

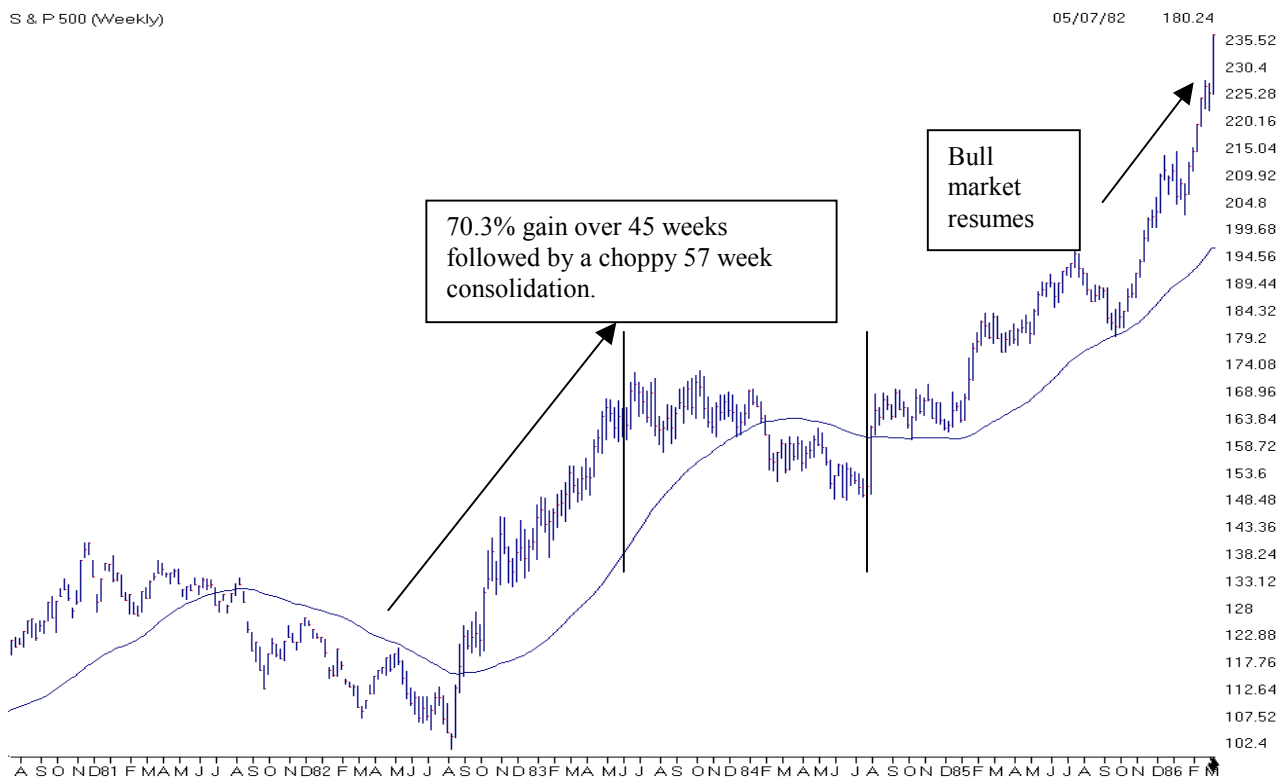


The Starboard Side Report

The week ending February 19, 2010

Over the past eighty years of stock market history severe declines in the major US Indexes have always been followed by big rallies. Some of these rallies were the start of a multi-year bull move, while some were simply countertrend advances within a much bigger bear market downtrend. Our focus last week and this week are the lengthy consolidation periods that follow the initial surge off the bottom. Last week we touched on the 2003-2004 analogy. Today we are going to look at the 1982-84, 1974-1977, 1938-1940 and 1932-1935 episodes.

