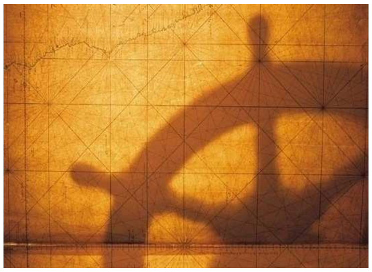
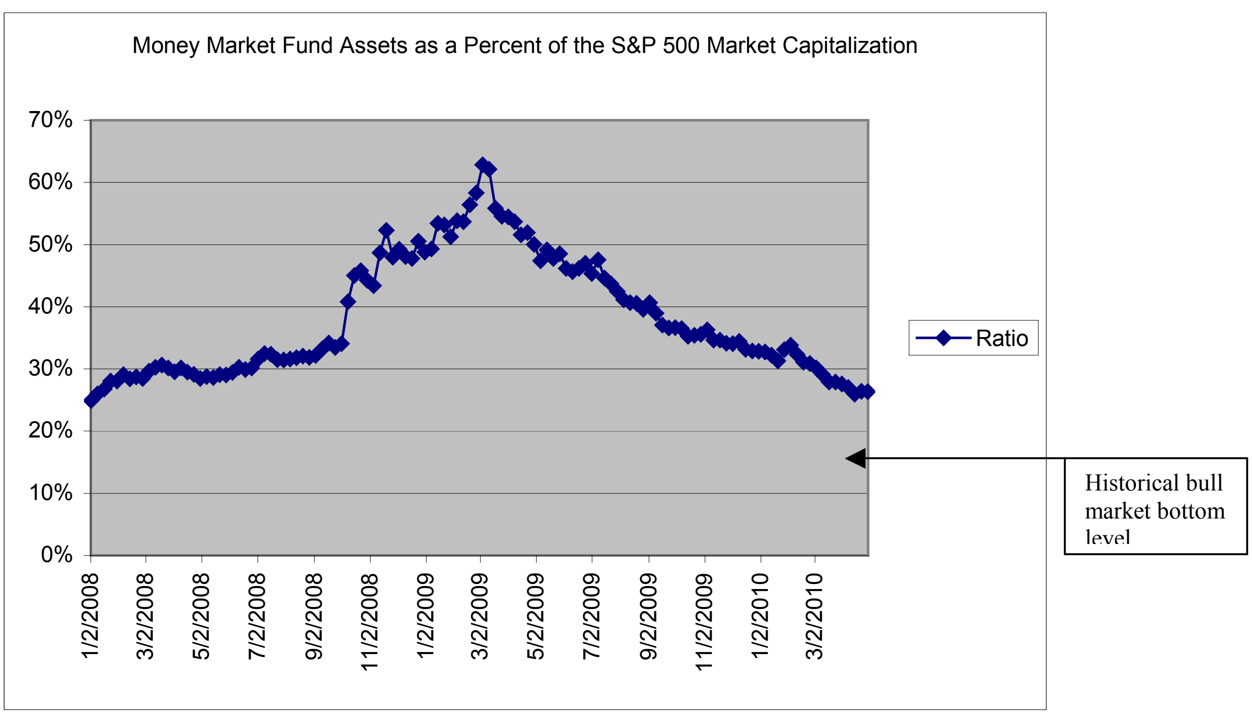


