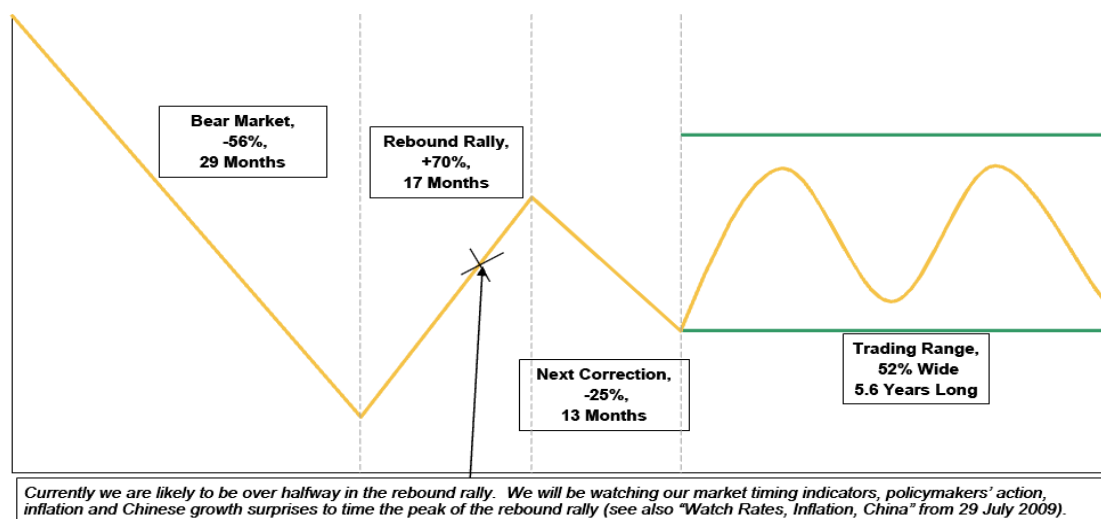


# The Starboard Side Report

The week ending January 08, 2010

The market has broken out to the upside to start the year. This has been enough to reverse the NYSE Bullish Percent Index back into X's for the first time since October. This means demand has officially taken control back from supply for the time being. That's the good news. The bad news, as we see it, is that this latest rally leg is occurring from a very elevated level and could very well be the last major upside run for a while. We don't know if this strength will last three weeks or three months, but it may be a good opportunity to start locking in profits that have accumulated over the course of the past year. Unlike 2009 when just about every thing rallied, we expect 2010 to be a much more challenging investment environment. Sector and stock selection will play an increasingly important role going forward. We believe the two S's, seasonality and stimulus, are fueling the market higher right now. Seasonality has a few more months to go before it shifts against us in May, whereas stimulus will start to wane come March. We want to be careful not to overstay our welcome too long given the magnitude of the problems facing the US economy. Below is a chart from Morgan Stanley's European research team that we used in August to help confirm our bullish stance. This time we will include it to help support taking a more cautious tone in the months ahead. Their analysis covered 80 years of global market history and looked at eighteen major market declines and recoveries. The chart seen below is a graphical representation of the mean time and price outcome of each episode that they analyzed.



