



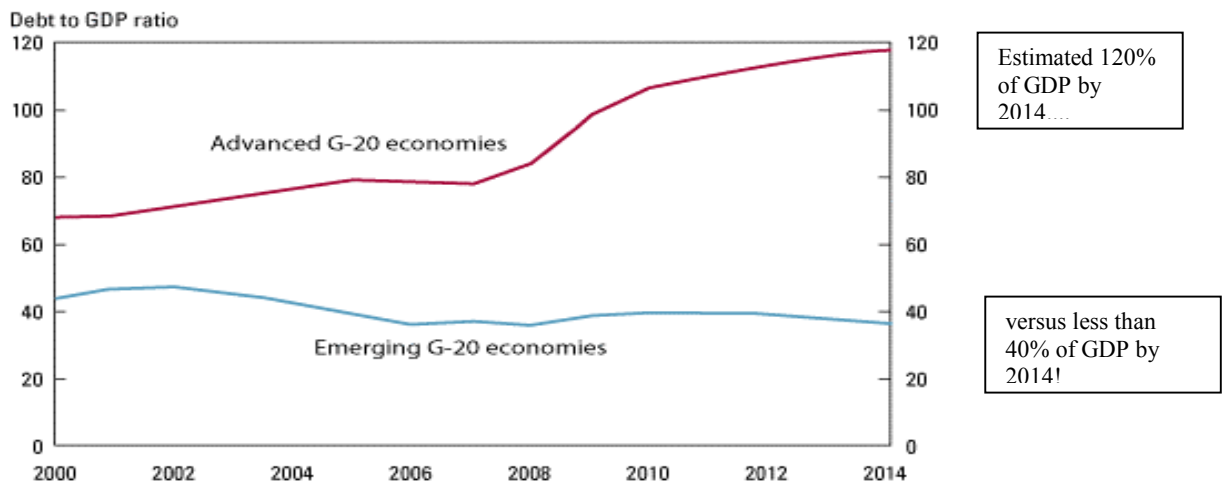
# The Starboard Side Report

The week ending March 19, 2010

We wanted to use this week's report to provide a little perspective on the recent rally and why we feel that any gains achieved from these levels are unlikely to be sustainable in the long-term (especially in the markets of the developed world). The majority of the rally since last March has been a reversion to the mean following one of the most brutal declines in history. The S&P 500 isn't even back to where it stood before the Lehman Brothers collapse in September of 2008. From that standpoint, it doesn't make sense to get too bearish just yet. Interest rates are still extremely accommodative and inflation is temporarily subdued. So while extreme bearishness like 2007 probably isn't warranted just yet, caution should most definitely be exercised from this point forward. The main reason for our concern can be summed up in one word - debt. The debts accumulated during twenty years of easy monetary policy have not gone away, they have simply been transferred from the balance sheet of the private sector to the public sector. In addition, we feel stock market gains above and beyond these levels can be looked at as a symptom of the problem, not a cure. By that we mean that government coerced asset price inflation through artificially low interest rates is not healthy given current leverage levels, but it is seen as the only way to get the economy moving. This easy money thinking has been policy for the past twenty years and you would hope that we could have learned from our mistakes and change this broken system. However, that is not the case, so we are still stuck using the same remedies that got us into the mess in the first place.

As we have frequently discussed in this report over the past few months, there is a big problem brewing with regards to sovereign debt in the developed world. This is not new news, but we feel it is something that most market participants do not quite grasp the severity or ramifications of. As Mohamed El-Erian stated in this week's *Financial Times* "Every once in a while, the world is faced with a major economic development that is ill-understood at first and dismissed as of limited relevance, and which then catches governments, companies and households unaware.....today, we should all be paying attention to a new theme: the simultaneous and significant deterioration in the public finances of many advanced economies. At present this is being viewed primarily -and excessively - through the narrow prism of Greece. Down the road, it will be recognized for what it is: a significant regime shift in advanced economies with consequential and long-lasting effects." Below is a look at another version of a chart we have displayed in recent reports. It shows debt continuing to be an albatross around the neck of the developed world at least over the next five years.

