

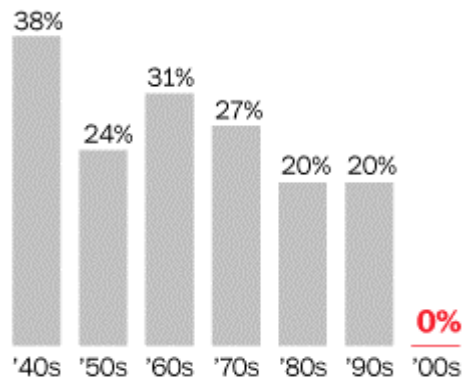
The Starboard Side Report

The week ending January 15, 2010

Of all the charts that we have seen about the decade just past, one stands out pretty dramatically. Below is a look at US job growth over the past ten years courtesy of the *Washington Post*.

There was **zero net job creation** in the first decade of the new millennium, compared to healthy job growth in each of the previous six decades.

Job growth: percent change in payroll employment.*



*2000s extends through Nov. 2009

THE WASHINGTON POST

The reason we feel that this graphic is important is that it really highlights the dilemma facing the US political economy at the moment. There is no consistent net job creation to help restart economic growth. In the four economic contractions between 1970 and 1983, it took on average 19 months to regain all of the jobs lost in the downturns. In the 1990 and 2001 recessions, it took 32 and 48 months respectively. So far, we are 25 months past the start of this downturn and employment is still contracting. This means another extremely long stretch of poor employment growth to start; another so called jobless recovery. Furthermore, middle income Americans have seen their wages stagnate like no other time in modern history. The result is that 2009 income levels were actually lower than in 1999 after factoring in inflation. It is the first such decline for a decade period since records have been kept. This lack of wage growth created the need to use debt in order to try and get ahead. While incomes stagnated, total household debt rose by 117%! Our debt more than doubled, but our means to pay back that debt stayed flat. Therefore, as we have so painfully discovered over the past three years, debt led expansion is nothing more than an illusion without job and wage increases. Unless something drastic changes, we will have more of the same troubles ahead for the US in the next decade.

The phenomenon of jobless recoveries has caused the economy to become increasingly reliant on asset price growth in order to drive economic expansion. Repeated attempts by the Federal Reserve to artificially prop-up asset prices in order to support our credit driven economy has

lead to a vicious boom and bust cycle in which fewer and fewer citizens participate in each recovery. This creation of asset rich haves versus the asset poor have nots is very bad for the long-term structural underpinnings of our nation. Therefore, without a traditional broad based jobs recovery, we once again do not see this economic expansion having a solid foundation. If we connect the dots, this means that the gains in the US stock market averages are probably not sustainable as was the case after the 2002 bottom. As we have discussed, certain sectors like energy and materials have solid fundamentals and can perform relatively well. Yet, these two groups are only 15% of the S&P 500. Technology, consumer and financial stocks still make up the large majority. Should the next wave of asset price increases continue to flow towards "unfriendly" asset classes like commodities, then the discretionary consumer and technology *things we want* will continue to be squeezed out by the food and energy *things we need*.

<u>S&P 500 Sector</u>	<u>Top of</u>				<u>Top of</u>						
	<u>Present</u>	<u>Credit Bubble</u>	<u>2005</u>	<u>2000</u>	<u>Tech Bubble</u>	<u>1995</u>	<u>1990</u>	<u>1985</u>	<u>1980</u>	<u>1975</u>	<u>1970</u>
Energy/Materials (Commodities)	15.2	13.5	12.3	8.9	8.0	15.2	20.2	18.7	37.9	29.6	25.7
Financials & Technology	37.2	40.3	39.4	44.0	52.5	31.1	18.0	23.6	17.5	17.0	18.2
Sector Weighting Spread	(22.0)	(26.8)	(27.1)	(35.2)	(44.5)	(15.9)	2.2	(4.9)	20.4	12.6	7.5

Above is an updated graphic that we first put together for our 06/26/09 weekly. We developed this to track the difference in the legacy bull market sectors that have busted (technology and financials) and the new bull market commodity sectors (energy and basic materials). For those unfamiliar with the materials sector, it consists mainly of companies in the steel, natural resource mining, forestry and chemical industries. Institutional and retail portfolios in the US are still stuffed with technology and financial stocks, but are still light on materials and energy. This over saturation matters because at a certain point there is no more room for the same highly correlated investments. Especially if those sectors are in secular decline due to overvaluation (technology) or poor fundamentals (financials). We got a good glimpse of the problems facing the financials sector this week with JP Morgan Chase reporting increasing credit losses. In addition, the government seems intent on squeezing profit margins and reverting banks back to their prime utility function of interest rate spread based lending. On the other hand, Intel's good earnings and the subsequent sell-off in the share price show that when a stock is over-owned and overvalued it can fall regardless of the fundamentals. It's the old "who's left to buy" syndrome.

