

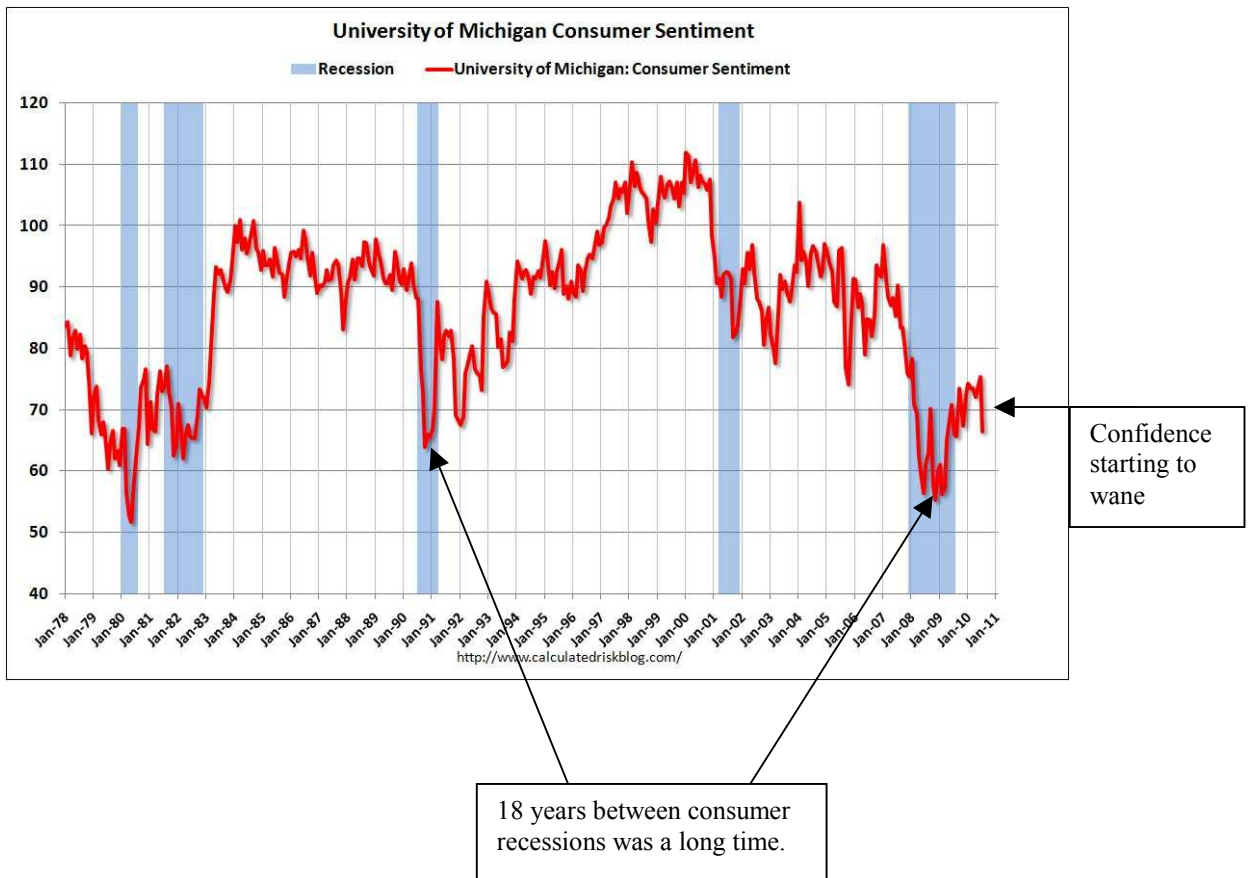


The Starboard Side Report

The week ending July 16, 2010

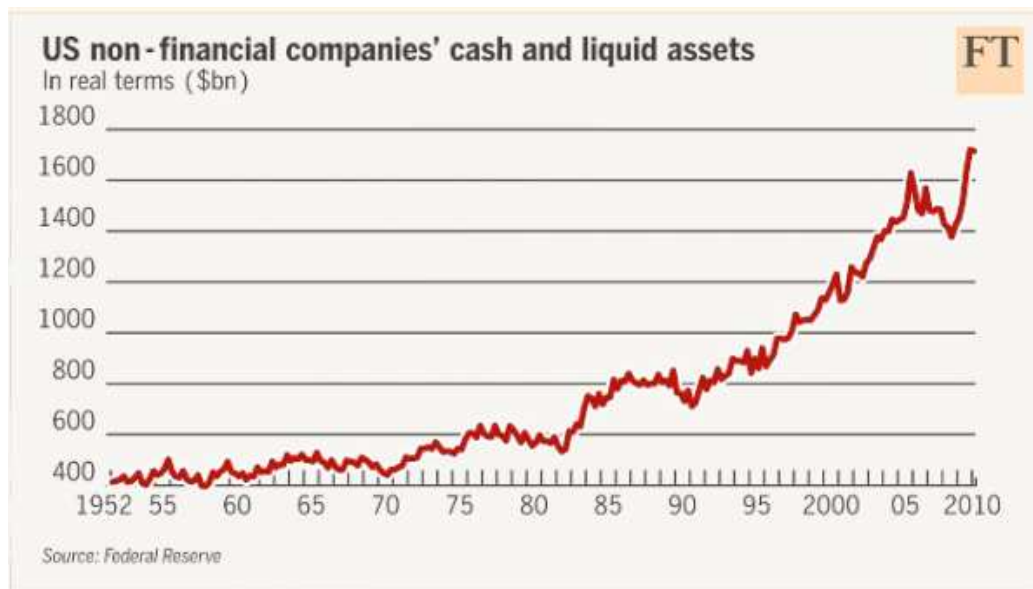
One of the key issues that the market may be faced with in the months ahead is a divergence in the path of the US economic recovery. We could start to see companies that sell to other businesses and emerging market consumers hold-up better than those that rely solely on US consumption for growth. The 2008-09 recession was the first consumer led downturn since 1990. Therefore, it has been tough times for many companies that banked on the resiliency of the US consumer lasting forever. The excesses (debt) that built up through an eighteen year uninterrupted expansion came home to roost in a big way in 2008. Those that had the foresight to see the train wreck developing were able to manage the crisis better than others. Following the stock market bottom in March of 2009, a strange thing happened. Many of those US retail, real estate and consumer finance stocks that lost the most value during the bear market were the best performing ones during the recovery. This created the illusion that the worst was behind us and that the US consumer would once again lead a normal healthy economic rebound. As we have started to find out over the past three months, not all recoveries are created equal. The inertia that led to a giant bounce off the bottom for retail and financial stocks has suddenly run out of steam. One of the reasons for this development is that all of the excesses could not possibly be unwound during the past recession. Instead, that event marked a watershed moment for our economy. We have entered new long-term cycle that will likely see the US consumer forced to take a back seat as they repair their tattered balance sheets and search for new sources of income other than real estate appreciation. Now this negativity may sound contradictory to our rather positive market stance over the past few weeks. We want to make clear that, for investment purposes, we are still constructive on narrow segments of the US and global economy, but still have very big long-term concerns about the average consumer in the US. Going forward, we foresee a thinning of the herd in terms of retail and financial names as there is only so much consumer firepower left to go around. The areas that we want to focus on for long-term investment are those positively correlated to: 1) global enterprise (business) spending; 2) emerging market consumer spending; 3) commodity price increases and 4) currency debasement.

Below is a chart from Calculated Risk that shows a long-term view of US consumer confidence. As you can see, it has started to roll over after having rebounded nicely off the bottom last year.