## Debt burden divergence

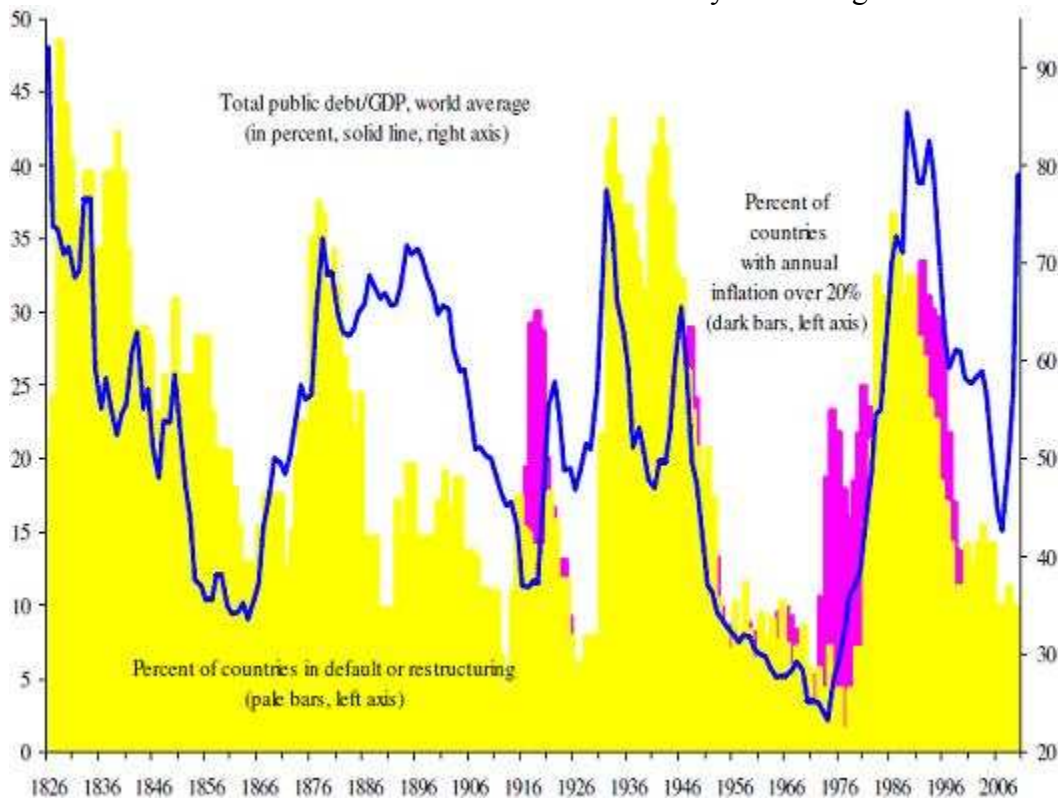


Source: IMF, <http://www.imf.org/external/pubs/ft/spn/2009/spn0925.pdf>; Morgan Stanley Research

According to Citigroup's chief economist more than 40% of global GDP is generated by countries that have fiscal deficits of over 10% of GDP. The majority of these are in the advanced economies of the world. 40% of GDP coming from debt laden countries is extremely troublesome. As a reference, over the past thirty years, debt laden countries have traditionally produced less than 5% of GDP. So basically, we have gone from a world where small emerging economies were the main source of over indebtedness and a minor factor in output to one where almost half of all economic output is generated within a risky and unsustainable debt framework. Truly scary stuff that has enormous consequences for future economic activity once the stimulus sugar high wears off. We believe these fundamental facts point to a world that will increasingly favor the lower debt emerging economies over the developed world. In addition, commodities tied to emerging world growth should also do well.

We believe we are only in the middle stages of a perception change in the investment world. Pension funds are desperately in need of higher returns to alleviate their massive funding gaps and will start to allocate more capital towards the emerging world as a result. Traditionally, US and UK pension funds have parked less than 10% of assets into emerging market stocks. This underexposure is still very prevalent today despite the much lower leverage that we mentioned and much higher growth forecasts of emerging economies. The fact that emerging economies are now over 30% of world GDP (closer to 43% at purchasing power parity), yet have such a small allocation in pension schemes is a major disconnect. One that we see providing investment opportunities in the years ahead. There is still a very deeply ingrained investment mentality that emerging markets are riskier than developed markets. The looming sovereign debt crisis in the advanced economies presents an opportunity because it will reduce the relative risk of investing in emerging markets and drive capital flows to this better fundamental picture.

Regular readers of this report know that we love to study history in order to aid our investment process. Imagine our delight when we stumbled upon a highly relevant chart that has almost two centuries of historical data on it. Below is that very interesting chart:



Source: Carmen Reinhart and Kenneth Rogoff

What we see above are three key data points tracked since 1826. 1) Total world public (government) debt as percent of GDP is illustrated by the solid blue line and fixed to the right axis. 2) The percent of countries in default or restructuring marked by the yellow bars and fixed to the left axis. 3) The percent of countries with annual inflation over 20% marked by the pink bars and also fixed to the left axis.

