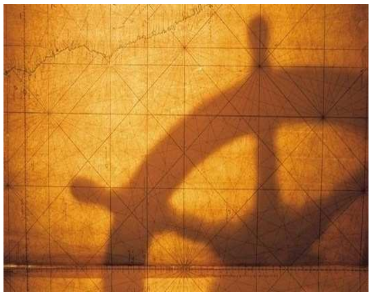
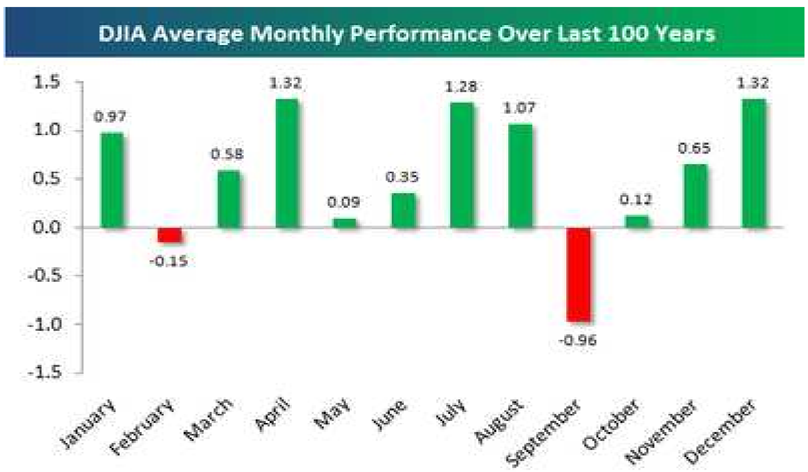


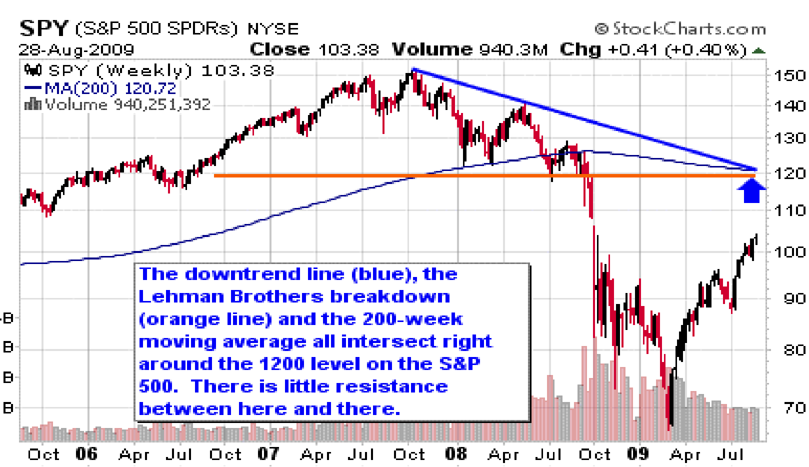
The Starboard Side Report

The week ending August 28, 2009

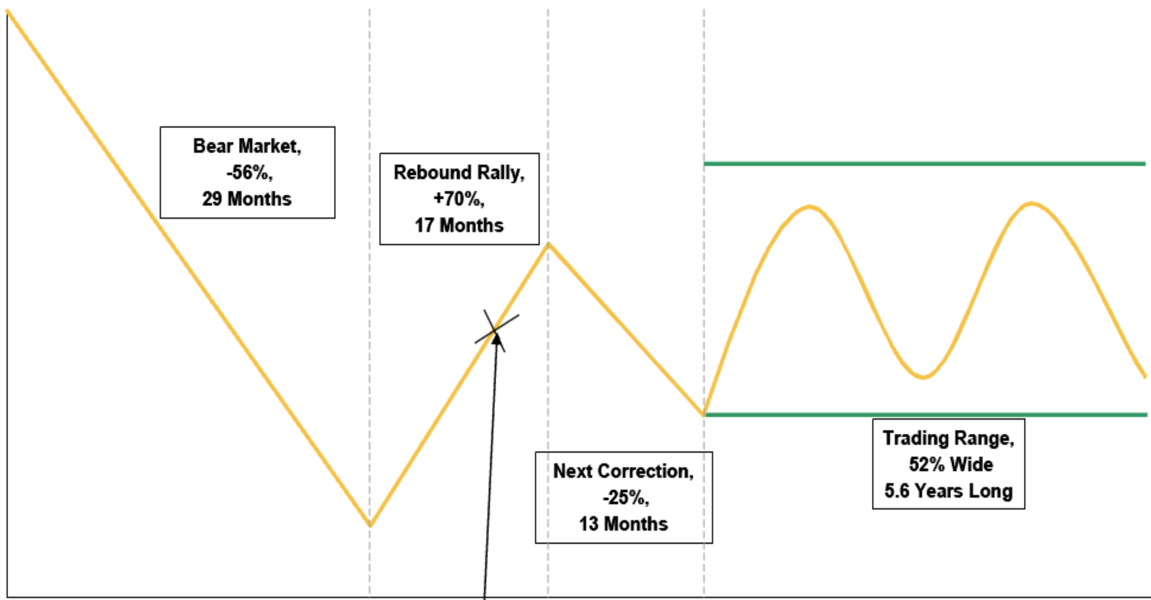
Pullbacks have remained shallow as the "buy the dip" mentality remains in control. While seasonality increases the odds that the next several weeks could be very bumpy, we do not yet see the bottom falling out of this rally like some bearish commentators do. September and October are traditionally two of the worst months of the year for stocks as seen in the chart below from Bespoke Investment Group. Therefore, a quick 5-10% September correction would not be a huge surprise. The short-term overbought nature of the market at present also lends itself to a pullback.