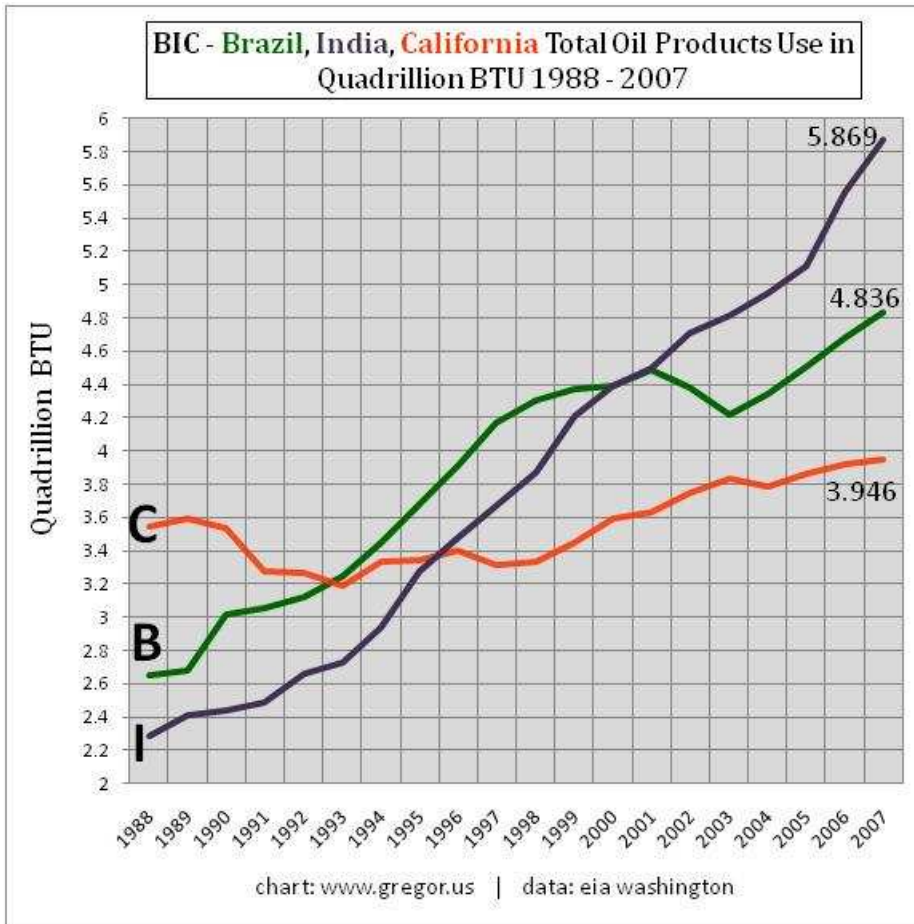
While it may take several years for the US consumer to recover and rebuild from the great recession, those other areas we listed above should be able to generate respectable returns for their shareholders. We discuss them in more detail below:

1) Global enterprise spending: According to Strategas Research Partners, 168 out of the 419 nonfinancial firms in the S&P 500 have at least \$1 billion in cash apiece, and 16 have more than \$10 billion each. In total, the non-financial firms in the US have close to \$1.8 trillion parked in cash at the moment (see chart below). The returns on this money is paltry with short-term rates hovering above zero, so we could start to see a wave of M&A, stock buybacks, dividend increases or investment in plant & equipment. These are all shareholder friendly activities that should put a floor under stock prices. In addition, businesses that sell to other businesses should provide a relatively safer place to hide in the coming years.