The Starboard Side Report

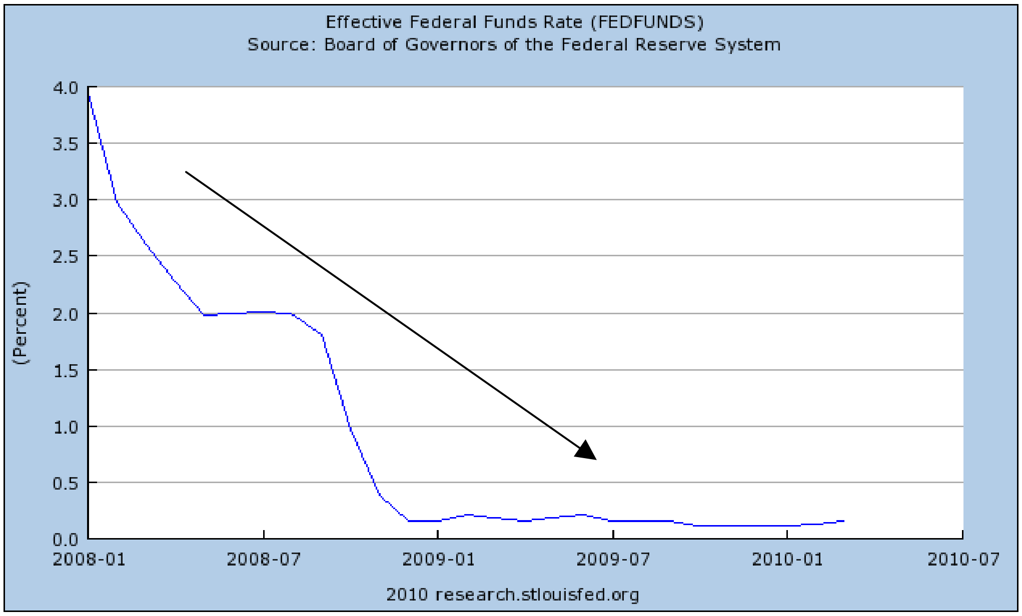
The week ending April 30, 2010

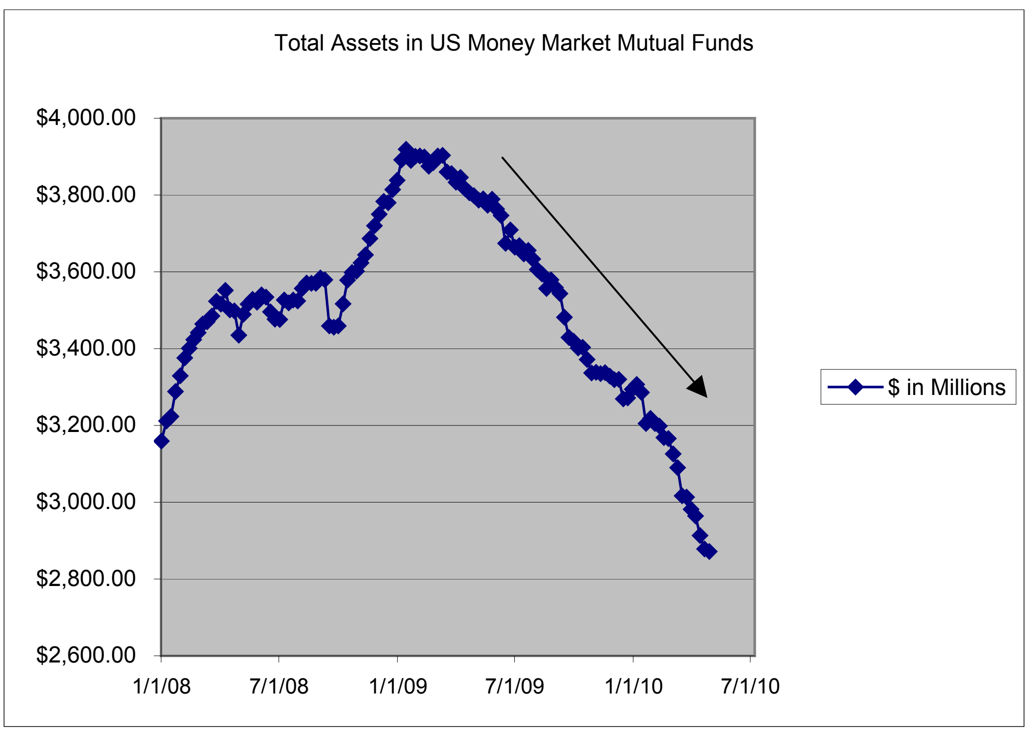
It feels as if the fiscal turmoil in Europe and the Goldman Sachs witch hunt have been enough to finally break the bullish fever. If we are correct, this sets up a several week span of volatility/consolidation for global markets. Therefore, this past Monday's high price on the S&P 500 of 1219.80 may be very tough to breach over the next couple of months. Despite our near-term caution, we still see extremely impressive momentum in this market from an intermediate term prospective. One of the amazing things is how well equities have done considering the constant flow of money into long-term bond mutual funds versus equity mutual funds. Using data from the Investment Company Institute, you have to go all the way back to December of 2007 to find a month where equity fund inflow/outflow data was better than bond fund data. So, for almost two and a half years, capital has preferred bond funds over stock funds. We think it is wrong-headed for investors to be chasing bonds at these levels with the inflation risks that lurk on the horizon. In terms of money flows, the pendulum may start to swing back to equities after this correction plays itself out. That would be sufficient fuel for another leg higher in the stock market.

