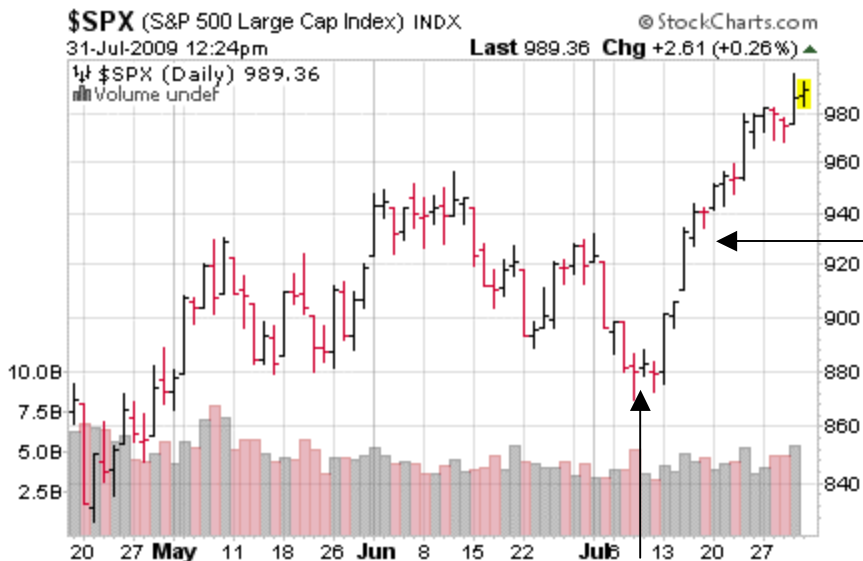


# The Starboard Side Report

The week ending July 31, 2009

We read a good quote about investing this week that very succinctly sums up the month of July, "investors usually oscillate between the fear of losing and the fear of missing out." This is a play on the age old adage that markets are driven by fear and greed. Just three short weeks ago all the talk was about a return of the bear market following a big break lower on the S&P 500 Index (see below). However, ultra pessimistic earnings forecasts have been surpassed rather easily, proving yet again that Wall Street analysts get too euphoric at market tops and too pessimistic at major market bottoms. This underestimation of corporate cost cutting ability led to a major reversal that had short sellers scrabbling to cover and under invested fund managers desperate to keep pace.



A 15% rally in 3 weeks is a big move that may have to be digested before another up-leg can begin.

Things looked bleak for the bulls after this breakdown in early July. Instead what transpired was the mother of all fake outs.

The question now becomes, where do we go from here? The Nasdaq and the S&P 500 are fast approaching nice round numbers at 2,000 and 1,000 respectively. These may be psychological resistance points in the weeks ahead and serve as a catalyst for traders to lock in some gains. In the more intermediate term, we are still positive on the rest of this year as we believe the consensus forecast for little or no global growth over the next year will prove to be too conservative considering the massive amounts of stimulus still working its way through the system. Most likely, the real problems won't start to manifest until the middle of next year after the stimulus begins to wear off. That is when corporate bankruptcies and more residential real estate mortgage resets could cause additional havoc.

One of the things we have been keeping an eye on to gauge the future market direction is the stock of bellwether financial Bank of America (BAC). This financial behemoth had been consolidating in what we refer to as a triangle chart pattern. As they build, these patterns signal distribution of stock between buyers and sellers. As supply and demand battle it out, a winner is determined by which way the pattern breaks. In this case, BAC broke out to the upside this week- please see below

**Bank Of America Corp. (BAC) NYSE**

31-Jul, 12:45 ET, daily, O: 14.10, H: 14.44, L: 14.02, C: 14.305, V: 175.8M, Chg: +0.335

**P&F Pattern** Triple Top Breakout on 30-Jul-2009

Traditional, 3 box reversal chart

Bullish Price Obj. (Rev.): 31.5

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BAC breaks out of a three month triangle pattern signaling that demand has won the battle versus supply.

This bodes well for the market because it tells us that financial stocks may once again be able to lead the market higher in the months ahead (as they did off the March bottom). While we feel that the long-term prospects for the US banking system is still relatively poor, we have to respect the fact that chart action argues against another leg down in the credit markets right now. This should be supportive of stocks in general.

One of our favorite sectors, precious metals, has been consolidating in a volatile sideways pattern for the better part of six months. The group is only fractionally above its February peak. One of the main catalysts that caused gold and gold stocks to rally in late '08 and early '09 was the fact that the Federal Reserve was aggressively expanding its balance sheet to bail out the financial sector. Lately, their balance sheet has been hovering right around the \$2.0 trillion mark. The chart below illustrates that this is still more than double the size it was before the Lehman and AIG debacles last year, but a bit lower than the peak in January '09.

