

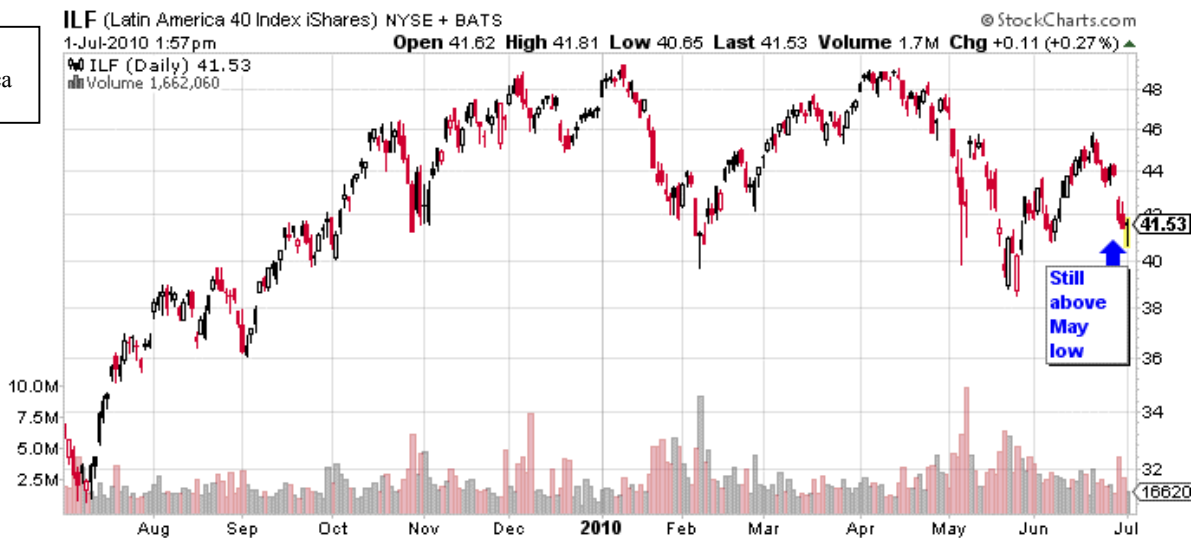


The Starboard Side Report

The week ending July 02, 2010

It was a rough week in the market again as selling pressure dominated the tape. We were obviously not correct in our short-term view that the worst of the economic news had already been priced into the market. At the half way point of the year, the key question becomes—where do we go from here? We feel that the answer depends on whether or not the market will be higher in six months time when the calendar turns to 2011. Many are expecting that the back half of 2010 will be a replay of the 2008 meltdown. As we made clear last week, we do not think that will be the case. Even if we have some more downside pain in the weeks ahead (the NYSE Bullish Percent just reversed back to O's), there is still too much stimulus in the global economic pipeline to run for the hills just yet. While Main Street US and Greece may be hurting, we feel the focus should be on those parts of the world that are fundamentally well positioned to take advantage of the stimulus provided by rock bottom interest rates. This group is generally confined to the emerging world in China, Latin America and Central Europe. It also incorporates the resource companies needed to help carry out their ambitious growth plans. Most of the headlines this week were focused on the breakdown in US stocks. As we show below, the three most prominent regions of the emerging world (Latin America, Asia and Central Europe/Russia respectively) were all still comfortably above the lows they hit in May.