Yet, there is still a lot of cash on the sidelines waiting for cheaper prices. This latent buying power should allow for another push to the upside before the bear market rally dies out later this year or early next year. Cash held in institutional and retail money market funds is still over 40% of the S&P 500 market capitalization versus 20% back in the summer of 2007 near the last market peak. Not only is there a lot of cash waiting to enter the market, but it is yielding next to nothing. The average money market fund yield is just 0.08% with nearly a quarter of these funds yielding nothing at all! This cash mountain, in conjunction with government created liquidity, should continue to act as a support for stock prices and limit downside moves in the near-term. The chart below shows that the S&P 500 can run all the way to 1200 level and still not break its bear market downtrend. We consider that level to be the ultimate technical roadblock.



We came across a study this week from Morgan Stanley's European Research team that provides an excellent look at the four stages of a bear market. Their analysis covered 80 years of global market history and looked at eighteen major market declines. The chart seen below is a graphical representation of the mean time and price outcome of each stage that they analyzed.



Currently we are likely to be over halfway in the rebound rally. We will be watching our market timing indicators, policymakers' action, inflation and Chinese growth surprises to time the peak of the rebound rally (see also "Watch Rates, Inflation, China" from 29 July 2009).

This analysis supports what we have been saying for several months now that the S&P 500 was due to have about a 65-70% rally off the bottom. However, after that rebound, the investment climate will get appreciably more difficult. A 25% move down followed by multiple years of choppy trading is the norm after the first big rally off the bottom. The risk to owning stocks increases materially once the S&P starts to climb over the 1130 mark (70% off the March low). The "X" on the chart above and the S&P 500 chart from page one of the report both show that we are gradually getting closer to that decisive inflection point. This is not to say that there won't be areas to hide once it arrives. We see inflation, not deflation, as one of the biggest risks in the years ahead. Starting next year the rate of inflation should jump meaningful above short-term bond yields. This means negative real returns for those holding cash. We expect inflation hedges such as commodities and precious metals to outperform. Higher growth areas like emerging markets should also hold up relatively well due to their stronger fundamentals and more attractive valuations.

We are not the only ones to have a fear of inflation. Below is a quote from famed investor Warren Buffet that we felt compelled to pass along:

> "Legislators will correctly perceive that either raising taxes or cutting expenditures will threaten their re-election. To avoid this fate, they can opt for high rates of inflation, which never require a recorded vote and cannot be attributed to a specific action that any elected official takes. In fact, John Maynard Keynes long ago laid out a road map for political survival amid an economic disaster of just this sort: 'By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. . . . The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose.'"
>
> Buffett continues, "Unchecked greenback emissions (i.e. US dollar printing) will certainly cause the purchasing power of currency to melt"

Basically. the destiny of the US dollar lies in the hands of Congress. We have seen that movie before and do not like how it ends. When faced with the difficult choice of saving and debt reduction versus debasement of the currency, they will chose the latter every time. We believe that portfolios should have lots of inflation protection in the years ahead in order to guard against rampant government spending and money printing. In the next five years, the US Debt to GDP may approach 120%. This is an out of control level that will result in higher interest rates, higher inflation and a lower standard of living for US workers.

Even in the face of weakening demand, companies are still trying to push through price increases due to rising input costs. Once the inventory liquidations, caused by the closing tens of thousands of retail stores, run their course, the pricing power of the survivors will be much improved. We will also see a lot more businesses offering lower quality goods and services at the same or higher prices. Eric Jansen of iTuplip.com had a very good piece this week that refutes those that still fear deflation. Below is the conclusion to that article.:

"The current administration's economic advisers do not appear to understand what is happening. They are too busy fighting the last war.

