



The Starboard Side Report

The week ending April 9, 2010

Not much has changed since we last reported two weeks ago. To borrow a phrase from money manager John Hussman, the market currently remains overbought, overvalued and overbullish. All of this is occurring in the face of hostile yield and oil price trends. The current environment is starting to remind us of some of the liquidity fueled booms of the last bull cycle in 2005, 2006 and early 2007. Stock and credit markets are extremely stretched on a short-term basis, yet markets continue to grind their way higher. Investors are afraid of missing the upside, so dips have been very short lived. This is a dangerous game to be playing and we would rather sit back and wait for a meaningful correction before prematurely joining the buyers at the top of a short-term cycle. It is much easier to make up lost opportunity than it is to make up lost capital.

Below is a chart of the S&P Volatility Index or fear gauge. This points to the overbullish aspect of the market. As you can see, the options market has once again become very complacent in the short term and this is a very dangerous position for investors. We like to be more conservative when others turn overly optimistic as they appear to be at present. This current overbought condition does not necessarily mean that we are about to head back down to the 2009 lows. However, it does mean we need to exercise caution until we see some froth and euphoria taken out of the market as was the case in January of this year and June/July of last year. The last two interest rate cycles engineered by the Federal Reserve after the 1990 and 2000 recessions saw the VIX fall all the way to single digits before the true bear arrived in force (see charts below). Therefore, the VIX may have further to fall over the course of the next year or two even though it is a bit stretched right now.

Volatility Index - New Methodology (\$VIX) INDX

09-Apr-2010, 16:00 ET, daily, O: 16.32, H: 16.65, L: 16.06, C: 16.14, Chg: -0.34 (-2.06%)

No New P&F Pattern

Traditional, 3 box reversal chart

Bullish Price Obj. (Rev.): 23.0

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The VIX has reached an inflection point. It is pointing to one final rush higher next week should we breach 16 and break the triple bottom seen on this chart.

Volatility has collapsed in the past year down from a high of 50 last March to 16.14 as of Friday's close.

Triple bottom formation.

VIX Index 1990-Present

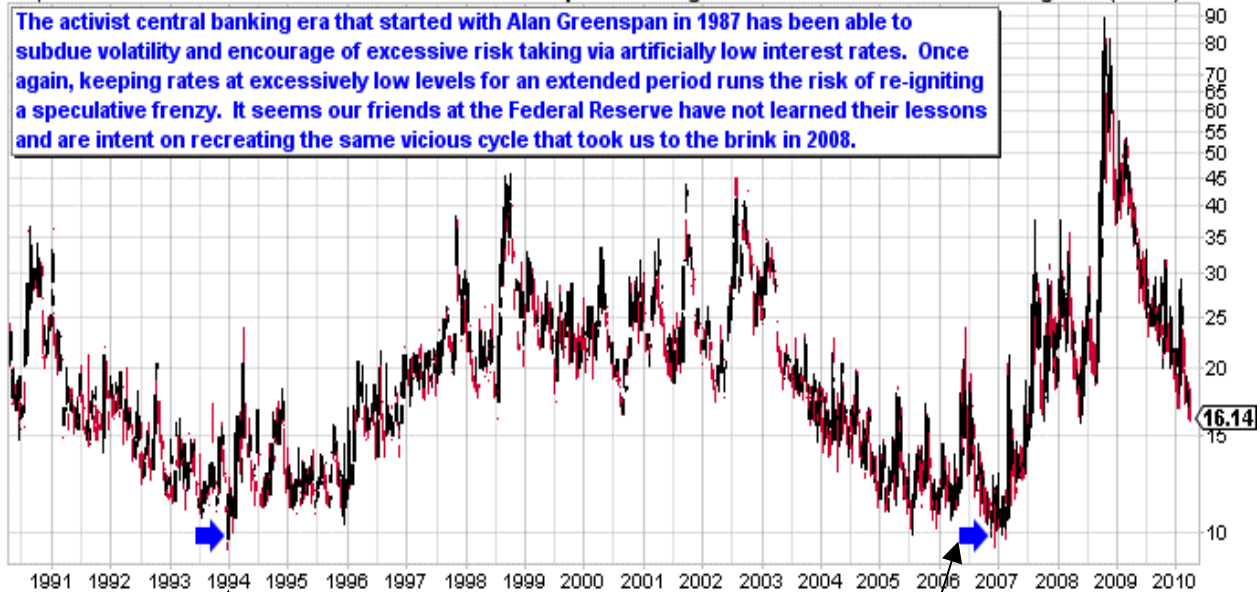
\$VIX (Volatility Index - New Methodology) INDX