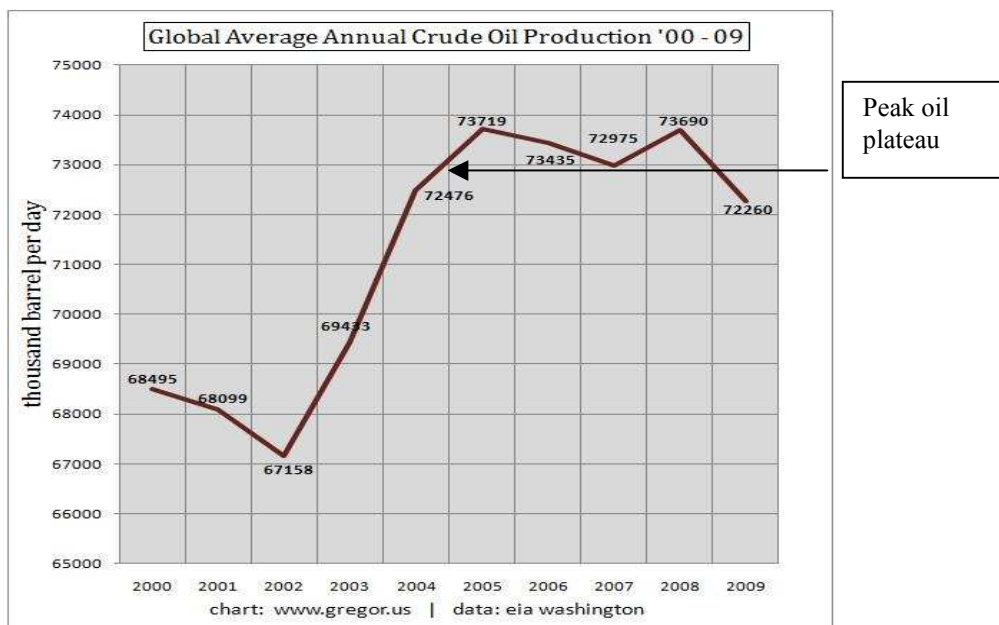


Cash is king!

2) Emerging market consumer spending: It is estimated that there will be a wave of three billion new capitalists entering the global financial system over the next few decades and they are all striving to attain the middle class ideal. This means all the accoutrements that go with it including cars, homes and consumer electronics. The long-term implications of this profound shift in wealth and resources to the East will be tremendous on global markets. It will be a volatile process, but one that must be taken into account when discussing long-term investment philosophy. Below is an interesting chart that shows total oil use in Brazil and India versus that of our largest state, California. As we can see on the next page, these two emerging BRIC nations have a very rapid thirst for energy. The scary point for the future of gas prices is that Brazil and India have 1.3 billion people compared to only 36 million in California! Should their per capita consumption come anywhere close to ours over the next twenty years, than we better start finding some alternatives fast. To quote the creator of the chart, Gregor MacDonald, *"this only confirms my view that we (continue to) underestimate the demand reduction for oil that's inevitable in the developed world, and the awesome potential for further demand increases in the developing world."*

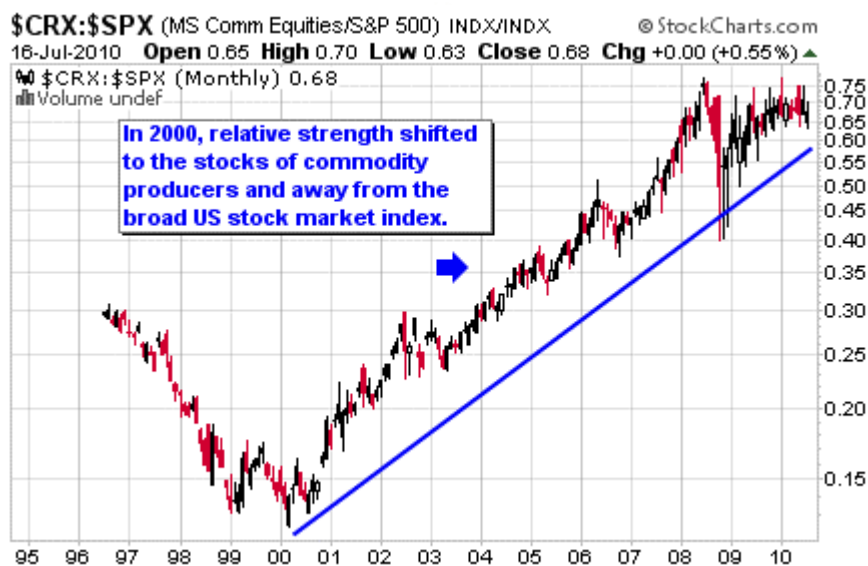


When we juxtapose this chart with the one below that shows peaking oil production, we can only wonder what the world will look like in 2030. Probably, a combination of the developed world using energy more efficiently, creating alternatives and getting by with less oil in order to free up supply for emerging world growth.