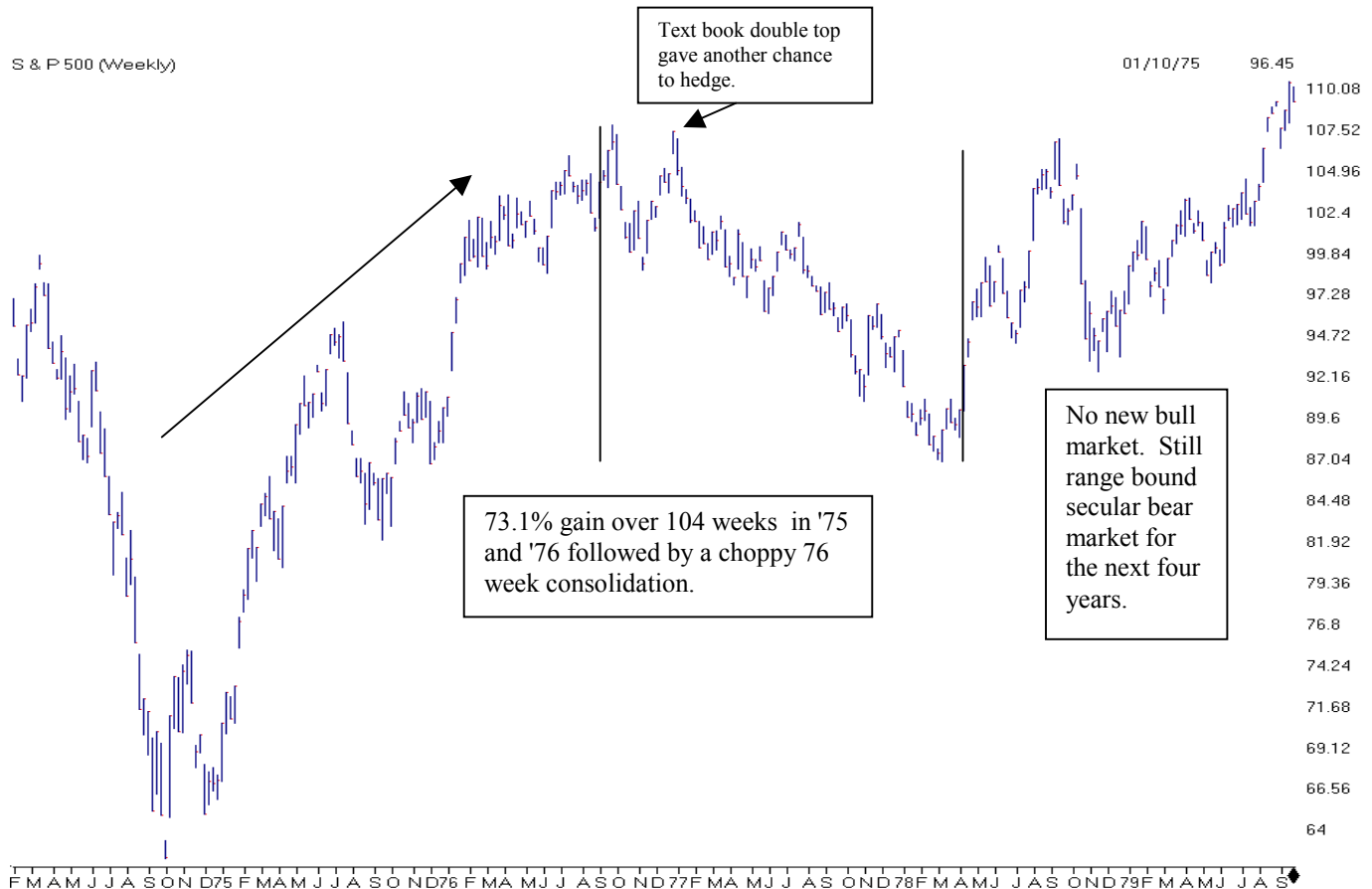
First is the period that occurred after the 1982-83 rally that took the S&P 500 up 70.3% over a 45 week period. The consolidation period that followed lasted 57 weeks and took the market 14.5% lower by the end of July 1984. However, as was the case in 2004, there were many little bull and bear cycles before it was all over. We have broken them down for you below the chart.



