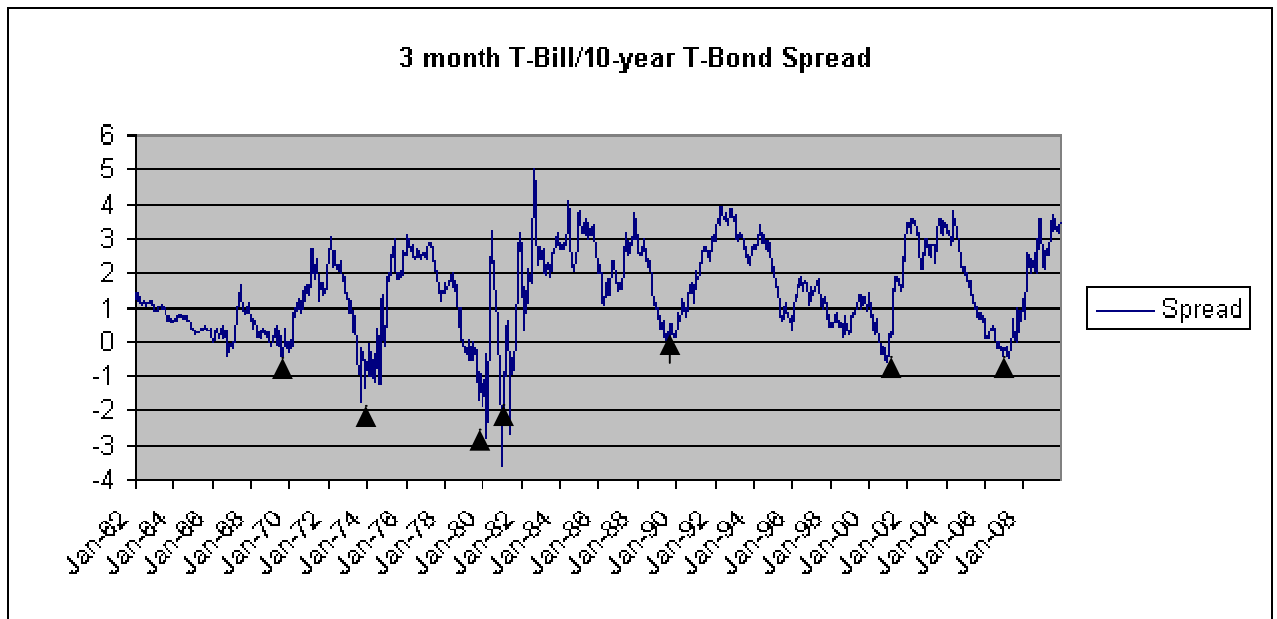


The Starboard Side Report

The week ending November 20, 2009

The correction in global stocks that began in the middle of September is now approaching the two month mark. The overall strong momentum of the market is illustrated by the fact that the steepest peak-to-trough decline for the S&P 500 over the period has only been 6.5%. This episode has all the makings of a healthy consolidation of gains, not the start of a new bear market down leg. As we have surmised in past reports, the highs of this cycle may have been hit in some sectors and stocks, but the market in general should be able to have another push higher into the first half of next year. Other than favorable seasonality, there are several barometers that point to sufficient liquidity to drive stocks higher.

One of the most basic, but accurate, tools for analyzing the market is the yield curve spread between short-term and long term interest rates. The greater the gap between short and long term yields, the more liquidity that is available for banks to rebuild their balance sheets. A wide spread allows banks to borrow at the cheaper short-term rates and lend to consumers and businesses at higher rates. In addition to lending, they can also park low interest money borrowed from the Federal Reserve in higher yielding and longer-term US Treasuries. As we will see, this latter strategy is the one being employed at the moment. From a historic perspective, a yield curve spread above 3% implies good potential for economic expansion. On the other hand, a negative or inverted yield curve signals a major economic slowdown ahead. We often commented on this recession warning sign back in 2006 and 2007 after it went negative.