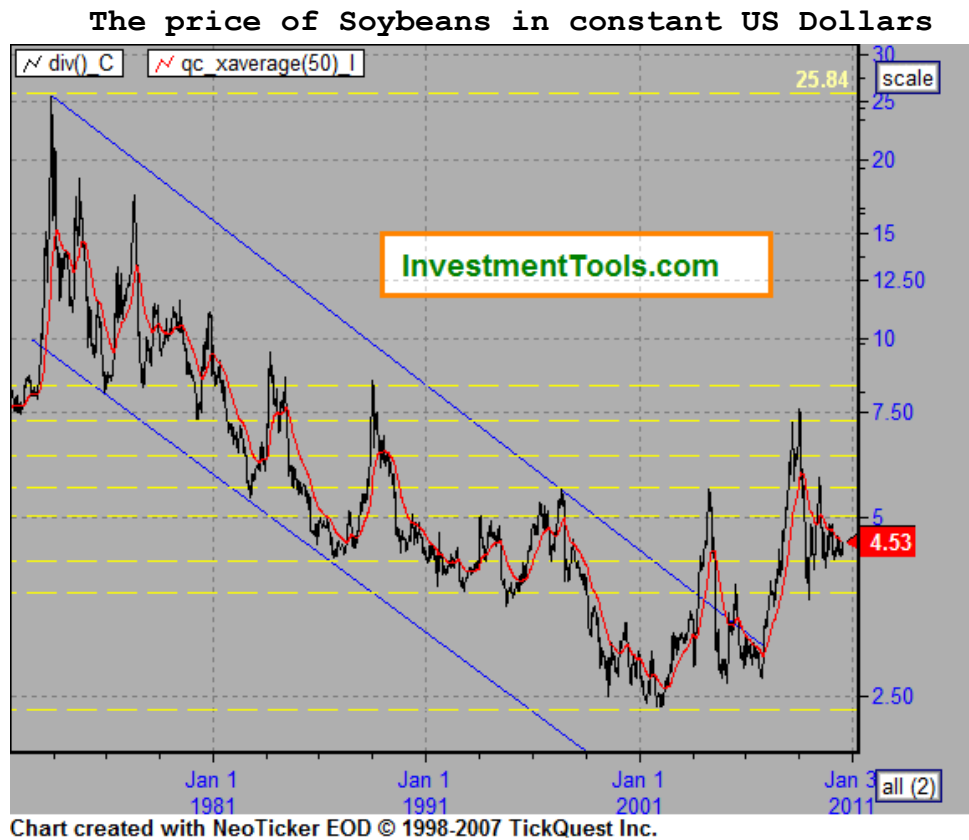


3) Commodity price increases: This can really be grouped together with the second topic above due to the effect that emerging consumers in Asia will have on natural resource demand. We believe we are in the midst of a bull market for global commodities due to this increased demand in conjunction with lack of adequate supply from years of capacity reductions. As stocks soared in the 80's and 90's, commodities were in a terrible bear market that led to enormous neglect. This means we are not going to obtain adequate supply to meet new emerging market demand until we get a commensurate increase in productive capacity. Even with the higher prices we have had over the past ten years, we still have not gotten output to where it needs to be to avoid future price spikes. Net world oil production stagnated even as oil prices went from \$40 to \$140 between 2004 and 2008. Prices finally collapsed due to demand destruction, not from a traditional supply response. We believe that this will be a feature that extends across the commodity spectrum in the years ahead. Below is a relative strength chart of commodity producers versus the S&P 500. As you can see, the outperformance has clearly been achieved by those companies whose stock price is tied to the commodity cycle. We feel that we are only about half way through this trend.