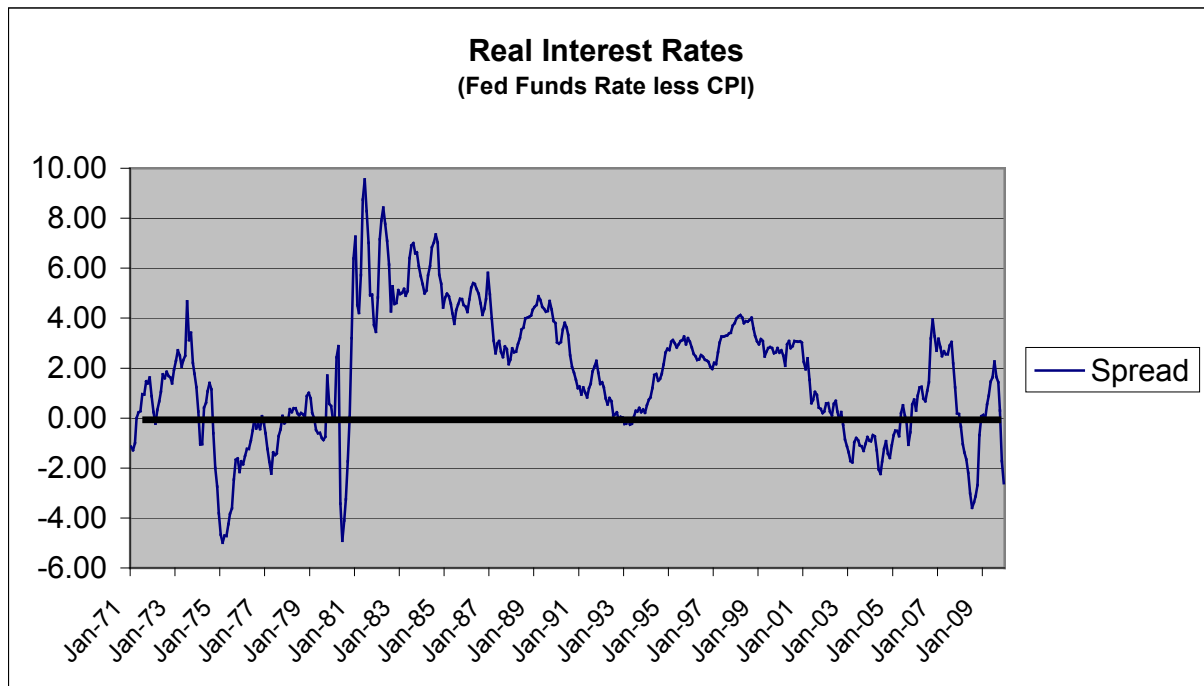
Back when we last did this analysis in June, the sector weighting spread was -19.5 versus -22 now. Therefore, the sectors with the best long term fundamentals have lost ground as a percent of the S&P 500 over the past six months. We would be very surprised if this trend continues in the months ahead. We see the portfolio managers starting to gravitate back to energy and materials as long-term fundamentals take over from short-term factors. This would lead to a resumption of the spread narrowing between these sectors that began in 2000 at the top of the technology bubble. As we have mentioned before, at some point over the next decade, we expect this spread to turn positive again as it was in four out of the five measurement periods between 1970 and 1990.

To come full circle, the jobs issue we discussed above is intertwined within the analysis of these S&P 500 sectors. The gutting of the US manufacturing industry and the creation of a credit-based services economy had huge implications for stock market returns over the past three decades. However, if the US is to grow its way out of this funk, it is not going to be on the back of the over leveraged consumer. There needs to be a rebirth of the industrial economy in this country if we are to remain competitive with the rest of the world. An alternative energy revolution and massive updates to our aging infrastructure could go a long way to rebuilding the US economic base, create jobs/income growth and more sustainable

prosperity. This should play into the hands of basic material, industrial and energy companies. Borrowing to buy more expensive homes and to support consumption created an illusionary standard of living for many. As a country, we need to funnel productive capacity back into things that will matter not into granite countertops and strip malls. To quote Chris Martenson *"It's a different future that awaits (the US). Not necessarily worse, but certainly involving a whole lot less stuff bought on credit. Some will interpret this as a distressing decline in living standards, but for those who can shift their perception, this will be an exciting time of transformation from a culture of consumption to something far more satisfying and lasting."*

The powers that be in Washington are busy trying to revive the same failed system that got us to this point. Meanwhile, the populist groundswell is only going to get louder until something is done to help change the system and put us on a new path. A path that is not reliant on asset price increases, but instead once again built on the hard working ingenuity of everyday American labors and entrepreneurs.

The Consumer Price Index (CPI) for December was released this week and it showed that inflation is starting to creep higher again with a 2.7% year-over-year increase. This is mainly due to rising energy prices, but as we saw in 2007-08, at these levels, it doesn't take much for higher energy prices to bleed through to other parts of the economy. This positive CPI number has pushed real interest rates decidedly negative again as seen below



Real interest rates below negative two percent are a rare and extremely stimulative monetary stance for the Federal Reserve to take. Historically, gold tends to perform very well when the real federal funds interest rate is negative because inflation is often the result as it was in the 1970's and after the last recession in 2003. This inflation can occur right away or with a lag. Either way we still want to be positioned in those assets that are deemed inflation hedges such as precious metals and commodities. Not only is dangerous government monetary and fiscal policy favorable for these assets, but the emerging market demand situation that we have discussed in length in prior reports is also driving long-term positive fundamentals.