The chart below shows the amount of cash in money market mutual funds as a percent of the value of the total value of S&P 500 Index going back to January of 2008. As you can see, money market assets have finally gotten back to the levels that existed at the start of the bear market (below 30% of the S&P). At the depths of despair in February of 2009, this figure got all the way up to 60%, but clearly has been trending steadily lower ever since. As mentioned, the majority of this cash has found its way into the bond market, not the stock market. Since the market bottom in March of 2009, $455 billion has flowed into the bond market versus only a net of $45 billion into equity mutual funds! Furthermore, for all of 2009, investors *withdrew* a net $9 billion from equity funds but added $376 billion to bond funds. It is amazing that the S&P 500 gained over 25% without there being any net new capital added into equity funds.



During a bull market cycle, money market assets as a percent of the S&P 500 have tended to bottomed in the teens. This means that by historical standards there is still ample liquidity on the sidelines to fuel the market higher. Especially when we consider cash is earning next to nothing (see the Effective Federal Funds Rate chart directly below). The big question becomes will money still flow into bond funds, or will investors finally get impatient and start to chase the higher returns being provided by stocks. In most economic cycles, this becomes a self-reinforcing proposition. To paraphrase Tony Dwyer of Collins Stewart; positive money flow into credit/bonds results in equity friendly moves such as extending maturities, stock buybacks and mergers & acquisitions. This in turn causes individuals to ramp up interest in equities.