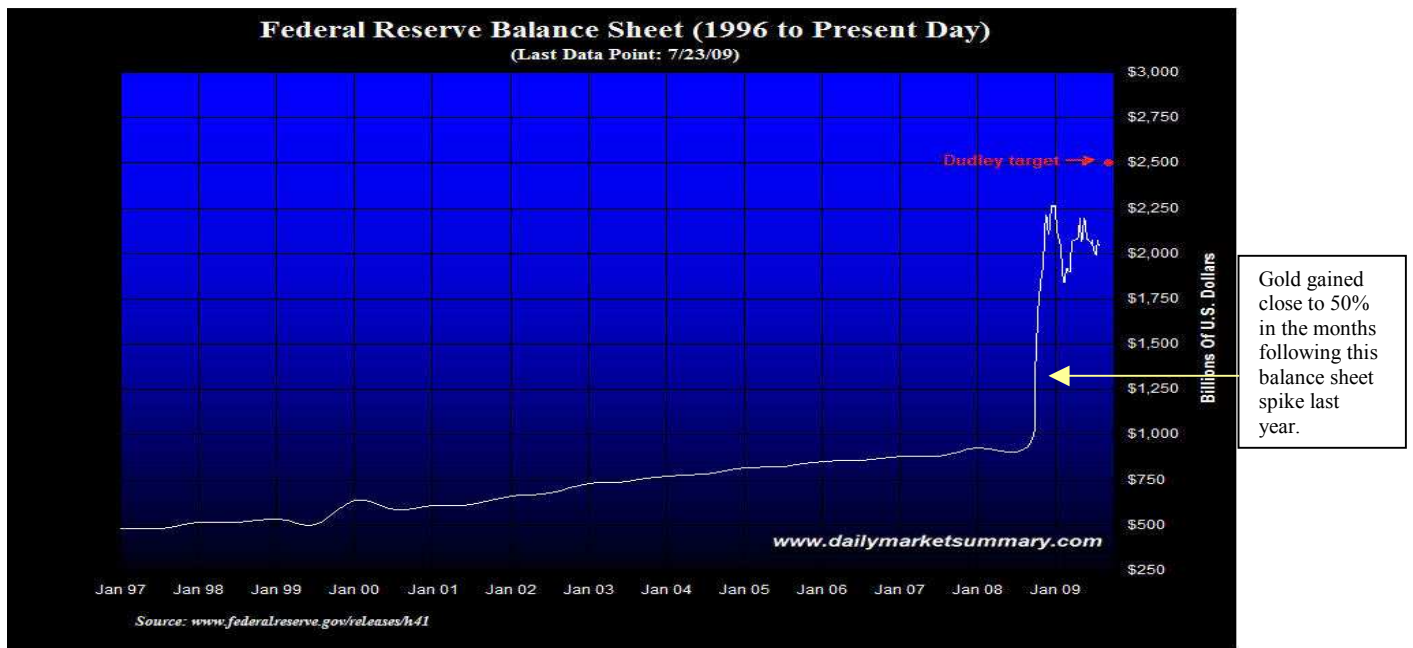


Chart Source: Lance Lewis Minyanville.com

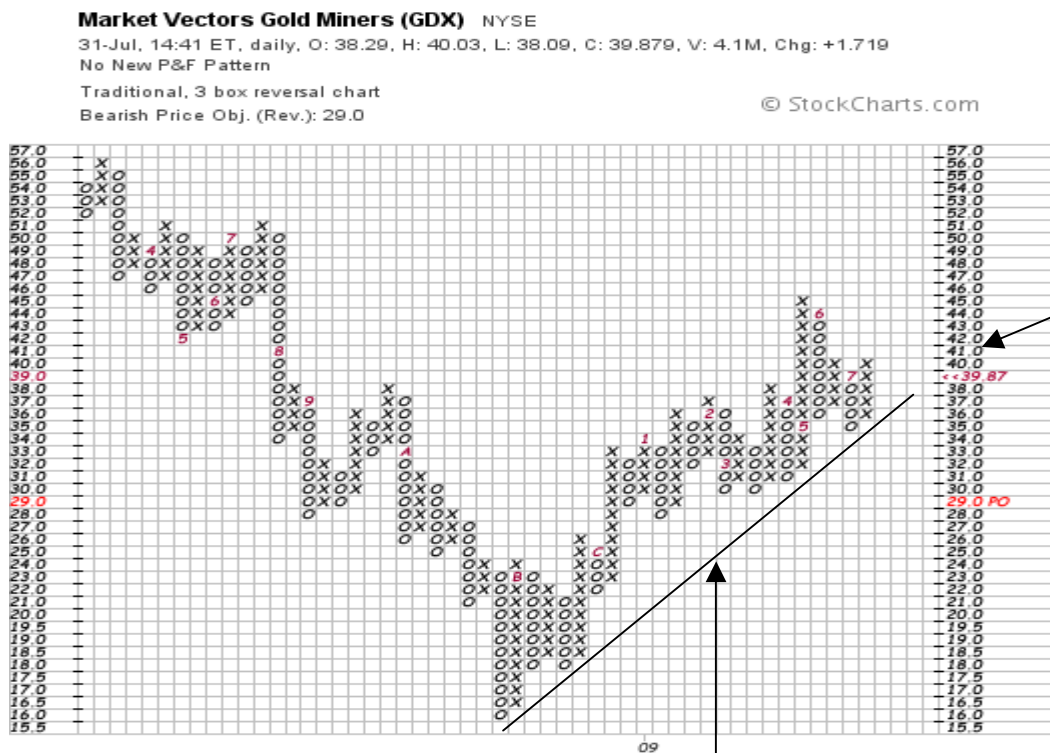
This week NY Fed President William Dudley tried to convince markets that the Federal Reserve has the "tools" to keep inflation under control. In a speech on Wednesday, he claimed there should be no worries about the desecration of the once pristine Federal Reserve balance sheet. According to Dudley, it is alright that two years ago the balance sheet consisted of mainly US Treasuries, but is now well over twice the size and largely made up of legacy toxic assets from the banking system. In the same breath, he announced that the Federal Reserve was going to once again ramp up asset purchases and that this would lead to a balance sheet expansion towards \$2.5 trillion in the months ahead. We are assuming most of this new growth is an effort to help bail out the floundering commercial real estate markets. Now, we have the same genius PhD's that did not foresee the greatest credit and real estate bubble of all time telling us that inflation should not be a concern. Should we really trust that they will be able to make everything alright and unwind these liquidity programs on a moments notice?

We are not that sanguine about the Federal Reserve and Congress getting this one right either. We foresee big inflation pains in the years ahead and are investing accordingly. As a result, we have an above average percentage of our portfolios in gold and gold related equities. This sector is essentially a bet against reckless central bankers and fiscally irresponsible politicians. Precious metals are certainly one area of the market whose fundamentals have improved since the credit crisis began.

We couldn't end this week without mentioning the "Clunkers for Cash" program that was splashed all over the media. This is the government program that gives \$4,500 towards junking an old car for a new more fuel efficient model. It appears as if the program blew through its one billion dollar budget in the first few days. Now Congress is in the process of authorizing another two billion to continue the