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9-Apr-2010

Open 17.96 High 18.16 Low 16.06 Close 16.14 Chg -1.33 (-7.61%)

The activist central banking era that started with Alan Greenspan in 1987 has been able to subdue volatility and encourage of excessive risk taking via artificially low interest rates. Once again, keeping rates at excessively low levels for an extended period runs the risk of re-igniting a speculative frenzy. It seems our friends at the Federal Reserve have not learned their lessons and are intent on recreating the same vicious cycle that took us to the brink in 2008.



\$UST1Y (1-Year US Treasury Yield (EOD)) INDX

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9-Apr-2010

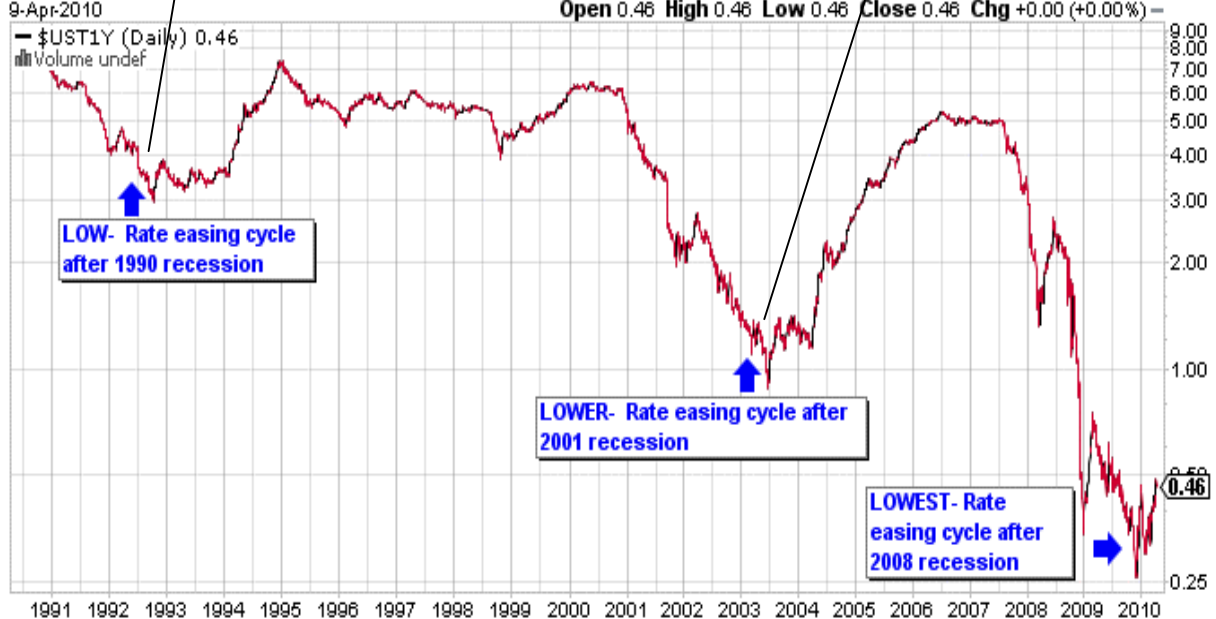
Open 0.46 High 0.46 Low 0.46 Close 0.46 Chg +0.00 (+0.00%)

