# Newsletter

***Our August 2014 Newsletter concluded with,* "We had been anticipating a technical correction that was clearly stated in our July Newsletter. This recent market correction has presented investors with an opportunity to reinvest. Investors should be cognizant that our target interim correction called for a 5-7% decline, which means that major indexes could loose another 3-4% before a short term bottom."**

Since the August Newsletter, the markets have gained approximaetly 3-4% as shown in the Table 1 below.

**Table 1**

| Indexes | Index Highest Level | August 1 2014 | Gain / Loss (%) |
|---|---|---|---|
| **Dow Jones Average** | **16,493.37** | **17,078.00** | **+3.50%** |
| **S&P 500** | **1,925** | **1,998** | **+3.79%** |
| **NASDAQ** | **4,353** | **4,555** | **+4.60%** |
| **Russell 2000** | **1,115** | **1,164** | **+4.40%** |
| **Volatility Index[1]** | **17** | **11.55** | **+32.05%** |

Many market pundits have predicted outrageous levels of targets for the Dow Industrial Average (DJIA). Following are some predictions that if not stun you, will definitely surprise you:

Kevin A. Hasset and co-author James K. Glassman startled the financial world with their 1999 book, **Dow 36,000;** September 1999.

A Pundit's Bold Prediction-Again Über-bull Harry Dent says the baby boomers' last gasp of spending will lead to **Dow 40,000**; September 2004

Having gone through one of the biggest bull and bear markets of the century; the mid 1990s bull run and the 2001-2002 dot.com bust combined with the 2008-2009 financial debacle, we at Continuum Global have become somewhat cynical and usually ignore such exaggerated statements regarding market predictions.

Having said that, we have undertaken a simple analysis which involves reviewing the long term movement of the Dow Jones Industrial Average (DJIA); one of the most popular broad based market indexes in the US.

[1] Volatility Index (VIX): The VIX index is calculated using PUTs and CALL options on the S&P 500 index. In layman terminology the VIX index gauges the fear in the markets. It can be clearly observed that this index moves inversely to the major market indexes.

Table 2 below clearly shows the ending value of the DJIA each decade since 1955. The table also illustrates the average Gross Domestic Production (GDP) in the United States for the same time horizon. The endeavor is to review the DJIA's long term market movement in relation to the growth of the US GDP.

**Table 2**[2]

| Date | Dow Jones Industrial Average (Value) | DJIA 10 Year Average Gain (%) | 10 Year Average US GDP Growth (%)[3] |
|---|---|---|---|
| 2/1/2014 | 16,179.66 | 27.85% | 1.30% |
| 2/1/2007 | 12,654.85 | 84.00% | 2.84% |
| 2/3/1997 | 6,877.74 | 209.25% | 3.55% |
| 2/2/1987 | 2,223.99 | 137.50% | 4.05% |
| 2/1/1977 | 936.42 | 11.56% | 2.46% |
| 2/1/1967 | 839.37 | 103.79% | 2.87% |
| 2/1/1955 | 411.87 | | 4.69% |
| Average | | 95.66% | 3.11% |

The following can be observed from the Table 2 above:

1. On an average the DJIA has gained approximately 96% every decade. In other words, the DJIA has doubled every 10 years for the last 6 decades.
2. The average yearly GDP growth rate for each decade under review has been approximately 3.1%.
3. The DJIA has experienced north of 100% gain during the decades with accelarating economic growth; 3.00%+.
4. 1967-1977 experienced relatively lower (2.46%) GDP growth and therefore subdued index returns were achieved during the corresponding time period.

**Table 3**

| Year | Date | Dow Industrial Average (Index) | Loss |
|---|---|---|---|
| 1929 | Oct-29 | 400 | |
| | Nov-29 | 145 | -63.75% |
| | | | |
| 1969 | 1965 | 1,000 | |
| | 1969 | 765 | -23.50% |
| | | | |
| 1972 | Dec-72 | 1,020 | |
| | Sep-74 | 607 | -40.49% |
| | | | |
| 1987 | Aug-87 | 2,746 | |
| | Oct-87 | 1,616 | -41.15% |
| | | | |
| 2000 | Jan-00 | 11,908 | |
| | Oct-02 | 7,181 | -39.70% |
| | | | |
| 2008 | Oct-07 | 13,930 | |
| | Mar-08 | 7,063 | -49.30% |

[2] Source: www.yahoo.com/finance
[3] Source: http://www.multpl.com/

While the markets have provided handsome returns for the last five to six decades, we cannot ignore the significant corrections markets have experienced over the same time horizon. Table 3 (page 2) clearly illustrates the significant market declines experienced over the last 60 years.

Despite the realities of market meltdowns illustrated above in Table 3, the fact is that the US Gross Domestic Product (GDP) has been consistently growing at an average rate of 3%+ each decade. If the US maintains a GDP growth of approximately 2.5-3%, it will grow more in absolute dollar terms than any other country in the world.

The US GDP grew at approximately 4.1% for the second quarter[4] of 2014. If we can creep upto 2.5% average economic growth over the next few years, we could experience a significant growh in the capital markets. **In other words, if we believe that the markets should double each decade, then we should be at approximately 24,000 for the DJIA index or a gain of 40% from the current levels.** Obviously, this valuation is dependent upon the US economy continuing its ascent at approximately 3% per annum or an absolute GDP growth of half a trillion dollars per year.

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.

Table 5

| **Fundamental Variables** (12 month Projections) | | **Market Projections** *Based on the regression equation illustrated below* | *As of August 1st, 2014* |
|---|---|---|---|
| S&P 500 Earnings | $125.00 | S&P 500 (12 Month Projection) = | 2,055.00 |
| S&P 500 Expected PE Ratio | 18.00 | S&P 500 (**Current, August 1st, 2014**) = | 2000.00 |
| 10 Treasury Bond Rate (%) | 2.30% | **S&P 500 (Gain/Loss) =** | **+2.21%** |
| Inflation Rate (%) | 2.50% | ***Standard Error*** | **+/- 6.54%** |
| Volatility (VIX) Index | 12.00 | | |
| 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**

[4] Source: http://finance.yahoo.com/

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

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We believe that earnings are 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. In addition, we have been, for a lack of better word, suckered into believing that he Price Earnings ratio (the measure of how much investors are willing to pay as a multiple of earnigs for a company stock price) will increase. In other words, we have increased the P/E ratio to 18 from our previous measure of 17. For context, we would like to mention that the long term S&P 500 P/E average is in the range of 15-16.

It can be observed that the model infers a gain of approximately 2% 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 lowered from 6-7% down to 2% (Since August Newsletter).

***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.***

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

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