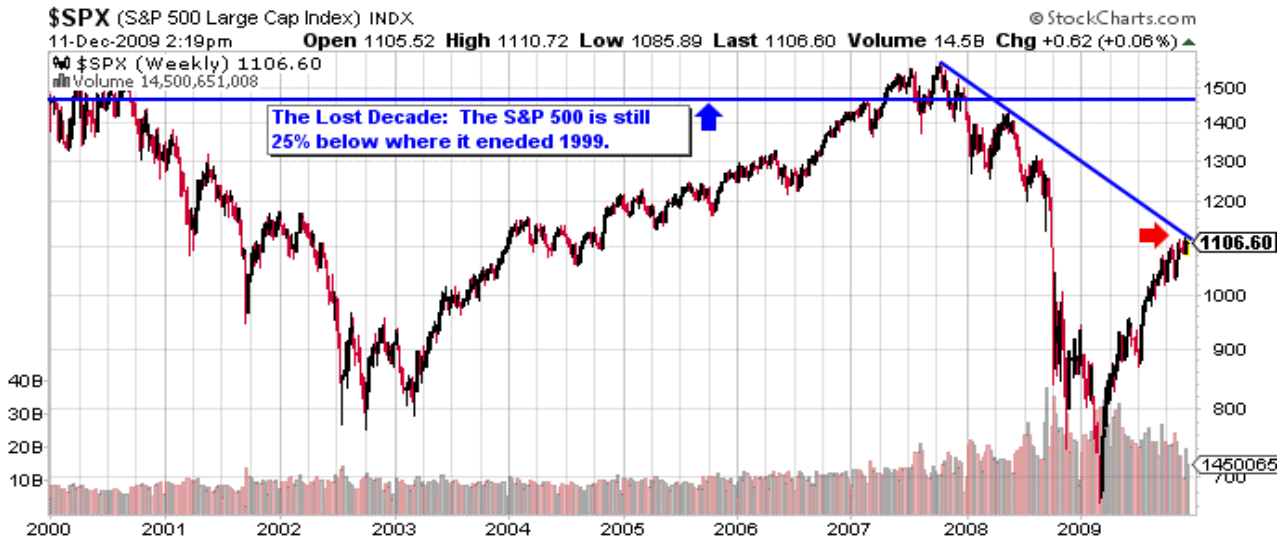


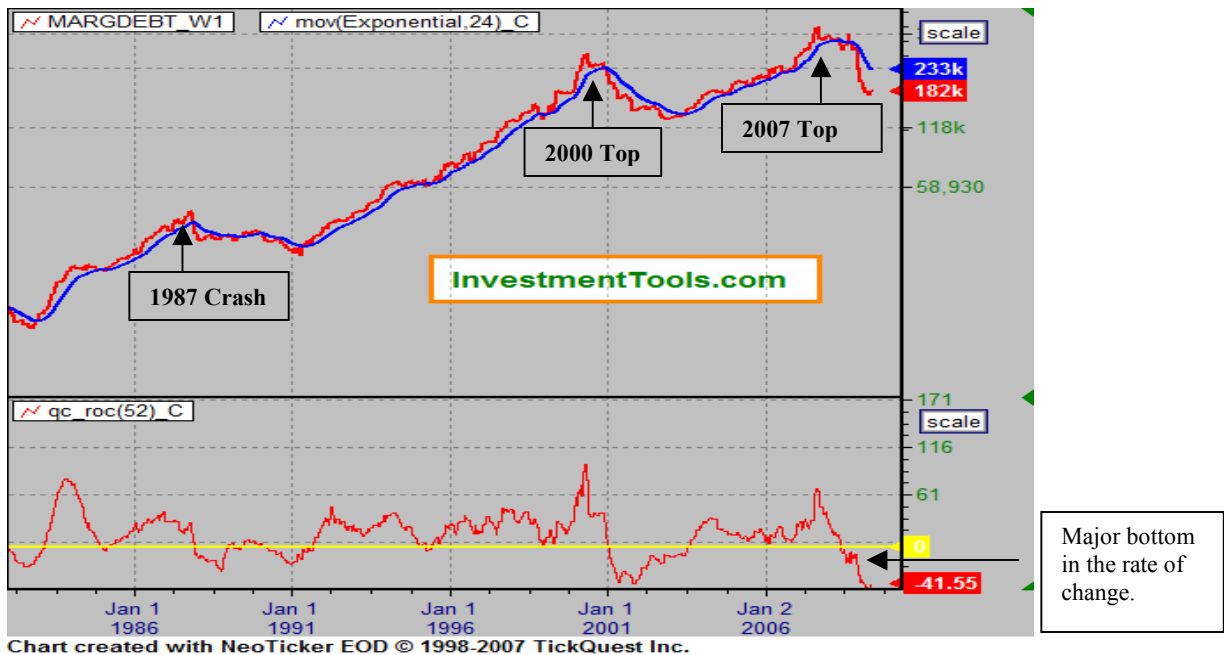
The Starboard Side Report

The week ending December 11, 2009

The S&P 500 continues its struggle to sustain a move above the 1,110 mark. In the chart below, the red arrow shows that the rally has stalled at the downtrend line drawn from the 2007 peak. It will take some effort to get through this area of resistance, but we suspect that there is enough firepower left to eventually make another thrust towards the 1250 level sometime between now and the middle of next year.