— \$UST1Y (Daily) 0.46
■ Volume undef

LOW- Rate easing cycle after 1990 recession

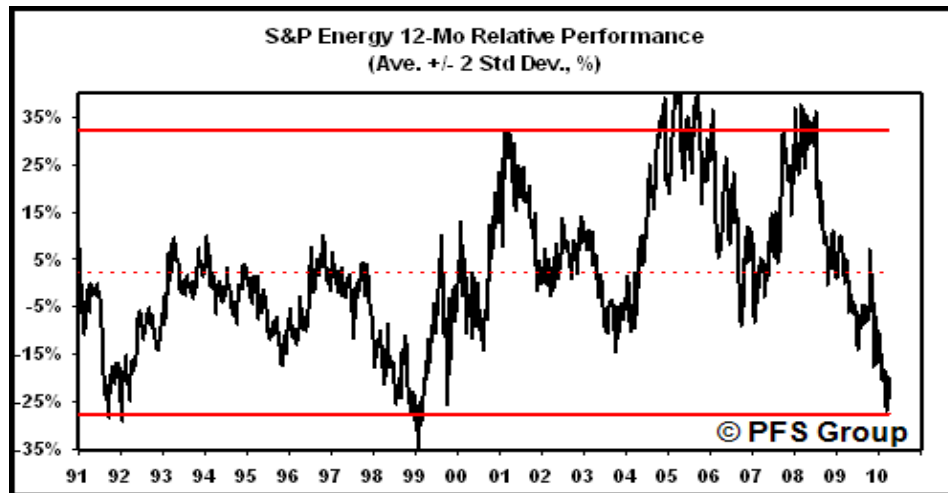
LOWER- Rate easing cycle after 2001 recession

LOWEST- Rate easing cycle after 2008 recession



As we see above, each economic slowdown since the 1990's has produced a lower low in interest rate policy (as measured by the yield on the 1-year US Treasury). This begs the question, what does the Federal Reserve do next time. It appears as if they have run out of bullets and rates have no where to go but up in the years ahead. There are no free lunches when it come to financial markets. We feel that the ultimate end game of all of this artificial suppression of rates will be a very nasty and extended bout of inflation.

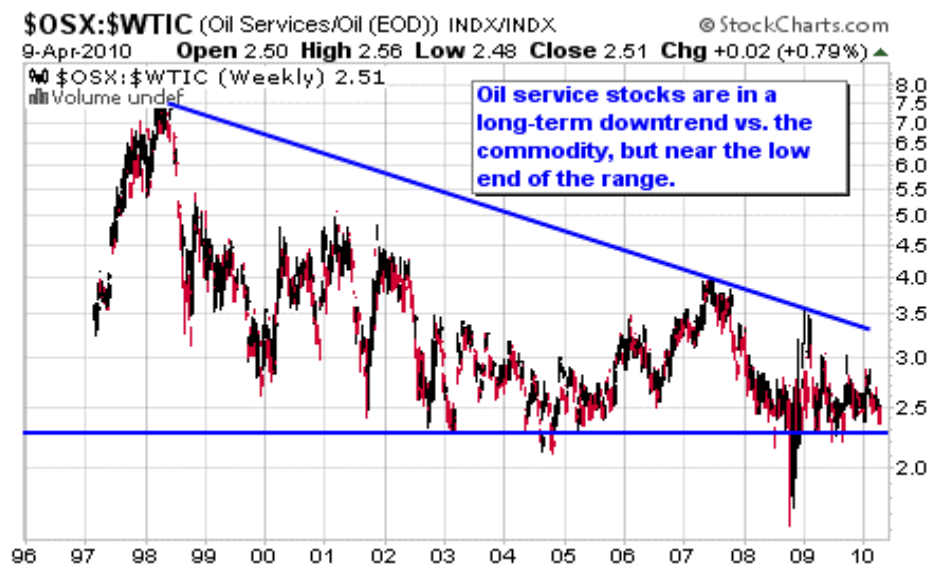
Oil prices continue to march higher, but oil and oil service stocks continue to lag behind. We feel that this may be about to change as this economic cycle starts to mature. Below are a few charts that point to stocks in the energy patch being pretty washed out.



