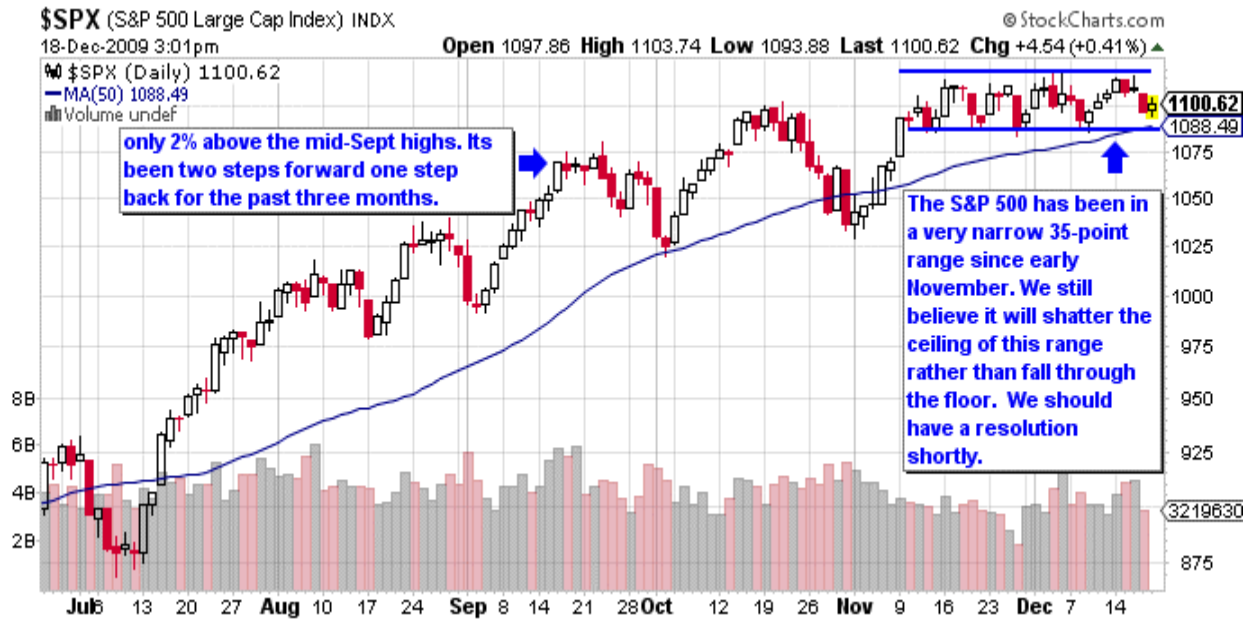


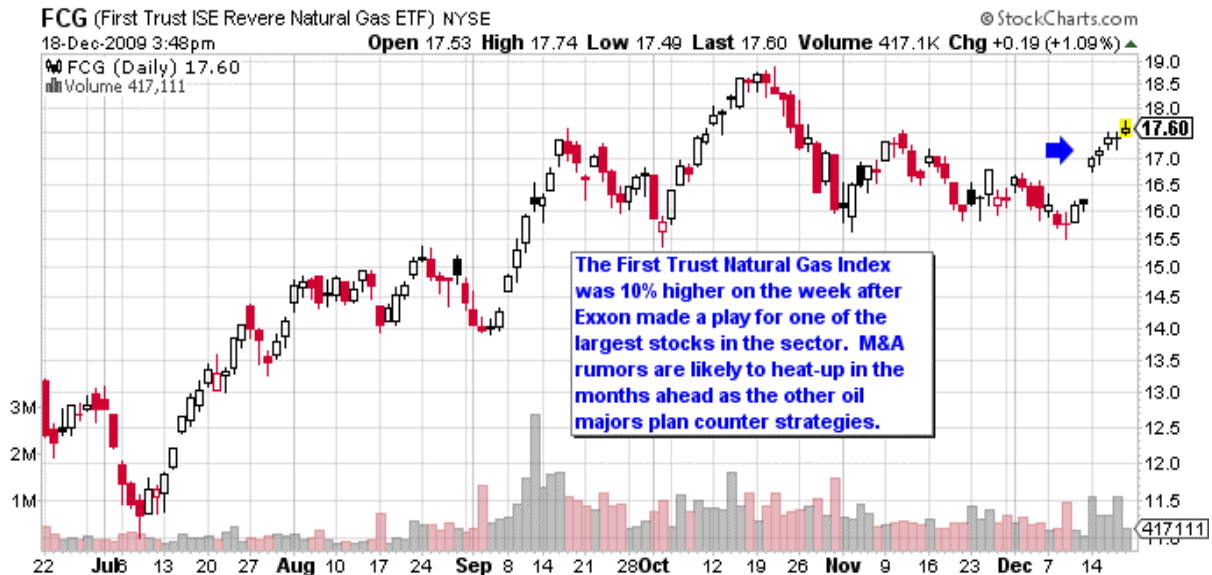
# The Starboard Side Report

The week ending December 18, 2009

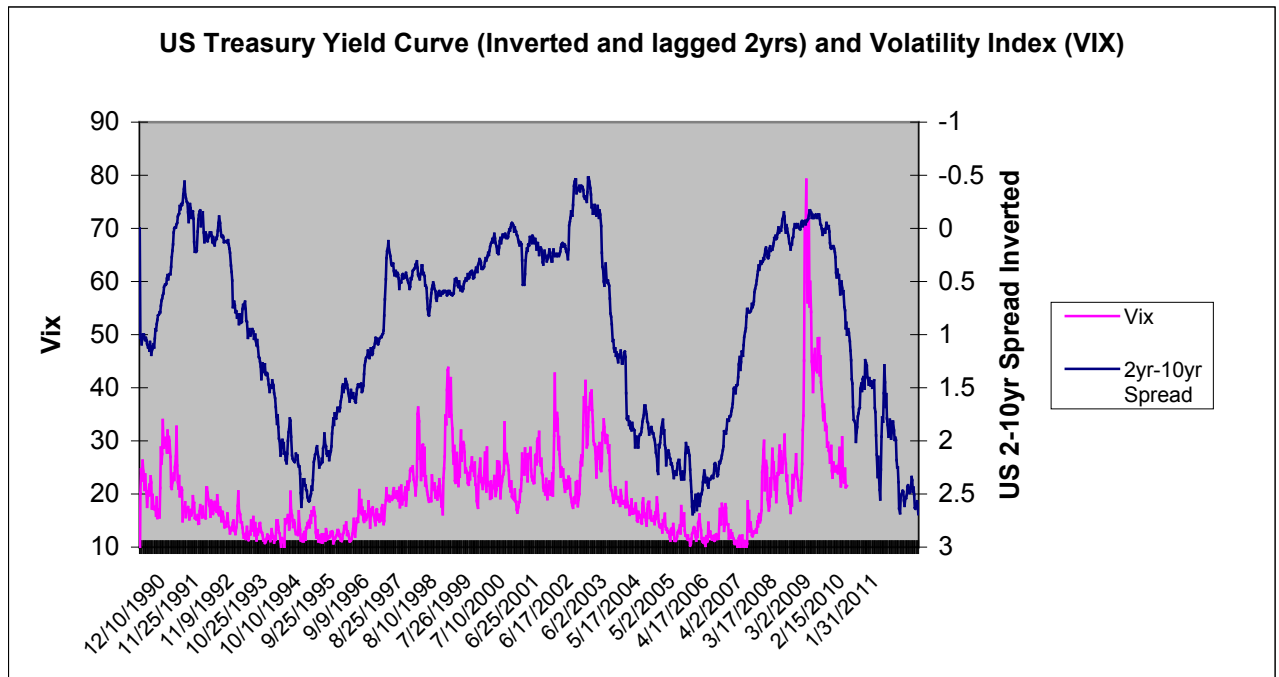
There has been no real change to the pattern we discussed last week. The S&P 500 is still facing serious resistance any time it climbs above the 1,110 level. As mentioned, we eventually see this stalemate breaking to the upside.



One of the big stories this week was Exxon's purchase of XTO Energy. This was a big deal from a company that has a history of allocating global capital very conservatively. It was essentially a \$40 billion bet on natural gas market and a recognition that the investment opportunities in the oil patch are few and far between. Natural gas prices and stocks both surged this week on the news. Below is a look at how the First Trust Natural Gas ETF.



