

Our October 2020 Market Update concluded with the following inference:

"I, therefore, believe that a 7-10% correction, that we are facing now could be a good opportunity to invest in specific areas of the markets. There could be a rotation in the market sectors as well, but the technology companies catering in the face of COVID-19 should continue to show improving earnings."

In retrospect...a good call.

The S&P 500 index has gained approximately 13% (see adjacent Chart¹) since we shared our views on the October 30th, 2020 Article **"2020 An Eventful Year To Say The Least."** In addition, the S&P 500 has gained approximately 16% for the year 2020.



Is there a disconnect of Economy with Wall Street...

We believe that markets are comprised of aggregate investor sentiment, which ultimately follows economic fundamentals. This issue of our Newsletter attempts to find the relationship between the current and expected state of the US economy and how much of that is being already factored in by capital markets.

Major Economic Indicators...

The adjacent table comprises of 19 economic variables which are compiled by Econ P.I. The endeavor is to recognize the quarterly trend of the aggregate leading indicators. This table illustrates the fundamentals of the economy and provides a comprehensive view of the direction of main street.

The direction of the indicator index is showing economic expansion in the US, despite the havoc created by the unprecedented pandemic.

Major Economic Indicators

Indicators	Mid-Nov '20	Aug '20	3-Month % Change	Nov '19	1-Year % Change	Sector
Consumer sentiment	-14.5%	-21.4%	+	30.0%	-	Consumer
Existing home sales	62.0%	72.5%	-	55.5%	+	Consumer
Real retail sales per capita	22.0%	22.8%	-	14.5%	+	Consumer
Total vehicle sales	2.3%	-15.4%	+	9.0%	-	Consumer
ISM nonmanufacturing	33.9%	40.5%	-	24.2%	+	Services
Private building permits	41.5%	38.7%	+	36.2%	+	Mfg
ISM manufacturing	46.6%	15.1%	+	4.8%	+	Mfg
Industrial capacity utilization	-21.9%	-36.8%	+	12.7%	-	Mfg
Industrial production	-25.3%	-41.0%	+	18.0%	-	Mfg
Small business optimism	27.4%	7.0%	+	21.7%	+	Services/Mfg
Chicago Fed National Activity Index	36.2%	100.0%	-	11.3%	+	Services/Mfg
Nonfarm hires per 100 workers	10.1%	47.7%	-	29.9%	-	Services/Mfg
Nonfarm job openings/100 workers	-3.6%	-14.3%	+	11.0%	-	Services/Mfg
Real nonfinancial corporate profits ¹	4.3%	4.3%	=	36.1%	-	Services/Mfg
Temporary employment	-25.1%	-49.0%	+	17.5%	-	Services/Mfg
Unemployment claims ²	-100.0%	-100.0%	=	18.5%	-	Services/Mfg
Credit Managers' Index	37.5%	21.4%	+	15.0%	+	Financial
St. Louis Fed Financial Stress Index ³	36.7%	24.9%	+	44.9%	-	Financial
Yield curve spread	-2.7%	-1.6%	-	23.9%	-	Financial
Mean of Coordinates ⁴	8.8%	6.1%	+	22.9%	-	All
Leading indicators	-4.3%	-14.6%	+	25.2%	-	All
<div> <div>% MoC From Baseline Prior to Typical Recessions</div> <div> <div>1 Mo. Prior</div> <div>3 Mo. Prior</div> <div>6 Mo. Prior</div> <div>9 Mo. Prior</div> <div>12 Mo. Prior</div> </div> </div>						
2001 Recession	2.4%	1.8%	10.6%	10.8%	12.7%	
2007 - 2009 Recession	4.9%	9.0%	14.9%	18.1%	20.3%	
Average	3.7%	5.4%	12.8%	14.5%	16.5%	