They believe we are dodging a second Great Depression by avoiding the mistakes of central bankers in the 1930s. They are 'stimulating demand' with loose monetary policy and fiscal stimulus spending.

They believe that they can then 'withdraw liquidity' at the first sign of inflation, and create a perfect balance between falling unemployment and rising inflation.

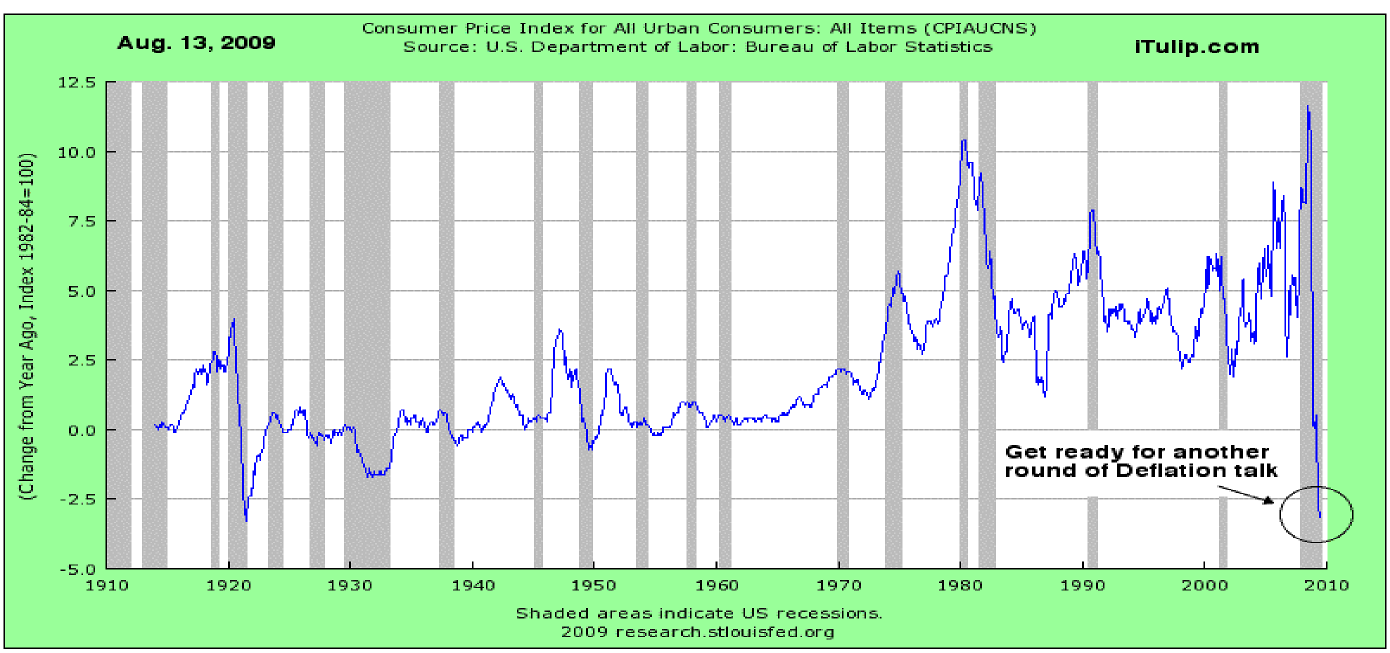
The theories behind these policies are fiction.

They do not understand that they are creating structural incentives for producers to offer lower quality goods and services at higher prices to consumers, and that this inflationary domestic structural change is combining with two trade-related global structural changes: high energy import costs due to Peak Cheap Oil and rising goods and services import costs due to a switch from imported to domestically produced goods as the dollar weakens and the U.S. loses its ability to finance trade deficits.

Anti-deflation economic policy has unleashed inflationary processes that were in the wings anyway. They cannot be contained.