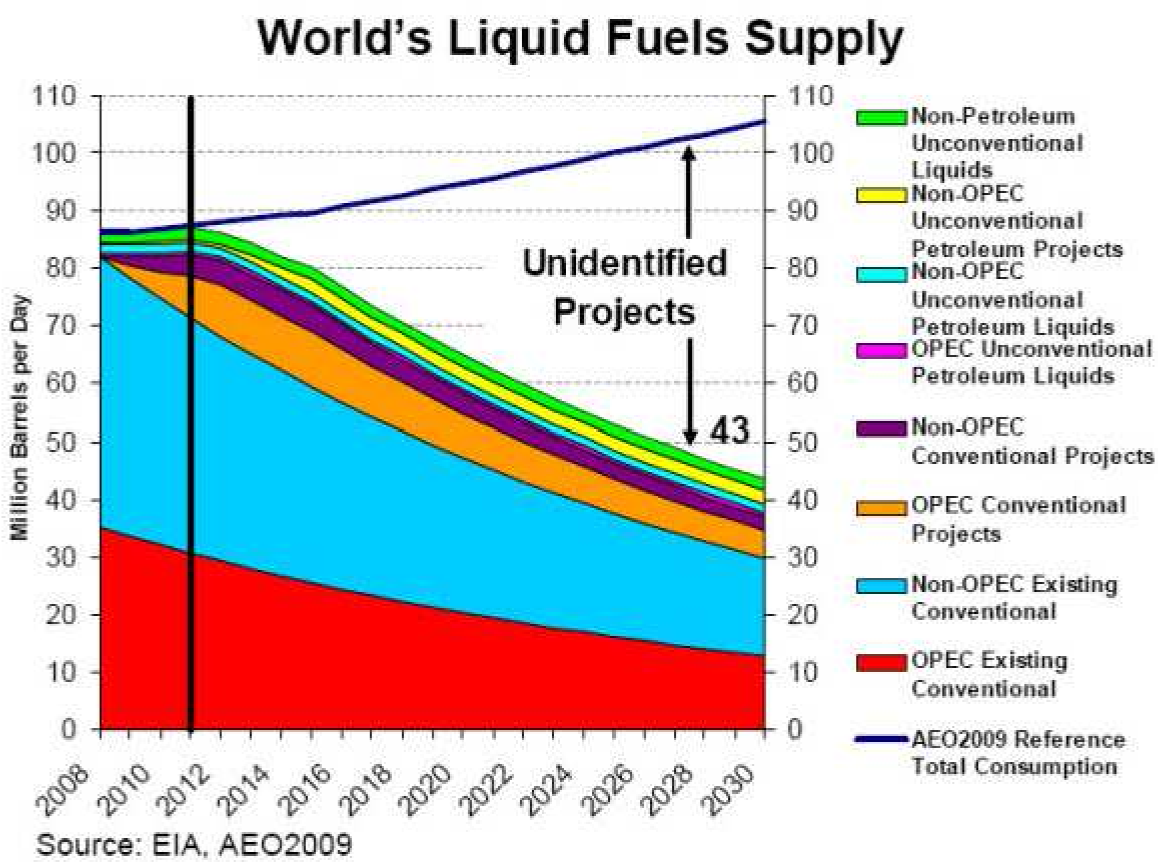




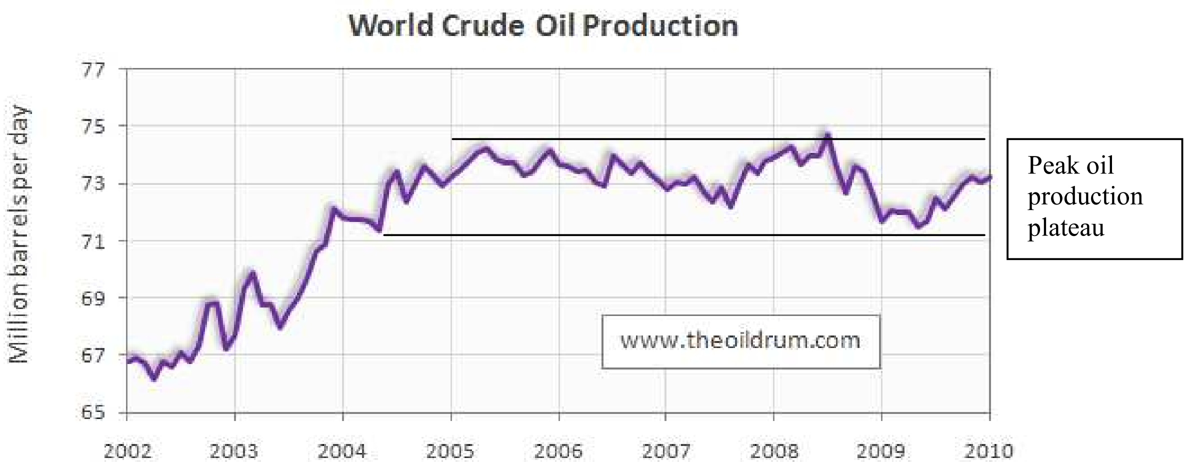
Source: ICI

The Fed has accomplished one of its goals in slashing rates to zero (chart 1). Namely, driving money off the sidelines into riskier assets. Over $1.0 billion has moved out of money market funds since the beginning of 2009 (chart 2).

