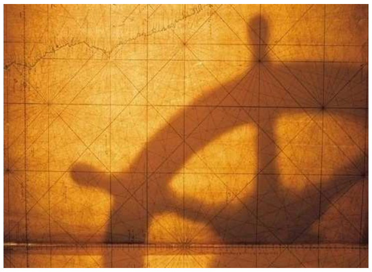


The Starboard Side Report

The week ending May 7, 2010

We have been expecting a volatile market correction to play itself out over the course of one or two months, but certainly not over one or two hours. The true definition of a crash is when the market stops functioning .... that certainly became the case for a few brief moments on Thursday afternoon. There will surely be fingers pointed and excuses made, but when it comes down to it, the market's fundamental and technical set-up was extremely vulnerable to such an event. The actual speed of the corrective process was likely triggered by some sort of malfunctioning computer trading algorithm that set off a nasty chain of events. The machines essentially took over the market causing it to go haywire. It is one of the dangers posed by trading programs dominating order flow in such a large way. It has become an arms race to see who can trade the biggest and the fastest. The process of high frequency trading will likely come under intense scrutiny in the weeks ahead due to this event. Interestingly enough, rapid advances in technology and program trading were also seen as a major culprit in the 1987 crash. Therefore, we are not entirely covering new ground here with this episode.

It is important to keep market panics like the one we are going through in perspective. Our analysis below shows a couple of interesting facts. First of all, the 65.6% swing in the VXO Volatility Index was the sixth biggest intraday spike in volatility since the VXO originated in 1986. Over those twenty-four years, there have only been nine other times that volatility has moved by over 50% in one session. Second, in the ten cases we looked at, the associated intraday decline by the Dow Jones Industrial Average this Thursday was second only to the 1987 crash in percentage loss terms. While nowhere near as painful as that historic episode in market history, this mini-crash was pretty powerful. The final point (also illustrated below) is the fact that in the nine prior volatility panics since 1986, the market was higher six months later in every single instance (by 13% on average). This means that it has paid to search for bargains amongst the rubble when markets are hit with panic and fear.

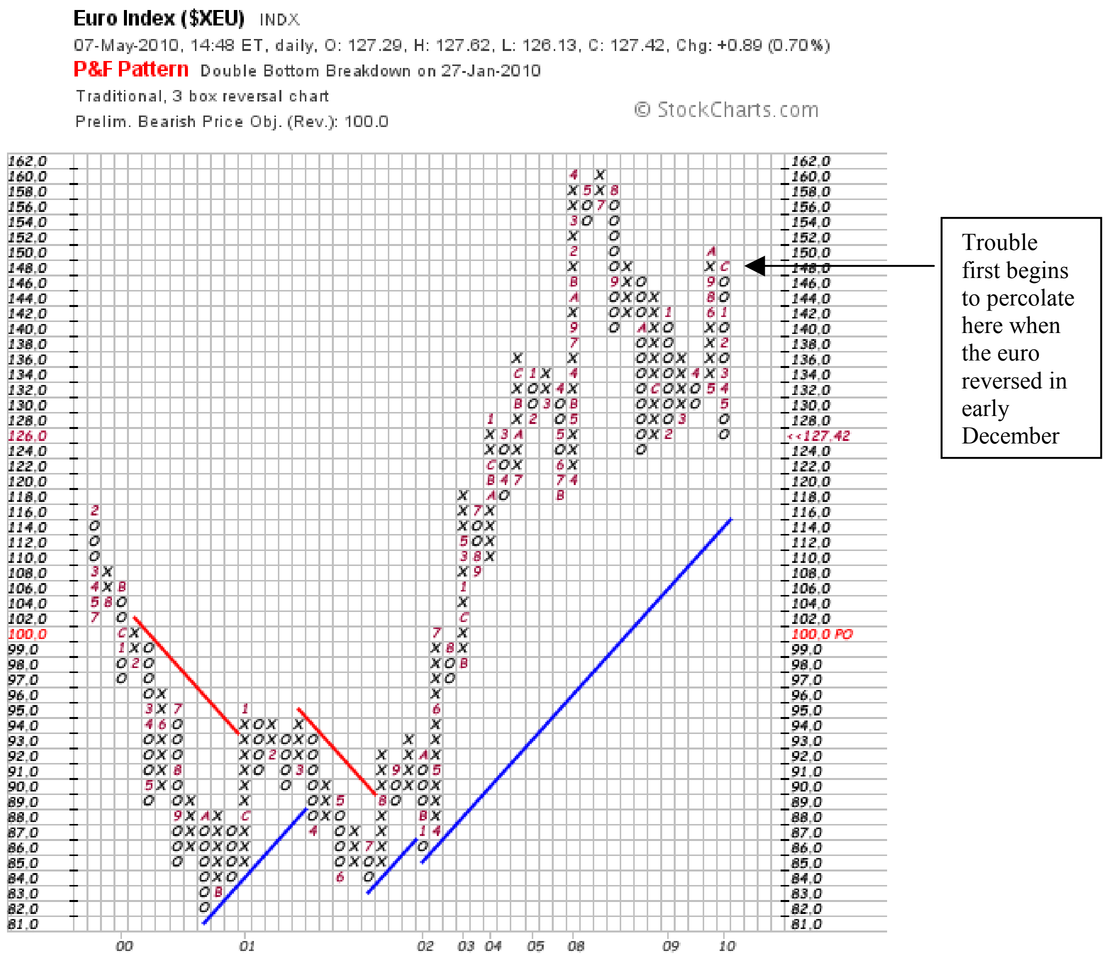
<u>Episodes of Intraday Volatility Spikes of Greater than 50%</u>