Please note that every single recession since 1962 in the US has been telegraphed by a negative yield curve (these recessions are marked in the above chart by the black triangles). 1966 was the only time it went negative and no recession followed, although the market did decline 24%. Below is an analysis we did back in 2006 when the yield curve first inverted and signaled trouble ahead. It leads us to believe that, for the time being, sufficient liquidity is available to prevent a double dip recession. Should this yield curve start to head back towards negative, it would be a major red flag for the economic recovery.

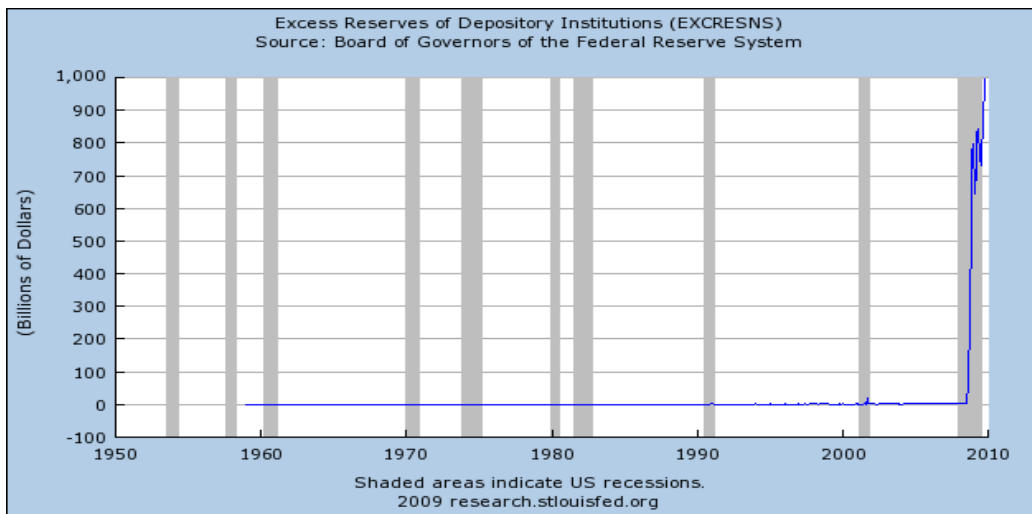
Historical Analysis of the Inversion of the 3-month Treasury Bill and the 10-year Treasury Note (1960-Present)

<u>Date of Inversion</u>	<u>S&P Cycle High Date</u>	<u>S&P Cycle Low Date</u>	<u>Market Cycle Duration</u>	<u>S&P Cycle High Price</u>	<u>S&P Cycle High Low</u>	<u>Market Decline</u>	<u>Recession Start Date</u>	<u>Months from Inversion to Recession</u>
Sep-66	Jan-66	Oct-66	1	94.56	72.28	-23.56%	None	N/A
Jul-69	May-69	May-70	10	106.74	68.61	-35.72%	Dec-69	5
Jun-73	Jan-73	Sep-74	15	120.71	60.96	-49.50%	Nov-73	5
Jan-79	Jan-79	Feb-79	1	102.59	95.38	-7.03%	Jan-80	12
Nov-80	Nov-80	Aug-82	21	141.96	102.2	-28.01%	Jul-81	8
Jun-89	Jul-90	Oct-90	16	369.68	294.51	-20.33%	Jul-90	13
Jul-00	Mar-00	Oct-02	27	1552.87	768.63	-50.50%	Mar-01	7
Aug-06	Oct-07	Mar-09	17	1576.1	666	-57.74%	Dec-07	16
Avg			13 months			-34.05%		8.3

