

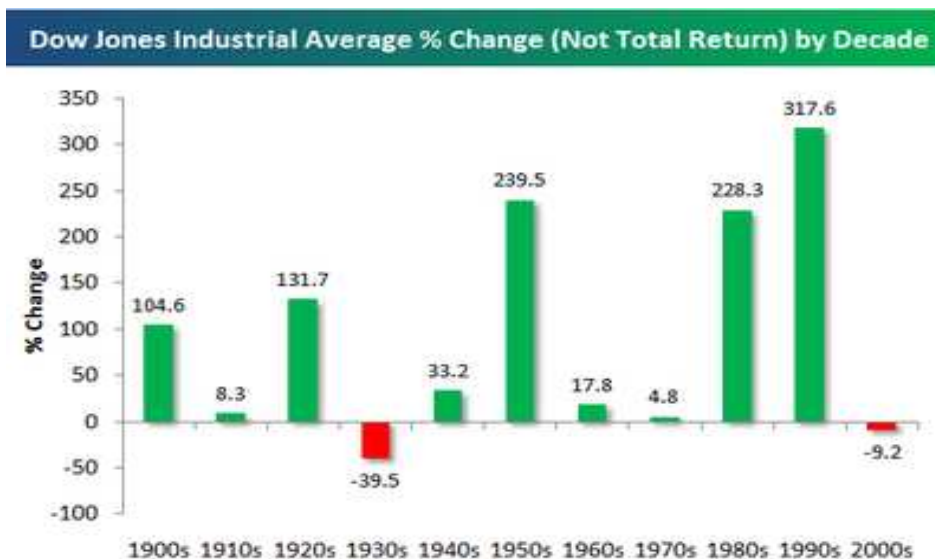
The Starboard Side Report

The week ending December 04, 2009

The debt default episode in Dubai last week was the first shot across the bow of this global economic recovery. The quick pace at which the financial markets were able to shrug the crisis off indicates that it probably won't be enough to derail the momentum behind the current expansionary phase. However, it is a microcosm of the troubles that will plague the global economy for years to come. Namely, too much debt underlying a now devalued asset base. It is ironic that this problem hit an emerging economy because, for the most part, emerging economies are where debt levels are manageable and cash flow growth more assured. Instead, it is the developed economies in the US, Europe and Japan that are at a greater risk of a Dubai like default down the road. While a sovereign default in Dubai appears to be a manageable affair for the global economy, we are certain that a default in a major developed market economy would cause a much more drastic negative reaction. Governments are still in the process of trying to inflate asset prices to help increase the value of collateral backing the debt mountain, but this strategy will either lead to inflation, if pursued for too long, or renewed deflation of asset prices and more defaults once the stimulus wears off.

As we mentioned in our last report, Central Banker attempts to revive the banking system and inflate asset prices is providing a window to capture investment returns before the next crisis erupts. Our market momentum indicators have just reversed back to the upside following a several month retrenchment. This leads us to believe that the market has at least one more move higher before it becomes time to more aggressively manage portfolio risk.

The decade is drawing to a close and there will certainly be a lot of retrospective analysis coming in the weeks ahead. A recent *Time Magazine* cover story proclaimed the first decade of the new millennium "The Decade from Hell". One look at the total return (factoring in dividends) of the S&P 500 bears that out. This benchmark US stock index is on pace for its first negative total return decade ever unless we get a 12% rally in December. Below is a look at the Dow Jones Industrial Average by decade. As you can see, barring a big rally over the next three weeks, the Dow is on pace to have its worst decade since the Great Depression years of the 1930's.