Here is what *The Economist Magazine* had to say about the chart.

What you see here are levels of public debt, the share of countries facing default or debt restructuring, and the share of countries with inflation over 20%. I quite like this chart. What you see is a clear correlation between debt loads and defaults and restructurings. It would be an extraordinary aberration if a raft of debt defaults and work-outs didn't ultimately accompany the latest peak in levels of public debt.

The inflation picture is also interesting. We see four clear peaks (pink bars) in the share of countries with inflation rates over 20%. The first two are associated with the First and Second World War (recall that after the Second World War, America cut its [debt load](#) in half through inflation). The third corresponds to the late 1970s, when oil price increases and runaway wage-price spirals fueled inflation. And then there is a fourth in the early 1990s, associated with emerging market debt crises (Brazil experienced a hyperinflationary episode during this period, for instance).

It's a fascinating image. The authors are right: debt cycles do appear to be somewhat rare and about a half-century in duration. And the struggle to work out recurring debt tends to play out in consistent ways, with increases in default and the occasional bout of rapid inflation.

Big tax increases in conjunction with brutal spending cuts are in order for those countries that will be forced to take the hard medicine. Many of the countries in the Eurozone fall into this camp because they do not control their own currency/printing press. For countries like the US and the UK that control their monetary system, inflation via money printing is the most likely long-term solution. This will likely be accompanied by half-hearted attempts to undertake fiscal discipline, but we feel those will pale in comparison to the inflation measures taken behind the scenes. Whether its through fiscal discipline or inflation, one thing for certain is that slower than normal economic growth in the developed world will be the end result. In the US, we see stagflation at best and hyperinflation at worst sometime in the course of the next decade.

This analysis does not include what will happen to interest rates in the developed world should the correlation hold of higher government debt leading to inflation and/or sovereign defaults. One look at Greece over the past few months and we can clearly see what the cost is once investors loose confidence in the ability of governments to pay their bills. It is costing them on average 2.5% more to borrow in the debt markets than a few months ago. This rising cost of credit flows right through to the rest of the economy as borrowing for businesses and homeowners alike gets much more expensive. The US, UK, Portugal, Spain, Italy, Ireland and Japan are all living on borrowed time with respects to cheap and easy access to credit. It may happen one by one or all at once, but there is no doubt in our mind that over the next decade interest rates are going to go up throughout the advanced economies of the world as the bills of overextending and overindulgence come home to roost.

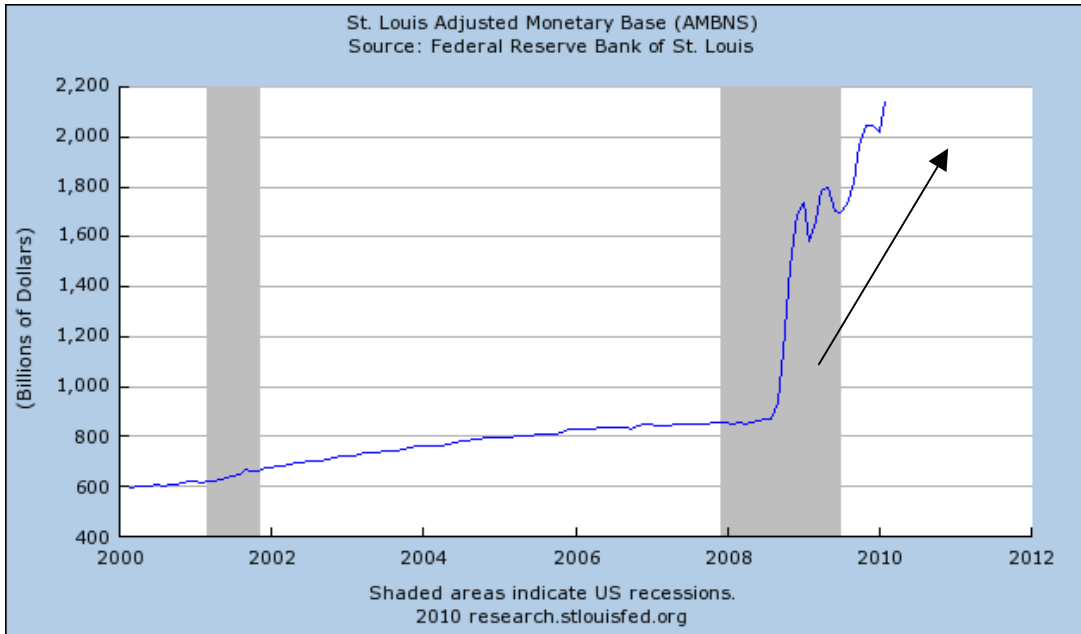
Over the past 200 years debt binges such as this have been rare, but as the chart above shows, there are no free lunches. We have enjoyed a powerful bond bull market over the past thirty years that has seen rates go from the high teens all the way down below 3% in December of 2008. We feel that the clock is fast running out on this good fortune and that higher rates may be lurking around the corner (especially on the long-end of the yield curve.)