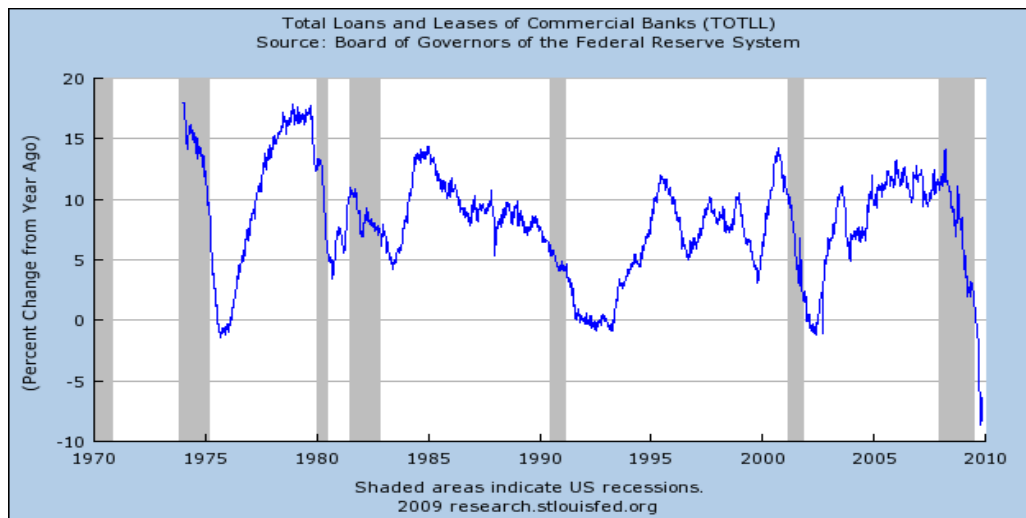
Sources: Jas Jain, United States Treasury, National Bureau of Economic Research, Dorsey Wright & Associates, Yahoo Finance

The general point is that the Federal Reserve orchestrates a steep yield curve to try and nurse the banking system back to health. This is when the old saying "don't fight the Fed" comes into play. It is the same tool that they have used after each recession since 1960 and it is being attempted again in full force to restart the economy. Obviously, this time the banking system is the most impaired it has ever been, so the medicine has been more aggressive and more radical than prior episodes. The most similar recession may be the 1990 consumer recession that was brought on by the Savings & Loan crisis. Below is a picture book that describes the current situation we are facing.

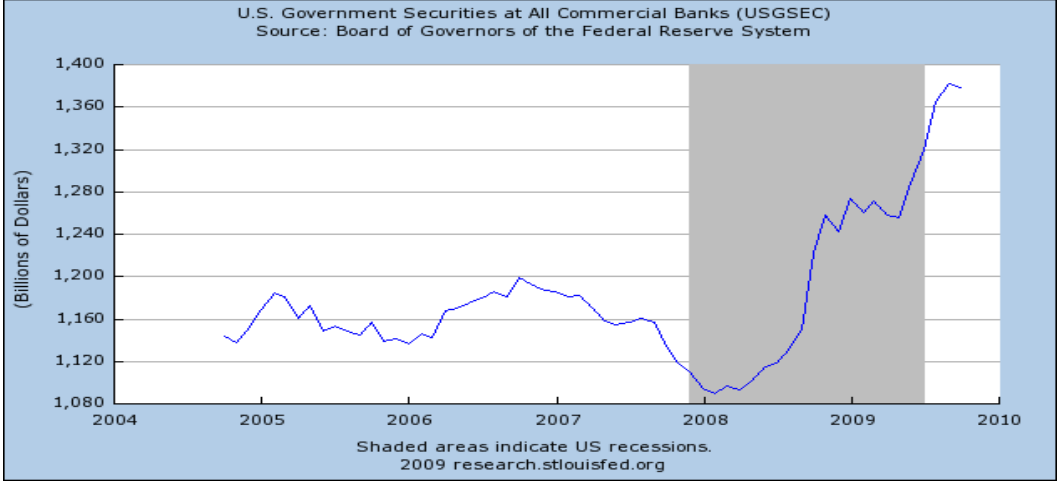
The Federal Reserve has flooded the banking system with unprecedented amounts of capital. There is almost \$1.0 trillion of excess reserves at US commercial banks. This is a tenfold increase over any prior recession.



