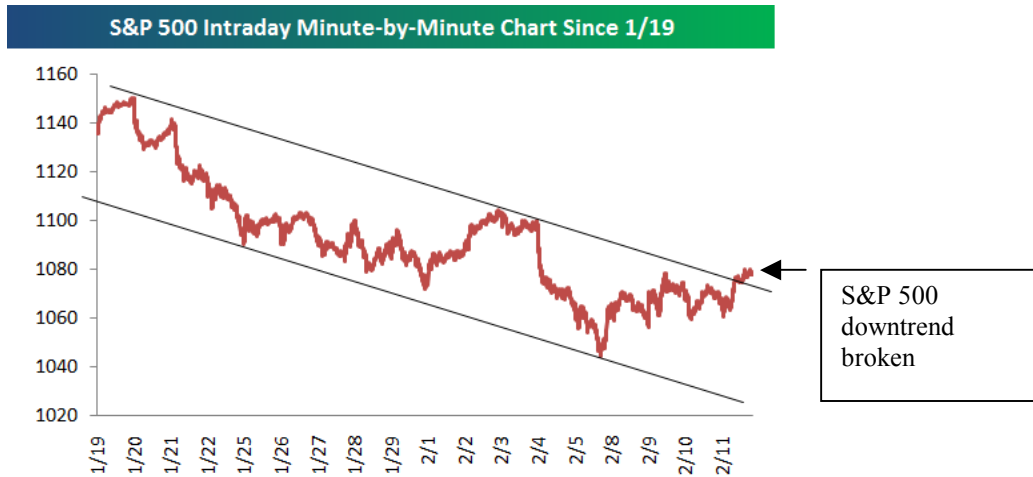




The Starboard Side Report

The week ending February 12, 2010

The sharp market correction that began in early January appears to be winding down for now. Downward momentum has reached a level that has historically signaled a near-term bottom for the US market. Once momentum reverses back to the upside there should be a respite from the storm for at least a few weeks. An additional positive is that the recent downtrend was broken to the upside during Thursday's rally (see chart below).



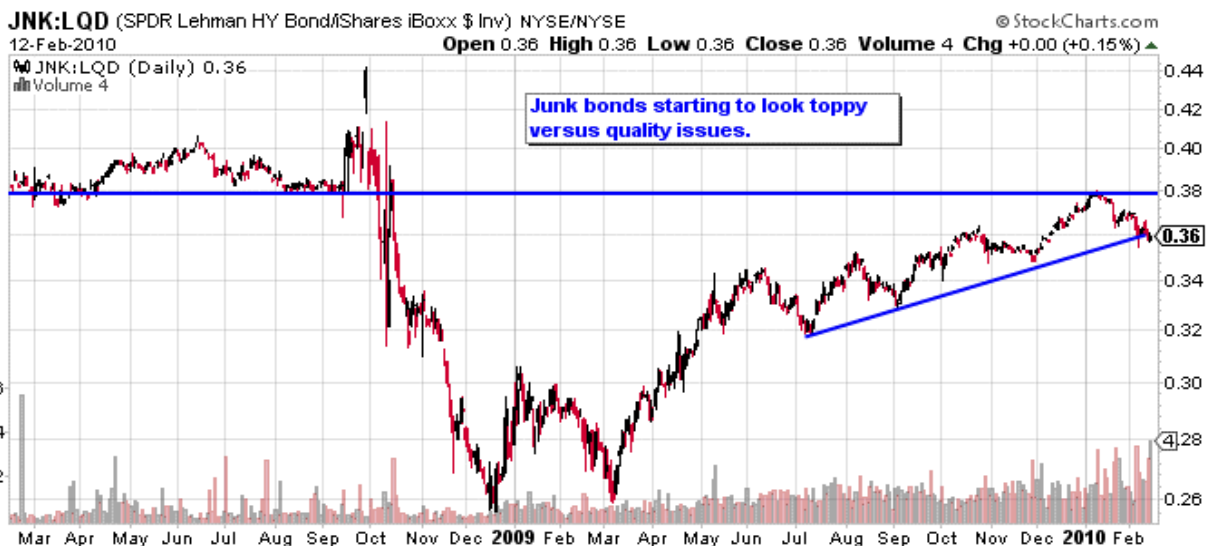
Source: Bespoke Investment Group

As we mentioned last week, we expect to see a very choppy range bound market for at least the next few quarters. If this environment plays out as we expect, the average stock will have a tough time sustaining gains achieved during the rally phases. As such, bounces will provide a good opportunity to raise some more cash and hedge gains achieved over the past year. We believe that a more attractive buying opportunity than now should present itself later in the year. Those that were patient in 2004 were rewarded with a better chance to add stocks in August of that year. Below is a breakdown of how that year played out in the S&P 500 Index.