1983-84 S&P 500 Consolidation Cycle

Date	Price	Gain/Loss	Duration
8/13/1982	101.44		
6/24/1983	172.76	70.31%	45 weeks
8/12/1983	157.62	-8.76%	7 weeks
10/14/1983	173.1	9.82%	9 weeks
12/16/1983	160.61	-7.22%	9 weeks
1/13/1984	169.51	5.54%	4 weeks
2/24/1984	152.13	-10.25%	6 weeks
5/4/1984	162.11	6.56%	10 weeks
7/27/1984	147.78	-8.84%	12 weeks
Total Decline		-14.46%	57 weeks

One thing you will notice with all these episodes is that early on in the correction process the market tends to gravitate back to the level from which it first broke down and form what is known as a *double top* chart pattern. This illustrates how difficult it can be to break the back of the momentum that took the market to such heights. It also means that there is a good chance that the S&P 500 will revisit the 1150 level that it hit in January. The big difference between the 1983-84 consolidation and the present one is that 1983 was the start of a major new secular bull market, whereas we still feel that US stock indexes are currently in the middle of a long-term secular bear market. As we will see next, that raises that odds that the consolidation we have ahead of us may be longer and more frustrating that just one or two years.

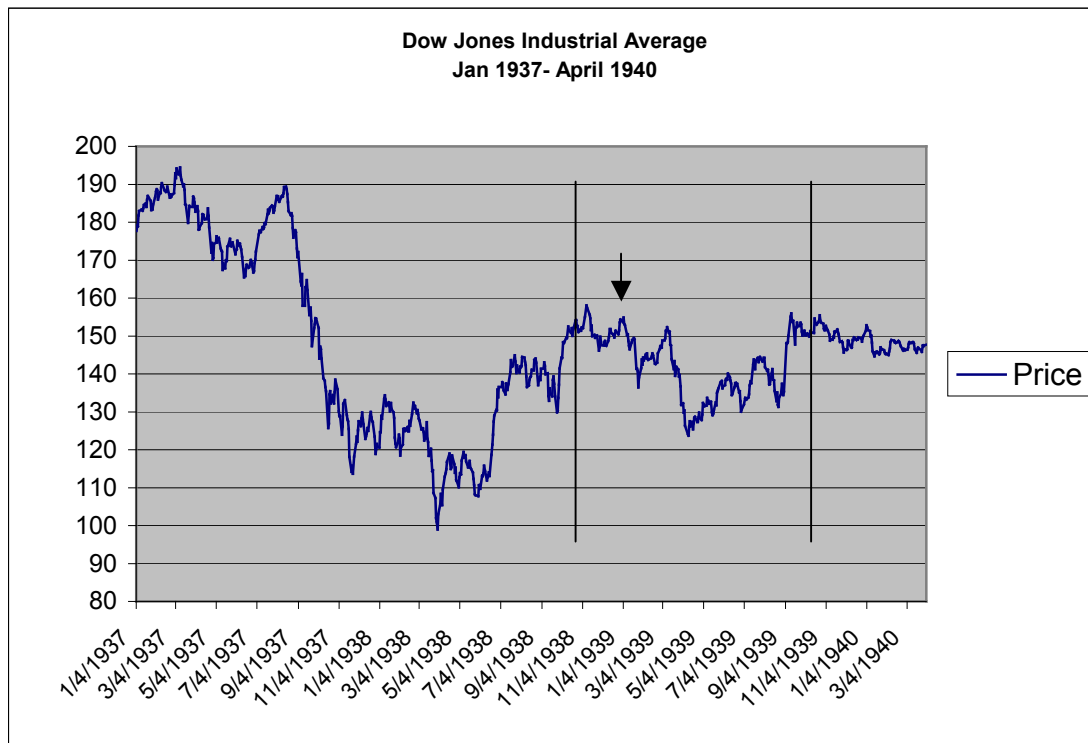


1976-78 S&P 500 Consolidation Cycle

<u>Date</u>	<u>Price</u>	<u>Gain/Loss</u>	<u>Duration</u>
10/4/1974	62.28		
9/24/1976	107.82	73.12%	104 weeks
11/12/1976	92.24	-14.45%	7 weeks
12/31/1976	107.46	16.50%	7 weeks
6/3/1977	96.12	-10.55%	22 weeks
7/22/1977	101.79	5.90%	7 weeks
11/4/1977	90.71	-10.89%	15 weeks
11/25/1977	96.69	6.59%	3 weeks
3/10/1978	86.9	-10.13%	15 weeks
Total Decline		-19.40%	76 weeks

