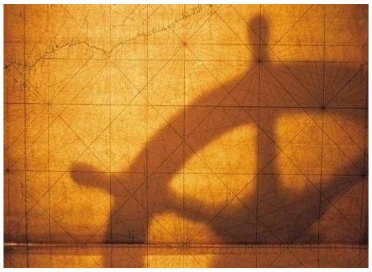
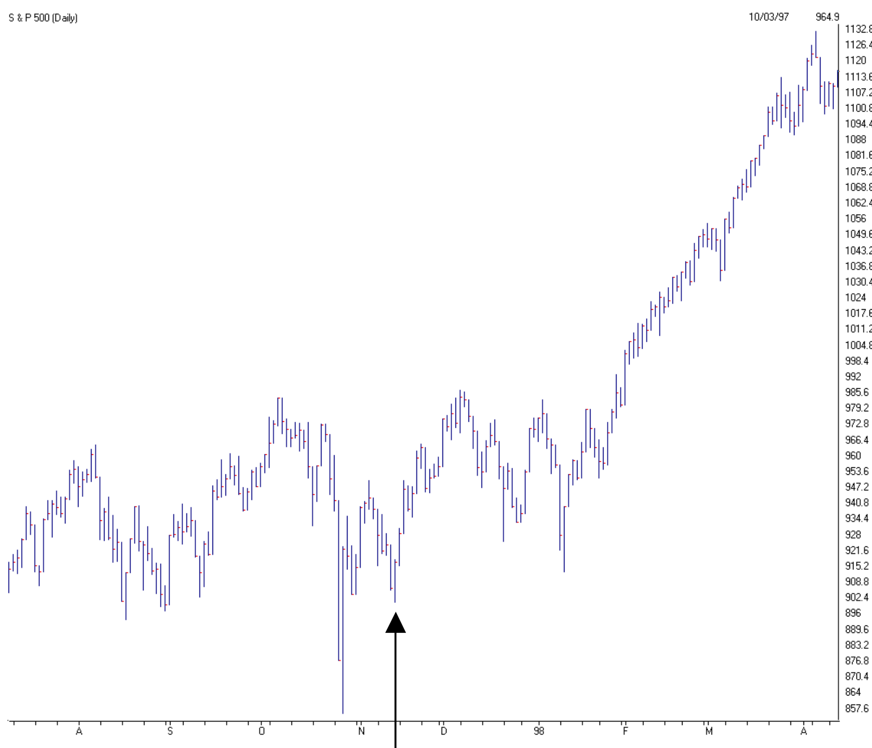


The Starboard Side Report

The week ending May 14, 2010

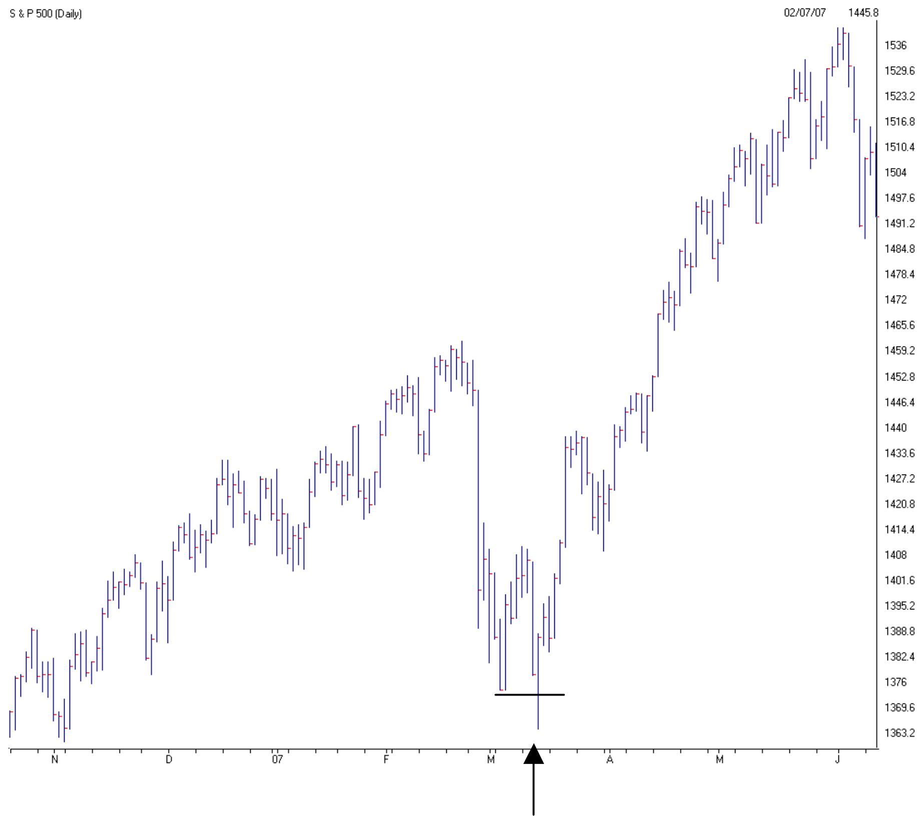
When the market experiences a panic like we had a week ago, it does not usually reverse and run higher unabated. The textbook reaction is a swift and equally violent snapback rally in the days after the initial plunge. This is fueled by short covering and relief that the world is not actually ending. However, once that rally runs out of steam, downside volatility tends to return for a few weeks. This pullback usually takes one of three paths. A complete retracement of the rally that tests and holds the panic low, a partial retracement of the gains or a new low that slightly undercuts the old low by a percent or so. Given the magnitude of the uncertainty surrounding the Euro, we feel that a full retracement/retest or slight undercut of the 5/6/10 panic low may be in the cards. There is an old saying that the second mouse gets the cheese. In keeping with that slogan, we will patiently wait for this retracement to play itself out over the next couple of weeks before actively committing fresh capital. We will also be able to see what countries, sectors and stocks hold up the best during the decline in order to gauge any subtle shifts in relative strength. Below are three different examples of each type of pullback. They are all from the high volatility episodes that we highlighted last week.

