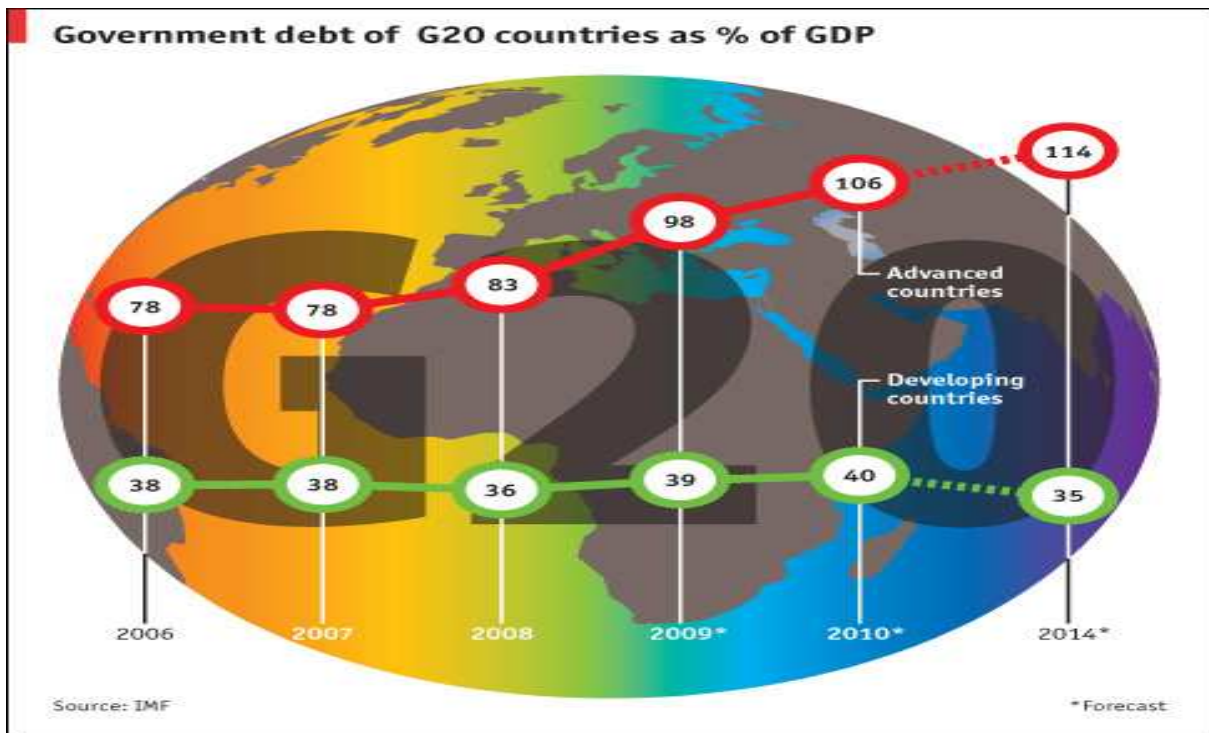




# The Starboard Side Report

The week ending February 05, 2010

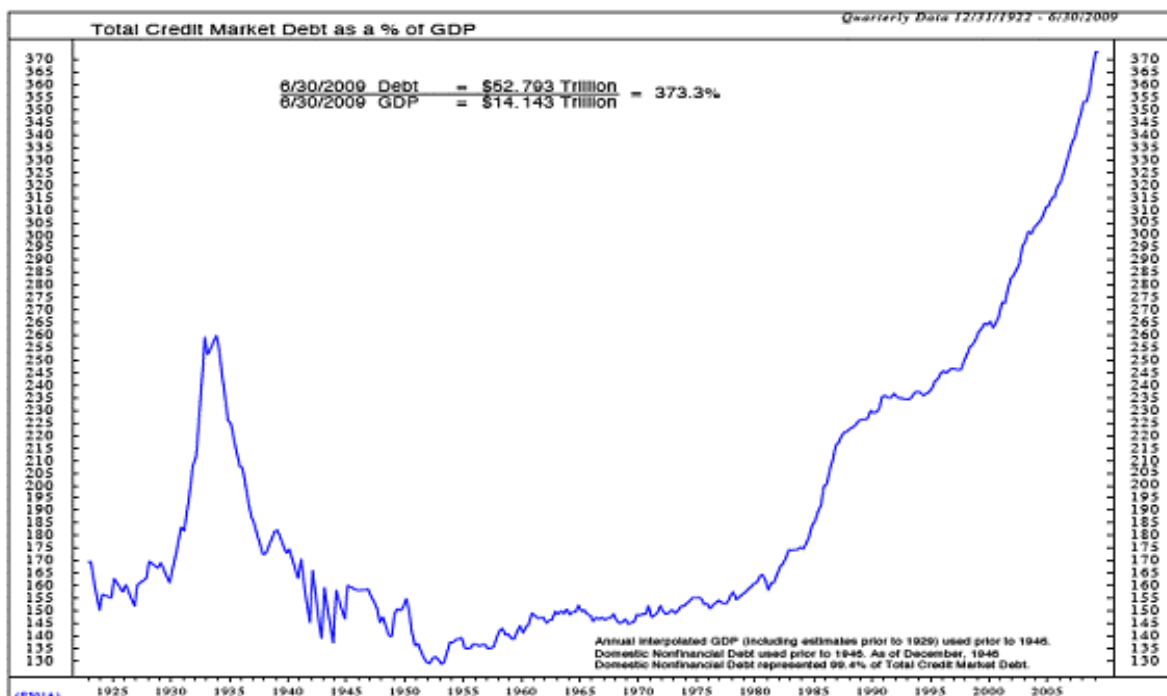
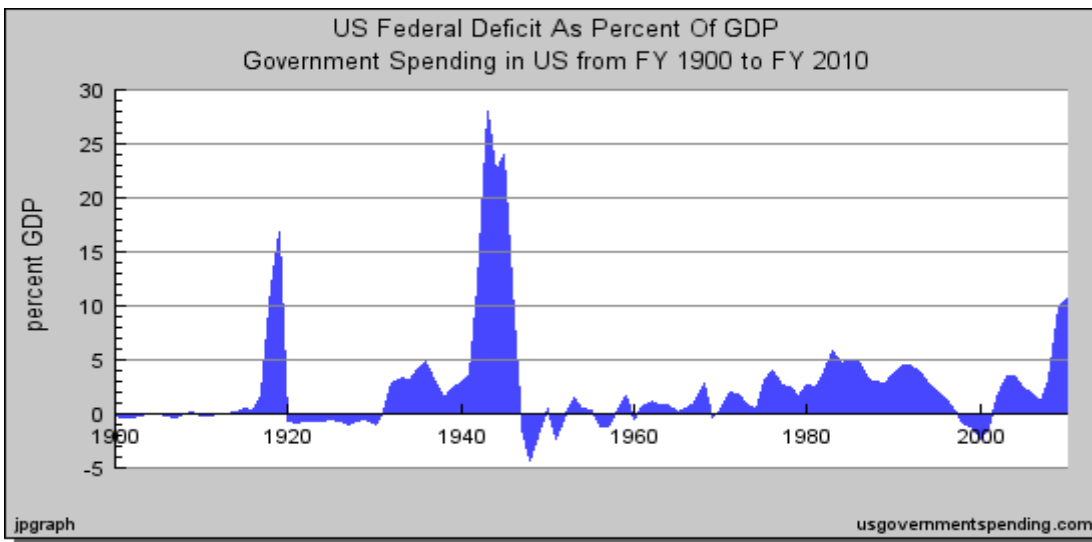
You have probably heard us mention the BRIC (Brazil, Russia, India and China) economies in this report. Experimentation with capitalism in these populous nations is creating a growing middle class that is in turn helping to fuel global growth. Unfortunately, there is another Wall Street acronym making the rounds that is much more sinister and unfriendly to global growth. The PIIGS (Portugal, Italy, Ireland, Greece and Spain) are the debt laden developed economies of Europe that are sucking the life and liquidity out of global stock markets. Below is a chart that we showed a few weeks back that perfectly illustrates the divergent path that of the emerging world versus the advanced countries.