Source: Morgan Stanley

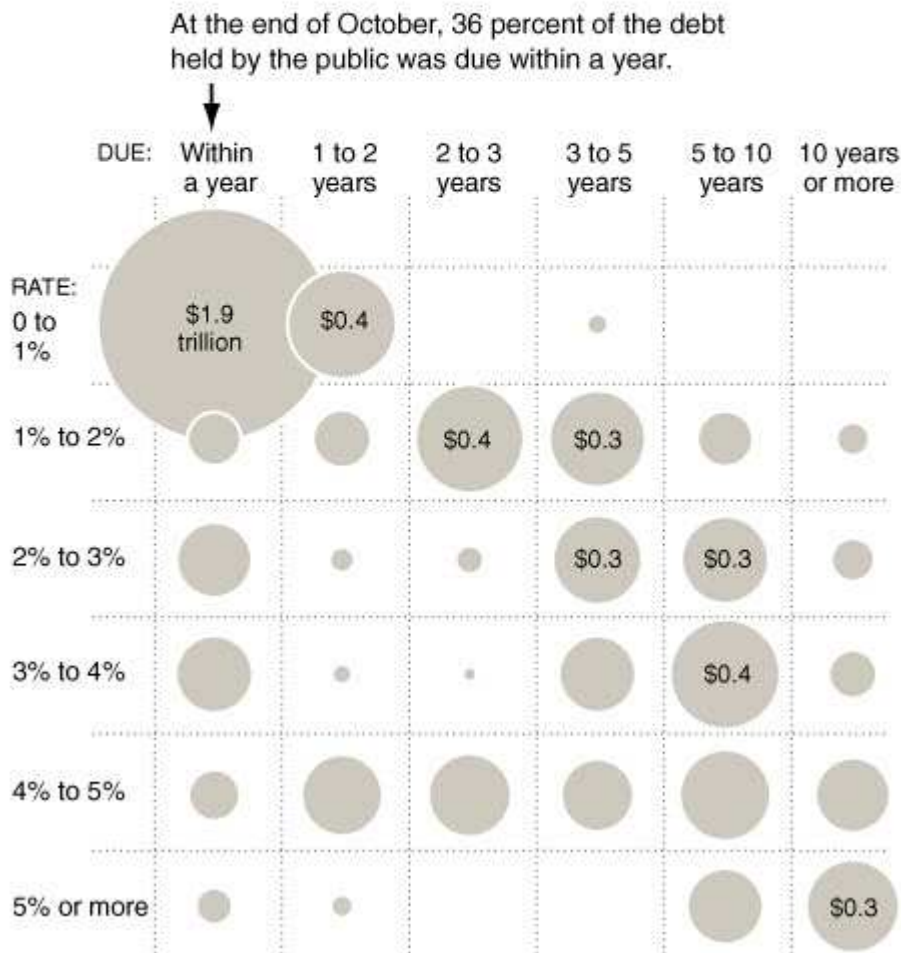
As you can see, the rebound rally phase has historically been a move of 70% over 17 months. At the time of this analysis last summer, the rebound rally was still only about halfway finished and the risk-reward was much more favorable. The S&P 500 is now 72% above its lows, so more caution is warranted. Forecasting via historical analysis is not an exact science, but it does give us a framework from which to assess our risk and make decisions. Given that the next phase tends to be a year long 25% correction, we feel it prudent to be getting more risk adverse as we move forward. This does not mean sell everything and hide. As we mentioned, the buyers have regained control of the market for the time being and momentum still appears positive. Rather, it means the easy money has been already made and a more difficult investment climate may return in the next few months. This would require a shift out of capital appreciation mode into capital preservation mode.

Some of the headwinds that the market is likely to face in the near future are rising interest rates and rising energy prices.

The NY Times recently had a great graphic that showed the massive amounts of short-term US government debt that needs to be rolled over in the months ahead. Below is that excerpt:

### A balloon of short-term i.o.u.'s coming due

Historically, the government has tried to limit its short-term debt — Treasury bills that are due from 30 days to one year — to less than 25 percent of its overall issuance. But the financial crisis created a sudden large need for cash, and short-term debt soared to 36 percent of the government's much-bigger portfolio. More than \$1.6 trillion is due by March 31 alone. Replacing any of that with longer-term bonds will require paying higher interest rates.



As you can see, the government seems to have taken a page out the mortgage market playbook. Namely, borrowing at short-term teaser rates in order to get access to cheaper credit. However, \$1.9 trillion of debt will need to be rolled over by March of this year. Should the market reject the risk of lending at short rates to an increasingly risky borrower, then the government will have to venture further out the yield curve where rates are higher. Economic researcher Chris Marteson summed this problem up nicely:

"It is devilishly attractive to use short-term financing when rates are low, and that is exactly what the US has been doing lately. Caught with enormous financing needs, upwards of more than \$125 billion of new deficit financing per month (the 2009 average YTD), the Treasury Department has decided to 'manage' its debt by financing itself with short-term debt.

