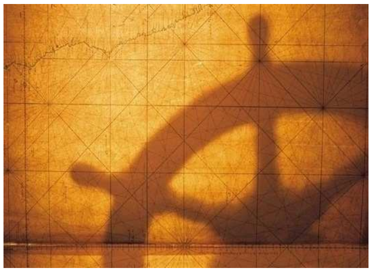
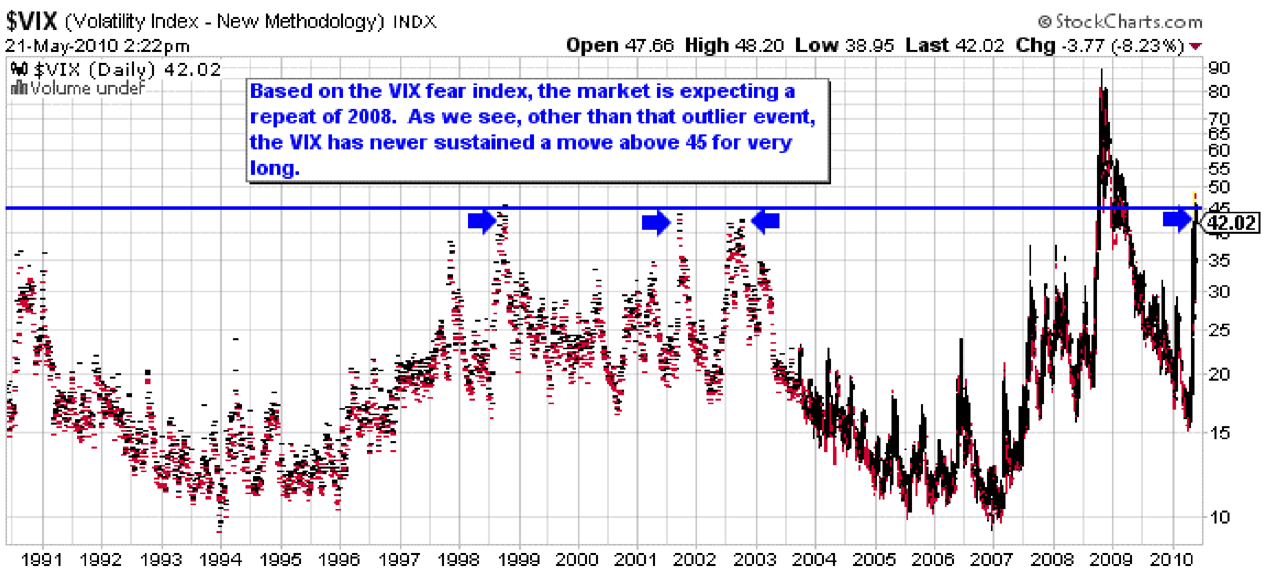


