

The Starboard Side Report

The week ending June 19, 2009

The correction that has been brewing appears to have officially kicked-off this week. After unsuccessfully trying to break higher for the better part of a month, stocks have finally been overwhelmed by selling pressure. Confirmation that supply has taken back the upper hand is evidenced by a reversal in the NYSE Bullish Percent Index seen below. This puts the defense back on the field as we wait to see how this will play out. We want to make it clear that we do not see the bottom dropping out as it did last year; rather, we believe that we are in the midst of a healthy consolidation that will keep the S&P 500 in a relatively tight trading range over the next few months as recent gains are digested. Rallies are more prone to failure in these corrective phases. Therefore, it will pay to exercise patience with buy orders in the weeks ahead.

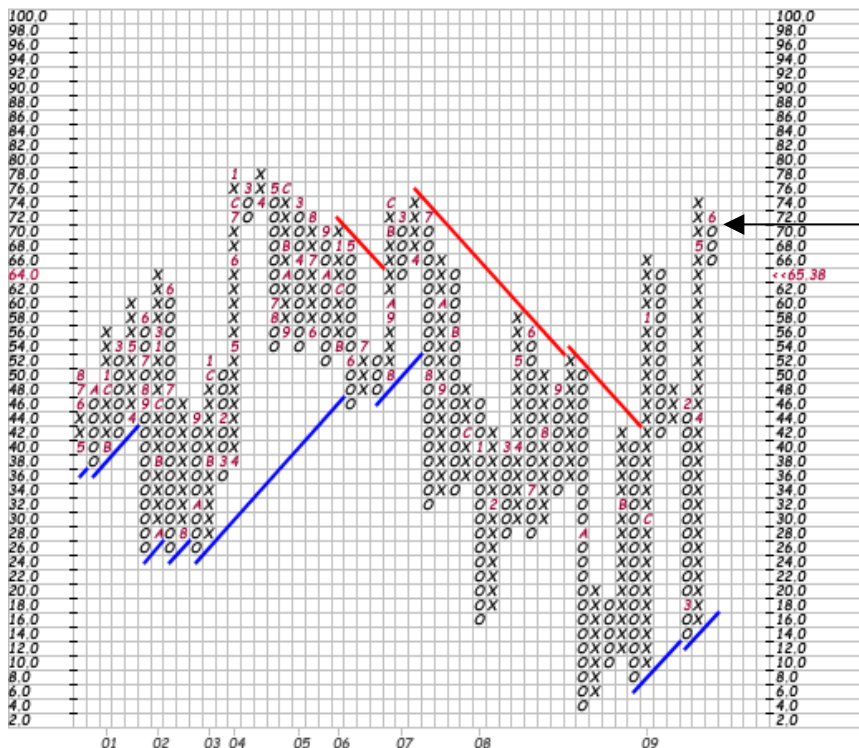
NYSE Bullish Percent Index (EOD) (\$BPNYA) INDX

18-Jun-2009, 16:00 ET, daily, O: 65.382, H: 65.382, L: 65.382, C: 65.382, Chg: -0.385 (-0.59%)

Status Bear Alert on 17-Jun-2009

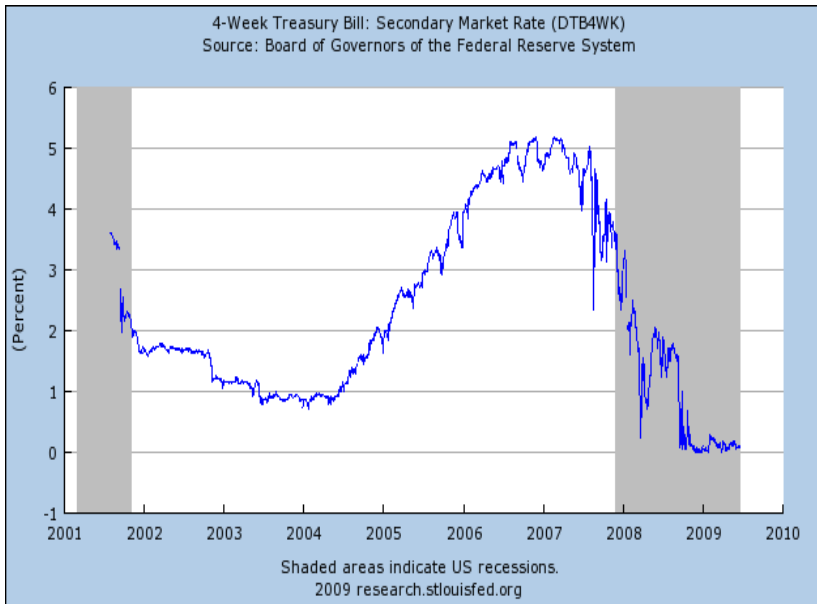
User-Defined, 2.0 pts/box 3 box reversal chart