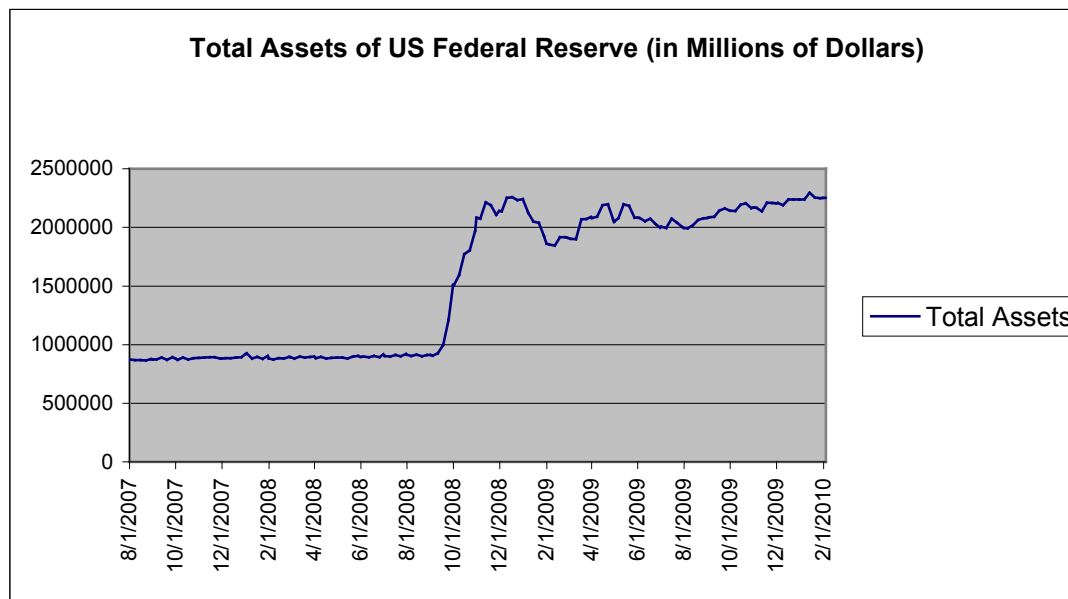


The debt burden of the PIIGS in addition to the UK, US and Japan are an albatross around the neck of the global economy. Going forward, we are entering a world that will increasingly be affected by a series of these rolling sovereign debt crises. Greece is less than 1.0% of global GDP, yet it is a microcosm of the problems the markets faced in the aftermath of the Great Recession. The troubles that began late last year in Dubai have now made their way to Greece. This has had the effect of driving down the Euro currency and bidding-up the US dollar and Japanese Yen in a flight to "quality". But make no mistake, US finances are not any better than those of the PIIGS. The major difference is that our debts are funded in our own currency (a currency that can be printed at will to buy that debt) and we still have the most liquid bond market in the world. We will have our turn to face the music played out by the market vigilantes. Sharply higher interest rates in the US will trigger a rapidly depreciating US currency and the inflation that goes with it. The only question in our minds is when does this hit the US shores and how long can the Federal Reserve get by with smoke and mirrors? We suspect that the day of reckoning for the markets is still a few years out; perhaps late 2011 or early 2012 as a best guess. As long as the global markets are preoccupied with the PIIGS, the US can still escape with lower interest rates and buoyant capital markets due to the flight to

quality effect. But, as soon as rates start to head meaningfully higher in the US, it is time to really get cautious. Preparations can and should start now nonetheless.

Below in the first chart, we see that the US deficit is above 10% of GDP in line with Greece. The only other times it was this high was during WWI and WWII. The second chart from Ned Davis Research shows total credit market debt as a percent of GDP. This illustrates the ballooning effect of Wall Street balance sheets and the real estate/consumer finance bubble of the past twenty years. Finally, we have included a chart of the huge balance sheet of the US Federal Reserve. Recent growth reflects the Federal Reserve stepping in as the buyer of last resort and adding an assorted toxic brew of loans from the banking system. The asset growth has mostly been in the form of mortgages as the Fed now holds over \$1.0 trillion in MBS (mortgage back securities) versus zero at the end of 2008. In total the Fed balance sheet has expanded by 150% over the past two years to over \$2.4 trillion. The Fed has single handedly been propping up the US mortgage market and owns about 80% of current 30-year mortgage paper. We feel that this grand experiment of taking private debt and stuffing it onto public balance sheets will ultimately fail.





Source: US Federal Reserve

The main reason that we are showing this mountain of debt overhanging the US economy is not to stoke fear in an already fearful environment. This information is not new to the markets. Rather, it is to illustrate that we are not really any better off than Greece, Spain or Portugal. In fact, we may have a larger problem on our hands when all is said and done. The almost bankrupt state of California is five times larger than the economy of Greece! The big difference between the US and the Euro PIIGS is that we have the ability to inflate our way out of our problems by printing currency to finance the debts. This is in lieu of taking the hard medicine of saving and fiscal discipline that would otherwise be needed to get the problems under control. That means a much weaker US dollar and higher inflation down the road. It is these fundamental factors that drive our long-term investment decisions and serve as the real basis for managing risk going forward.