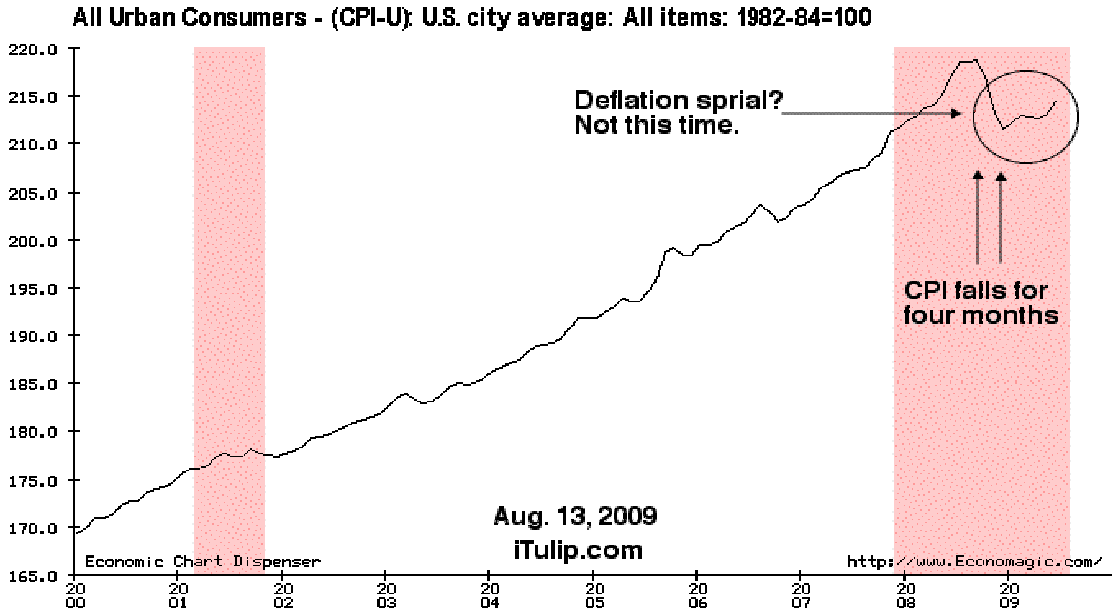
They have built a snowball of inflation and sent it down the mountainside."

The fact remains that the current deflation situation in nothing like the Great Depression at all. Below are three charts from Jansen that sum this us nicely.

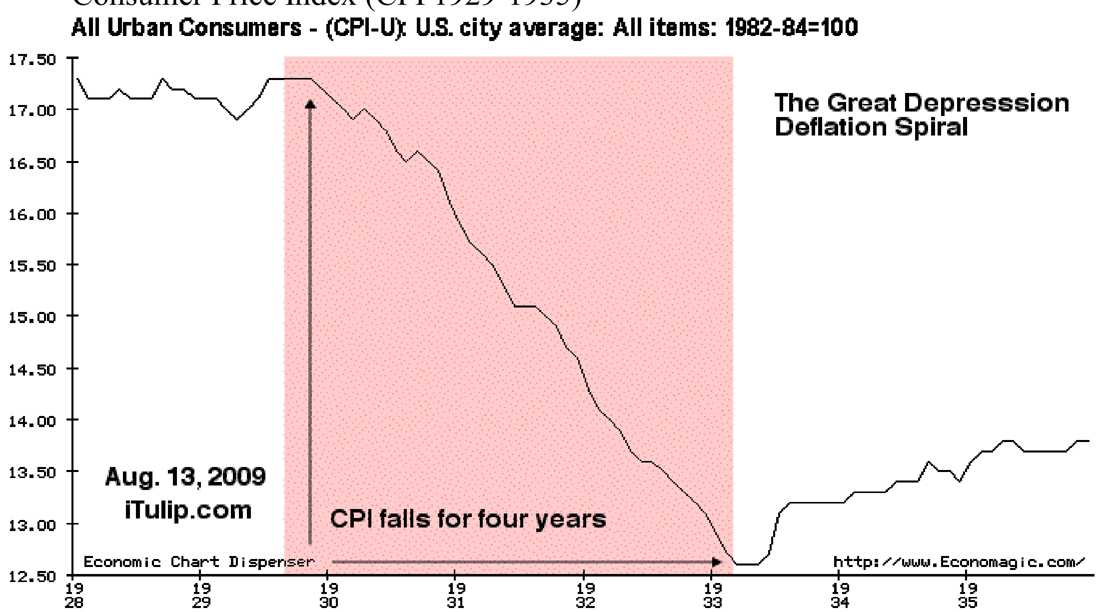


While the over 2.5% decline in CPI seems like a monumental fall, it is coming from an extremely elevated level. Oil prices falling 50% year-over-year seems drastic, but the fact remains that they are still up 600% over the past 11 years. This can be seen in the two charts below that shows the absolute change in prices both now and in the Great Depression.

Consumer Price Index (CPI 2000-Present)



Consumer Price Index (CPI 1929-1935)



In this recent episode of economic chaos, prices fell for all of four months as opposed to four years during the Great Depression. Prices are clearly still much higher than they were at the start of this secular bear market back in 2000. The Federal Reserve is essentially using the cover of asset price declines to enject enormous amounts of liquidity into a system that may not have needed it (Wall Street clearly needed it, but not the real economy). From an asset market perspective, this liquidity will most likely find a home in those areas with the strongest fundamentals such as commodities, precious metals and emerging markets. Unfortunately, higher commodity prices will ultimately be passed along to the consumer at a time when they are over-leveraged and can least afford to deal with it.