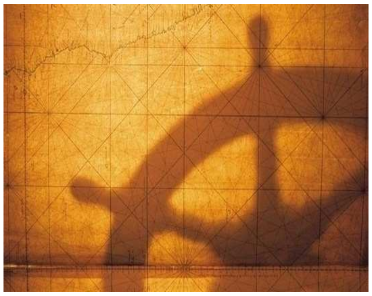

The Starboard Side Report

The week ending August 21, 2009

Last week we discussed the turmoil brewing in Asia, specifically in the Chinese stock market. This weakness was enough to reverse the Asian Bullish Percent Index to a column of O's on its chart. This means that, for the time being, sellers are in control of the region's stock exchanges. Rather than panic over this development, we are going to view it as a healthy correction until we start to see a meaningful shift in relative strength versus the rest of the world. It is most likely a case of the Asian markets getting a bit ahead of themselves and needing to take a breather. Below is a chart of the Hong Kong Hang Seng Index that shows a very orderly channel over the past twenty years. After briefly breaking through the bottom of the channel in last year's stock panic, we have barely recovered to the middle of the long-term trading band. The prior two bull cycles (1998-99 and 2003-07) each had a similar pause after the initial surge off the bottom (see red arrows on the chart).

At the bottom of the chart, we have included a MACD analysis. Without going into too much detail, this is essentially a study of advance decline velocity as measured though moving averages. It is very helpful at identifying big changes in trend. As you can see, the Hang Seng's long-term MACD has just crossed over into positive territory. If we look at the prior two bull cycles for this index, we see that this occurred in February of 1999 and there was still 75% on the upside. In 2003, it took place in June and there was still four years and 300% to go. Our channel analysis above points to this bull cycle being closer to the 1999 episode with about 75% between current levels and the top of the long-term trend channel.

The Chinese Shanghai Composite Index can be a bit of an anomaly due to the communistic style of capitalism practiced in China. In fact, after the last bear market in global stocks, Chinese shares bottomed in 2005, not early 2003 as did the rest of Asia. Below is a relative strength chart that shows China versus free market neighbor Hong Kong. Between April 2003 and June 2005, while the Hong Kong Hang Seng Index was 83.11% higher, the Chinese market fell over 30%. This was despite 10% GDP growth during these years.

Therefore, even if Chinese stocks don't perform well, that does not necessarily mean that their economy is not still humming along. Their stock market has not traditionally been a good barometer of Chinese growth due to government controls and the fact that the market is closed to foreign investors. It has been just as profitable to own securities in more developed capital markets that are leveraged to Chinese growth. This includes many of China's Asian tiger neighbors and commodity producers in the West and Latin America. According to the *Financial Times*, the domestic Chinese stock market in Shanghai is only 1.5% of the FTSE ALL World Stock Index versus 41% for the US. Therefore, while this month's dramatic 20% fall in the Shanghai Index made for sensational headlines, we would not yet spend too much time worrying about it without weakening of from relative strength and fundamentals in the rest of Asia. Below is a list from the most recent *Economist* magazine on why Asia is leading this recovery:

1) Huge government stimulus

Japan, having learned its lesson from the Lost Decade to counter recessions with speed and vigor, unleashed a stimulus that amounted to 5 percent of GDP, about the same as the US. China's stimulus (more than 12 percent of GDP, by some reports) has been spent much faster than ours.

2) Low debt

One reason many American economists are worried that our stimulus won't juice consumer spending is that American need the money to get out of debt, not to buy new clothes and furniture. But many Asian countries are famous savers. The continent is swimming in liquidity and some are wondering whether countries like China will recalibrate their economy to make consumption a much larger part of their their economy.

3) Healthier banks

This is a simple one: Many Asian banks were not nearly as tainted by the mortgage-backed securities and credit default swaps that took Western investment banks, hedge funds and insurance companies. When the world economy fell, they fell too, but onto a higher floor.

4) Manufacturing's comeback
During a recession, many Asian-based products like electronics are the first to go. But as the world economy gets back on track, consumers are returning to their techie wish lists and Asian manufacturing is clicking again.

