

# The Starboard Side Report

The week ending September 18, 2009

The market remained in rally mode for most of the week and that was enough to push the S&P 500's gain from the March low to over 60%. Most short-term measures are getting very extended. Coupled with the seasonality factors that we have been discussing, it seems reasonable to expect that stocks are at least due for a breather, if not a short/sharp correction.

Not only are the short-term indicators starting to get stretched, but we also have a case where our intermediate gauges look to be getting towards the high end of their historical ranges. For instance, the NYSE Bullish Percent has just crossed the 80% threshold for the first time since September of 2003. This does not happen very often as witnessed by the fact that it is only the sixteenth time since 1955. Even more rare is a coast to coast move from below 10% to above 80% in under twelve months. This is only the fifth time in the past 54 years that this feat has been accomplished (first time since 1974-75). The power of this rally can be summed up by the fact that the US market has just had its biggest six month advance since 1938.

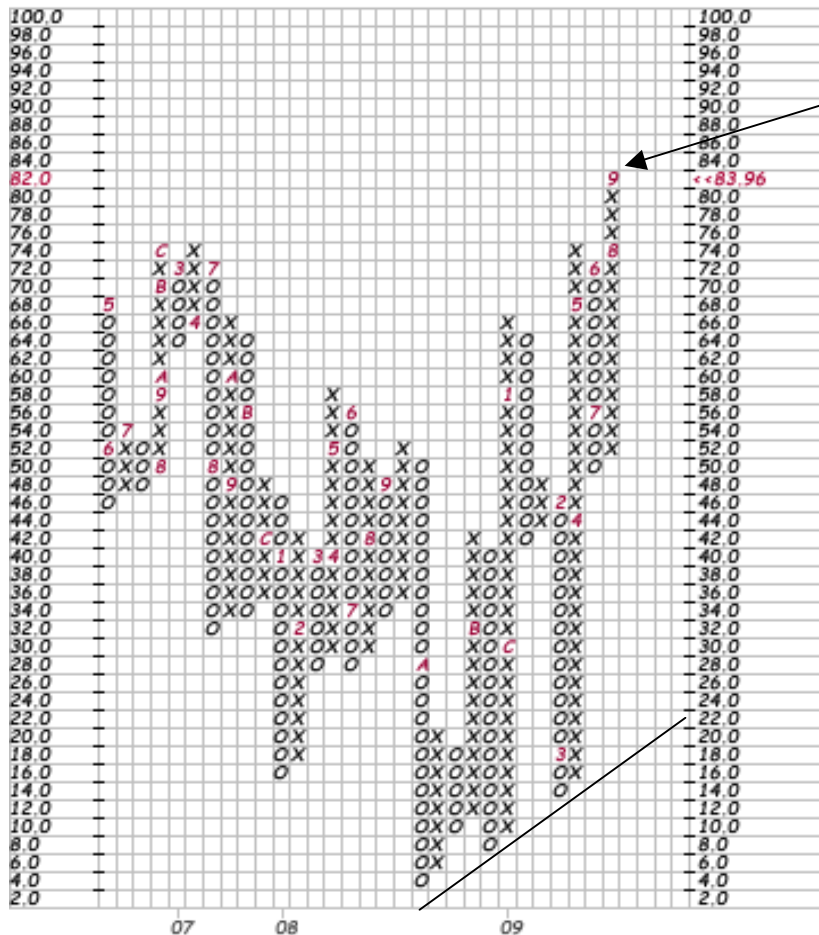
## New York Stock Exchange (NYSE) Bullish Percent Chart

**\$BPNYA** INDX

17-Sep, 16:00 ET, daily, C: 83.967, Chg: +0.992

Status Bull Confirmed on 20-Jul-2009

User-Defined, 2.0 pts/box 3 box reversal chart

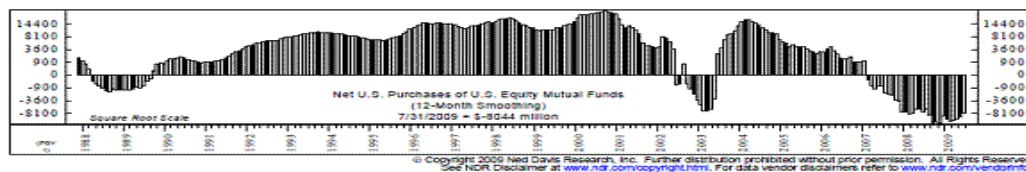


Almost 84% of the stock charts of NYSE listed companies are currently on a Point & Figure buy signal. This compares with only 4% last October. Since that low on 10/10/08, we have consistently seen a healthier market with fewer and fewer stocks breaking down during each successive pullback (marked by the O's columns). We believe that we are approaching the later innings of this rally. That means at some point in the next few months, we should start to expect a narrowing of participation. This will warrant a renewed focus on risk management in portfolios. Sector and country relative strength analysis will be instrumental to this process.