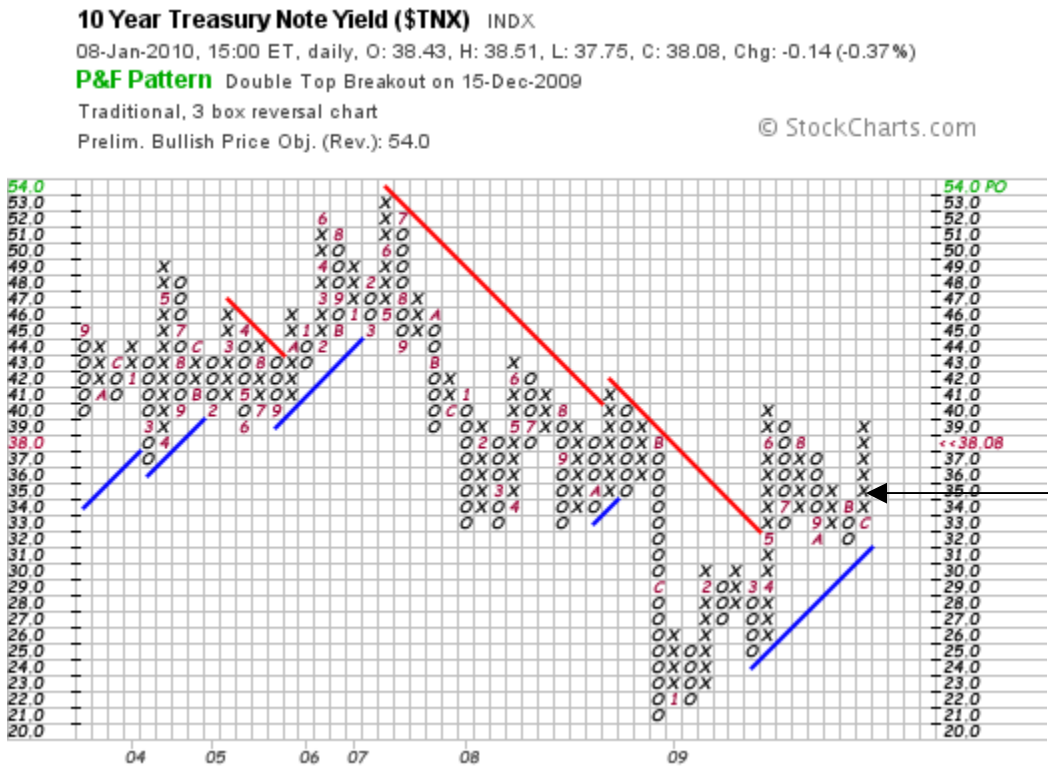
The US government has essentially ballooned its short term debt by 50% over the past few years. More than \$1.6 trillion of this will be due by March 31, 2010. On top of this, the US government probably will need at least \$1 trillion, but possibly as much as \$1.5 trillion, in additional new debt financing over the next year.

Adding it all up, the US government will need to either "roll over" or issue an astounding \$2.9 to \$3.5 trillion in debt. And the year after that? The number will only be higher.

When debtors get in over their heads, the first thing they seek to do is lower their interest payments. This gives the appearance of better fiscal health, as the cash flows improve for awhile. But eventually, unless they pay down their existing debts and resist the urge to go deeper into debt, reality rears its ugly head and the lower interest payments are discovered to have only delayed the day of reckoning."