We have talked a lot about the amount of cash on the sidelines as a reason to remain positive on stocks. We got further confirmation of this situation when the Federal Reserve's Flow of Funds report was released this week. It showed private cash holdings of households and companies at a record 72% of GDP. The Fed is trying to get that cash into riskier assets and we suspect that investors will oblige by continuing to venture out further on the risk curve in the months ahead. One way to judge the risk appetite of the market is to look at margin debt.



As you can see in the chart above, margin debt (or securities bought with borrowed funds) points to very little speculation taking place at the moment. People usually are more apt to buy stocks using leverage if they are confident of future returns. This confidence is slowly starting to return, but human psychology is such that it takes a couple of years for "animal spirits" to fully come back to the market. Mark Dow of Pharaoh Asset Management characterizes this as disaster myopia. The term refers to the propensity to over or underestimate the probability of an adverse outcome based on how far one is from a similar event in the past. In a recent interview, Dow had the following to say about this phenomenon and how it relates to markets- "disaster myopia is a psychological concept that the day after you get mugged, you are going to assign far too high a probability to getting mugged for quite sometime until that memory fades. We just went through a big bubble (and crash). The new bubble is in calling bubbles and people getting excited about bubbles. If you look around, we still have bubbles that are deflating like the commercial real estate market and real estate in general....people are worried about their balance sheets and household leverage. It's really hard to get the kind of bubble that is destructive to economic activity when you still have deflating sectors."

This is one of the reasons that the Federal Reserve feels safe leaving interest rates at such low levels, because the chance of a new dangerous bubble is not very high *yet*. We stress *yet* because it is likely that the easy money policies of the Federal Reserve are once again creating the fertile ground for a new bubble to take hold once the memories of 2008 start to fade. Right now, we see bull markets resuming in gold and some emerging markets, but would not classify them as bubbles at this point. The difference between a bubble and a bull market is starting to get blurred with all of the bubble calling out there. The Fed is using the exact same policies that created the technology bubble and the credit/housing bubble, so the odds are that this easy money campaign has already sown the seeds of another one. However, it will take some time to fully materialize as was the case with tech and housing.

The question becomes, in what sectors and asset classes will the froth show up? The likely candidates are those areas that retained strong fundamentals during the crash. This is how the bubble cycle has worked before. The easy money campaigns in 1994 and 1998 were the fuel for the technology melt-up and the 2001-2003 easy money campaign sowed the seeds of the irrational exuberance we had in house prices. Each of those areas did not need the extra stimulus, so reckless easy money Fed policies supercharged the sectors with already strong fundamentals. Doug Noland, of the Prudent Bear, summed this dynamic up nicely; "The reliable old Monetary Process - where Federal Reserve and GSE reflationary measures would immediately stoke rapid (and self-reinforcing) mortgage Credit growth, housing inflation, inflating household net worth, equity extraction, spending and booming government receipts - is no longer operable. Reflationary liquidity, that for years gravitated predictably to our MBS (mortgage-backed securities) and agency debt, now prefers 'undollar' asset classes, including emerging debt and equities, gold and metals, and commodities more generally." Translation, easy money is no longer flowing to the credit market machine that inflated housing prices and spawned the home equity ATM. Instead, it is heading out of the US into emerging markets, precious metals and commodities. These are the fundamentally strong areas of the global economy and should remain the prime beneficiaries of excess liquidity for the foreseeable future. The longer monetary policy remains highly accommodative, the bigger the next bubble will be. We have learned nothing from our mistakes. It is simply a matter of not having the stomach to take the tough medicine. Instead, we feel that the easiest way out of trouble is to inflate our way out. The potential problem should this newest bubble cycle materialize is that the money is flowing to areas that the US government would rather not see inflated such as commodities. At the end of the day, the powers that be can create the liquidity, but can not control where it flows.

As we have seen in recent weeks it will not be a straight line higher for these fundamentally stronger areas. The US dollar is in the midst of a counter trend rally that is putting pressure on commodities and precious metals in particular. These assets tend to be inversely correlated.



But....we prefer to look at the big picture:



Despite the recent rally in the US Dollar Index, we still believe the world is in the midst of a generational shift away from dollar assets. This diversification will weigh on the US currency for years to come as the mess created by our economic policy makers over the past twenty years continues coming home to roost.