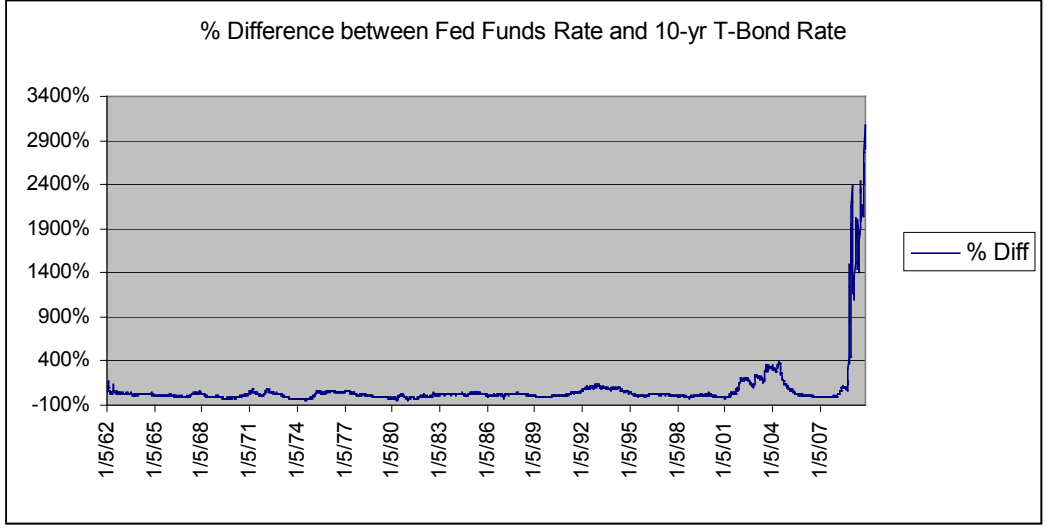
But, the picture on the right of bank lending shows that this money is not being lent out into the broader economy. You can see that this is not so different from prior recessions, but it is clearly a more violent lending retrenchment.



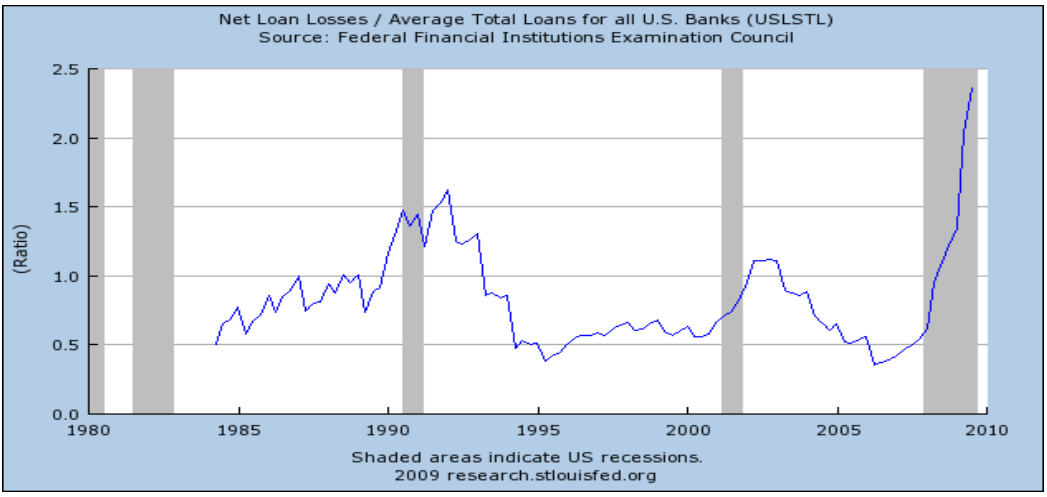
Instead of being lent out, the money that is being borrowed at essentially zero percent from the US Central Bank is being invested in Treasuries. The interest earned should help repair bank balance sheets from the damage caused by the great recession.