In Asia, what we appear to have then is a strong technical and fundamental picture emerging from one of the most severe declines in modern market history. We believe this contrasts with the US where we have a good set-up from a technical perspective, but not a sound fundamental backdrop. As the US market inches closer to our target of this cycle (1100-1200 range on the S&P 500), we are going to get more vocal on what we believe are the structure flaws in the US economy that will result in years of stagnant growth. The banking system, weak consumer spending and deteriorating government finances remain our main concerns. The residential real estate market and commercial property markets are both still a mess. The residential problems will become especially apparent at the higher end of the spectrum. Whereas the prior crisis was triggered by subprime mortgages, the next wave of trouble will be from those who were deemed more "credit worthy" at the time. The chart below from Deutsche Bank shows why there are some dark clouds starting to form on the horizon. This is most likely a 2010 and 2011 problem, but not too early to start to get concerned. Especially, with the S&P 500 already fifty-percent above its lows.

Figure 2: The next leg of the decline will have the biggest impact on conforming borrowers

Estimated percent of borrowers with negative equity, by product

	Q1 2009	Q1 2011 Projected
Conforming [1]	16%	41%
Prime jumbo [2]	29%	46%
Alt-A [3]	49%	66%
Subprime	50%	69%
Option ARM	77%	89%
Total mortgage market	**26%**	**48%**

Source: Deutsche Bank

As the chart about shows, Deutsche Bank figures that 48% of all mortgages will be underwater by early 2011. This is up from 26% at present. Notice how the rate of change is the greatest in the Conforming and Prime Jumbo categories. This will hit bank balance sheets at the same time they are still grappling to get out from under commercial real estate and credit card delinquency problems. Get ready for more bailouts come this time next year.

The final segment of our weekly report will deal with the US dollar. One of the reasons that the price of oil is rising to new highs despite a lackluster demand picture is that the demand for US dollars is falling faster than the demand for oil. This will remain a huge theme in the years ahead and one that US citizens must be prepared for through ownership on non-US assets, commodities and precious metals. The structural weakening of the dollar through money printing (inflation) is the only way politicians want to get us out of this mess. The only question becomes- will the unwind be an orderly or a chaotic fall? We hope it is the former, because the later would create a crisis of equal magnitude to last year, only this time we would experience hyperinflation instead of credit deflation.

Two areas of the foreign investing world have gotten our attention recently; one is a currency (Mexican Peso) and the other a frontier market (Vietnam). Both of these ideas are based on a trend that is developing in corporate America called "footprinting". This is the new buzz word to go along side globalization and labor outsourcing, Until recently, most multi-national companies would source labor in one single site that had the cheapest workers. However, the financial crisis has led to a rethinking of risk across the board and this concentration of labor is being judged as too risky. Now, instead of one site, the trend is towards investing in multiple smaller sites in a effort to spread risk. One of the near-term beneficiaries of this footprinting strategy is Vietnam, whereas we see Mexico benefiting in the longer-term. A recent *Financial Times* article quoted CEO of employment services group Manpower Inc as saying "I am discussing possible investments in Vietnam with a *staggering* number of clients which are attracted by the low labor costs." In addition to low labor costs, there is a very young and entrepreneurial workforce with close to 50% of the population under the age of 25. Interestingly enough, Van Eck Global advisors just launched the first Vietnam ETF this week, so US investors can now get access to this market.

