Continuum Global Asset Mgt., LLC

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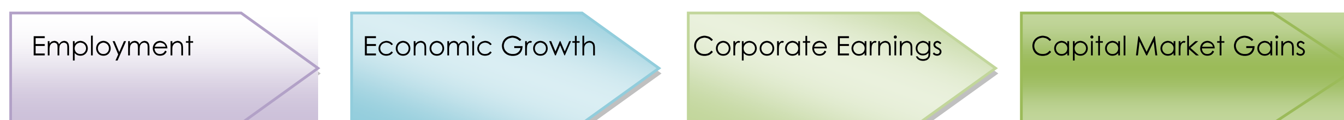
Newsletter

It is bewildering to see the markets experience a 16% decline since the July highs. The major reasons for this decline range from European and US federal debt, unemployment, decelerating GDP growth, and the list goes on. One way to negotiate a market with such uncertainty and ambiguity is to concentrate on fundamentals that drive the markets in the long term.

Market projection models that are based on history repeating itself believe that investor sentiment moves in cycles. In this issue we have used crucial fundamental and technical variables to develop a regression model with an endeavor to shed light on the future of the markets. We start with explaining the basic concept used, followed by an S&P 500 estimation equation. This equation uses variables that have empirically attributed to the movement of the index for a longer time horizon. The data used to develop this model dates back to the 1950s.

Table 1 below illustrates the variables used to develop the following equation. It is interesting to note that over 94% variation in the S&P 500 is explained by these parameters. Before we explain the model, it is important to briefly review the fundamental concept behind this exercise.



As shown in the schematic above, the US economy is primarily propelled by its consumers (Employment). The fact is that 70% of the US Gross Domestic Product (GDP) is fueled by the US domestic consumer. Therefore, it is critical that jobs are created in the US so that increased (sustained) spending and consumption can propel the GDP domestically. Economic growth will in turn be a catalyst for the corporate earnings which is a major factor that research analyst, economists and investors watch and use in developing their respective market projection models.

Based on this basic concept, we have used crucial variables to develop a regression equation that attempt to guide us on the direction of the capital markets. The process of developing this model consisted of regressing each variable considered with the S&P 500 (a broad based index used as a market proxy). After using historical date for over 3 decades, we finalized the model with 7 variables listed in Table 1 below, which statistically explained 93% movement of the index.

Table 1[1]

Independent Variables	
S&P 500 Earnings	$ 85.00
S&P 500 PE Ratio	14
S&P 500 Dividend Yield (%)	2.2
Treasury Bond Rate (%)	2
Inflation Rate (%)	3.1
VIX Index	35
Unemployment (%)	9.5

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

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S&P 500 (Estimate) = 594.83+4.3x(S&P Earnings) +33.55x(S&P PE)-33.63x(S&P Div Yield)-94.89x (Treasury Bond Rate) +20.84x (CPI) +4.13x (VIX Index)-11.55x (Unemployment)

The model equation stated above is based on the data going back over three decades. The major reason for the length of data chain is twofold. One, some variables like the VIX (Volatility or fear gauge in the market) Index have limited data, and two; we wanted to use the time line that would be pertinent to current economic and capital market conditions.

Table 2

Final Model	
S&P 500 (Projection) =	1,267.21
S&P 500 (Current) =	1,165.00
S&P 500 (Gain/Loss) =	+8.75%

The inferences derived from the model are stated in Table 2 above. This clearly shows that the markets can gain approximately 9% over the next 12 months. This model has the benefit to review the sensitivity to various variables included. Even though we have used a conservative measure for the S&P 500 earnings, we believe that the market sentiment based on US political uncertainty, European debt issues, high US unemployment etc., can create disruptions in the economic recovery that the markets have been experiencing since the economic recession of 2009.

We have changed our bullish stance to one more cautious for the short to medium term. To state this clearly, we would discourage investors from investing fresh assets in the market currently. We would like to experience some sense of political certainty and more importnatly a turn around in employment before recommending allocating assets to the capital markets. On the same token we donot expect an armageddon type scenario as the markets have already discounted stock prices significantly. In other words, we would not divest investments into companies with global exposure and high dividends. Dividend paying stocks may loose value just like another investment in a market panic phase but empirical evidence states that these investments recover the fasterst during economic recovery.

To summarize, we believe that the uncertainty and the hightened market volatilty has brought such ambiguity in the market that it becomes not only difficult but foolhardy to attempt to predict the market direction on the short term. Therefore, it behooves prudent investors to not react to market noise, but to wait and watch through this turbulence and start investing when times are more opportune.

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

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