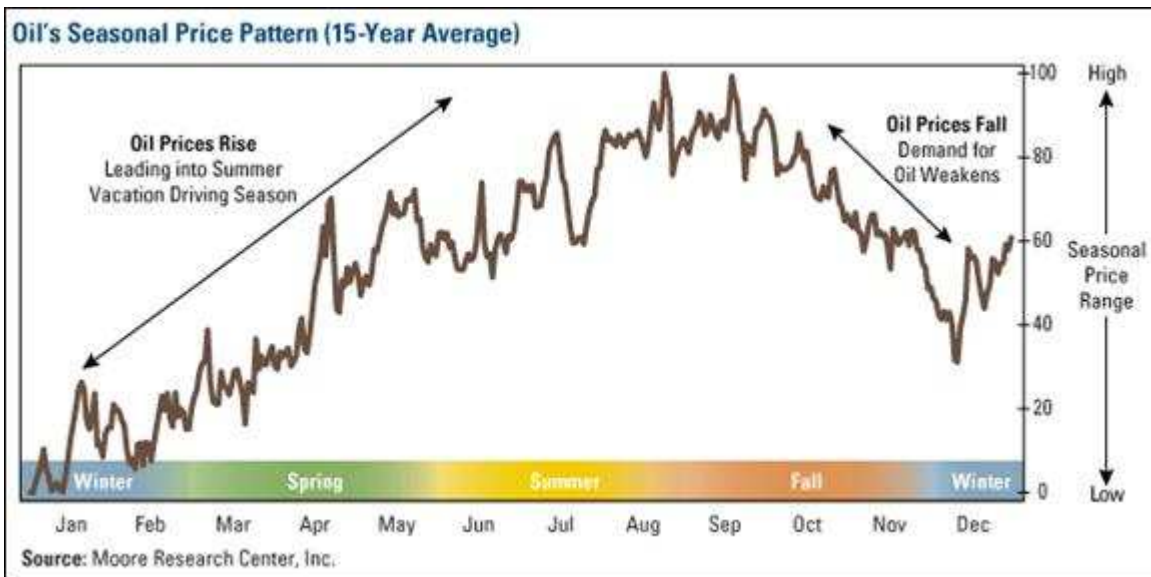
This is the trap that plagued the sub-prime mortgage market and eventually led to its implosion in 2007. This shell game can continue as long as investors are willing to play along and lend to the government at 0-1% interest rates. However, as we learned in 2007, once the game is up, it has some pretty nasty consequences.

The other black cloud overhanging the debt markets is the fact that the Federal Reserve is planning to stop back-stopping the mortgage market at the end of March. Over the past year, the Fed has added \$1.0 of mortgage-backed securities (MBS) to their once pristine balance sheet. That is up from owning zero MBS prior to the financial crisis. This enormous buying power has had the effect of driving down mortgage rates to artificially low levels. Once this prop is removed in March, mortgage rates may spike higher if the private sector is unwilling to step back into the market for these securitized loans. A scenario like this would obviously be bad news for the fragile housing market recovery. The rise in 10-year Treasury yields below shows that the market is getting worried about these issues.



Longer term yields are on the march higher due to worries about the extraordinary financing needs of the US government.

Inflation is another problem on the horizon for the economy in the second half of this year. Energy price increases should start to trickle through to the rest of the economy. A return of \$100 oil will be a tough challenge for the economy, especially if it coincides with an increase in interest costs. As you can see below, we are about to head into the seasonally strong period for oil prices.



If we put it all together, the US economy may be about to face some bumpiness ahead as rising interest rates collide with rising energy prices. Couple this with the fact that the S&P 500 has already rallied over 70% from its lows and we see *gradual* profit taking during the first quarter as a prudent course of action. Funds raised can be used down the line should a sustained correction sneak up on the market and knock stock prices lower.

Our final chart this week is one that we have not shown in a while. It is an in-house market risk barometer that goes back to the mid-1980's. Readings of over 300 indicate risk levels are getting extremely high, whereas moves below 0 are often good low risk long-term buying opportunities. As you can see, we just went over 300 for only the fifth time in the past twenty-four years. Usually, momentum carries over for a few weeks or months upon reaching this elevated level, but it has historically been a good time to start getting more defensive.