The Starboard Side Report

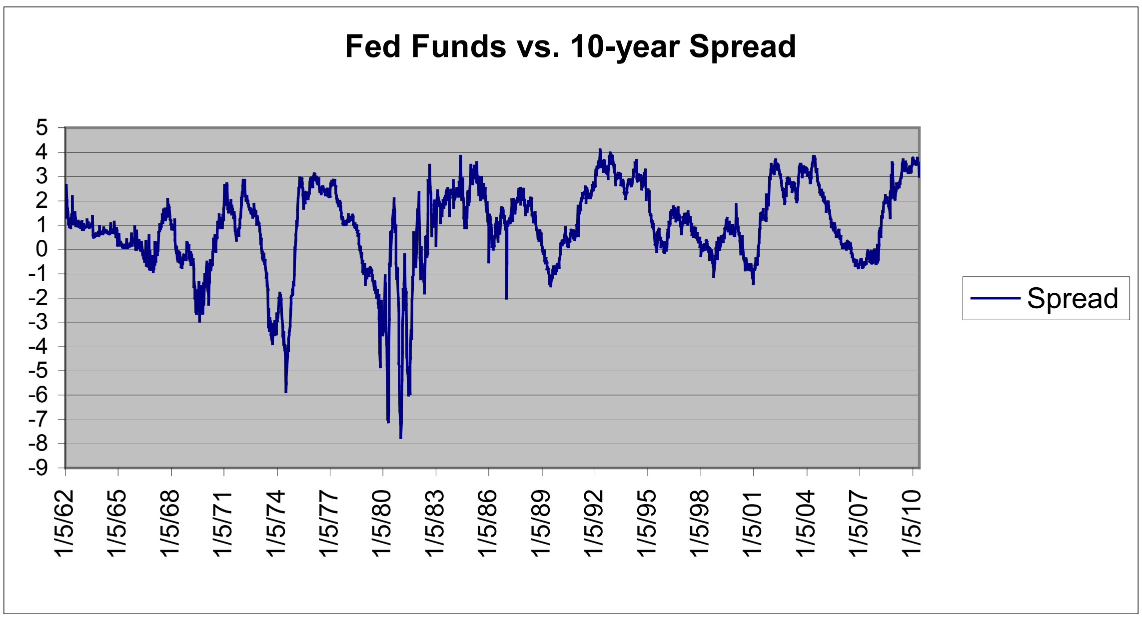
The week ending May 21, 2010

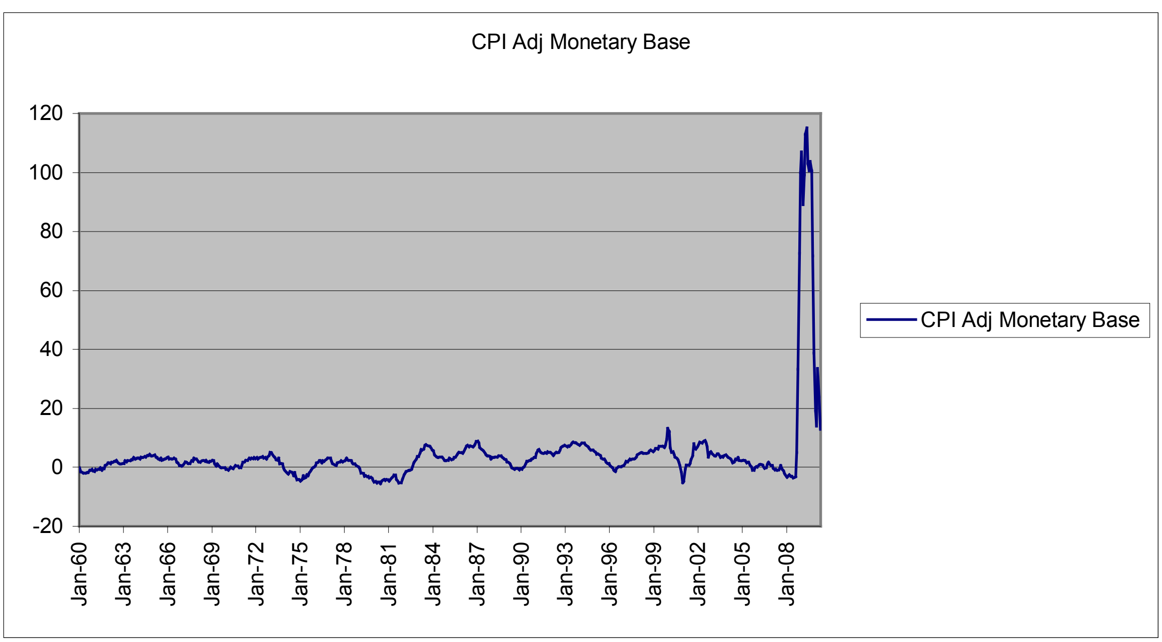
Much like the "flash crash" of May 6th, the re-test episode that we discussed in last week's report appears to have played out at an extremely fast and volatile manner. We had a slight undercut of the 5/6 lows on Friday morning with the S&P 500 trading down to 1055. Buyers stepped up at that level and brought the market back from the brink. Should that price hold, this would amount to a 13.5% correction. As we discuss below, we feel that downside from these levels is relatively small and any more losses should be made up rather quickly. Based on the VIX options volatility fear index shown below, markets have pretty much started to price in a repeat of the fall of 2008. We do not believe that that is in the cards just yet. Therefore, we believe that the risk-reward pendulum has shifted enough to allow us to start seeking some reward from the market. Market psychology is such that the closer you are to the occurrence of a traumatic crash event, such as the 2008 Lehman failure, the higher the odds investors place on that same event occurring again... even if the chances are extremely remote. At the moment, many are fearful and panicked that we are headed back into a deflationary abyss. However, we may be in the minority here, but the liquidity crisis in the fall of 2008 was an extremely rare statistical outlier that will not be easily repeated in the short-term. That is not to say that it can't happen again so soon, but the odds simply do not favor it at present. As a result of this view, we will sift through the wreckage to see if we can find any bargains that over-leveraged hedge funds have been forced to throw out due to margin calls.