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NYSE Bullish Percent Index reverses into O's from above 70%. This means sellers have regained the upper hand for the first time since early March. Normally a reversal from above 70% would be a concern. However, it is more likely that this decline will be muted because the most recent rally left a lot of investors at the station with cash in hand. As a result, money managers may be more eager than normal in an effort to make up for performance lag.

Despite the emergence of this squall, we are still relatively bullish on the remainder of the year. There is plenty more government stimuli in the pipeline that will work its way through the system in the back half of the year. In addition, there are still enormous amounts of cash parked in money market funds earning zero interest. Below we have a chart of the yield on the 4-week US Treasury Bill in order to illustrate the approximate level of interest that investors are earning in money market funds. According to Crane Data, US money market mutual fund assets have grown by 45% over the past two years from \$2.5 trillion to \$3.675 trillion. Yet, the yield on this cash has plummeted from around 4.5% to 0.15% (a 96% decline in interest payout). As the deflation clouds continue to lift and inflation worries heat up, this sideline cash should continue to make its way into riskier assets.



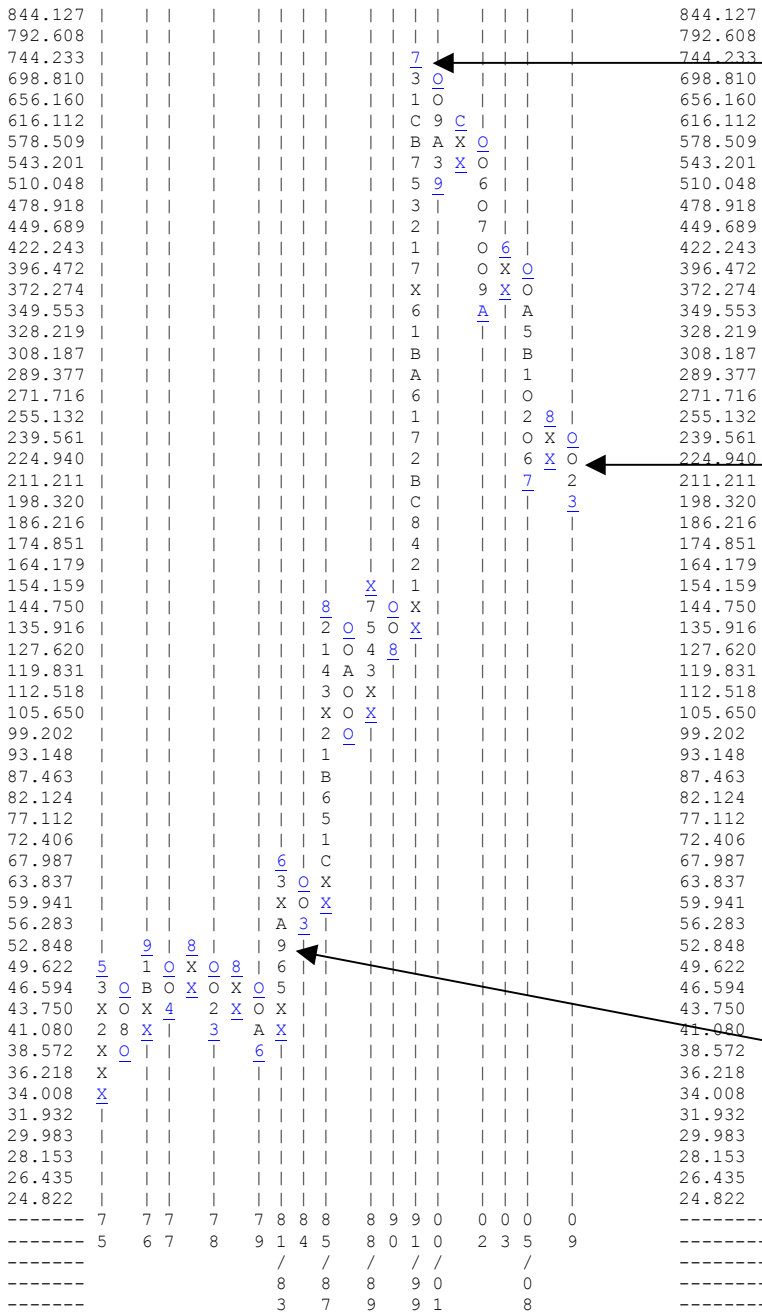
Source: St. Louis Federal Reserve

As short-term money rates fell from close to 5% all the way down to almost zero, assets in US money market mutual funds swelled 45% or by \$1.14 trillion. We suspect these same investors will scramble to find higher yielding assets or inflation hedges due to government spending and money printing.

One way to measure the relative level of cash sitting in money market funds is to divide the total assets in these ultra conservative funds by the entire market capitalization of the S&P 500. Intuitively, the lower the percentage of assets that investors park in these money funds; the more they are out chasing risky assets and vice-versa. When stocks are on the verge of a major decline, money fund assets have tended to bottom below 16% of the S&P's market cap. On the flip side, money funds have peaked at over 28%, 24% and 28% during the past three recessions in 1982, 1990 and 2002 respectively. According to our calculations, using data from Standard & Poors and the Investment Company Institute, money market funds are presently 46% of the entire S&P 500 market cap. This is over 75% greater than the average of the past three recessions, yet the interest being earned is much lower. Even more amazing is that at the market bottom this March money market assets were about 66% of the S&P 500! The major take away is that inflation fears appear to be very underestimated if investors are comfortable sitting on historically high cash levels at such historically low interest rates levels. Furthermore, investors are still being extremely risk-averse with their money. While stocks should benefit from the gradual flow of money out of money market funds, we believe that the major beneficiary will be commodities due to the relative strength picture we discuss below.

