mind, It can be observed that the model infers a gain of approximately 7-8% in the S&P 500 index with an error rate of about 6% for the next 12 months. The total return expectation of the broader market indexes has been increased to 6-7% (Since September Newsletter).

We believe that the currennt market correction is not based on fundamentals. It can be attributed to exogenous factors like geo-politics, changing stance of the US Federal government and to a certain extent; profit taking. As a contrarion manager, we believe that this is an opportunity to invest in the market selectively as the US economy continues to improve.

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

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

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Please review the following disclaimer

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