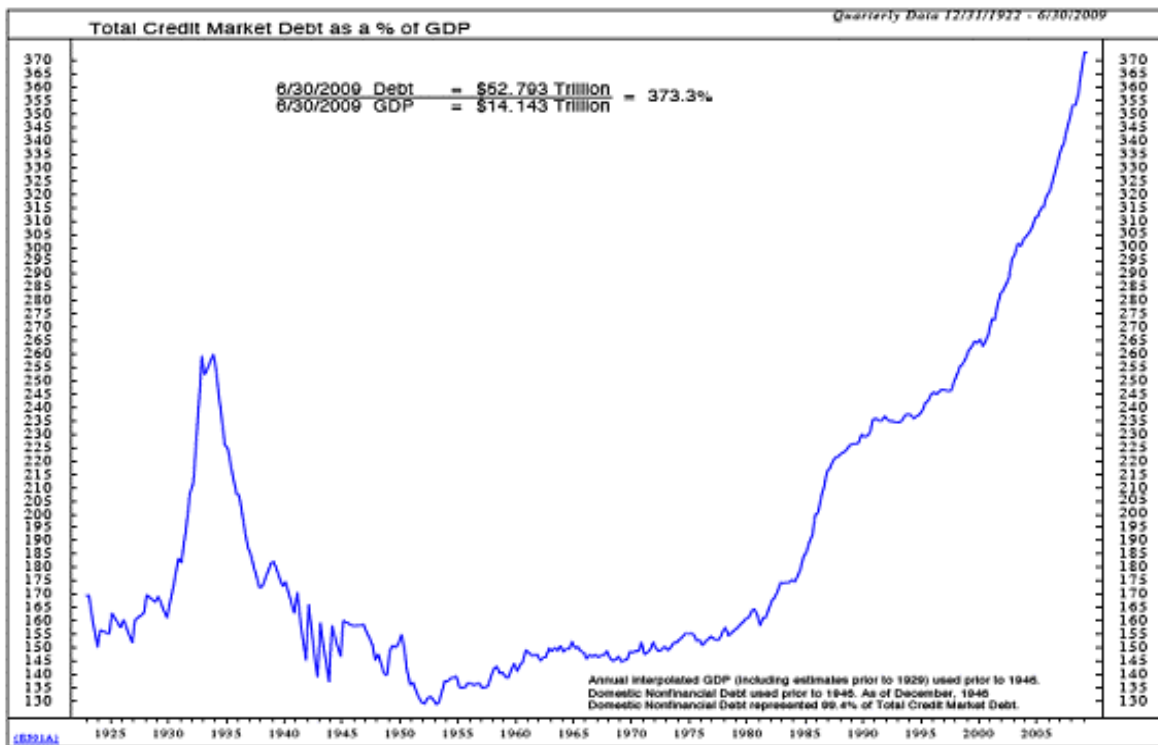
0.10% money borrowed from the Fed can be invested in ten year gov't paper at a yield of 3.40%. That's a record reinvestment premium of 2900%.



Desperate times call for the desperate measures pictured above. Loans losses continue to plague banks making them gun-shy to lend and needing to set aside more loan loss reserves.



In a nutshell, this is why the Federal Reserve has slashed the Fed Funds rate to zero. At the end of the day, they work for the banking system and will do everything in their power to make sure it does not implode. The stakes are very high and we argue that going to the same playbook in this inflationary environment is a long-term recipe for trouble. The 1970's proved that providing easy money in an inflationary backdrop has serious repercussions. The Fed claims that when the time comes, they will be able to drain the system of its excess reserves in time to prevent a massive inflationary episode. Let us not forget that these were the same folks responsible for oversight of the banks during the credit bubble. If the economic recovery appears to take hold next year and the banks do decide to start lending out the trillion dollars of reserves sitting on their books, then inflation insurance will come in handy. A mid-term election year in 2010 will make it difficult for the Fed to do any liquidity draining that is needed due to political pressure to keep their foot on the gas pedal. Part of what we are seeing in the bullish action of the gold market is a lack of trust in the financial establishment that got us into this mess and essentially a bet against the competence of central bankers getting us out of it. It is in these periods of low government confidence that gold thrives. The 1930's and 1970's are good historical examples of this. This last chart is why we think that that confidence is not coming back anytime soon and why the old methods eventually won't work this time. The capacity for the economy to take on more debt has just about reached its limit as this total credit market debt as a percent of GDP chart from Ned Davis Research illustrates.



The Federal Reserve's efforts to revive the banking system are providing us a window to capture investment returns before the next chapter of this bear market commences. We don't know exactly how long the window will be open, but charts like the yield curve spread and other liquidity measures tell us we have some time. However, we feel that this window will be shorter than the four-year risk seeking environment that followed the 2001 recession. At some point next year, we feel that the risk-reward trade off will become much less inviting. At that point, we will take profits off the table, reinstate hedges and stick to some core positions in emerging markets, precious metals and energy. Essentially, keeping exposure to those areas that have the best fundamentals in an otherwise challenging long-term investment environment.