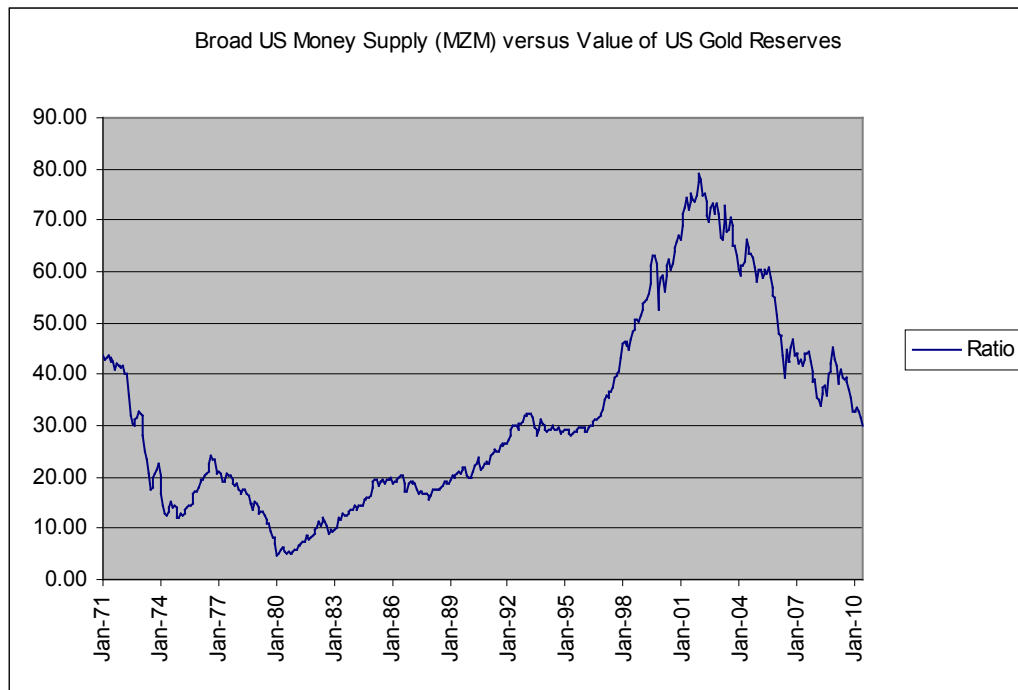
Relative Strength Chart
Morgan Stanley Commodity Related Equity Index versus S&P 500



One of the best charts to show the potential price gains ahead for the commodity complex is the price of soybeans adjusted for inflation. The chart below shows that we are still in the early stages of this cycle since prices still have to gain 450% to reach their old inflation adjusted high. Agriculture prices are one of the last remaining things on earth that are this cheap compared to where they were in the 1970's. We don't think this discrepancy will last.



4) Currency debasement: This primarily means that we want to focus on protecting ourselves from the printing of money by central banks. Precious metals and other hard currencies are the primary beneficiaries when currencies are debased through monetary policy. Gold does not necessarily go up in price, it is just a measuring stick for the amount of dollars in the world. It is basic supply and demand. The more currency, the lower the value of that currency in the world market. Money printing (i.e. inflation) is the way that we expect the developed world to pay off their debts. This means that precious metals should continue to do well in all major currencies. Especially US dollars, British pounds and euros. The final chart that we will leave you with is one that we have shown before. It is essentially a Central Banker trust index. When this chart is trending higher, the markets are confident in economic growth, credit expansion and the ability of central bankers to keep inflation under control. When this is trending down, as it has been since 2000, then the market is suspicious of the Federal Reserve's motives and eager to protect purchasing power via stable currency like gold.



In conclusion, we have been trying to show over the past few weeks that even though the markets are likely to remain volatile, there should still be pockets of the world economy that can provide adequate returns. With interest rates on cash at zero percent and a Federal Reserve that time and time again has shown the willingness to print their way out of trouble, sitting and hiding in a money market fund can turn out to be a very risky proposition in its own right. A loss of purchasing power through inflation is still a loss. We are starting to become the minority regarding the threat of inflation ahead, but we will stick to the game plan in our attempt to preserve and grow capital.