Well, what does this all mean you might ask. From a big picture perspective, the fact that the bullish percent indexes are very elevated is not enough in and of itself to get concerned just yet. To the contrary, it means that the market is very healthy right now with numerous stocks participating in the rally. Most importantly, the NYSE Bullish Percent Index is confirming the new highs in the market by going to a new high itself. In 2003, the market rallied for six more months after the 80% threshold was crossed, albeit with much less velocity. We discussed non-confirmation signals at length when the market was making its bottom earlier this year. They are a very important tool when trying to nail down major market inflection points and work both ways. Therefore, the warning signs that we will be looking for are gradual new highs in the indexes, but with fewer and fewer companies participating. Financial stocks will be an especially important sector to look at for divergences, since they are at the heart of our economic problems. However, we want to stress that we are just not seeing any red flags on the divergences front yet. Although, we suspect that we are now approaching the point in the festivities where it is smart to expect the participation on the upside to begin to narrow (i.e. the easy money has probably been made). Therefore, for the broad market, this is why we suspect that the climb from here will be much more gradual than the rapid advance we have experienced so far. There will certainly be exceptions on a more micro scale when we look at specific stocks and sectors. Going forward, relative strength analysis will become even more crucial as the market begins to separate the wheat from the chaff. At this point, both our fundamental and technical analysis points to emerging markets, commodities and precious metals as the three areas that we want to remain overweight in portfolios.

For the first time since the week of 10/1/08, money market funds assets have fallen below 40% of the S&P 500 market capitalization. As we have frequently mentioned, one factor that should limit declines is the amount of cash parked on the sidelines in zero yielding money market funds. The total amount of cash sitting in these ultra conservative investment vehicles has consistently been over 40% of the S&P 500 market capitalization for over a year now (it was as high as 63% in March). Historically, cyclical stock rallies don't top out until total money market fund assets fall below 20% of the market's value. The US Government guarantee of money market assets, that was instituted one year ago when the Reserve Primary Fund "broke the buck", expired this week. The loss of that guarantee, coupled with an average yield of 0.06%, should continue to push money towards more risky assets. Exhibit 1 below shows that after having net outflows for most of 2007 and 2008, US equity mutual funds are finally seeing net inflows. Interestingly enough, that pales in comparison to the flow of funds into fixed income. The majority of assets that have left money market funds this year are flowing in bond funds, not equities. Morningstar said that through August, 90% of all 2009 inflows into US mutual funds have gone into bond funds!

**Exhibit 1 – Negative Money Flow into U.S. Equity Mutual Funds Has Clearly Turned**



Source: [www.ndr.com](http://www.ndr.com)