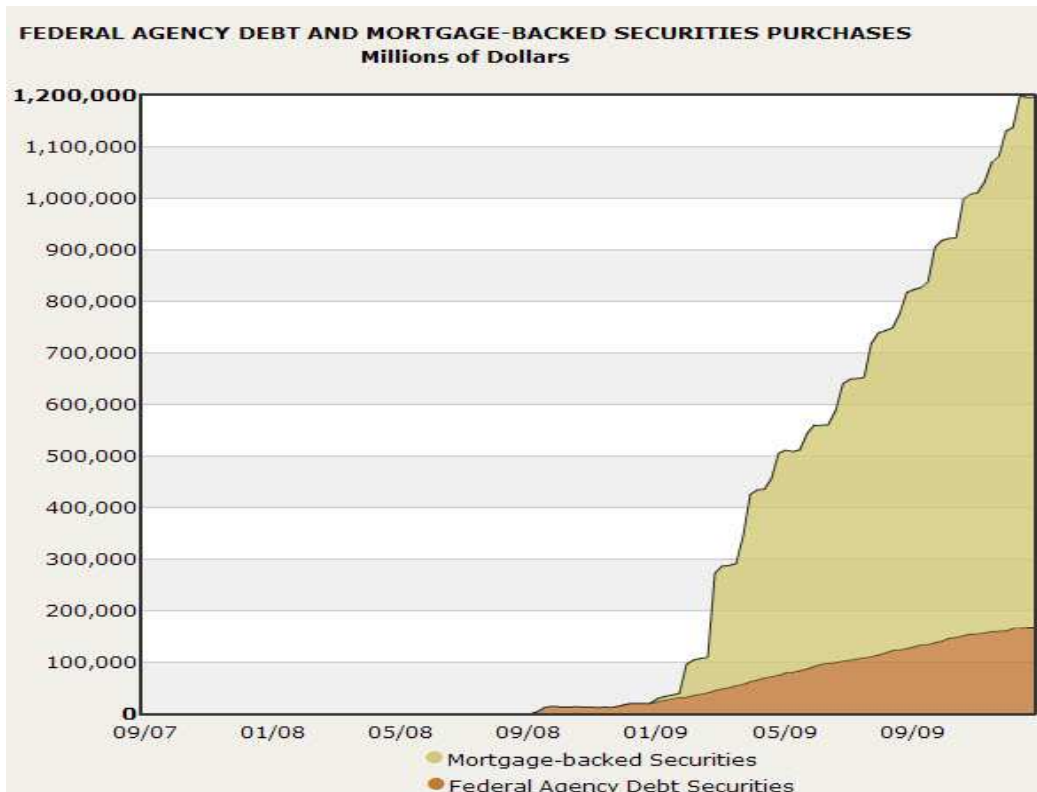
As we mentioned above, the strength in the market is a symptom of the problems we face, not a cure. Stock valuations are still extremely elevated, yet investors feel compelled to chase risky assets with money market rates at essentially zero. The Federal Reserve continues to promote a reckless inflationary strategy for mopping up recessions. Strategist Chris Martenson explains this situation quite nicely in a recent piece. "Suppose, for the sake of argument, that there is a world in which banks are allowed by their regulators to pretend their default losses simply do not exist. And, even more outlandishly, some of these banks are allowed to sell heavily damaged loans to their central bank at nearly their full original price. What does "deflation" mean in such a world? Not much, as it turns out. At least from a monetary perspective, because money is not being destroyed at nearly the rate that would be expected or predicted by the size and rate of the defaults.....Where we should have experienced a crushing bout of deflation, we instead have seen a near-complete return to risk-taking and asset price inflation. Stocks are not cheap. Bonds are not cheap. Derivatives are back with a vengeance, and the big banks are busy making big bets. All of these signs are consistent with the idea that the money supply has not only *not* shrunk due to deflation, it has actually expanded." The result is not only are debts not destroyed, but the money in circulation is expanded at twice the rate. The money from the original loan still exists, but then it is essentially doubled when the Fed creates money out of thin air to buy the troubled asset back from the bank.