In our weekly report dated 11-20-09, we analyzed how the steep yield curve between short and long-term interest rates was supportive of economic growth. In our opinion, the risk of a double dip recession next year is relatively low as long as the Federal Reserve keeps their foot on the gas pedal in the form of low short-term rates. This week we wanted to take this analysis one step further and show the effect the yield curve has on market volatility because it has been an excellent predictor of volatility trends.



The chart above shows the S&P 500 Volatility (known as the VIX) overlaid against the *inverted* spread between the 2yr and 10yr Treasury Bonds. This spread is then lagged by two years to illustrate the predictive power it has had over volatility during the past twenty years of activist central banking. The blue line yield curve leads the VIX both up and down. As you can see, the VIX has retreated significantly from its 80 reading last fall as the Federal Reserve has slashed rates. However, as the other two yield curve steepening cycles show, we may still have a way to go before volatility stops declining. Excess liquidity has driven the VIX down to 10 in the past two Fed easing cycles. While one could argue that this time is different due to the magnitude of this credit crisis, we need to keep in mind that the stimulus response was also unprecedented in its scale. So far, this recovery appears to be following a pretty similar script.

Just because this analysis points to volatility continuing to wane in the months ahead does not mean that we let our guard down and ignore managing risk. However, volatility still has room to compress from its record highs hit last fall. Should the world continue to lose confidence in the "magical" powers of central bankers and lose patience in financing enormous developed world fiscal deficits, this orderly picture could change in a hurry. The US Treasury is essentially running the US on low interest teaser rates, and any backlash by our creditors as this is rolled over to longer-dated paper could result in a big spike in long-term funding costs across the entire economy. We believe that these problems are ones that we will need to face, but a bit further down. The below chart of the VIX shows a pretty good set-up for markets in as we head into the New Year.

# S&P 500 Volatility Index (February 2009 - Present)

## Volatility Index - New Methodology (\$VIX) INDEX

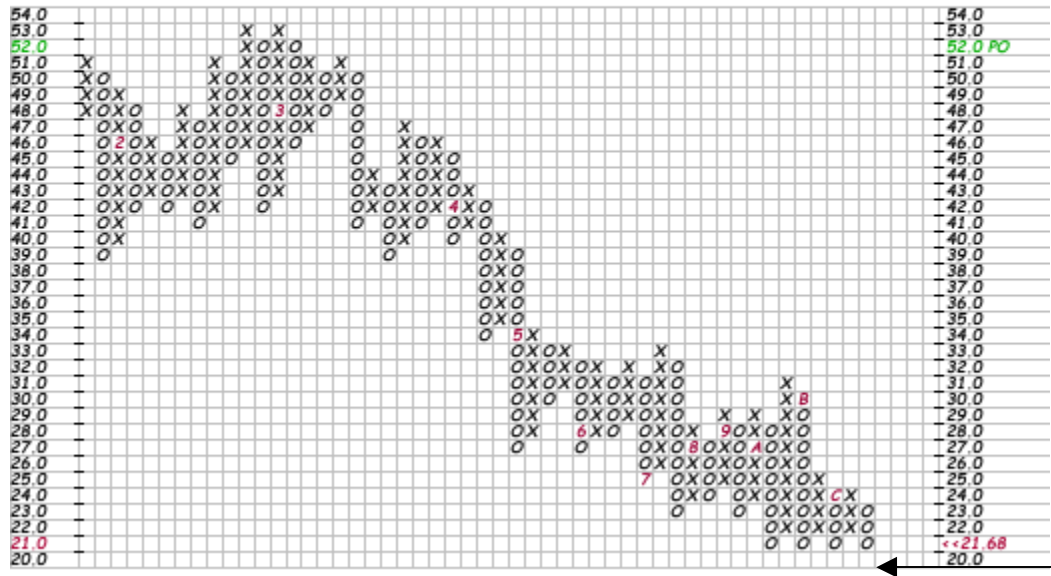
18-Dec-2009, 16:00 ET, daily, O: 21.84, H: 23.02, L: 21.68, C: 21.68, Chg: -0.83 (-3.69%)

No New P&F Pattern

Traditional, 3 box reversal chart

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Bullish Price Obj. (Rev.): 52.0



A move to \$20 would break a quadruple bottom and provide more evidence that volatility will continue to wane next year.