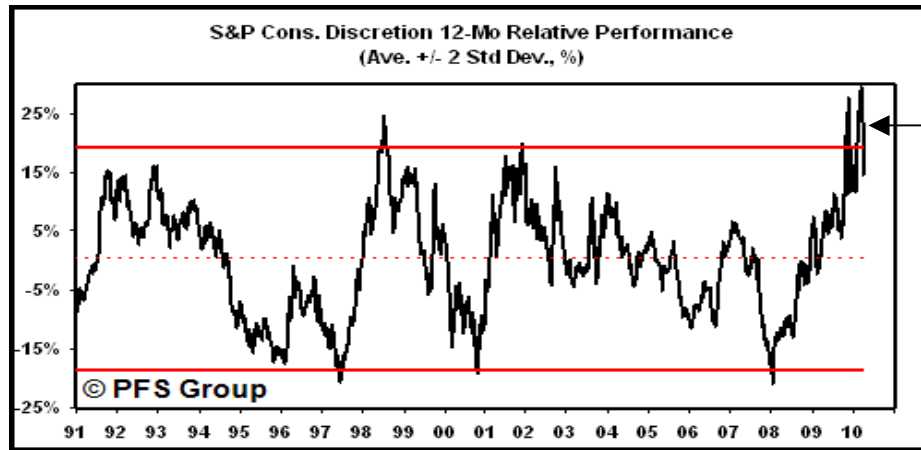
Source: Chris Puplava Financial Sense

Above we see a chart that shows the twelve month relative performance of energy stocks in the S&P 500 versus the index itself. As we see, there have been only two periods since 1990 that the sector underperformed this badly over a 12-month period. Both of the other times (1991 and 1999) were great contrarian investment opportunities.

Next is a look at the price of the oil service index versus oil prices. We can see that the stocks are very cheap in relation to the commodity. This is another data point that illustrates the relative value in oil stocks.



Surging oil prices should also provide a tailwind for the energy group. As we see below, the price of oil has just broken out of a six month consolidation. This can't be good news for the fragile US consumer sector. On the other side of the spectrum, we see that consumer discretionary stocks in the S&P 500 are at a twenty year peak in terms of 12 month relative performance. We expect this area of the market to cool off if energy prices continue to heat up.



This doesn't jive with this

Oil - Light Crude - Continuous Contract (EOD) (\$WTIC) INDX
 09-Apr-2010, 16:00 ET, daily, O: 85.56, H: 86.37, L: 84.12, C: 84.91, Chg: -0.48 (-0.56%)
P&F Pattern Triple Top Breakout on 01-Apr-2010
 Traditional, 3 box reversal chart
 Prelim. Bullish Price Obj. (Rev.): 104.0
 © StockCharts.com

