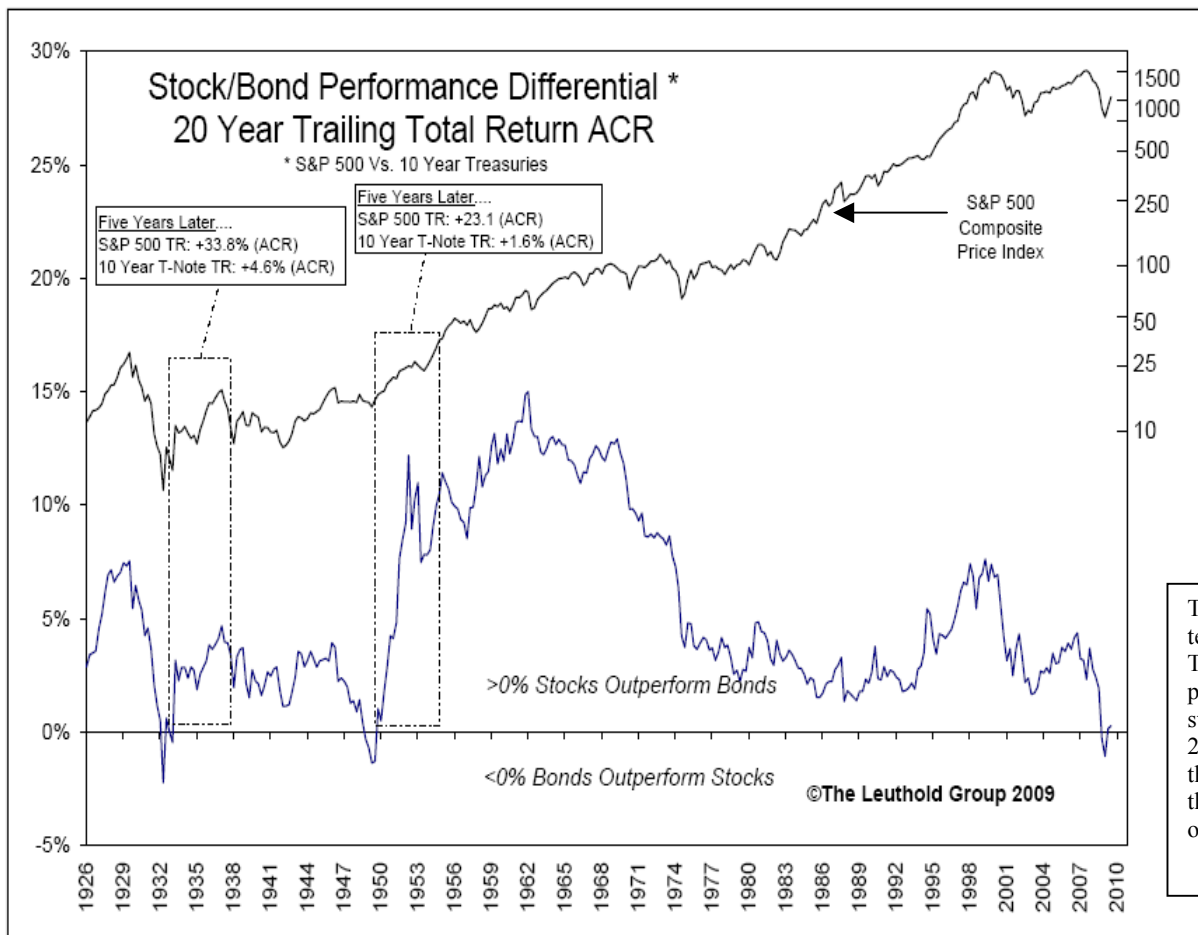




# The Starboard Side Report

The week ending October 09, 2009

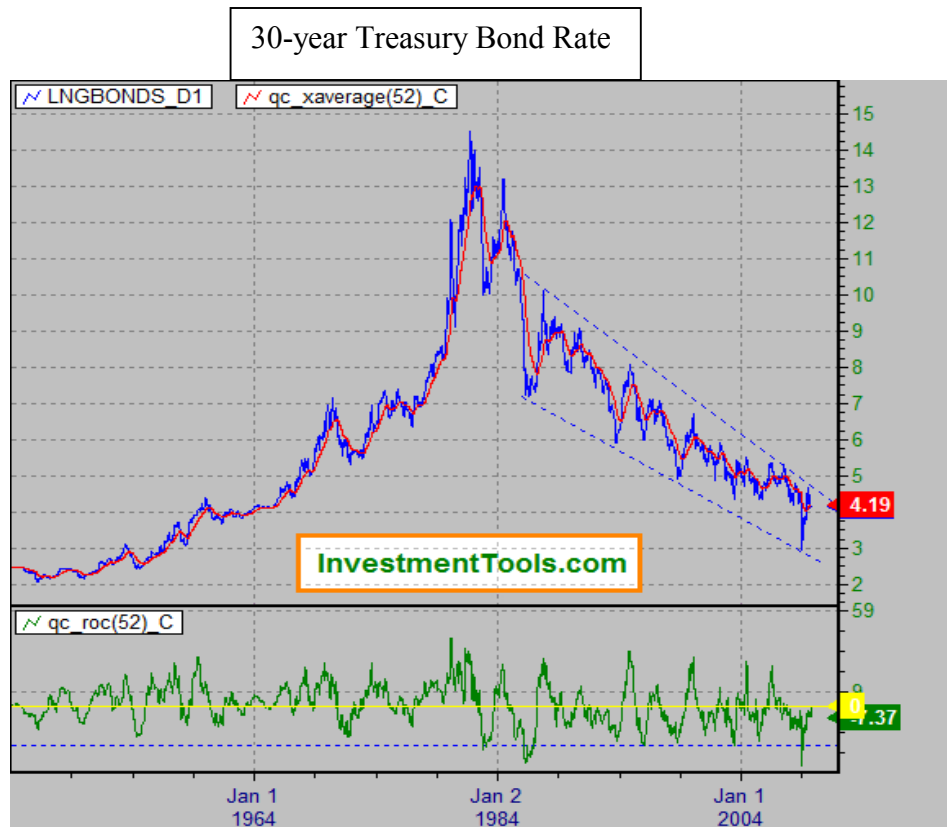
We have been focusing a lot on the micro situation lately with our analysis of Sept/Oct seasonality. This week we wanted to take a step back and look at the big picture to see where we stand with the US stock market and the gold market. The first chart we have included is from the Leuthold Group. It is a rather busy cart, but very important nonetheless. The bottom blue line is a graph of the 20-year total annual compounded return of stocks in the US versus the US 10-year treasury bond. As you can see, the crisis last year pushed the trailing 20-year total return of stocks below bonds for only the third time since 1926. The other two times proved to be excellent times to buy equities for those with a 5-year time horizon. The first was in the midst of the Great Depression in 1933 and the other was at the end of the 1940's. One was a counter-trend rally in a larger bear market and the other was the beginning of a powerful bull market advance that lasted for 16 years. We feel that today's environment is more similar to the first scenario. Stocks returned 33.8% per year between 1933 and 1937, but then went back into a deep funk that lasted another 10 years. We clearly don't see 35% returns over the next four years, especially from these levels. However, 15% per year (from last year's lows) over the next few would not be entirely unprecedented based on the data. This chart shows that even in the worst of times, a bear market rally can be a very powerful force when stocks get this undervalued versus bonds.



