



# The Starboard Side Report

The week ending June 25, 2010

The Chinese real estate market is about to collapse, the US economy is going to enter a double dip recession and the European currency union is on the verge of imploding. According to many of the headlines we have been reading lately, all of this economic doom and gloom is going to happen in the second half of the year and take stock prices back into the abyss. We say not so fast. While all of these issues are clearly worries, the old saying is that the market loves to climb a wall of worry. One of the reasons that we were so concerned and negative back in the 2006-2008 period was that the rest of the investment world had blinders on as to the risks that were bubbling up in our credit markets. Excessive optimism breeds careless decision making behavior by market participants. However, it now seems as if the pendulum has swung entirely in the other direction and the popular path is to focus on the negativity and ignore any signs of good news. As counterintuitive as it sounds, we try to become more positive when the market psychology seems the most dire and vice versa. This has kept us in relatively good shape during the past several years. We are not out of the woods in terms of the debt mountain that the developed world is digging out from under. We simply feel that there is still opportunity to capture additional returns before this economic cycle comes tumbling down into another recessionary tailspin.

As we discussed last week, we feel the recent correction has brought price and risk levels back to a point commensurate with the surrounding doom and gloom. Despite the market's setback this week, we still feel that we are on course for a nice rally phase that could take stocks back towards their April highs. The new found risk aversion by the US public has led to equities being shunned by the masses in favor of cash and bonds. We believe that this is a wrongheaded approach to long-term risk given our inflation concerns. There are many large global enterprises with low debt and high cash flows trading at very cheap valuations and sporting nice dividend yields. Getting bond like yields on blue chip stocks is an attractive proposition. Fellow investment manager Jeremy Grantham has identified "high quality" US large cap stocks as one of the most promising asset classes over the next seven years. We see this group as a nice fit to our emerging market and commodity heavy portfolios.

Even though the market was down close to 4% on the week, we did not see a big change in the NYSE Bullish Percent Index (see chart below). What this means is that a relatively few number of stocks led the decline and that the market still remains relatively healthy under the surface. A consolidation after the big move we had the prior two weeks was not entirely unexpected. In fact, it is a relatively healthy event provided the intermediate-term internals of the market held up like they did. The majority of stocks we follow simply pulled back to their support lines.

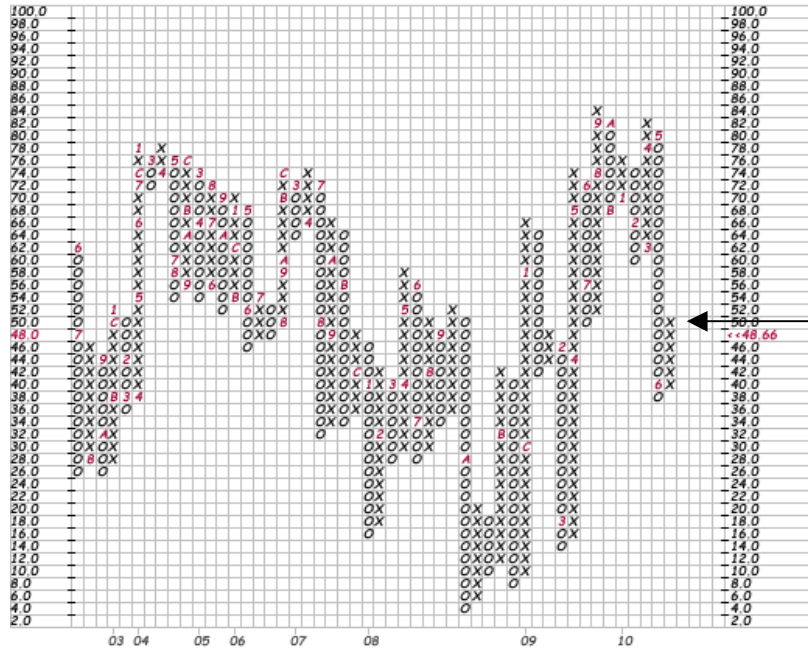
**NYSE Bullish Percent Index (EOD) (\$BPNYA) INDEX**

24-Jun-2010, 16:00 ET, daily, O: 48.668, H: 48.668, L: 48.668, C: 48.668, Chg: -0.57 (-1.16%)

**Status** Bear Correction on 16-Jun-2010

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

© StockCharts.com



NYSE Bullish Percent Index remained relatively stable during this week's pullback. That keeps the rally option we discussed last week fully in play.