There were several cycles after the market topped out in March that proved challenging to navigate. Patience and discipline were the best strategies. The average of the four down cycles was a decline of 6.2% over 31 days, while the three corresponding rally phases averaged a 6.5% gain over 36 days. For comparison, the most recent correction in the S&P 500 was 9.2% and lasted 17 days. The fact that this decline was greater than any in 2004 makes sense because the gains off the lows in 2003 were not as large as the ones we had off the 2009 bottom. Notice how each of the rallies in 2004 took the index back to about the point where the correction started. In addition, the rebound tended to mirror the decline in both price and duration. A similar pattern would bring the market back towards the 1,150 level over the next few weeks. We understand that history does not always repeat exactly. However, we want to establish an analytical framework based on similar historical circumstances in order to anticipate possible high probability outcomes. We are also studying the 1930's and 1970's to see if we can glean any insight from those troubling macro economic environments.

Liquidity provided by central bankers fueled a rush into risky paper versus quality. The relative strength ratio chart below shows that junk bonds have been solidly outperforming investment grade issues for over a year. However, in early January the ratio ran into serious resistance from the same level it broke down from in the fall of 2008 during the credit crisis. We believe that this may be a sign that demand for riskier credit is starting to wane and high quality is starting to come back into favor. Falling risk appetite usually favors large cap stocks and defensive sectors. We will see if this is the case going forward.



In keeping with the 2004 analogy, it will be interesting to see if we get new leadership coming out of this recent period of turmoil. Will defensive issues and large caps hold up better and start to gain relative strength versus cyclical sectors and small caps or will materials, technology and emerging markets continue to lead as they did during 2004? We will monitor relative strength closely to help us make this determination. Below is how certain sectors and asset classes performed over the eight months of choppy trading in 2004. Notice there were a large number of areas that outperformed over this eight month period of 0% return for the S&P 500. The weakness was led by the finance, technology, healthcare and consumer sectors. Small cap and cyclical issues performed the best. Energy was clearly a standout performer and signaled that it would be a strong relative performer over the next few years. At inflection points, it's sometimes best to sit back and let the market do the talking in order to help gauge future leadership.

Performance between 3-5-04 and 11-03-04

<u>Symbol</u>	<u>%Change</u>
Crude Oil Continuous	37.24
Natural Gas Continuous	22.37
Dow Jones U.S. Transportation	21.80
iShares Dow Jones U.S. Energy Sector	16.41
PHLX Oil Service Sector	7.41
Dow Jones U.S. Utilities Sector	7.11
Gold Continuous	6.20
Dow Jones U.S. Industrial Sector	5.88
Dow Jones U.S. Real Estate Index	5.27
MSCI EAFE Index Fund	4.55
Continuous Commodity Index	2.90
Dow Jones U.S. Basic Materials	2.34
MSCI Emerging Markets Index	2.19
Dow Jones U.S. Telecom Sector	1.84
S&P Homebuilders	0.28
Russell 2000 Index	(0.70)
Market Vectors Gold Miners	(0.85)
S&P 500	(1.18)
Copper Continuous	(1.22)
DJ U.S. Consumer Services Sector Index	(1.97)
NASDAQ	(2.11)
Dow Jones U.S. Financial Sector	(3.34)
Russell Top 50 ETF	(3.78)
Dow Jones	(4.33)
Dow Jones U.S. Consumer Non-Cyclical	(4.86)
Dow Jones U.S. Broker Dealers Index	(5.90)
Dow Jones U.S. Tech Sector Index	(6.44)
Dow Jones U.S. Healthcare	(8.65)
NASDAQ Biotech Index Fund	(14.52)

Source: Dorsey Wright

Two final charts we wanted to show this week are the price of gold and gold mining stocks in Euros over the past four years. Despite a 14% correction in gold priced in US dollars, the precious metal has held up well when viewed through a European lens. In fact, gold in euros is within 1% of an all time high. A decisive break above \$810 should signal the start of another up leg in the European gold market. This added demand could be a catalyst for the global precious metals mining sector and help spark a new rally. We see value in that the mining stocks are trading at the same level as early 2006 whereas the metal itself is up over 75% during this period. This indicates good relative value in the mining stocks. In addition, those that are calling the gold bull market over due to the 14% correction in dollar priced gold have clearly not looked at the euro priced chart. If anything, the economic turmoil in Greece has added to the bullish case for gold and the bearish case against paper currencies that are backed by mountains of increasingly shaky debts.

\$GOLD:\$XEU (Gold - Continuous Contract (EOD)/Euro Index) INDXX/INDX © StockCharts.com
12-Feb-2010 **Open 7.85 High 8.05 Low 7.79 Close 8.02 Chg +0.23 (+2.95%) ▲**



\$GDM:\$XEU (Gold Miners Index - NYSE Arca/Euro Index) INDXX/INDX © StockCharts.com
12-Feb-2010 **Open 8.57 High 8.95 Low 8.26 Close 8.85 Chg +0.31 (+3.67%) ▲**