#	Date	Intraday VXO Spike	Event/Suspected Trigger	Dow Jones Intraday Decline	Dow Jones 6 months later
1	10/19/87	319.00%	1987 Crash/Program Trading/Options	-23.6%	16.6%
2	2/27/07	96.00%	Subprime Failure/China rumors	-4.4%	10.3%
3	10/13/89	83.80%	Failed UAL LBO	-7.8%	8.1%
4	10/16/89	83.10%	Failed UAL LBO	-2.8%	10.7%
5	11/15/91	72.00%	Options Expiration	-4.2%	14.2%
6	**5/6/10**	**65.60%**	**Greek Crisis/Program Trading**	**-9.2%**	**?**
7	8/3/90	59.30%	Iraq Invades Kuwait/1990 Recession	-5.0%	1.8%
8	10/22/87	57.00%	1987 Crash/Program Trading/Options	-7.0%	24.7%
9	10/27/97	52.90%	Mini-Crash/Asian Crisis	-7.3%	24.7%
10	3/8/96	51.30%	Unclear	-4.4%	6.3%

While the actual mini-crash itself may have been caused by a programming error, there have certainly been underlying fundamental issues brewing in the currency markets since the Euro topped out in early December 2009. There are massive imbalances in the world that need to be resolved in the coming years. Much of this turmoil will play itself out in the currency markets. As a result of the troubles in Greece, the Euro's standing as a reserve currency is under great pressure as the continent tries to untangle itself from its web of debt. There are four major culprits when it comes to leveraged excess in the developed world. The Euro PIIGS (Portugal, Ireland, Italy, Greece and Spain), Japan, the UK and the US. Europe just happens to be the first to feel the pain and face a loss of market confidence. Make no mistake about it though, the other countries mentioned will have to face the music sooner or later. As a result, we may be about to enter a period of rolling sovereign debt and currency crises until the imbalances are rectified.