The four arrows on the chart above indicate the times over the past twenty years (other than 2008) that fear was so rampant that it drove the VIX Index to 45 (as we discuss below, two were also mid-term election years). This Thursday marked the fourth such occurrence. The other three proved to be decent buying opportunities for those brave enough to fight the fear. We feel that the excessively overbought condition that prevailed for the first four months of the year has been successfully alleviated in just five short weeks. The pendulum should now slowly start to oscillate back towards the fear of missing out from the fear of losing.

We are not just turning more constructive here for the sake of being positive. Rather, there are several items of note that point to sufficient liquidity being available to drive the market higher in the intermediate term. When combined with now extreme oversold conditions, they make for a relatively healthy set-up. One of the things that has started to get priced into the markets by the bears is a double dip recession. We do not feel that this is a factor at this point of the cycle. According to research by Paul Kasriel of Northern Trust, since 1960 there has never been a US recession when the year-over-year monetary base adjusted for inflation has been growing at the same time that the yield curve spread has been positive. Kasriel's definition of the adjusted monetary base is the sum of bank reserves and coin/currency, both of which have been created out of thin air, as it were, by the Fed. Strong growth in money is a liquidity enhancer. A steep yield curve is also very stimulative to economic growth because bank profits can recover by borrowing at much lower rates than they lend out or invest. Below is a chart that illustrates the long-term view of these two important barometers.





While Kasriel usually uses his indicator to warn of recessions, we will use it to help us see that there is no imminent recession threat on the horizon. The annual rate of change of the CPI adjusted monetary base is still almost 13% whereas the yield curve spread is still historically very steep at 3%. This means there should be ample liquidity in the system for banks to continue to heal their balance sheets. We will continue to monitor this closely for signs that the recent turmoil will change this set-up. However, for the time being, we do not believe 2010 will go down in history as a double dip recession year. Even though we don't think that there will be a recession this year, doesn't mean we can't have a mid-cycle slowdown and more volatility. We still feel that country/sector/stock selection will be of utmost importance going forward. So while the worst of this episode may soon be behind us, things have the potential to stay fragile for a few more months and we will stay selective.