1 After tax with IVA and CCAAdj

2 Inverted (positive number is decline in claims)

3 Inverted

4 Column average

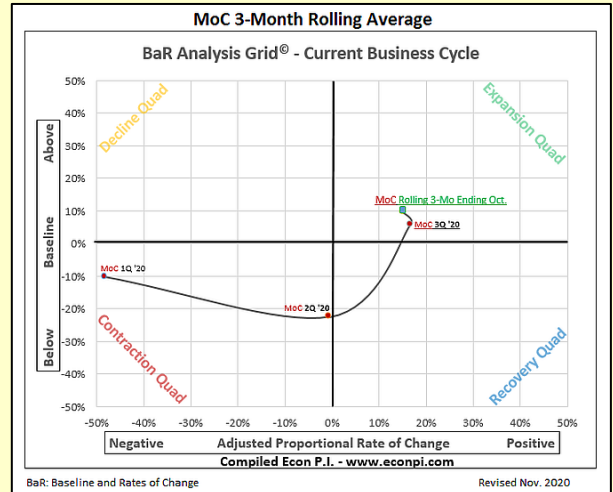
Compiled by Econ P.I. (www.econpi.com)

¹ Source: www.streetsmartpro.com

...are showing
Economic
expansion.

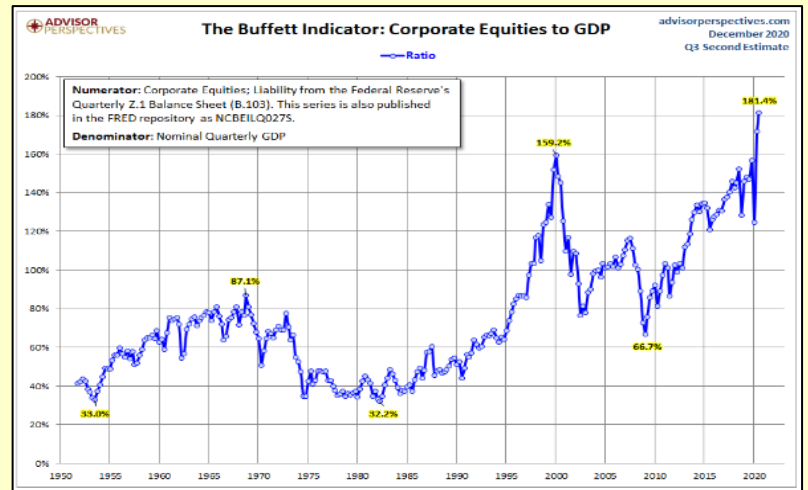
MoC (Mean of Coordinates): The adjacent chart visually illustrates the movement of the average of the leading economic indicators over the last three quarters. This is particularly important as the COVID-19 pandemic severely started impacting the US and global economy at the end of Q1, 2020.

Since, the MoC is showing progress from being in the Contraction area to now being in the Expansionary phase.



Let us turn our
attention to
technical
variables...

Year 2020 has been an unprecedented year due to the adverse impact of COVID-19 pandemic on the US economy. The US Federal government supported the US economy by infusing an unprecedented stimulus amount of over \$6.5 trillion and counting. The proactive monetary and fiscal policy of the Federal government fueled the US capital markets. Major US stock indexes ended the year with a bang. The S&P 500 gained a healthy 16% for FY 2020.



...Warren Buffett
indicator shows
that we are
"SIGNIFICANTLY
OVERVALUED".

One of the most popular technical variable used on Wall Street is the Warren Buffett indicator. This is a simple way to understand the valuation of the total market relative to the Gross Domestic Product (GDP); in other words all the value created by production of goods and services in an economy. The chart above shows the movement of the ratio of corporate equity vs US GDP.

Ratio of Total Market Cap to US GDP
Table 1 (AdvisorPerspective.com)

Ratio = Total Market Cap / GDP	Valuation
Ratio ≤ 73%	Significantly Undervalued
73% < Ratio ≤ 94%	Modestly Undervalued
94% < Ratio ≤ 114%	Fair Valued
114% < Ratio ≤ 135%	Modestly Overvalued
Ratio > 135%	Significantly Overvalued
Where are we today (2020-12-15)?	Ratio = 182.5%, Significantly Overvalued