Like the most recent rally that just peaked this January, the move off the 1974 bottom was exactly 73%. The main difference was that it took 104 weeks to achieve those gains versus just 46 weeks in this most recent instance. Using the 1970's template is probably more apt than the mid-1980's because the late 1970's were also an extremely challenging economic environment in the middle of a long-term secular bear market. The markets were in the grips of a cruel mix of high inflation and stagnate growth otherwise known as stagflation. The economic environment in 1983 was the opposite of what we have today. It was difficult, but Paul Volker had just broken the back of historically high inflation through tough love monetary policy. This rare act of courage from a central banker set the stage for interest rates to embark on a 30-year downtrend that acted as the fuel for both a long-term bull market in stocks and credit. The unimaginable asset inflation that we have had over the past thirty years has created excesses the likes of which the financial world has never seen. We believe it will take at least another decade before these excesses are unwound and the system is fully deleveraged. We feel that US interest rates have nowhere to go but up and the amount of money created to save the banking system may make the late 1970's inflation seem tame by comparison.

Two other major rally-consolidation phases in US market history occurred in the 1930's. The first one we will look at in the 1938-1940 time period. As you can see, there was a 63% rally between April and November 1938. The Dow then proceeded to trade in a sideways to down consolidation for the next several years and had a peak to trough decline of 19% between November 1938 and April 1939. Once again, there was a double top after the first major correction in November that gave investors another change to take money off the table (see arrow).

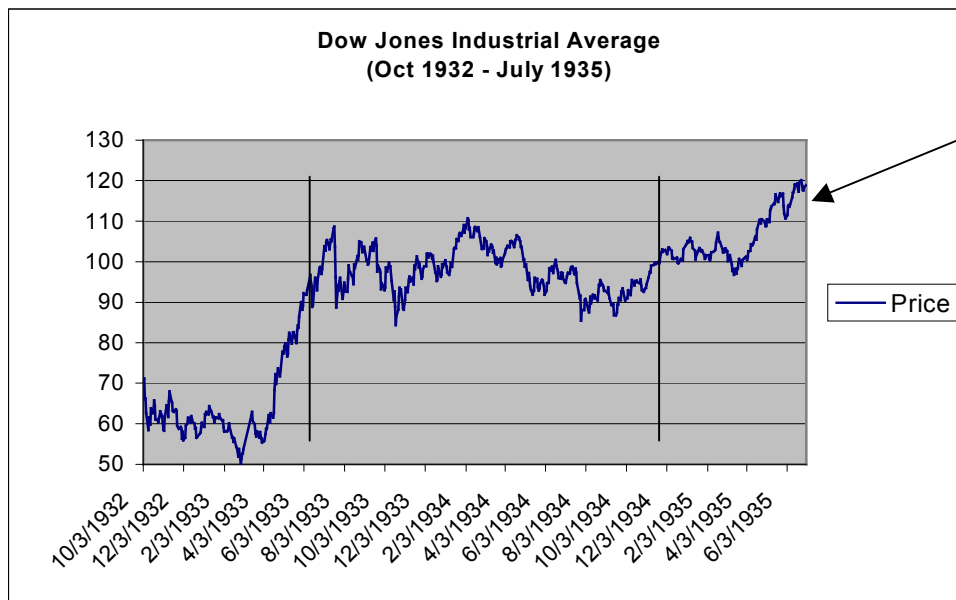


The Dow lost 36% over the next two years after this long consolidation. Although WWII was certainly an extenuating circumstance.