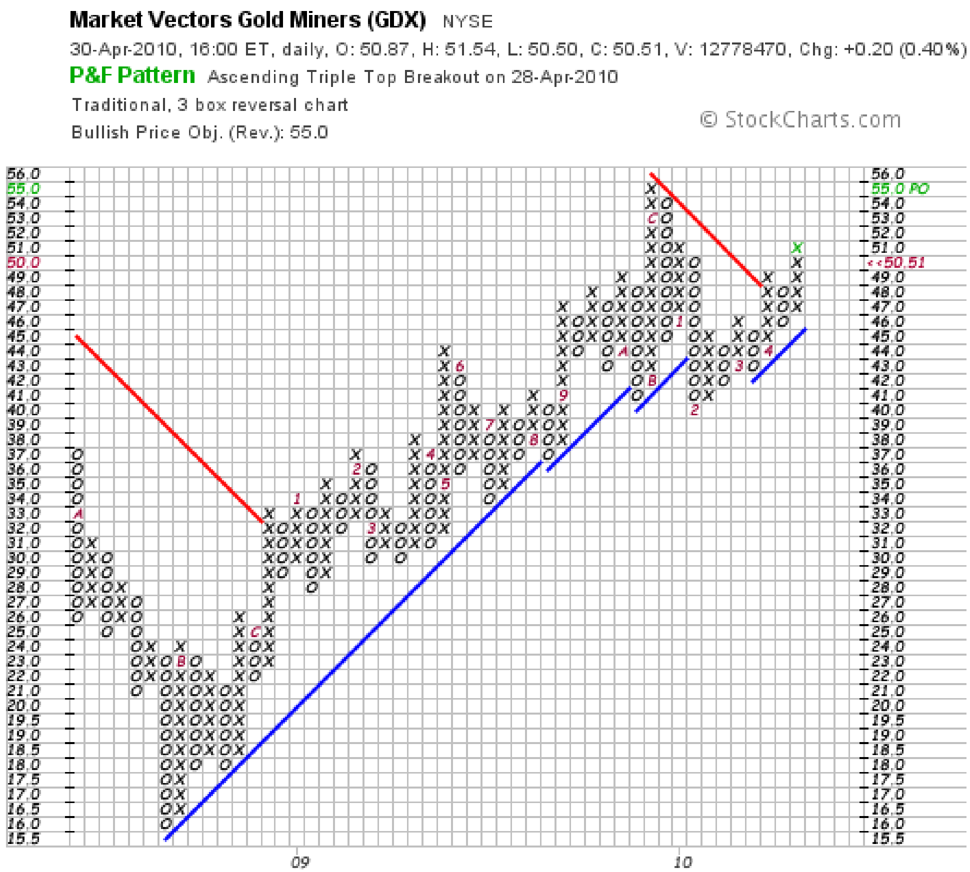
The fallout from the oil rig blowout tragedy in the Gulf of Mexico continues to grow. Eleven lives were lost and we are now faced with a potentially devastating environmental impact and clean-up. The one thing that this episode brings home to roost is the fact that it is getting tougher and tougher to get the remaining oil out of the ground. Deep offshore oil fields discovered in Brazil and the Gulf of Mexico have recently been seen as saviors that would help quench the worlds growing thirst for oil. But it now appears as if getting oil out of a hole up to 35,000 feet below the surface may be more difficult than previously imagined. The pressures are much greater, the temperature of the oil much hotter and the stresses on the metal are more extreme. As strategist Chris Martenson said this week; "the last remaining pockets of oil, while technically reachable, may not be economically feasible to exploit.....Sure, there may be a lot left down there, but the engineering complexities required to get it are magnificent. After this accident, you can be sure that every company will be cautiously re-examining their interest in ultra-deepwater prospects." As the chart below shows, we can ill afford any setbacks in the race against peak oil. The blue line is global oil demand and the colored bars are existing supply projected into the future. The supply-demand gap that remains is truly scary stuff.



Over the next twenty years, the world will need to find 43 million barrels per day of production to offset existing oil field depletion and decline. Unfortunately, all this oil will increasing need to come from remote regions of the world like the deep water Gulf of Mexico and Brazil. In addition, new sources of heavy oil production from places like the Alberta Tar Sands are extremely energy intensive. Therefore, we will get less net energy out of each new barrel produced. These factors will sharply drive up the cost of production over the long term and result in higher prices for all. BP and drilling partner Transocean Offshore are clearly the bad guys in this latest oil spill disaster. However, the world will not be able to turn their back on them and the oil that they can provide without massively disrupting the energy supplies desperately needed for global economic growth. We can't have it both ways in a world of peak oil production.



Precious metals was one of the few asset classes to have a good showing this week. This most likely resulted from a flight to quality away from toxic European sovereign debt and into a safe haven store of value. While we mentioned above that the market appears poised for a corrective period, precious metals appear ready for the opposite. This sector has run counter to the rally we have seen in US groups that are leading the pack this year such as financial, retail and technology. Gold topped out in December and has been consolidating ever since. We could have hit an inflection point this week with the Greek crisis starting to spread to the other PIIGS such as Portugal and Spain. Below we see gold priced in Euros is in the midst of a great run that appears to be spilling over into the gold mining stocks listed in the US.



After a relatively orderly five month consolidation, gold mining stocks may be poised to resume their leadership role thanks to the mess in Europe.