S&P 500 July 1997-April 2008



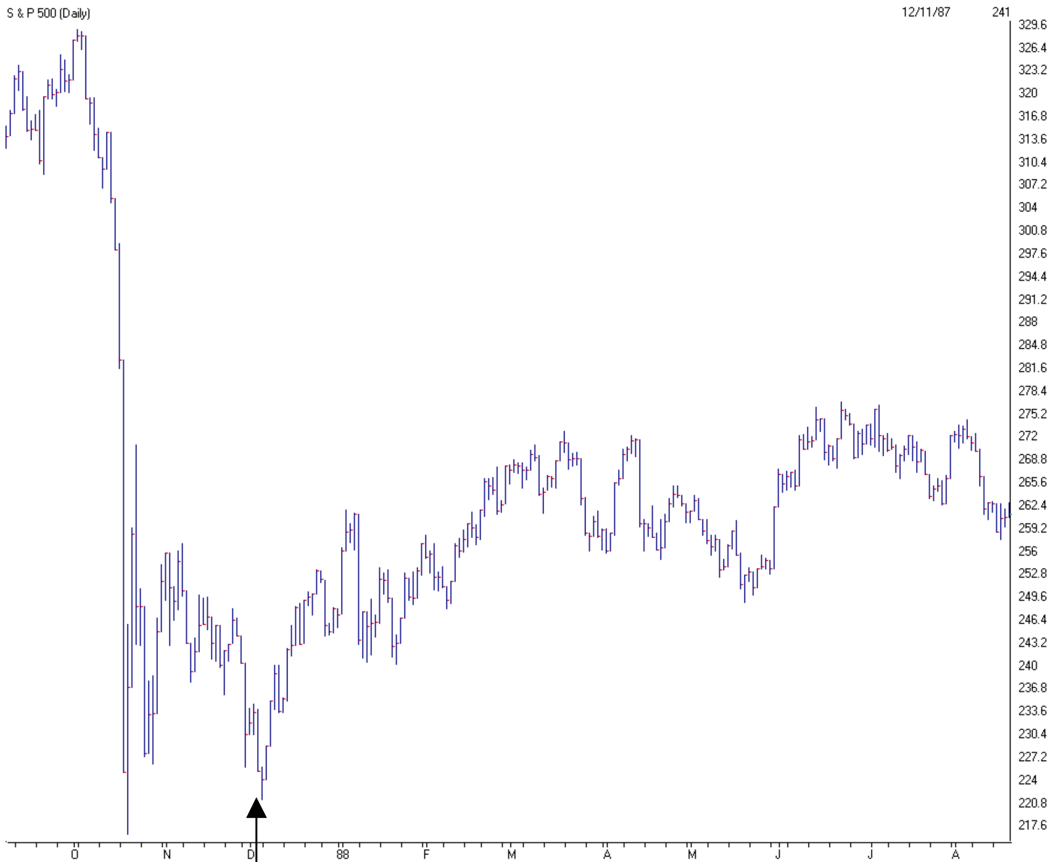
Asian financial crisis mini-crash was a 50% retracement episode. A similar 50% retracement in this instance will take the S&P 500 back to 1120. As you can see, markets remained volatile for two months after the panic.

S&P 500 November 2006- June 2007



The beginning of the subprime mortgage crisis and China slowdown fears caused this mini-panic. This was a full retracement episode with a slight undercut of the panic lows. A similar move in this instance will take the S&P 500 back to the 1050 range in the next few weeks. As you can see, markets were much higher only three months later.