This bottom chart tells us that US Treasury bonds have performed better than stocks over the past 20 years. It's only the third time since 1926 that this has occurred.

Source: The Leuthold Group via Systematic Relative Strength

On the negative side, perhaps this chart is not so much telling us that stocks are undervalued, but that bonds are incredibly overvalued. US Treasury bonds have just had one of the most incredible bull runs in history over the past 28 years. The chart below shows that rates have fallen from a high of over 14% in 1982 to 3% last December. Given the rapidly deteriorating US fiscal situation, we do not see how bond yields can stay this low for very much longer. A three percent yield may very well have been a generational low for the US Long Bond.



Bond prices move inversely to yields. As a result, bond prices have just had an amazing run. It is one of the reasons (and few times in history) that treasury bonds have actually outperformed stocks over a 20-year period!

Chart created with NeoTicker EOD © 1998-2007 TickQuest Inc.

Given the dynamics at play, we come out somewhere in the middle. Stocks are somewhat undervalued on an absolute basis (as per the next charts), but a very attractive investment relative to long-term Treasury bonds.

Valuation is the main thing that stocks have against them versus the other two times that they got this cheap versus bonds. As we see below from the *Financial Times*, the cyclically adjusted price/earnings ratio (left chart) never got below 10 as it did in the prior two instances.