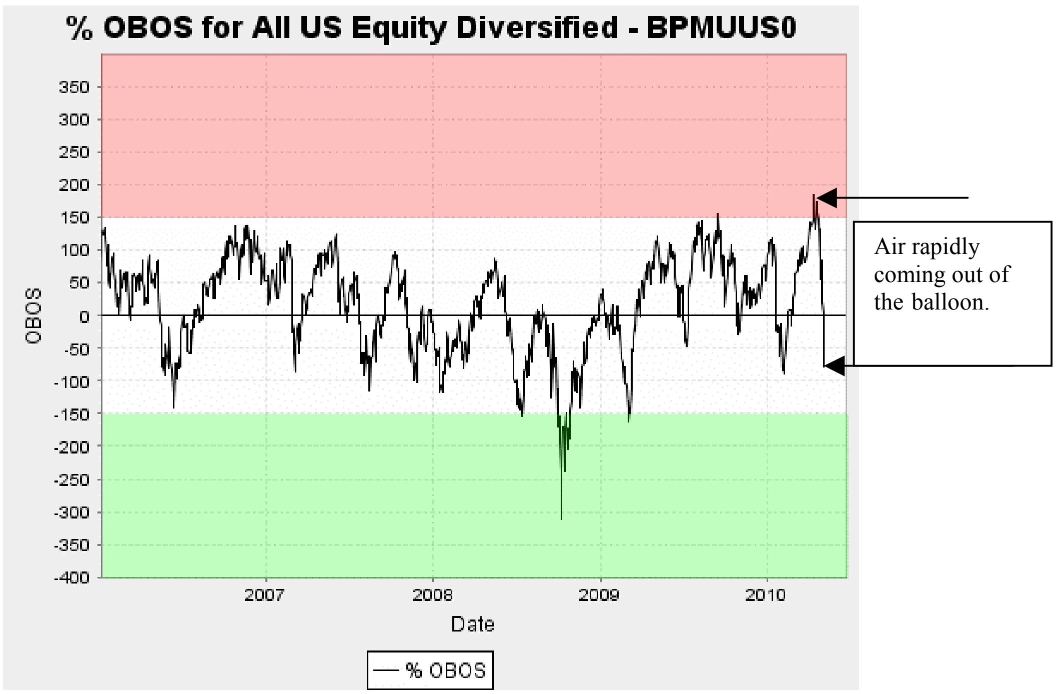
Greece does not have its debts funded in its own currency, so they will have to face dramatic and painful fiscal tightening much like an emerging market. This will force the country into a deep and painful recession from which it will need to rebuild. Similar turmoil may also spread throughout the other European trouble spots. Meanwhile, the other three big debtors (US, UK and Japan) have other options as they wait their turns. Instead of taking the hard medicine, they can crank up the printing presses and flood the world with even more paper money. This is the added flexibility that comes from controlling ones central bank and denominating all debt in the home currency. Furthermore, the US has the distinct advantage of being the world's primary reserve currency. This will make it even easier to print its way out and inflate its debts away.