[VNM] Market Vectors Vietnam ETF

Last Price 26.97 | Performance

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48.0 | |         |           |                   48.0
47.0 | |         |           |                   47.0
46.0 | |         |           |                   46.0
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36.0 | X     8 X O X O       |   •               36.0
35.0 |-X-----O-X-O-X-O-------|-----•---------    35.0
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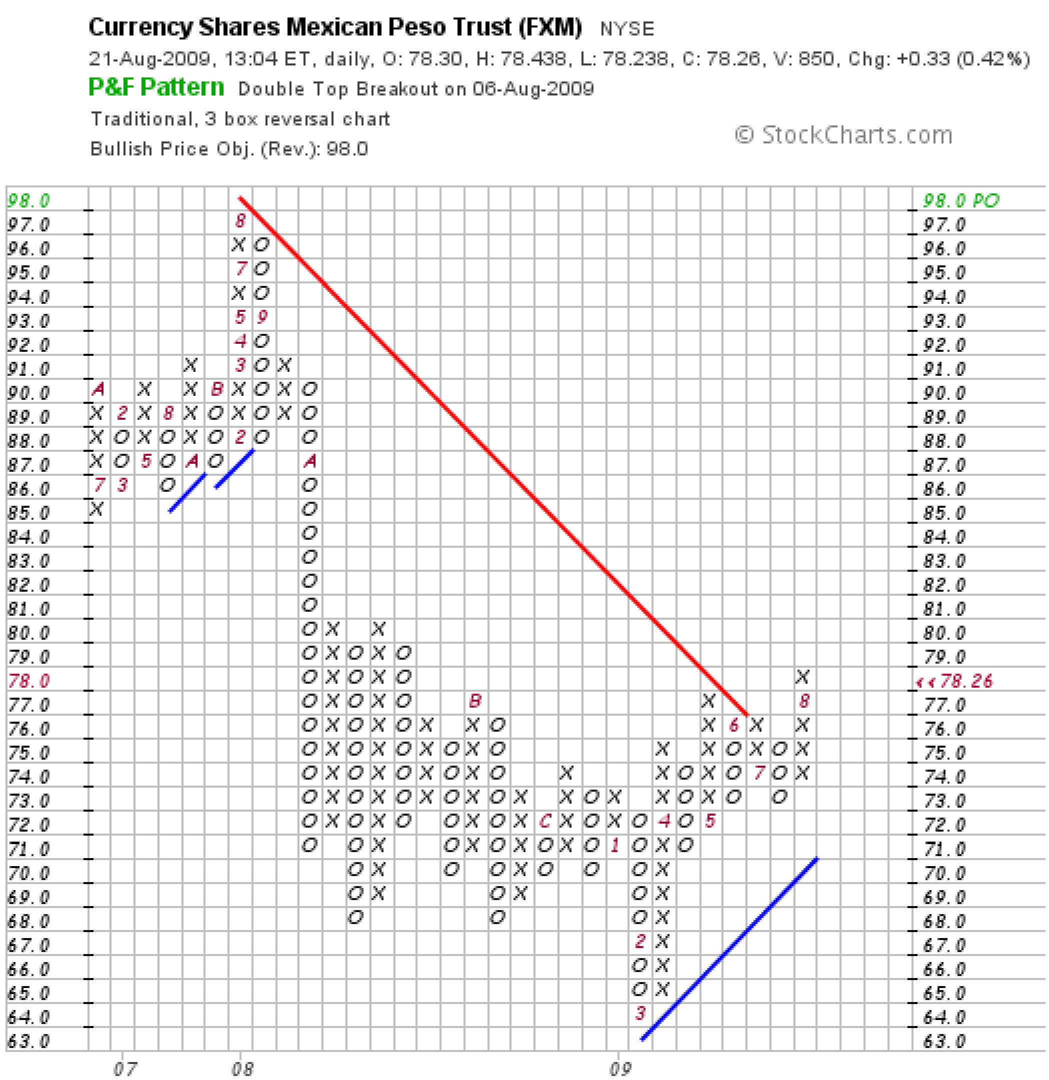
The above chart is from Dorsey Wright and it includes back-data for the past three years. As you can see, the index has doubled off its lows after falling 70% in the bear market. That still leaves it 40% below its old highs. We would prefer a bit more consolidation or correction of the move off the bottom before investing.

The Mexican Peso could be a long-term winner should energy costs continue to rise as we expect and the footprinting mentality continue to take hold. In his book "Why Your World Is About to Get a Whole Lot Smaller", Jeff Rubin theorizes soaring energy prices will make it economically unfeasible to continue making stuff on the other side of the world. Companies will start to source goods closer to home in order to prevent profits from getting wiped out by high transportation costs. We feel that Mexico, due to its position as the closest low labor cost country to the US, should eventually start to steal more business away from low cost Asian manufacturers. The dual power of close proximity to US end markets and a truly diversified investment location should benefit the undervalued Mexican Peso. In the meantime, the relatively high yield of 4% pays us while we wait for this to play out.



The Peso crashed 34% in only eight months during the emerging market melt-down. However, it is now coming back nicely and looks poised to keep trending higher versus the US dollar.