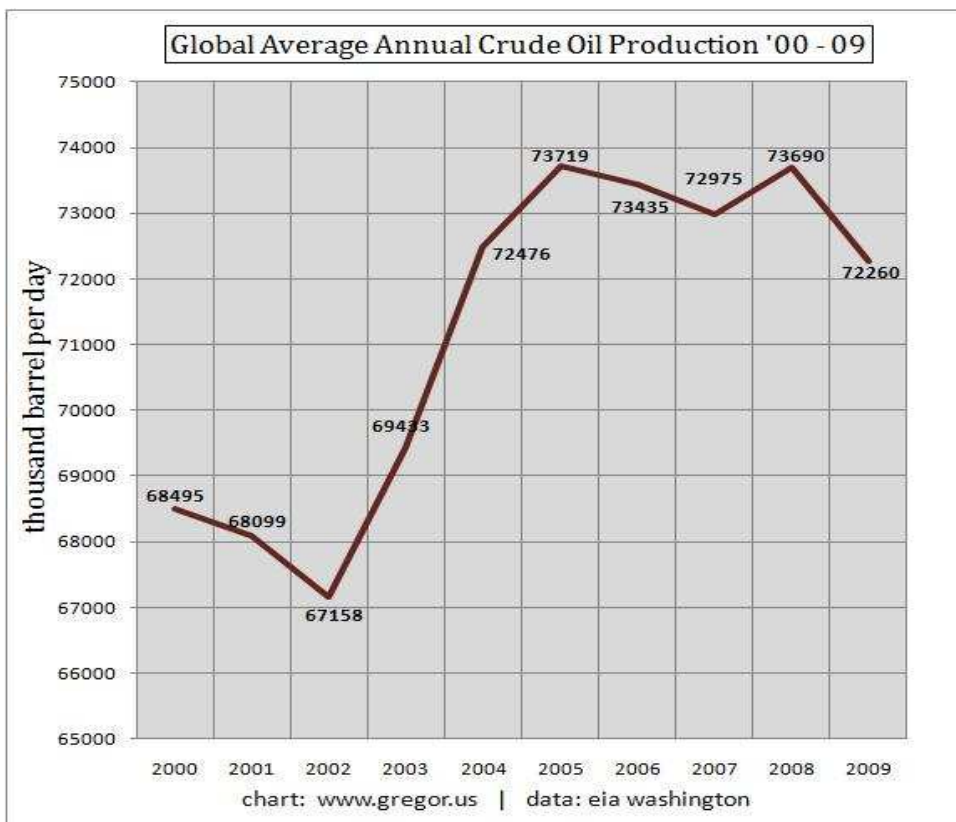


Breakout of a six month consolidation

We may be about to embark on a period where retail and financial stocks, the leaders of the cyclical bull market up to this point, pass the baton to the underperforming sectors such as energy. What many analysts in the US fail to grasp is just how dramatically the game has changed in terms of oil supply and demand. Energy analyst Gregor Macdonald put it very well recently when he wrote:

"Back in the days when US oil demand controlled the price of oil, a massive recession in the United States would have sent oil to 12.00 dollars a barrel. That era, which ended last decade, was defined by ongoing spare capacity in OPEC, low-cost oil in Non-OPEC, and nascent demand for oil in the developing world. That was then, and this is now. And so it's rather quaint that the energy analysts from that previous era still gather each week on American financial TV, to discuss the inventories at Cushing, Oklahoma. Inventories at Cushing, Oklahoma? The US has been removing discretionary demand for oil for years, starting back in 2004. And current unemployment in California is at 13.2%—another new post-war high. Yet oil is at 82.00 dollars? Get these analysts off TV. Please. We need analysis of diesel demand in Guangdong, and Uttar Pradesh (China).....The US no longer controls the geology or oil, or the price of oil. But, we carry on as though we will again in the future."

News came out on Friday that China's passenger car sales rose to 1.26 million vehicles in March, a rise of 63 percent from a year earlier! Manufacturers were trying to meet surging demand by running double shifts leading to a 84% surge in output in autos during the first quarter. So when pundits question why the price of oil is rising, even though US demand is weak, they can thank the emerging world. The great recession has allowed China to increase consumption pretty dramatically at the permanent expense of US supply. Therefore, as the economy recovers following the recession, the advanced economies like the US will be locked-out at lower levels of consumption versus the emerging economies. If the advanced economies want to raise consumption in the future and resist this dynamic it will result in price spikes, like the one we saw in 2007-08, followed by deep recessions. Economic growth will increasingly come at a price for the developed world.



Amazingly, oil prices went from \$40 to \$140 between 2004 and 2008, yet producers were not able to respond with increased production.

Welcome to peak oil: when the world's remaining supply of oil is more diffuse, of lower grade, harder to extract, and is *unable to flow* in the aggregate at higher production levels.

Source: Gregor Macdonald