Corrections like the one we are going through come and go. They are the known commodity in the market that we can manage. They sting for a little while, but then usually work themselves out (see final chart below). It is the bigger systemic risks that can set back retirement portfolios for years, so we need to make sure we are prepared to face the challenges. The recent credit crisis was a prime example of systemic risk. We read somewhere recently that the next crisis that we are going to be facing as US citizens won't be a crisis of lack of liquidity (like the 2008 panic), rather it will be a crisis of too much liquidity (i.e. inflation). We could not agree more. That means we want to have protection against the savage toll that currency debasement, inflation and higher interest rates will have on long-term investment performance. Below is a good, but frightening exchange between Marc Faber and Felix Zulauf in a recent edition of the *Barrons Magazine* annual strategist roundtable:

Faber: The deficit will be above a trillion dollars a year as far as the eye can see. One day, Mr. Bernanke or whoever is at the Fed will have to increase short-term interest rates. When that happens, America's interest burden will go up dramatically. Interest payments could go to 35% of tax revenue in 10 years' time, but that is an optimistic assumption. I'm inclined to think 50% of tax revenue will go toward interest payments on government debt in 10 years. Then you are bankrupt. There is only one way out -- the Zimbabwe way. You will have to print and print and print (money).

Zulauf: It is true. All federal debt, including unfunded liabilities, isn't 100% of GDP, but 600%. In most industrialized countries, federal-government debt is between 350% and 360% of GDP. Eventually the U.S. will arrive at the point where, as Marc says, interest payments on government debt all of a sudden go to 20%, 25%, 30% of tax revenue. And once you go above 30%, you are done. You go into default or your currency breaks down and your system collapses.

Hopefully, we can get our house in order before the system collapses as Mr. Zulauf says. However, we do not have much faith in US politicians getting this right. They have not recently been ones to take proactive measures in order to solve long-term problems. The housing bubble and peak oil are prime examples. As a result, the US and the rest of the advanced world are not where we want to have the majority of our capital positioned going forward. Emerging countries with lower debt loads and growing middle classes, precious metals, defensive common stocks with yields above long-term US Treasuries and commodities are still the best positioned assets to protect us from the inflation storm clouds brewing on the horizon.

The recent rally in the dollar has been very strong to say the least. However, it has been driven by the lesser of two evils mentality, not an improvement in structural underpinnings. We are seeing signs that this leg of the dollar rally may be about to run out of steam. Momentum has been positive for 17 weeks now and the Dollar Index is three standard deviations over bought in the short-term. In addition, as we pointed out last week, the Euro is extremely oversold and it makes up 60% of the US Dollar Index. Risk assets have been trading opposite the dollar of late, so any retreat for the dollar should at least allow for a bounce in global stocks. This would be a welcomed relief from the constant pounding they have taken of late.

Despite the worrying debt analysis we discuss above, there is still enough stimulus in the pipeline to create some decent opportunities in the months ahead. Short-term real interest rates are still negative due to the excessively low Federal Funds Rate. This should stimulate investment demand out of cash into higher yielding opportunities. We will balance this view with the understanding that risks are growing and the longer these imbalances are allowed to fester, the greater the ultimate mess we will need to clean-up. The signs of the credit crisis started to appear in 2004-2005 with the housing bubble, yet markets traded higher for three more years. We see this bull cycle as being much more compressed than that five year cycle, but we don't think it is over just yet.

We will leave you with one chart (see next page) that is a good step back and look at the big picture type of analysis from Dorsey Wright. Focus on the yellow highlighted area because that is the most relevant to this market. After a huge gain in 2003 and early 2004, the S&P 500 consolidated during a ten month period of whipsaw trading between March and October 2004. This set the stage for three more years of gains even as the signs of a credit bubble grew all around us. There is an old saying in the short-selling world that markets can remain irrational longer than you can remain solvent. This means that markets usually surprise on the upside before the day of reckoning comes. The fact that we may have just entered a period of consolidation such as this will be frustrating at times; especially after the straight up nature of 2009. Yet, this is actually a more normalized environment that will require patience and discipline to navigate. Prudent risk management and relative strength analysis should help in that regard.

# S&P 500 Chart: 2002 Bottom to 2006