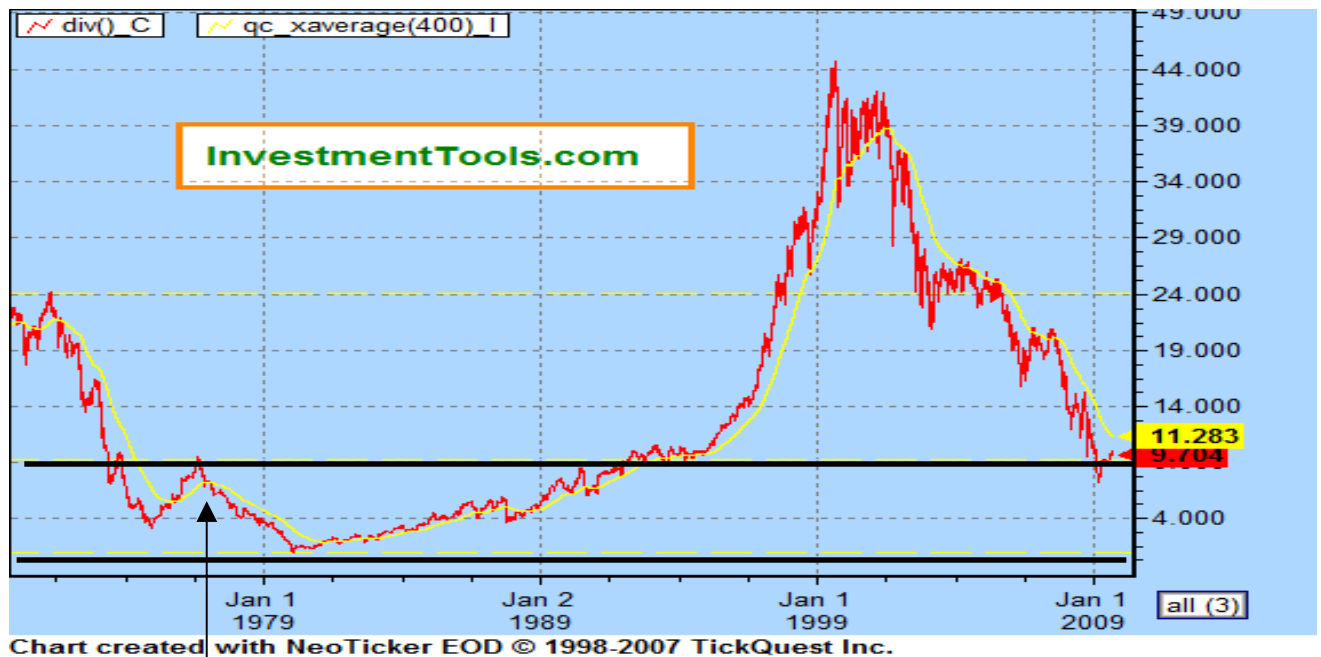


This means that stocks still have a way to go before they can be considered cheap on an earnings basis. However, there are other metrics that can support equities in the near-term. Namely, corporate cash-flows are at all-time highs due to the fact that we just went through one of the greatest inventory liquidations and employment restructurings in history.

The other chart on the above right shows the rolling 10-year total return of the Dow Jones Industrial Average. This indicates equities have some nice upside potential. Last year's stock panic pushed this statistic negative for the only time since the Great Depression. It also got close to negative at the bottom of the 1973-74 bear market, but never quite went negative. Due to the Federal Reserve having pumped liquidity equal to almost 30% of GDP into the economy, it is tough for us to see this number heading towards negative five as was the case in the 1930's. Therefore, the general climate for stocks should be better over the next ten years than it was for the prior ten. That is not to say it will be all rosy. After the 1933-1937, advance stocks lost 50% in a brutal fifteen month down leg. Even the 1950-1955 bull market lift-off had it's share of steep corrections and a multi-year trading range from 1951-53. Finally, even though the US market made an absolute price bottom in 1974, it had corrections of 13%, 20% and 25% over the next eight years. In addition, inflation adjusted returns over this 1975-1982 period were still dramatically negative.

The poor inflation adjusted returns of the stock market in the later half of the 1970's may best be viewed through the lens of the Dow Jones Industrial Average to Gold Ratio. This is getting closer to the historic cycle bottom of 1.0, but is still very far from that level on a percentage move basis (89%). Gold gained 600% between 1977 and 1980 as this ratio went from ten down towards one.

## Dow-to-Gold Ratio



Even though US stocks never revisited their 1974 lows, they continued to plunge in value when priced in gold. The final move from ten down to one took about three years and saw gold gain over 600%.

The final long-term analysis we wanted to explore is the gold market. Our bullish posture on gold has been well documented in prior reports (for our latest near-term outlook on the precious metals sector please revisit our 9/11/09 weekly). The charts below are a very long-term look at both the nominal and the real (inflation adjusted) price for gold.