Our final addition to the report this week is an extremely important big picture chart that shows the relative strength relationship between US stocks and commodities.

S&P 500 versus the Equal Weight Commodity Index (1975-Present)



Stocks peaked versus commodities in 1999 and went to a sell signal in 2002.

As we can see, stocks have recently resumed their steep downtrend versus commodities.

Stock relative strength shifts to a buy versus commodities in 1982. This signaled the beginning of a massive 20-year bull market for stocks and a long bear market for commodities. Twenty years of outperformance is now being unwound. This chart shows that we are not even half way through that process.

Relative Strength Signal History

S&P 500 vs Equal Weight Commodities Index

Signal	Date	Calc	Last
Buy Signal	09/21/1976	53.38	107.83
Sell Signal	03/27/1978	40.82	88.87
Buy Signal	09/14/1982	52.88	123.10
Sell Signal	06/25/2002	471.13	976.14

These two asset classes have long-term buy and bear cycles that often last 15-20 years. A 20-year buy signal for stocks ended in 2002. Relative strength now rests firmly with commodities.

In the category of a picture is worth a thousand words, the chart above clearly illustrates our thesis that US stocks entered a long-term bear market in 2000 at the same time that commodities were emerging from a twenty-year bear market. It wasn't until 2002 that our long-term relative strength analysis officially confirmed this view with the S&P 500 going to a relative strength sell signal versus commodities (as shown in the box via the green and red highlighted text above). While on a buy signal, US equities blew away commodities during the 1982 to 2000 bull market by an astonishing 1700%. However, the tide has clearly turned and we are working our way down the backside of the mountain. The equal weight commodity index has outperformed stocks by 275% since late 1999. It appears to us that we are not even half way through this cycle of strong commodity relative strength. Commodities would have to outperform stocks by another 500% over the next several years to get back to their prior cycle peak relationship.

It is interesting that the 1987 stock market crash was analogous to the crash in commodities last year because it happened relatively early in a long-term bull market cycle. When all is said and done, we expect 2008 to be a blip on the screen for the commodity indexes the same way that, in hindsight, the 1987 crash proved to be a buying opportunity for stocks. The interesting thing, as we have discussed before, is that commodities are one of the few asset classes that have seen an improvement in long-term fundamentals as a result of the credit crisis. Excess capacity that will be sorely needed to fuel emerging world growth was shuttered or canceled as funding dried-up. Once global growth resumes, we may start to have some significant supply squeezes as demand sways production capabilities.