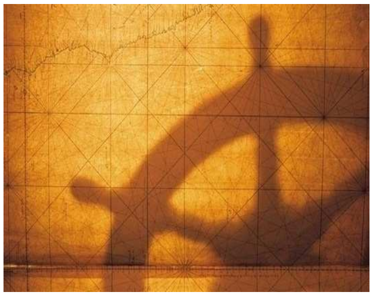
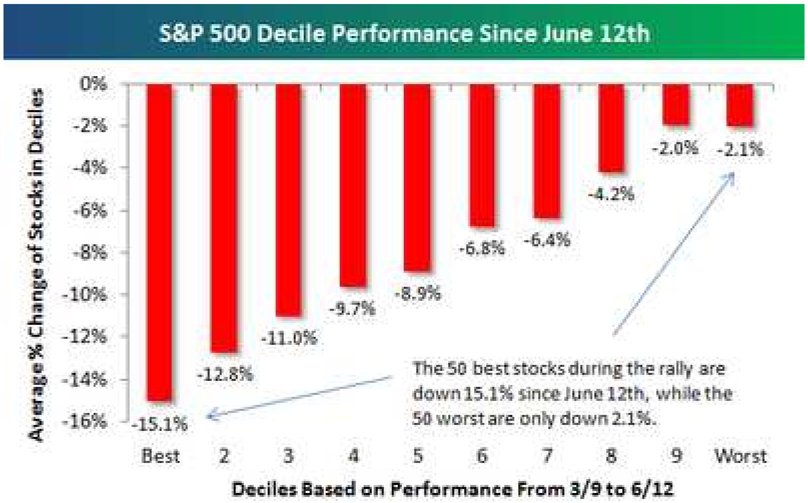


The Starboard Side Report

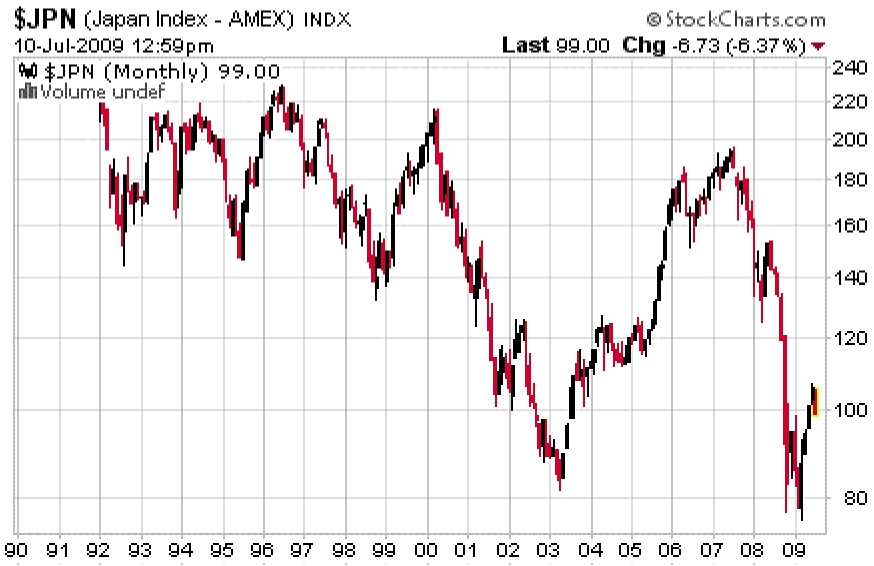
The week ending July 10, 2009

"I think it is a mistake to get too bearish here." We strongly agree with this recent quote from Raymond James Chief Strategist Jeffery Saut. While there is little doubt that the market is having a bit of a struggle right now, we see this as a natural readjustment of investor expectations. Things got a bit ahead of themselves in the first three months of the rally and needed to come more in line with the type of second half recovery we are going to get. The relatively weak nature of the rebound is now causing some to pull in their aggressiveness and take some profits. Nonetheless, the fact that any kind of recovery is the cards is a big change from the free fall and panic of late last year. Below is a chart from Bespoke Investment Group that characterizes the correction so far. As you can see, those stocks that rallied the most in the bounce off the bottom are the ones suffering the most significant declines since the June 12th market peak. This is consistent with profit taking and readjustment of growth expectations.



Unprecedented amounts of stimulus should begin to kick-in and help stabilize the dreadful employment picture as we go forward. As a result, we expect this correction to fizzle out some time in the next few weeks. That should set the stage for a more orderly and sustainable advance in the fall and early next year. We believe the risk-reward from the 880 level on the S&P 500 is about 6% to the downside (830) and 25% to the upside (1100). That is fairly compelling, so we expect to put some cash back to work after our short-term indicators get a bit more washed out and start to show a reversal. It is natural to expect the bottom to fall out given that the pain of last year is still fresh in most investors minds. However, we feel that one should not assume a repeat of that calamity is forthcoming. Our study of market history tells us that we should still have several more months of a positive investment climate before it is time to get aggressively bearish and defensive. In addition, over a three-to-five year time horizon, we still believe there are areas of the global economy that will do well. Asia, energy and precious metals remain our favorite core areas in which to invest for the longer-term. Our relative strength analysis will also help us identify other places to hide as we move forward.

