The Starboard Side Report

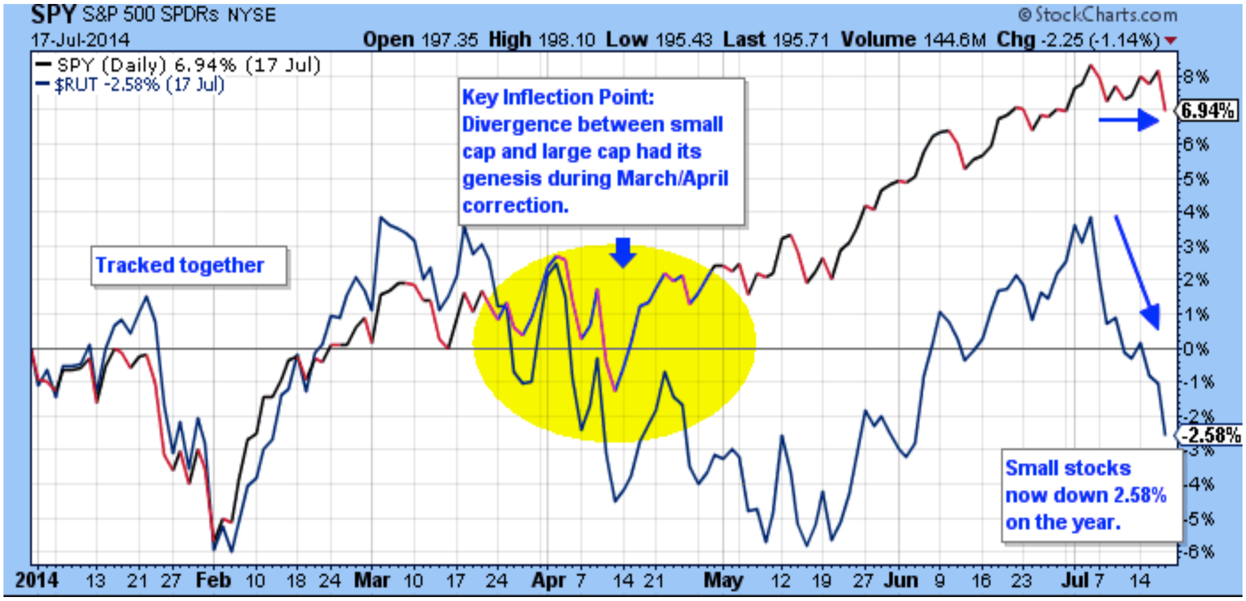
The week ending July 18, 2014

We have been harping on US Small Cap stock overvaluation for well over a year now and it's finally starting to look as if that reality is finally sinking in with the Wall Street Investment Community. As James Grant once said; "successful investing is having people agree with you…. later." Even Fed chair Janet Yellen gave a shout out to the overvaluation in the group this week in her semi-annual report to Congress. Every bear market has its overvalued asset class or sector that leads on the downside. In 2000, it was technology and large cap stocks leading the way lower. Of course, we all remember that financials were the big loser in the 2007-08 bear. When the next bear market hits, it may very well be small cap stocks leading the way on the downside given their extremely excessive overvaluation.

We did an interesting exercise this week that we wanted to share regarding the start of bear markets. Even though they sneak up on most investors, the signs of the bear are there under the surface well before they get underway in the broad market indexes. We will return to financial stocks in 2007 and compare them to small caps in 2014 to help show what me mean about reading signals from the market at tops.

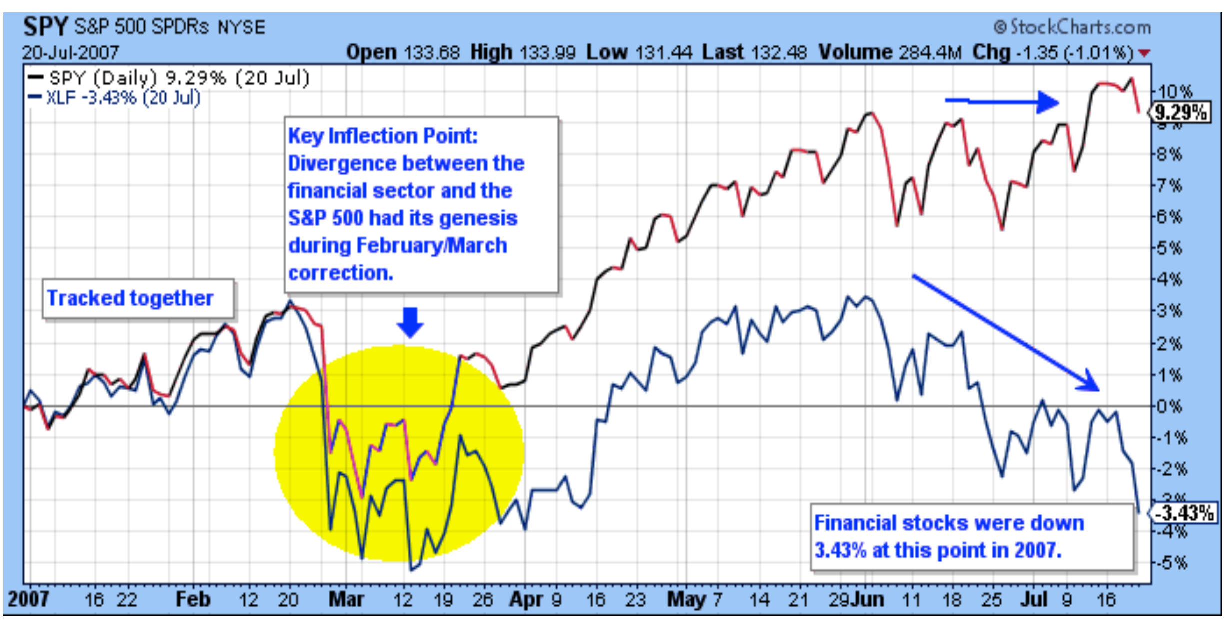
First up is a chart of the Russell 2000 Index year-to-date versus the S&P 500. The main takeaway from the chart below is to study the key inflection point that occurred during the March/April correction in the market. Up until that point the Russell and the S&P 500 were locked at the hip, as they normally are. However, notice that a funny thing happened during and after the corrective episode. The Russell 2000 went down more than the S&P 500 during the correction and has vastly underperformed the senior index since early March. This divergence is especially stark since July began with the S&P trading sideways and the Russell pretty much straight down. As you can see, the Russell is now down almost 3% year-to-date versus a gain of nearly 7% for the S&P 500.