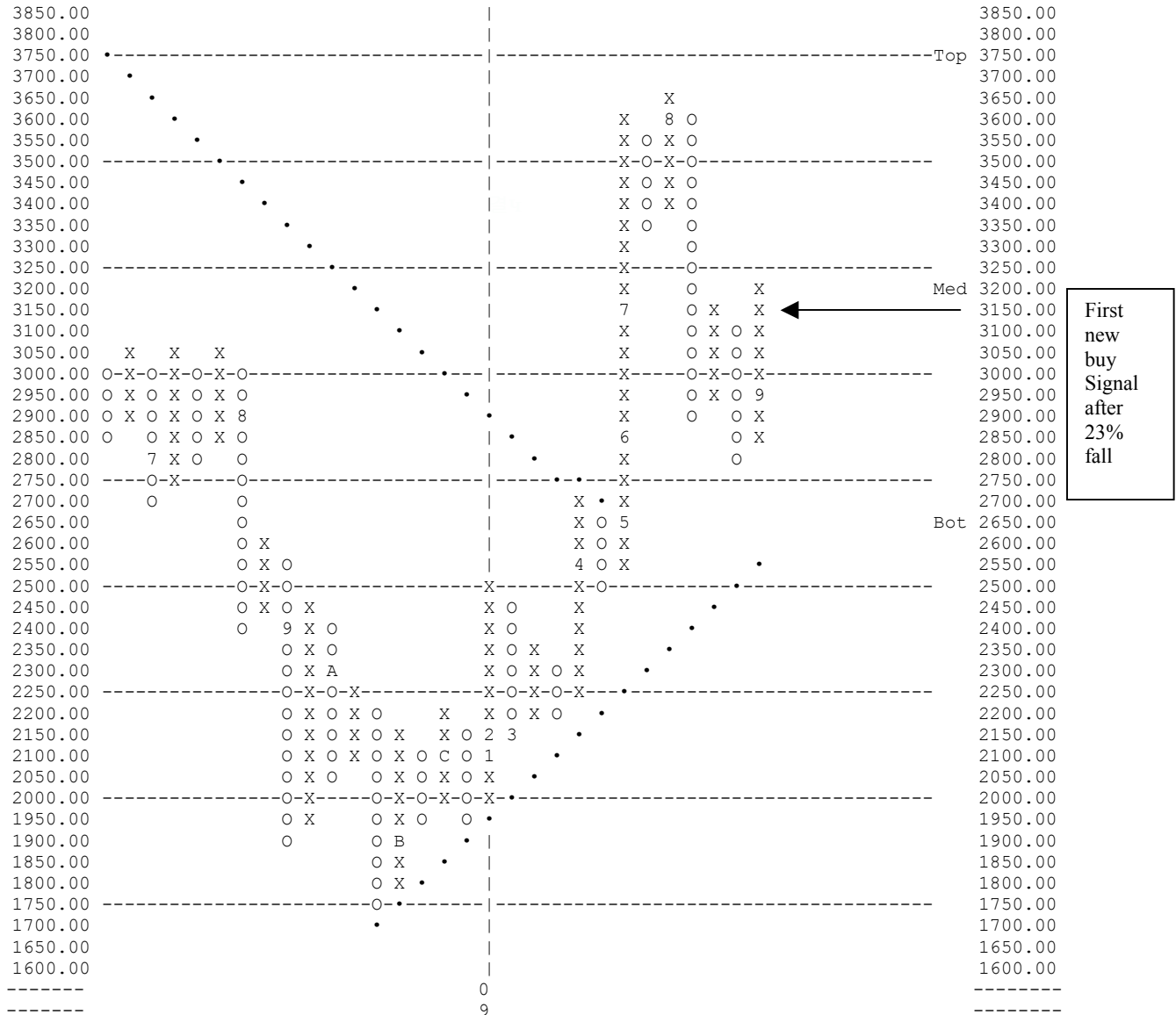
**Exhibit 2 – Retail Money Market Funds as a % of S&P 500 Market Cap Historically High but Trending Better**



Each week the Investment Company Institute (ICI) calculates the value of money market assets by looking at both institutional and retail funds. This week we wanted to drill down and show a 30-year look at the retail side of the equation. Exhibit 2 above from Sentiment Trader provides a good illustration of the cash mountain that we have been talking about. We would expect this ratio to compress more towards the 8% range by the time this bull market dies out. The interesting thing about this level versus the next highest peak in 1982 is that in 1982 investors were getting paid rates in the teens to hold cash versus zero now. This means to us that there is a good deal of complacency out there about inflation. We read a good quote this week in the *Financial Times* from Clive Crook "it is too soon to worry about inflation the same way it was too soon in 2005 to be concerned about securitised mortgages and house price bubbles." As more and more people start to prepare themselves for the inevitable up tick in inflation, expect these money market funds assets to start to move in the direction of inflation hedges and away from bond funds.

One final note this week regarding China. In our report on 8/14, we discussed the sharp price correction occurring in the Chinese A Share Index. Below is an updated chart:

**Shanghai A Share Index**  
Updated Through- 09/18/2009 (3109.173 Down 102.635)



The correction appears to have run its course. After a total decline of 23%, the chart above has reversed and given a new buy signal. If sustained in the weeks ahead, this reversal rally is encouraging because the positive psychology from Chinese growth is a major factor in the global recovery. One thing China skeptics have been known to say is that you can't trust the economic figures coming out of the government because they are manipulated. That may or may not be the case, but one universally agreed upon gauge of manufacturing growth is the power generation output figures. The chart below shows a "V" bottom that is back to 10% growth. This indicates robust economic activity in China. The continued surge in power generation and the stock market's recent buy signal may be telling us that we are on the verge of another major up leg in Chinese shares.