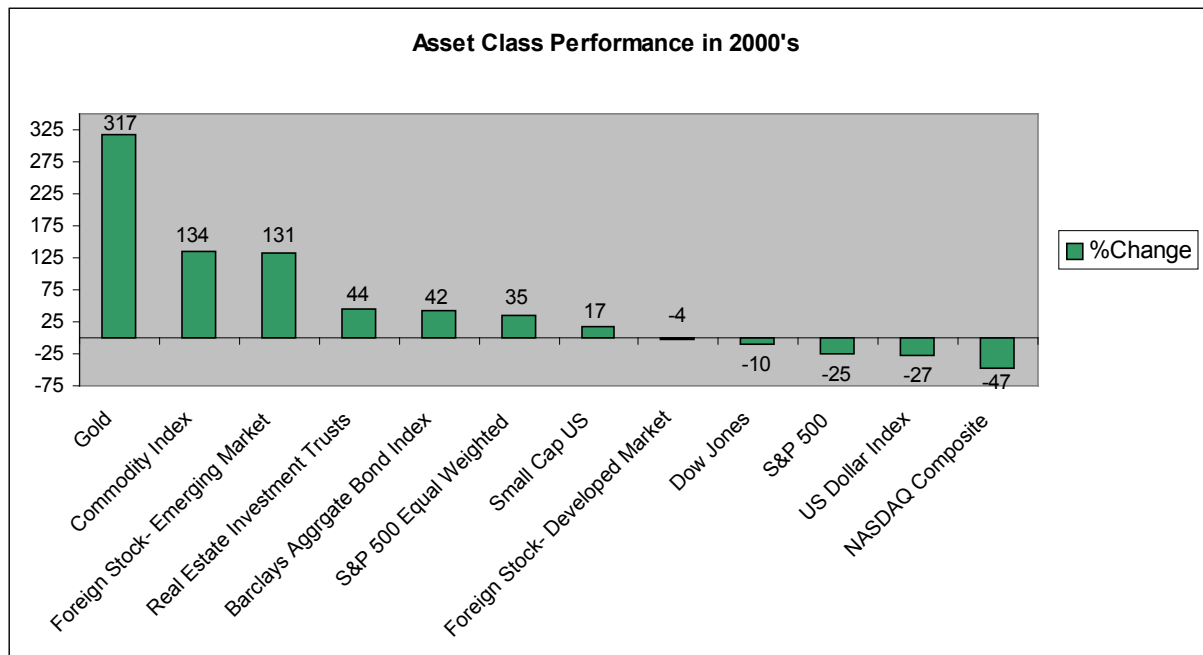


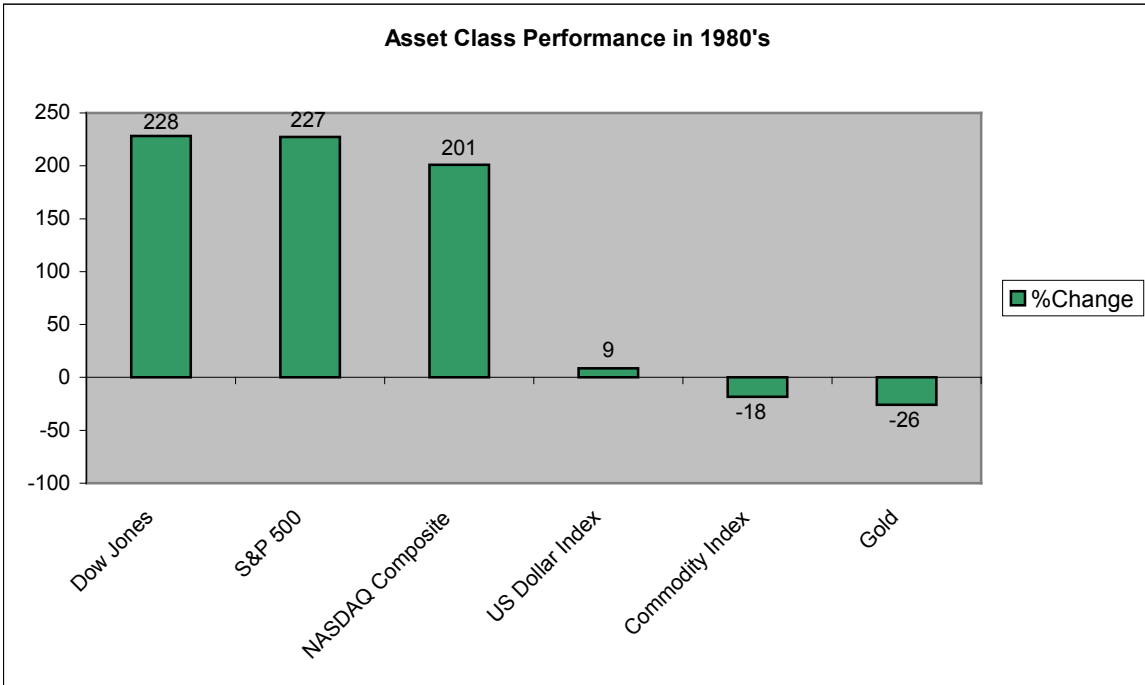
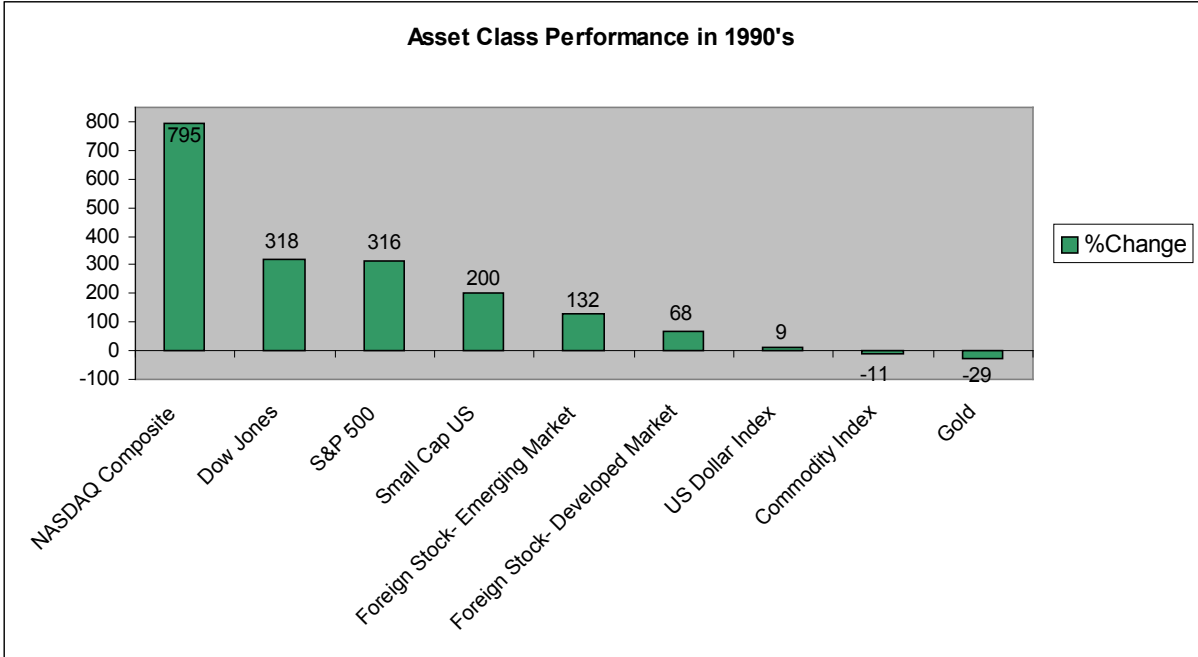
It's very interesting where we came from over these ten years and what groups have been most responsible for the market carnage. The dawn of the 2000's was characterized by a frenzied technology bubble. Yet, as we see below, technology and telecom were far and away the biggest contributors to the S&P 500's weakness.