program; 200% more than originally budgeted. We believe this is a great microcosm example of why inflation will be a huge problem in the years ahead. Once programs like this get started in the US, it is extremely difficult from a political perspective to take the punch bowl away. Multiple this by the trillions of dollars in stimulus programs and we see that are embarking on what Credit Bubble Bulletin writer Doug Nolan calls "The Government Finance Bubble." According to Nolan this bubble is coming to replace the Wall Street/Mortgage Finance Bubble that ran to such extremes. Neither Wall Street nor the private sector are in any state to provide the trillion of dollars needed to prevent our credit based economy from collapsing; only the government has the firepower...even if it means creating money out of thin air. The sophisticated credit instruments drawn up by Wall Street rocket scientists have been discredited and are no longer able to finance desperately needed credit growth. Nolan sums up this view with the following quote:

"It is in this context that I fear that the Trillions of Government Finance spent to save the world from 'deflation' will, in the end, require perpetual needs for Trillions more. There will be no kick-starting asset Bubbles or a return of private-sector Credit excess. Instead, it will be a case of throwing repeated doses of government-directed finance/purchasing power at the system. Temporary but fleeting economic boosts will then require only stronger doses of artificial stimulus.

We've commenced a new cycle dominated by government electronic printing presses in all their various forms. The inflationary consequences will be a different variety than we've grown accustomed to from previous reflations. But the bottom line is - and there's ample history to support this view - that once the "printing presses" get humming along it's going to be darn difficult to slow them down."



A move to \$41 will take gold stocks back to a buy signal and perhaps be the start of another leg higher.

GDX up trend is still nicely intact, but the fund is only 2 points above its early February peak of \$37.