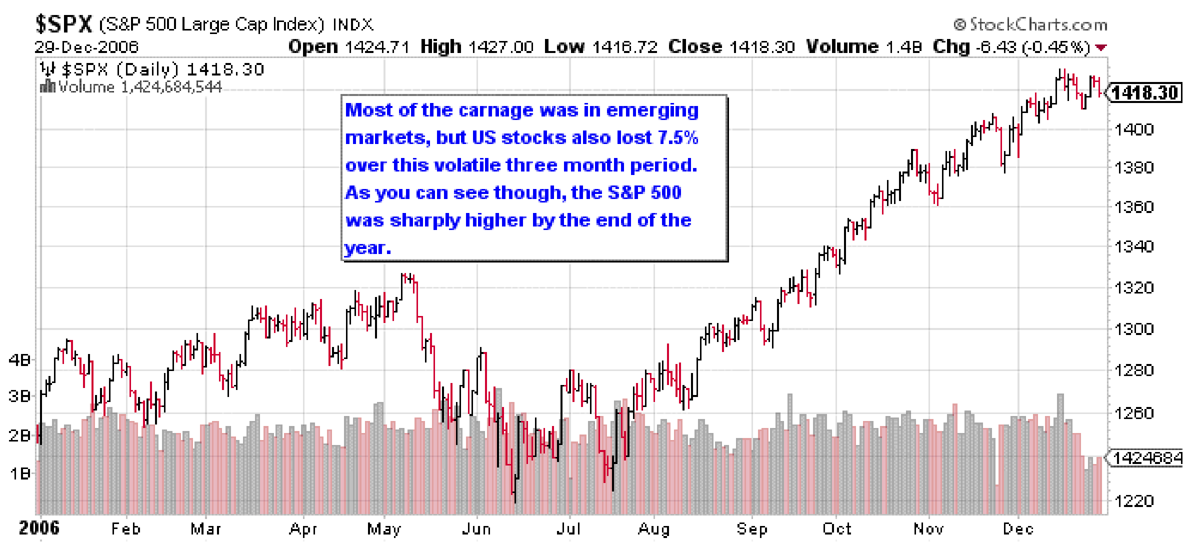
One item that should be discussed is that this is the fourth straight mid-term election year that volatility has had a major spike. Historically, mid-term election years tended to see volatility spike in October around the time of the election as politician rhetoric heats up and uncertainty is created. However, each mid-term year since 1998, the volatility spike has occurred earlier than the last. This may be a function of the 24-hour news cycle and the increased coverage of primaries combining to price in election insecurities sooner rather than later. Below are a volatility chart and market chart for each mid-term election year since 1998.

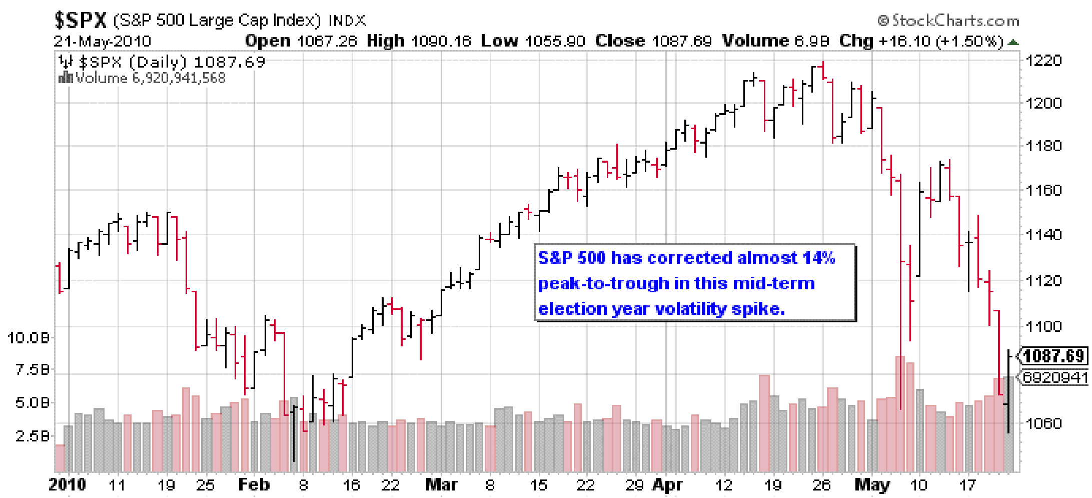

$VIX (Volatility Index - New Methodology) INDX
© StockCharts.com
31-Dec-2002
Open 28.62 High 28.62 Low 28.62 Close 28.62 Chg -1.00 (-3.38%)
$VIX (Daily) 28.62
Volume undef
2002 mid-term election year volatility spiked to 45 in late July. One month earlier than 1998.
45.0
42.5
40.0
37.5
35.0
32.5
30.0
28.62
27.5
25.0
22.5
20.0
17.5
2002 Feb Mar Apr May Jun Jul Aug Sep Oct Nov Dec