Even though we still see some decent absolute gains ahead for US stocks, we still strongly feel that the relative performance of paper will continue to lag versus a tangible asset such as gold. Below is an updated chart of the S&P 500 priced in gold. This shows that after a strong run for stocks since the March 2009 bottom, they have reversed and appear poised to resume the downtrend that began in 2000. This is a powerful chart and one that really tells a great deal about the state of US financial affairs. US stocks have lost over 80% of their value over the past ten years using this metric. Unfortunately, this chart shows that they still may have a long way to fall versus the yellow metal.



Equally as stunning (or depressing) is the next chart below that shows the average price of a US house priced in gold. Despite what conventional wisdom tells us about the housing bubble peaking in 2006, this chart provides evidence that home prices in the US actually topped out in 2000. This means that all other gains from that point on were illusory profits derived from the debasement of the US dollar. It is staggering to see the precipitous drop in US house values when priced in a stable currency such as gold. By this measuring stick, the average US house is worth 73% less than it was ten years ago and has fallen all the way back to early 1980 prices. I suppose one could actually make the argument that average US house prices are in the process of becoming a bargain when priced in gold. They appear much closer to finding long-term equilibrium than do stocks.

### Average US Real Estate Price Divided by Gold Price (1978- Present)

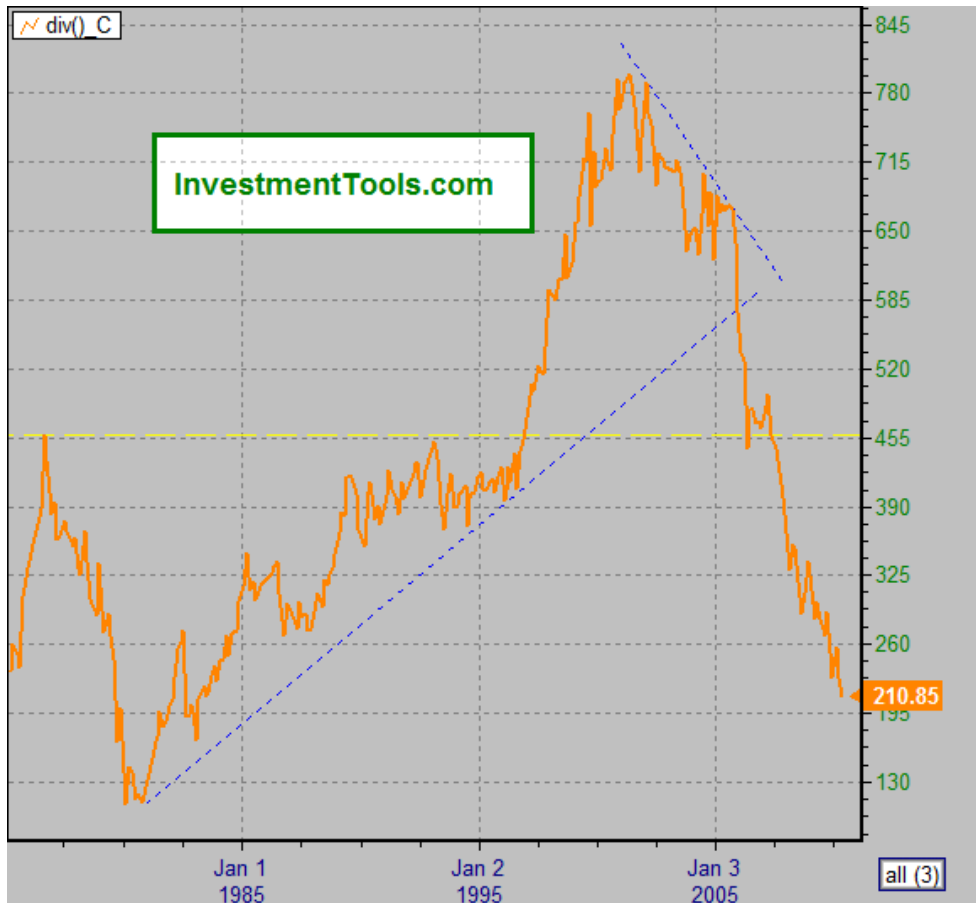


Chart created with NeoTicker EOD © 1998-2007 TickQuest Inc.

As they say, it's all relative. We firmly believe this expression when it comes to analyzing stocks and asset classes from both a short and long-term perspective. So while we see a window of upside momentum for stocks in the weeks ahead, in the longer-term we still see the relative strength picture favoring precious metals as the debt issues of the developed world continue to weigh on economic growth.

One example of short-term relative strength over the past month is the fact that emerging Asia is starting to outperform the US again (see final chart below). The Chinese decision to gradually revalue their currency higher again was a shot in the arm for the whole Asian economic bloc this week. These are the type of positive developments that get lost in the new world of ultra negative headlines.

***SPDR Emerging Asia Fund versus S&P 500 Relative Strength Chart (past 30 days)***