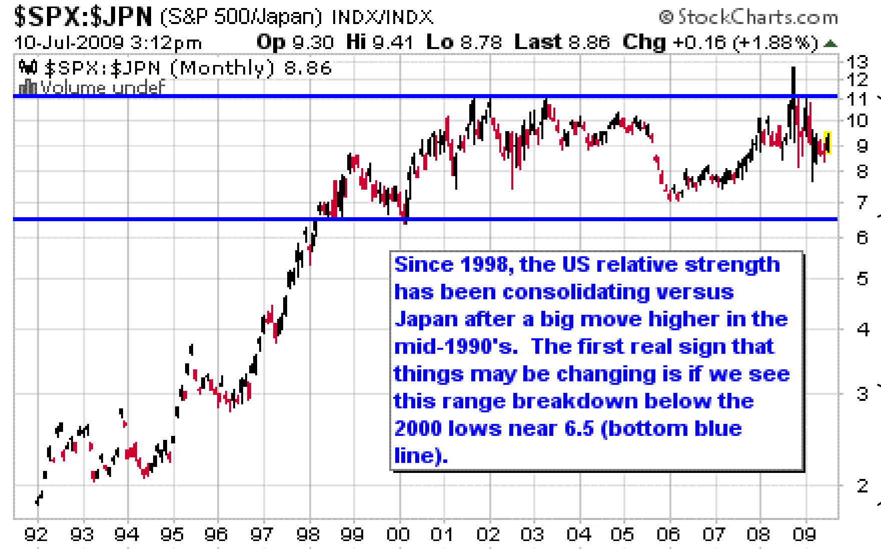
We have talked a good deal lately about our bullish outlook for emerging Asia, but have not touched on Japan lately. There have been several interesting developments recently that could start to reawaken investor interest in the land of the rising sun. The most encouraging is that Japanese investors are starting to invest at home again after years of combing the globe looking for higher returns. As the first chart below demonstrates, Japan has been locked in a brutal long-term bear market. Japanese stocks have gone nowhere over the past twenty years. It is a good example of the bad hangover that results from the bursting of a credit bubble.



Huge price swings, but no upward traction. This is typical of post credit bubble stock market action.

Japanese stocks still 55% below where they were in 1992.

When we do a relative strength analysis and compare large cap stocks in the US to Japan, we get an inconclusive picture. One thing is clear, Japan is much further along in their downward credit cycle. Some argue that they are through the worst and that the banking system is ready to support growth once again (see page 3 below). A return of this relative strength ratio back towards the early 1990's level of 2 or 3 would equate to huge outperformance by Japanese stocks versus their US counterparts. Here is a 17-year relative strength chart:

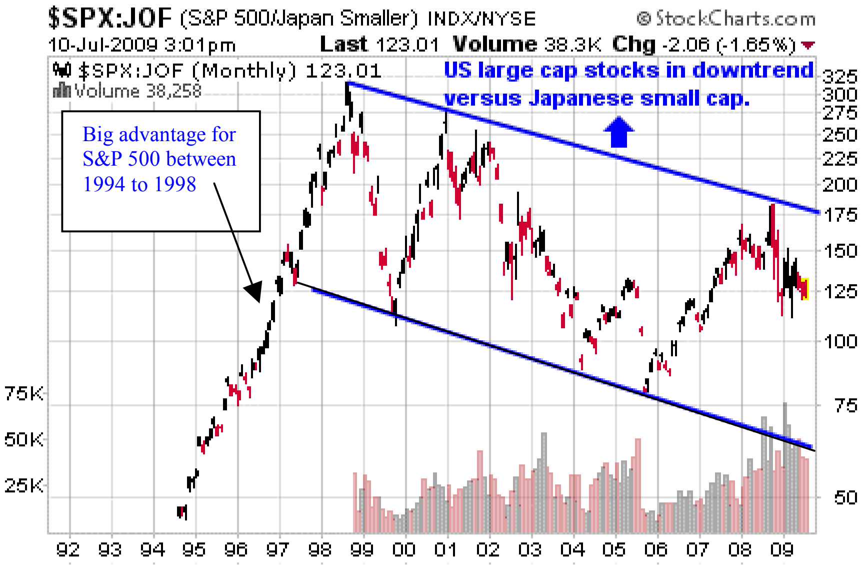


Since 1998, the US relative strength has been consolidating versus Japan after a big move higher in the mid-1990's. The first real sign that things may be changing is if we see this range breakdown below the 2000 lows near 6.5 (bottom blue line).

Relative strength has consolidated in a range between 6.5 and 11 over the past ten years.

First half of the 1990's this ratio was between 2 and 3.

The final chart we have included shows the relationship of US large cap stocks (the S&P 500) versus Japanese small cap stocks (the Japan Smaller Capitalization Fund). This paints a little different picture. Ever since 1998, it's actually been more profitable to be in small cap Japanese stocks than the S&P 500. After underperforming since 2006, Japanese small stocks hit the top of the channel last fall and now appear to have regained the upper hand. It is the best risk reward set-up since 2002.



This down-channel began in 1998. Since then Japanese small cap stocks have gradually outperformed large stocks in the US within a volatile range. After hitting the top of the channel last year, a reversal began that appears to favor small Japanese stocks for the first time since 2005.

Japan certainly has their share of problems such as an aging population, reliance on exports to debt-laden US consumers and lots of government debt. However, the fact that the Japanese market is still 75% below its 1990 peak means we should start to look for silver linings. Louis Gave of GaveKal Research recently gave several reasons to be optimistic:

- Japan's money multiplier is positive for the first time in two decades. This means banks are starting to lend again after years of balance sheet repair.
- The Bank of Japan is engaged in quantitative easing (money printing) which should provide ample liquidity for investors.
- Japan actually does more business with China than the US. Although the two have a history of frosty relations, this is starting to change. Any further integration between the two economies could be hugely positive for Japan.
- The ruling Liberal Democratic Party (LDP) is close to losing its 55 year grip on power to the Democratic Party of Japan (DJP). This political change could serve as a catalyst for much needed reforms and create international interest in Japanese equities.

As traditional trade routes to the US and Europe continue to dry-up in the years ahead, we expect Asia to increasingly look inward for economic growth and trade. We believe that the long awaited recovery of Japan may be close at hand as a result.