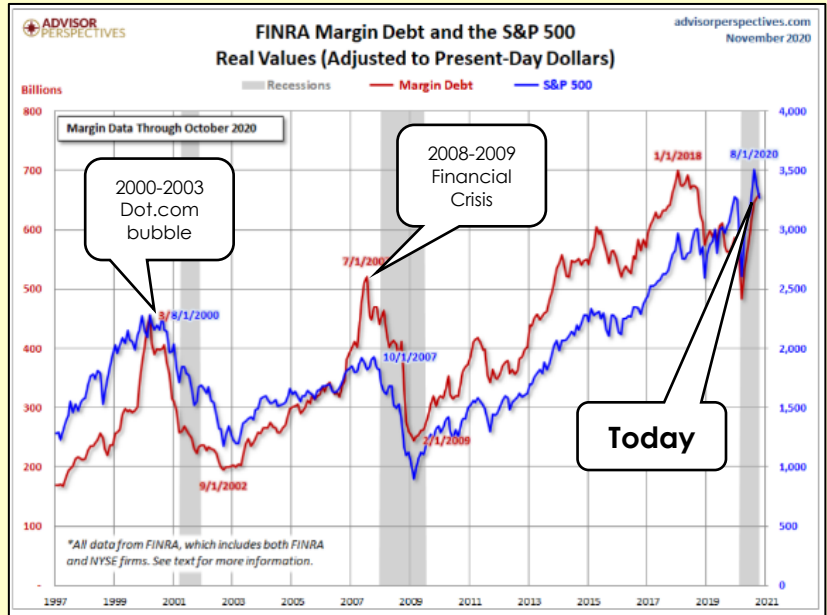
It can be observed in the chart above, that this ratio is trending north of 180%. A ratio that high shows that the US stock markets are in a "**SIGNIFICANTLY OVERVALUED**" state currently.

Margin debt...another technical indication of exuberance in the markets...

Margin debt is the loan, investors can avail to buy securities in their respective investing accounts.

The adjacent chart shows the real value of margin loans in brokerage accounts in the US relative to the movement of the S&P 500 index.

One can clearly observe that the red line (margin debt) has been at elevated levels prior to the most severe recent recessions (represented in grey bars): dot.com bubble in 2000-2003 and the Real Estate/Financial debacle in 2008-09.



Even though any one indicator can not be relied upon solely to project a market correction or imminent recession, there is enough empirical evidence that margin levels show the presence of euphoric investor sentiment.

CGAM's Market Model...

CGAM's Proprietary Market Model:

We at CGAM, have developed a proprietary Market model, which is intended to understand the direction of the broader markets. We have used the S&P 500 index as the proxy for the US broad based markets. The model was developed on our belief that investor behavior repeats itself based on a combination of economic fundamentals and investor psychology. The model is dynamic, as it constantly reviews the change in the index based on the changes in statistically significant economic variables.

The table below is an illustration of the variables used to project the 12 month target on the S&P 500. Our regression model uses six variables (shown on the extreme left column), which attribute to 93% of the movement in the S&P 500.

Fundamental Variables	FY 2022 (Estimate) ²	Market Projections	As of December 31 st , 2020
S&P 500 Earnings	\$178.50	S&P 500 (12 Month Projection) =	3,424.70
S&P 500 Expected PE Ratio	25.00	S&P 500 (December 31 st , 2020) =	3,756.02
10 Treasury Bond Rate (%)	0.89%	S&P 500 Estimated (Gain/Loss) =	-8.82%
Inflation Rate (%)	2.00%	Standard Error	+/- 4.07 %
Volatility (VIX) Index	25.00		
Unemployment (%)	7%		

² Source: CGAM, LLC's proprietary research.

...Projections indicate overbought market conditions

We have attempted to be liberal with our estimations, especially with US corporate earnings and market sentiment. The ratio of S&P 500 value (Price) to US corporate earnings (Earnings) illustrates the investor sentiment at any given time. The Price to earnings (P/E) ratio used in our model is 25, vs. the average P/E of the S&P 500 of 15-16 for the last three decades. In addition, the earnings growth used for the next 2 years has been 5% per annum.

Despite a rosy picture painted using bullish projected parameters, the model indicates that we are currently in an overbought position.

Conclusion...

We have just observed that the US economic data seem to be improving. The aggregate of US leading economic indicators are gravitating towards an expansionary phase. On the other hand, the US major market indexes seem to be in an overbought region based on empirical evidence.

After scratching my head for the last few weeks, I have concluded that it is better to err on the upside. Based on all the empirical evidence, I believe that certain areas of technology and healthcare have moved up into overbought territory. Therefore, I believe that it would be prudent to take profits in these areas of the market and raise up to 20% in cash. The endeavor is to wait for better opportunity in the market. This can and will only realized as markets evolve.

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

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