Below are a few charts that illustrate what has been going on in the banking system. The Federal Reserve continues to throw newly printed money at the problem. The main source of liquidity has been the purchase of Mortgage Backed Securities (MBS). This has single handedly propped-up the entire US mortgage market.

The monetary base has gone haywire over the past two years as the Federal Reserve stepped in to support the financial markets and flood it with liquidity by buying back toxic assets from the banks. The monetary base has expanded 163% over the past two years!



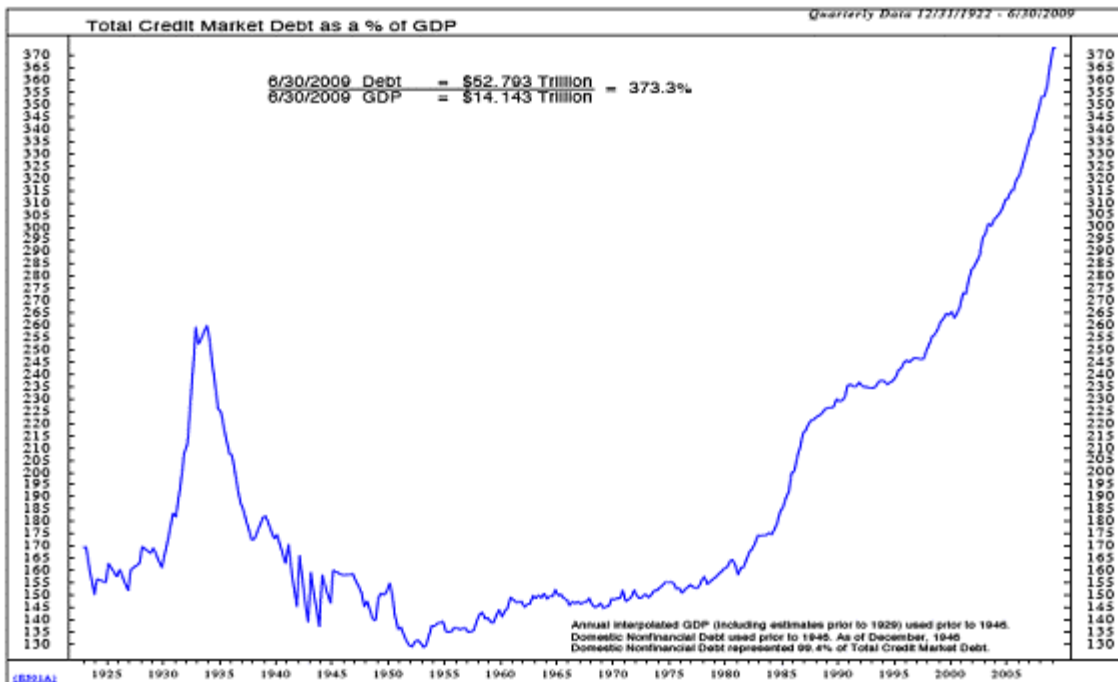
Those toxic assets on the Federal Reserves balance sheet have ballooned. As we see below, mortgage debt was zero percent of Fed assets two years ago, but now makes up nearly \$1.2 trillion of its balance sheet.



Source: Cleveland Federal Reserve

Finally, we see below that the debt problems that caused the great credit crisis of 2008 have not gone away at all. In fact, our credit system is still expanding thanks to the interventionist policies of the Federal Reserve. What we are seeing is that inflation is the most palatable way for a constitutional democracy, with its own reserve currency, to deal with such an enormous debt crisis. So here we sit stuck with the same expansionist monetary policies that caused the crisis in the first place. Unfortunately, this means another (probably worse) crisis still awaits us down the road. It may very well take the form of a currency crisis. In the meantime, we must accept the reality of the current boom-bust system and know that easy monetary conditions will be kept for as long as possible. However, in the words of Austrian economist Ludwig von Mises, "there is no means of avoiding a final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as a result of a voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the *currency* system involved." The chart below tells the current US dollar backed monetary system is eventually doomed under this scenario. How long they can keep the charade going is the only question.

### Total Credit Market Debt as a % of GDP (1920-2009)



Source: Ned Davis Research