$SPX (S&P 500 Large Cap Index) INDX
© StockCharts.com
31-Dec-2002
Open 879.39 High 881.93 Low 869.45 Close 879.82 Volume 1.3B Chg +0.43 (+0.05%)
$SPX (Daily) 879.82
Volume 1,323,497,472
SS&P 500 corrected 35% during this volatility episode and didn't fully recover from the panic until the next year. This was a different episode in that it occurred at the very end of a three year bear market.
1175
1150
1125
1100
1075
1050
1025
1000
975
950
925
900
879.82
850
825
1323497
775
4B
3B
2B
1B
2002 Feb Mar Apr May Jun Jul Aug Sep Oct Nov Dec


$VIX (Volatility Index - New Methodology) INDX
© StockCharts.com
29-Dec-2006
Open 10.95 High 11.65 Low 10.71 Close 11.56 Chg +0.57 (+5.19%)
$VIX (Daily) 11.56
Volume undef
In 2006, the most recent mid-term election year there was as big VIX spike in early June on global recession fears. That panic receded as the year went on.
11.56
2006
Feb
Mar
Apr
May
Jun
Jul
Aug
Sep
Oct
Nov
Dec


EEM (iShares MSCI Emerging Markets) NYSE
© StockCharts.com
29-Dec-2006
Open 36.41 High 36.52 Low 36.29 Close 36.33 Volume 8.4M Chg -0.07 (-0.18%)
EEM (Daily) 36.33
Volume 8,408,967
Emerging Markets plunged 26% in one month back in May/June 2006. This panic proved to be a good buying opportunity.
36.33
84089
60M
40M
20M
2006
Feb
Mar
Apr
May
Jun
Jul
Aug
Sep
Oct
Nov
Dec


$SPX (S&P 500 Large Cap Index) INDX
© StockCharts.com
29-Dec-2006
Open 1424.71 High 1427.00 Low 1416.72 Close 1418.30 Volume 1.4B Chg -6.43 (-0.45%)
$SPX (Daily) 1418.30
Volume 1,424,684,544
Most of the carnage was in emerging markets, but US stocks also lost 7.5% over this volatile three month period. As you can see though, the S&P 500 was sharply higher by the end of the year.
1418.30
1424684
4B
3B
2B
1B
2006
Feb
Mar
Apr
May
Jun
Jul
Aug
Sep
Oct
Nov
Dec



As mentioned, it is very interesting that in each of the past four mid-term election years, we have observed a successively earlier volatility spike: September 1998, July 2002, June 2006 and now May 2010. This may mean little, but it also could be telling us that this recent turbulence is not that abnormal for a mid-term election year *and* that we are close to a bottom. In three of the four of the volatility spike episodes, the market never ended below the closing price associated with the peak volatility spike. The S&P 500 closing price this Thursday when the VIX hit 45 was 1071.6. 2002 was the only mid-term election period that had a further decline, but it was only 2.5%. Perhaps this means that even though political posturing causes volatility, at the end of the day, the political class doesn't want to see the market fall apart in a key election year and jawboning starts to work for stocks instead of against them.

Aside from ample liquidity in the credit markets, one additional reason to stay constructive on the intermediate term, especially on tangible assets, is that real interest rates are still quite negative. This is means the Federal Reserve is begging financial markets to take risk. A lot of cash has been raised during this recent sell-off and that money will be losing 2% per year after factoring in the inflation rate. Negative real interest rates in the mid 1970's ignited a crack-up boom in commodities and gold as investors sought protection against inflation. We see a similar scenario as a possibility in the next few years. The fact that China is trying to slow their economy, at the same time Europe is forcing austerity measures on their high deficit countries, is causing an air pocket in the bullish commodity story. We feel that this is just another temporary setback that will be a blip in the big picture. Mountains of debt will keep central bankers overly accommodative for the foreseeable future. That money will have to flow somewhere and we feel emerging markets, precious metals and commodities are the friendliest home for that capital from a fundamental perspective.