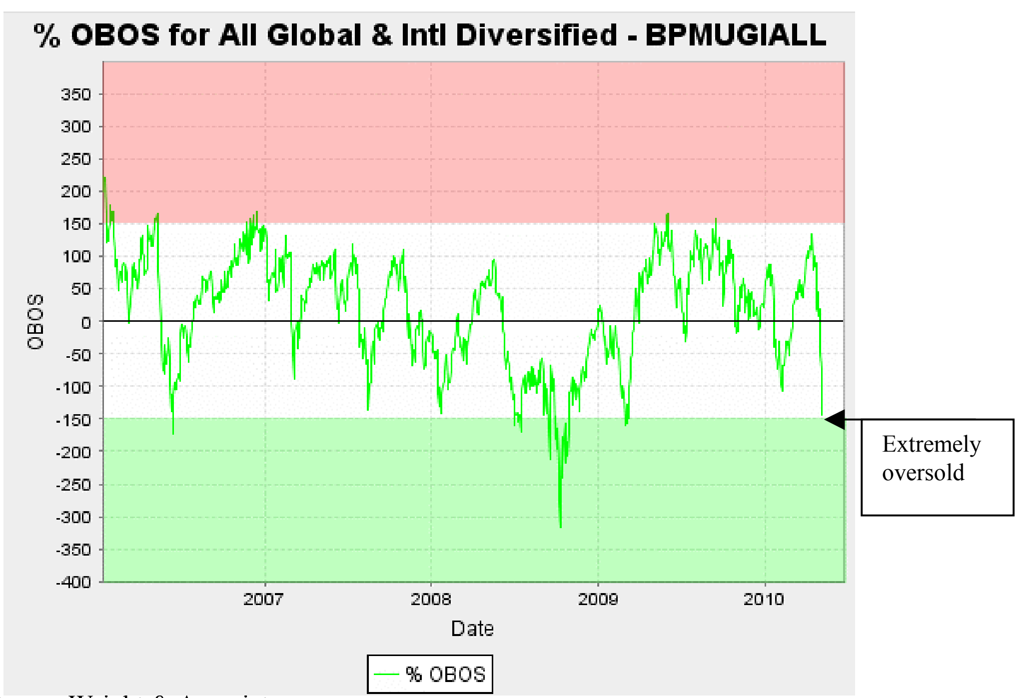
At the moment, the US is engaged in an ugly stepsister contest and it is the least bad option. Hence, the dollar is rallying against the Euro for the time being. The Euro is fast approaching a key inflection point regarding its future role as a global reserve currency. As we can see below, a move down to 1.22 would break the October 2008 lows and be the first shot across the bow that the European Union may not make it through this debt crisis intact. The major breakdown signal would come at the 1.14 level. This would take out the 2005 lows and break through the blue uptrend line shown on the chart. Gold has been rallying in the face of all of this chaos (especially when priced in Euros) because it is increasingly being viewed as an alternative to the worthless paper currencies that are being so rapidly debased.



If anything, the recent volatility in global markets endorses our decision to start raising cash at the start of the year. We see cash as an extremely valuable asset class at the moment, especially cash denominated in US dollars. However, this may not be the case for too much longer. We do not want to take our eye off the big picture. Namely, the powers that be in Washington want and need a much lower dollar in order to inflate away our debt burden. We are faced with the exact same problems facing Greece, only on a much bigger scale. The world is still awash in excess dollars and US liabilities from our consumption binge of the past twenty years. As the problems in Europe subside, we may or may not be next in the line of fire. It may be the UK or Japan. However, we don't want to guess which target the market will come after next. We simply want to be prepared that it may be the US and it may occur at any time. In our opinion, the way to prepare is not to hide under a rock, but to look for ways to preserve and ultimately grow capital in the event of a US debt/currency crisis. We still feel strongly that precious metals are the best insurance against currency debasement. Commodities and other hard assets should preserve capital nicely in the long term as well. In addition, blue chip stocks with stable dividends may prove to be a relatively safe inflation hedge due to attractive valuations and solid global brand recognition. Lastly, emerging markets that have much better growth and debt profiles should continue to attract capital away from the over-leveraged developed markets of the US and Europe. We would stay away from government bonds, as anyone that owns Greek debt will tell you. Also, for US investors, the value of dollar based cash reserves will be eroded by the effects of inflation.

Here are two final charts to wrap up the report. The first chart below is the overbought-oversold (OBOS) level for the All US Equity Mutual Fund Universe. We included a version of this chart in our 4-16-10 report to illustrate the market's vulnerability to a correction. In the past three weeks, this has gone from being almost 200% overbought to almost 100% oversold. Therefore, a lot of risk has been wrung out of the market, but we still have the potential for more volatility in the weeks ahead. We like to see this enter the green zone below 150% oversold before getting overly aggressive on the buy side. The second chart below shows the OBOS for the ALL Global & International Mutual Fund Universe. Not surprisingly, given the US dollar strength and European turmoil, global stocks are much more oversold than the US at present. As you can see Global stock funds are at the green zone indicating an extremely oversold situation. These OBOS indicators tend to exhibit a rubber band effect in that the further you stretch them the faster they snap back. We would not be surprised to see global stocks lead a recovery at some point over the next few trading sessions once the lasting effects of Thursday's sell-off work through the system.





Source: Dorsey Wright & Associates