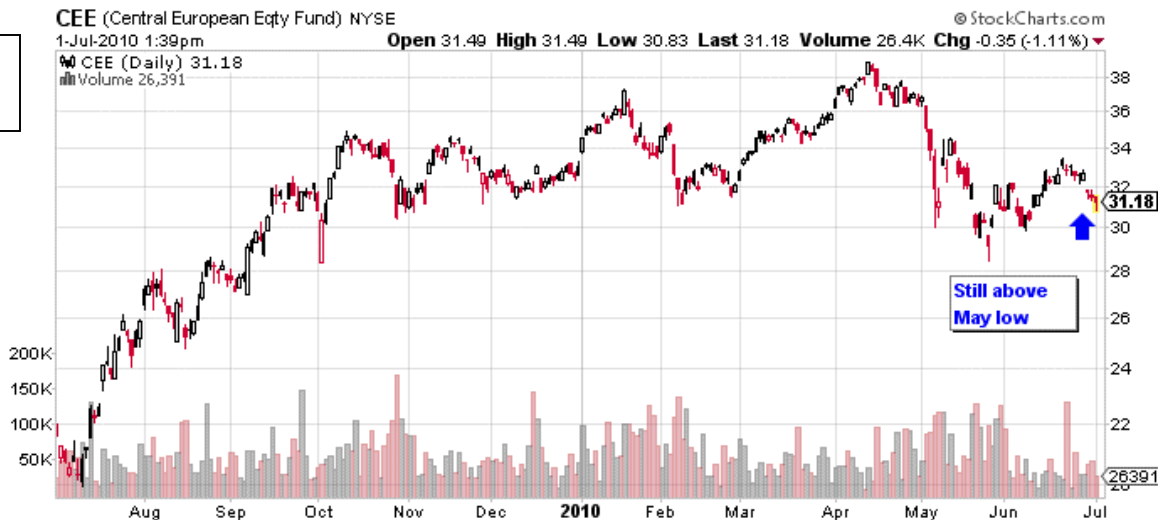
Latin America



Emerging Asia

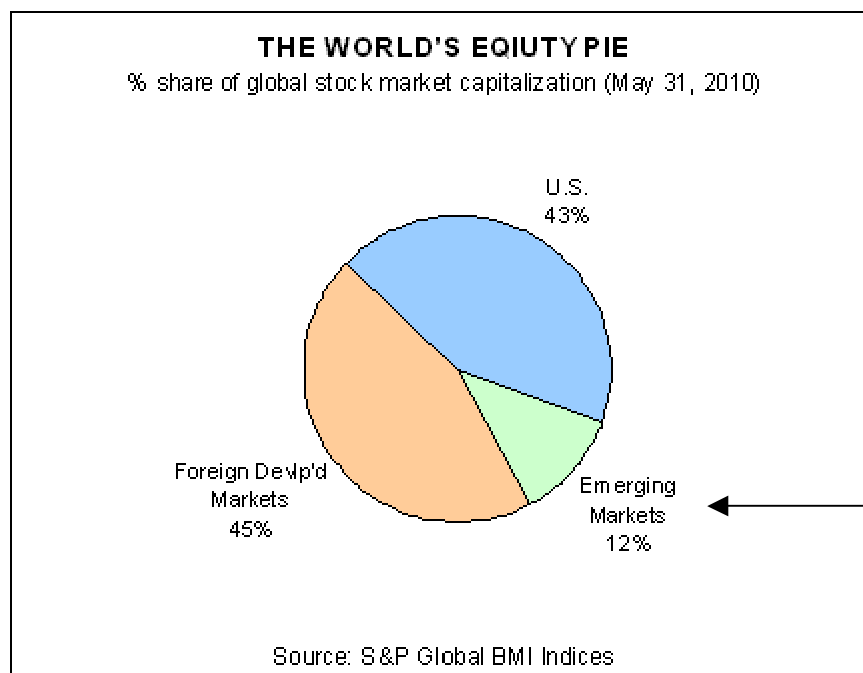


Emerging Europe and Russia

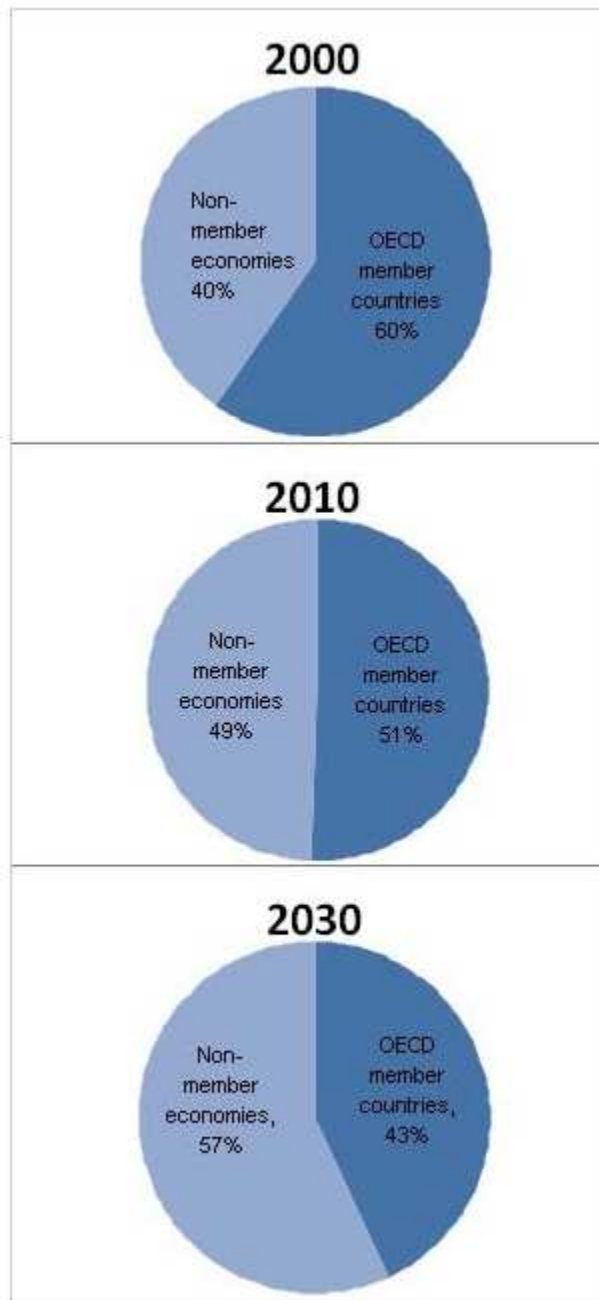


These pictures show that the relative strength of emerging markets is steadily improving after a year long consolidation versus the US and Europe. This may mean that the economic growth cycle still has further to run in this dynamic part of the world. We think that this important message of the market is getting obscured by all of the negative headlines of late. This price action by emerging markets is similar to their bottom late in 2008. Recall that emerging markets bottomed in November 2008, but the rest of the developed world did not stop falling to lower levels until March 2009. We will reassess this view should the emerging markets decisively break to new lows in the days ahead. Until then, we will stay the course in these assets because we feel that they are a relatively safer bet than the debt laden developed world from a long-term annualized return prospective.

One of the most attractive features of emerging stocks is how relatively little allocation they have in global portfolios relative to their economic contribution in the world. Below is a good pie chart from Standard and Poor's that shows this small slice of the equity pie.



In 2000, non-member OECD economies (generally those nations outside the rich developed world) represented a 40% share of the global economy, based on purchasing power parity. This year, the share has risen to 49%, and it's projected to reach 57% by 2030 as seen below.