Source: Bespoke Investment Group

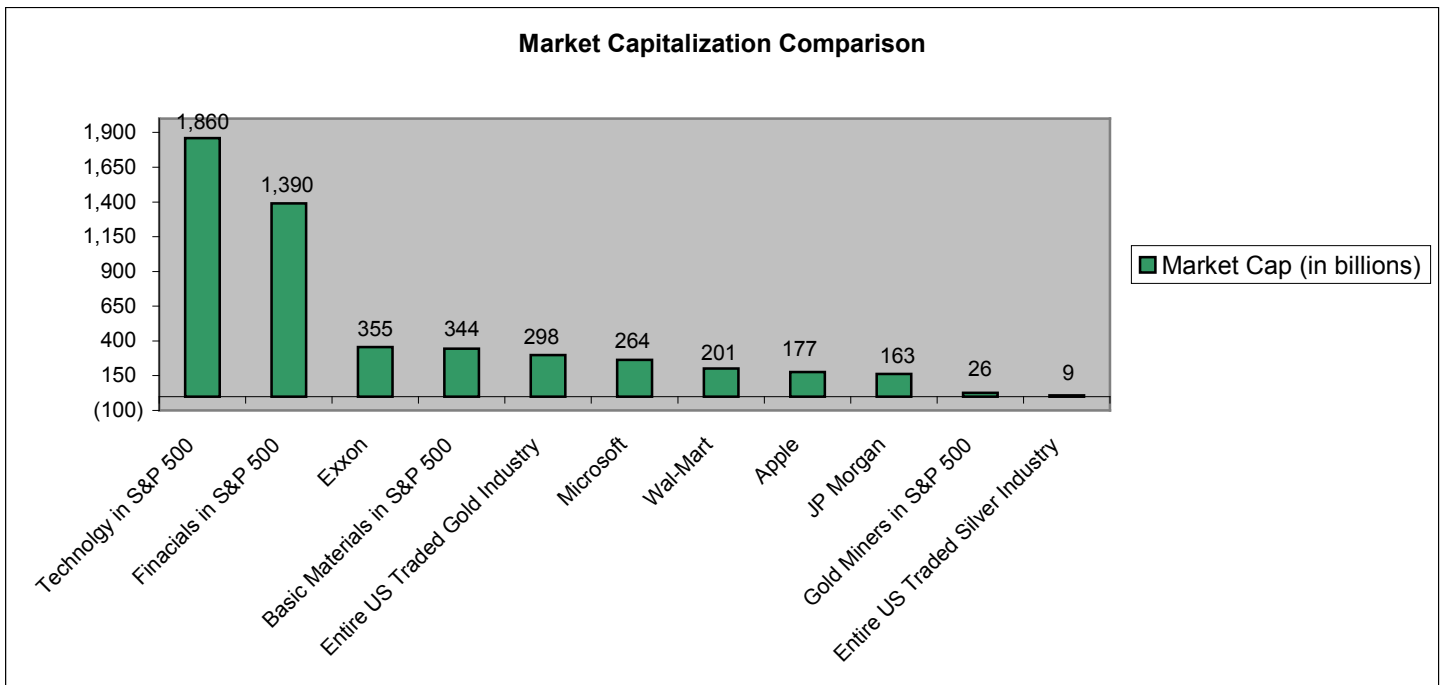
The only other sector to underperform the market were financials as a result of the bursting of the credit bubble in 2008. Although the market in general had a terrible showing, there were definitely places to hide. Five of the ten S&P 500 sectors had gains over the past ten years. Below is a breakdown of the percent gain/loss of various asset classes in the 2000's, 1990's and the 1980's. Unfortunately, our data vendor, Dorsey Wright, only had limited historic data. Therefore, you will notice the amount of asset classes included declines in each decade. It is an educational exercise nonetheless.