S&P 500 October 1987- August 1988



Cascading program trades were thought to be a prime cause of the 1987 crash. This point that we have highlighted was a retest of the initial October waterfall low. A similar move in this instance will take the S&P 500 back to the 1060 range in the next few weeks.

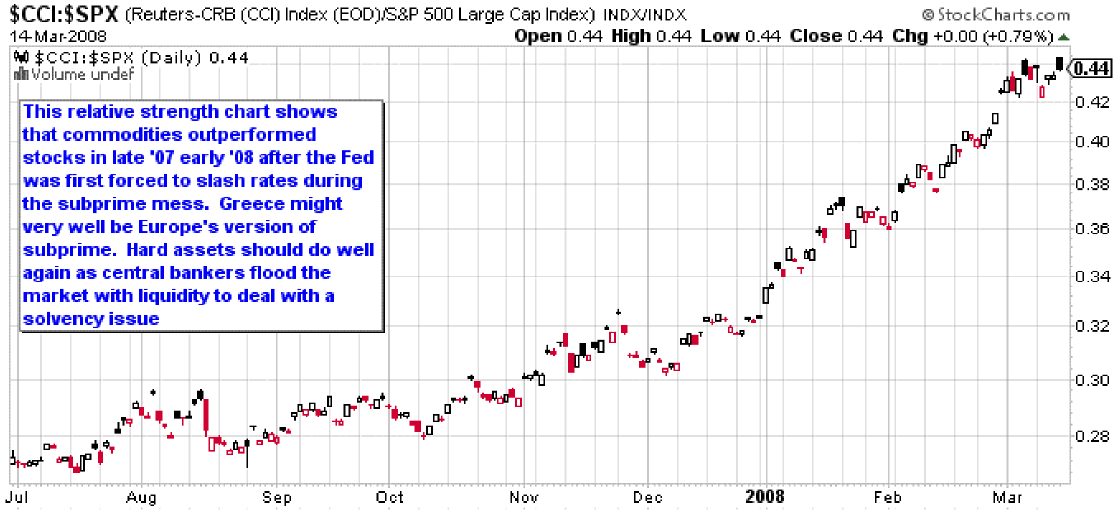
The bottom line is that we expect some aftershocks and volatility to continue over the next few weeks as the market continues to digest the implications of the European bailouts. Our historical analysis still points to more upside in the market after we work through this turbulence. As a result, we expect to remain cautious, but will try not to get too bearish, even if the market goes back and revisits the lows of May 6th as that would not be too out of the ordinary.

The European bailout announced last weekend pretty much summed up the bullish case for gold. Debts continue to be transferred from private balance sheets to public balance sheets. This will have dramatic repercussions for global currency markets. It is essentially stacking up as a race to the bottom for the big four developed currency zones (Euro, US, Japan and UK). The amount of public debts that have been amassed over the past two years will make it very hard for these countries to grow their way out from under the mountains of leverage. Currency debasement/inflating away the debt appears to be the only palatable option to the powers that be. Each successive bailout causes citizens and investors the world over to become more fed up with governments backstopping financial recklessness. As they catch on and demand protection, gold rallies ever higher. Gold is not viewed as negatively in the European culture, so they appear to be seeking out this inflation protection in mass. The chart below of the price of gold in Euros illustrates what we mean. It is in the process of going vertical. This recent price strength should bode well for gold mining stocks in the months ahead.

Source: Traders Narrative

These problems in Europe remind us somewhat of August of 2007 when the US Federal Reserve was forced to step in and start its bailout of the subprime mortgage markets. Below we can see what gold did in the six months following that bailout (in US dollars).

Again using the summer of 2007 as a guide (see final chart below), commodities should start to outperform stocks as investors look to asset classes that are better hedges against loss of purchasing power. It is important to note that the European Central Bank appears to be making the same mistake as the Federal Reserve in 2007 and 2008. Namely, treating a solvency crisis as a liquidity crisis. Ultimately, it is bound to fail and lead to a bigger bailout down the road (see TARP).


$CCI:$SPX (Reuters-CRB (CCI) Index (EOD)/S&P 500 Large Cap Index) INDX/INDX
© StockCharts.com
14-Mar-2008
Open 0.44 High 0.44 Low 0.44 Close 0.44 Chg +0.00 (+0.79%)
$CCI:$SPX (Daily) 0.44
Volume undef
This relative strength chart shows that commodities outperformed stocks in late '07 early '08 after the Fed was first forced to slash rates during the subprime mess. Greece might very well be Europe's version of subprime. Hard assets should do well again as central bankers flood the market with liquidity to deal with a solvency issue
0.44
0.42
0.40
0.38
0.36
0.34
0.32
0.30
0.28
Jul
Aug
Sep
Oct
Nov
Dec
2008
Feb
Mar