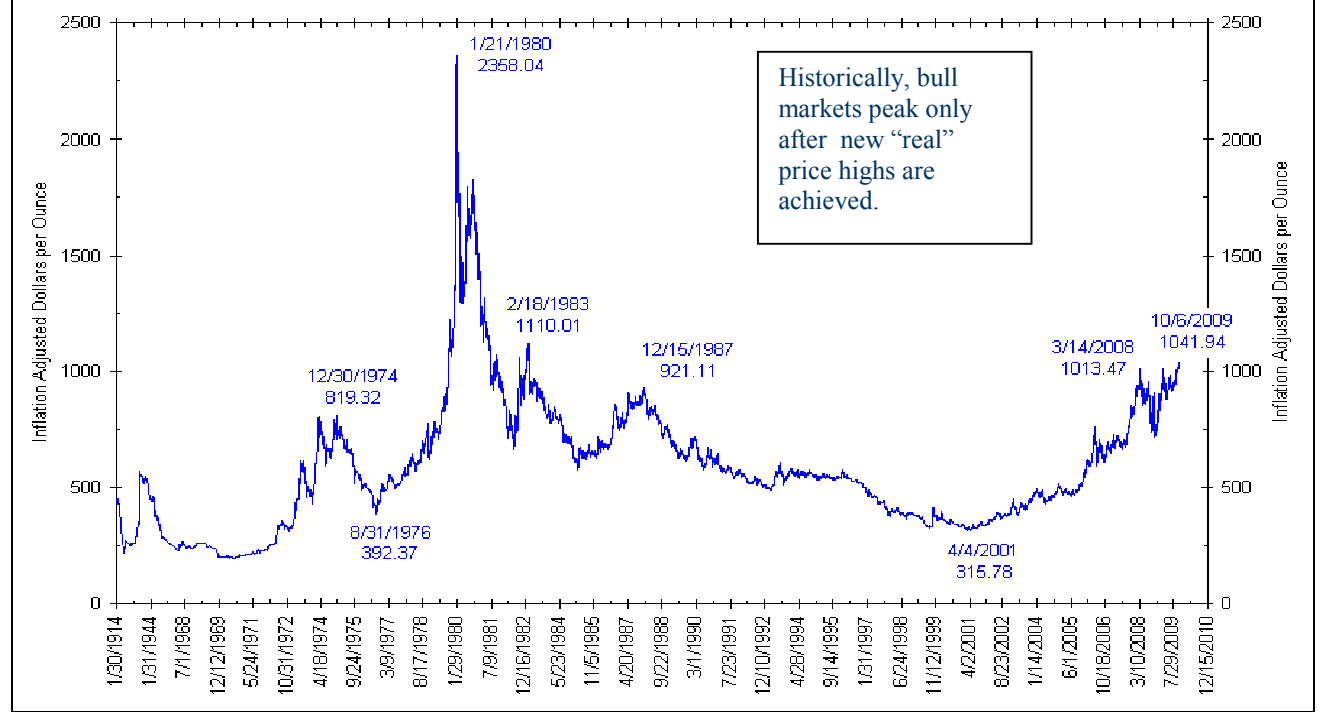
**Gold Price, \$ per ounce (London pm fix)**



New all-time nominal price for gold this week, but.....

Still 126% below old high inflation adjusted high

**Inflation-Adjusted Gold Prices**



The nominal chart on top goes back to 1971, whereas the real price chart goes all the way back to 1914. Even though the first chart shows that gold just broke out to a new all-time high, it is important to point out that this was not a new price high in real terms. It is extremely rare for a powerful bull market like the one we are experiencing in gold to end without setting a new inflation adjusted high. For the yellow metal, that is still 125% above current levels (assuming no inflation). At the end of the day, the nominal price gains will likely be much higher given our views on inflation in the years ahead.

The Yen is now the only major currency in which gold has not broken out above its March 2008 high. The US dollar-priced gold breakout above its 2008 high mark could officially mark the end of the great 2008-09 deflation scare. As an aside, we looked at gold priced in six major currencies that have already exceeded the March 2008 high and the average move above this level on the breakout was 26.4%. A similar move in US dollars would put gold around \$1,300 p/oz US sometime in the next six months.

The World Gold Council just updated their latest central bank reserve figures, so we are including an updated look at our in-house US money supply to gold ratio. This is a fifty-year look at the amount of gold reserves the US has versus the money that the Federal Reserve has printed into circulation. We first introduced this concept in our 4-24-09 weekly report. In 2002, money supply was over 75 times greater than the value of gold reserves versus 4.8 times at the peak of the gold bull market in 1980. In addition to showing gold as still undervalued, this chart illustrates that we are coming back down the liquidity mountain with gold prices once again running ahead of the Federal Reserve printing presses.