A couple things jump out at us from this analysis. First is the book-end position of the NASDAQ Composite in the 1990's and 2000's. This technology-laden Index gained 795% during the 1990's, but is bringing up the rear with a 47% loss this decade. The next general pattern to notice is that big picture asset class trends have tended to play out over the course of two decades, not just one. US stocks were strong in both the 1980's and 1990's, while commodities and gold returns were both negative over these twenty years. Therefore, just because gold and commodities were the best performers this decade does not mean that their momentum can't carry over deep into the next decade.

There was a very sharp correction in the precious metals market on Friday that warrants comment. Gold had become very extended on a short-term basis and was due for a breather. We would not be surprised if this was the start of a brief, but necessary consolidation of gains. Below are some pictures that we believe support the case for more upside in the months ahead and also refute those that are calling gold an asset bubble about to pop.



Newmont Mining, with a market capitalization of \$26 billion, is *the only* gold stock in the entire S&P 500. Basic Material stocks, which include coal, steel, chemicals and precious metal miners are only 3% of the S&P 500. Historically, bubbles occur when sectors become over 25% of the market, not 3%. It is this under investment by US portfolio managers that makes the entire basic material sector one of our favorite for the next decade. The *entire* US gold industry traded on US stock exchanges is just shy of \$300 billion and silver is even less at \$9 billion. The legacy of the technology and financial bubbles can be observed above by their still bloated status in US equity portfolios. At a combined market value of \$3.2 trillion, these sectors still make up over one third of the S&P 500 Index versus a 0.27% Index weighting for lonely Newmont Mining.

Next we have gold stocks as measured by the XAU (Philadelphia Gold and Silver Index). This helps to determine if the stocks are cheap or expensive versus the underlying metal. This exhibit shows that precious metals stocks still have a way to go to get back to the expensive range. Each of the three prior cyclical bull runs for gold stocks this decade have fizzled out only after the XAU to gold price ratio has exceeded 0.25. Last year's stock crash pushed this ratio down below 0.10; its lowest level of the past twenty-seven years. The gold mining stocks have just now gotten back to the bottom end of their range that marked major lows for the stocks in 1986 and 2000.



The chart below is the twenty-seven year absolute price graph of the XAU. As you can see this index is barely above the level it was back in the mid-1980's. When the Nasdaq and credit bubbles hit their bursting point, indexes related to technology and financial stocks had gained several thousand percentage points over multiple decades. From the low in December 1974 to the top in March 2000, the Nasdaq Composite Index gained almost 8000%! Now that's a true bubble.



Can a sector that has only recently broken out above its nearly 30-year trading range be considered a bubble? We don't think so.