1938-39 Dow Jones Industrial Average Consolidation Cycle

<u>Date</u>	<u>Price</u>	<u>Gain/Loss</u>	<u>Duration</u>
3/31/38	97.46		
11/10/38	158.9	63.04%	32 weeks
11/28/38	145.21	-8.62%	3 weeks
1/5/39	155.47	7.07%	5 weeks
1/26/39	136.1	-12.46%	3 weeks
3/10/39	152.71	12.20%	7 weeks
4/11/39	120.04	-21.39%	4 weeks
6/9/39	140.75	17.25%	8 weeks
6/30/39	128.97	-8.37%	3 weeks
7/25/39	145.72	12.99%	3 weeks
8/24/39	128.6	-11.75%	4 weeks
9/13/39	157.77	22.68%	3 weeks
Total Decline		-19.07%	44 weeks

The last example we are going to show is the market recovery that followed the great crash of '29 and the subsequent three year bear market. The rally from that decline was an amazing 116% in only 20 weeks. We do not feel that this as relevant as our other episodes due to the magnitude of the gains and losses involved, but it is a good look at the consolidation phenomenon nonetheless. It may be a more relevant template for emerging markets since many of them they had enormous declines in 2008 and then sprang back over 100% from their lows.



The Dow went on to gain another 70% over the next two years following the consolidation even as the Great Depression roared in the background..

1933-34 Dow Jones Industrial Average Consolidation Cycle

<u>Date</u>	<u>Price</u>	<u>Gain/Loss</u>	<u>Duration</u>
2/27/1933	50.16		
7/18/1933	108.67	116.65%	20 weeks
7/22/1933	88.42	-18.63%	1 week
9/19/1933	105.74	19.59%	8 weeks
10/21/1933	83.64	-20.90%	5 weeks
2/5/1934	110.74	32.40%	15 weeks
3/27/1934	98.76	-10.82%	4 weeks
4/20/2010	106.55	7.89%	3 weeks
7/25/1934	91.57	-14.06%	14 weeks
Total Decline		-23.03%	50 weeks

The 19.59% rally into 9/19/33 is another good example of momentum carrying the market back towards the level that the first corrective move began before it heads down again.

The purpose of this exercise is not to try and predict the future. Rather we are attempting to create an investment framework using market history and manage portfolio risk accordingly. A famous quote attributed to Mark Twain states, "history doesn't repeat itself, but it often rhymes." Looking back at similar episodes over the past eighty years tells us it is time to get cautious. We believe that the major breakdown the market just experienced in January is the first shot across the bow. If correct, it means we are about to enter into a lengthy consolidation process that may last a year or more. Our analysis points to one last rally back towards the old high on the S&P 500 of 1150, but that could be the last best chance for several months to sell weak relative strength stocks. If a double top forms, a total peak-to-trough decline in the fifteen to twenty percent range is a distinct possibility for the major US stock indexes. The relatively good news is that the odds are stacked against another massive fifty or sixty percent decline like we went through in 2008. In addition, there are still sectors and countries that could ride out the storm unscathed. For instance, even though the S&P 500 went nowhere between 1976 and 1980, energy stocks, precious metals and small cap stocks performed wonderfully.

One final caveat, should the market decisively plow through the 1150 level during the next month, then that could mean we have another up leg and that the consolidation period hasn't even begun yet. We do not believe this to be the case, but we have to allow for it as a possibility. The amount of liquidity being created by the Federal Reserve has been like nothing that we have ever seen before. Therefore, it could be enough to break down our historical analogies. How the market acts back at the old highs will be a big tell.