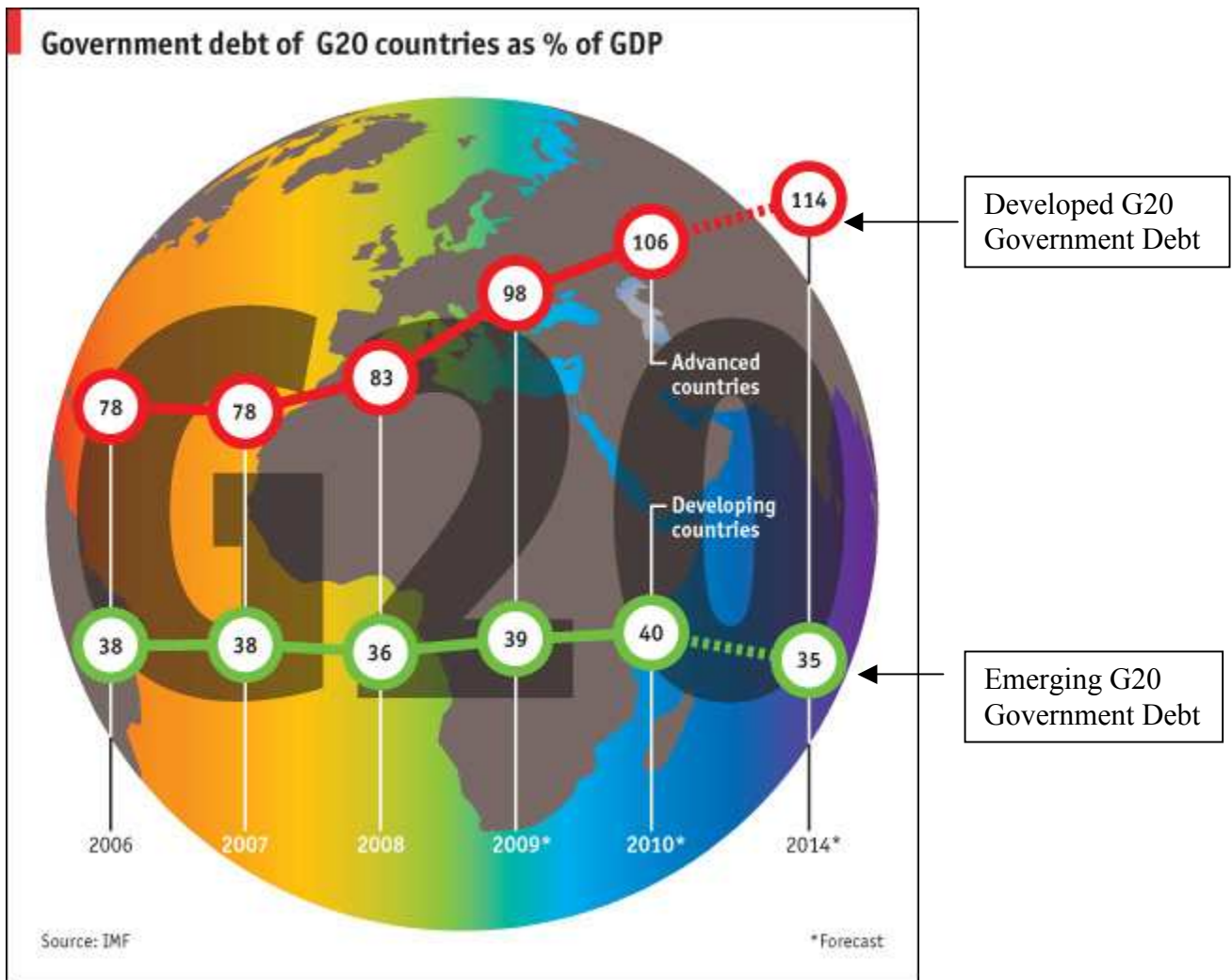


Source: OECD

Furthermore, according to Daniel Arbess of Perella Weinberg Partners, "developing economies will be spending about \$2.25 trillion annually for the next several years to meet their infrastructure needs. They have the money and the political control to make it happen, regardless of what's going on in our part of the world. China alone will increase its urbanization rate from 46% to 58%, adding 210 million urban residents in 70 million households. They need a lot of *stuff* to urbanize 20 million people a year....."

That gap between equity value and economic value shows that investors still pay an enormous premium for the developed world's more "stable" economic output. In the past, this was understandable. The developed world was less leveraged, had more liberal capital markets and faced considerably less politically risk than the emerging world. However, as we have stated many times in this report, this old model has been turned on its head following the global financial crisis and subsequent fallout. It is now the developed world that is filled with political risk, financial leverage and economic chaos. We feel very strongly that the markets have not fully come to grips with this new reality. As we have seen of late, this new world order is not the 1990's anymore. Why then do investors insist on putting more value on those developed countries that are becoming as equally uncertain in terms of volatility, growth prospects and credit market risk? We believe it is because this is what is familiar. Yet, true long-term value is not achieved by pursuing what is familiar. We need to look out and see what the world will look like in 20 years and calibrate our portfolios to that vision. What we don't see as sustainable is a 12% equity value for 50% of the global output and almost all of the global growth (emerging) versus 88% equity value for stagnating growth and massive debts (developed). It seems to us that, like two ships passing in the night, this divergence must start to narrow in the years ahead. As more investors discover that they are overexposed to a dying economic system and underexposed to the new growth engine of the world, the markets of the emerging world should steadily gain mind share and the corresponding stock market share that goes along with it.

The chart below from *The Economist* is a good picture of what debt ahead means in terms of risk profiles.



This road ahead will by no means be a smooth one. Air pockets like the one that we are experiencing will no doubt be part of the landscape. They are the result of a massive transition away from a political and economic system that has dominated the globe for decades. Arbes put it well when he said; "the world economy must transition to a more balanced model of global consumption and leverage, with more consumption in the East and less borrowing in the West. This is much bigger than the '08 financial crisis; it implicates the entire postwar global economic model." This means that investors will increasingly need to study the *global* big picture in order to find their way forward. This means increasingly venturing outside our shores in search of returns. It will not be easy or familiar, but paying close attention to the big top-down trends and looking beyond the US investment landscape should prove valuable as the global economy rebalances in the years ahead.