Below we see that gold has just started to break to the upside in currencies other than the US dollar. The chart shows the Euro just recently breaking out of a 10-month consolidation. Each of these prior breakout episodes of Euro priced gold have led to higher gold price and gold stocks over the next several months.



The final precious metals chart below is of the Central Fund of Canada. It is a hybrid trust made up of 55% physical gold 45% physical silver. This fund has just now broken out to the upside. This means that we should have more gains ahead if the prior three episodes can be used as a guide.



The bottom line is that we feel a consolidation of recent gains is about all that is occurring with this sudden price weakness. Whenever a group has momentum that has been as strong a precious metals have been over the past year, there are bound to be violent corrections. There is an old Wall Street saying that says the sharpest corrections occur within the context of a bull market. We believe this Friday's volatile price action was a good example of that theory in practice.

One final sector note this week comes from the Utilities group. As you can see in the chart below, Utilities have just broken out of a long base consolidation. This defensive group sports an average sector yield above 4%, so we will be looking for ideas in this area for income oriented accounts.

Utilities Select Sector SPDR (XLU) NYSE

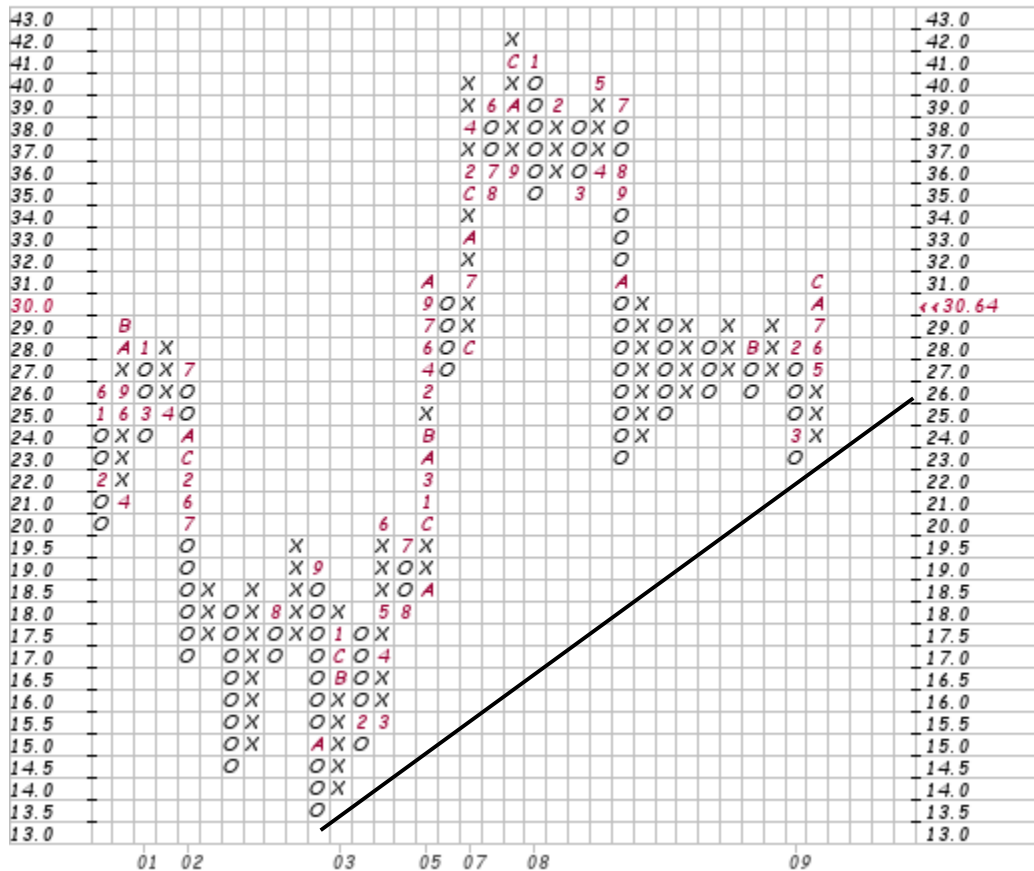
04-Dec, 16:00 ET, daily, O: 31.14, H: 31.22, L: 30.28, C: 30.64, V: 20.3M, Chg: -0.19

P&F Pattern Quadruple Top Breakout on 19-Oct-2009

Traditional, 3 box reversal chart

Prelim. Bullish Price Obj. (Rev.): 48.0

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The Utilities sector just broke out of a 14-month consolidation pattern that had a ceiling of \$30. The yield on this sector fund is currently 4.4%.