S&P 500 Performance vs. Russell 2000 Performance (January 1, 2014 - July 17th 2014)



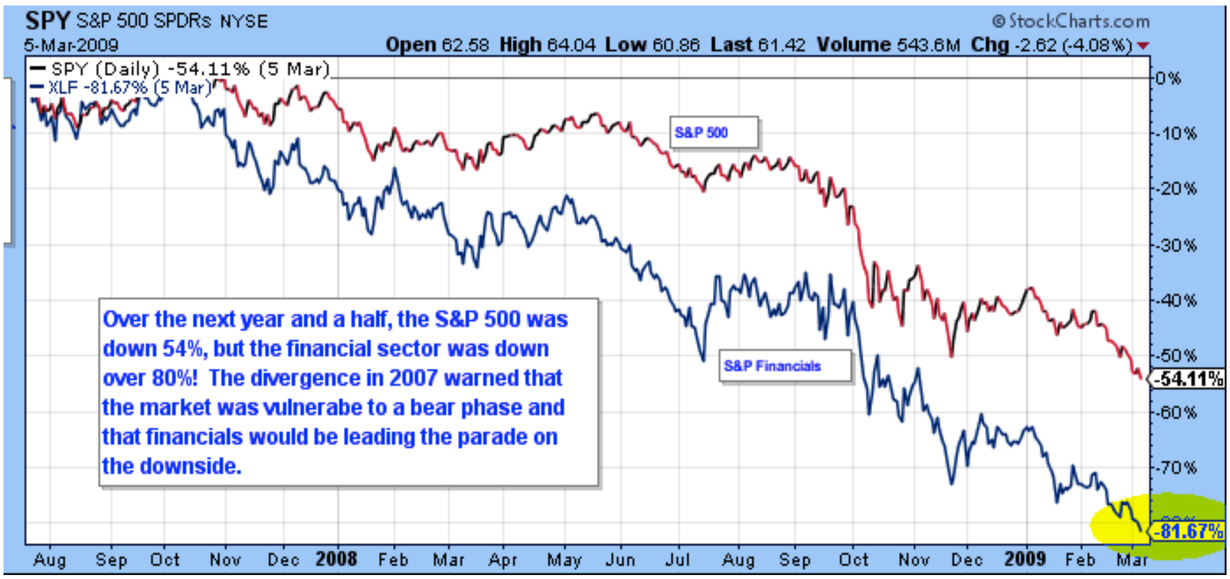
Next let's journey back to the first half of 2007 when the world was convinced that the subprime real estate problem was "contained." Even though that was the consensus of Wall Street pundits and the media, the market was telling us something very different as the chart below attests. Once again we had a key inflection point occurring during a February/March correction. Up until that point the financial sector and the S&P 500 were joined at the hip. However, notice that a funny thing also happened during and after this corrective episode in '07. The financial sector went down more than the S&P 500 during the correction and vastly underperformed the senior index into mid-July. As you can see, the financial index was down almost 3.4% versus a gain of nearly 9% for the S&P 500 at this same point in 2007.

S&P 500 Performance vs. S&P Financial Sector Performance (January 1, 2007 - July 20th 2007)



If one was paying attention through all the euphoric noise of the bull market top, the financial sector gave a loud and clear warning of the potential for a bear market. At 22% of the total market cap and over 50% of the profits of the market in 2007, the financial sector was the one most vulnerable to a bear market. The next chart below shows that identifying the key inflection point where financials diverged from the market helped prevent a lot of pain over the next year and a half. Should this current Russell 2000 divergence continue it might be issuing a similar warning of trouble ahead.

S&P 500 Performance vs. S&P Financial Sector Performance (July 20th 2007 – March 5th, 2009)

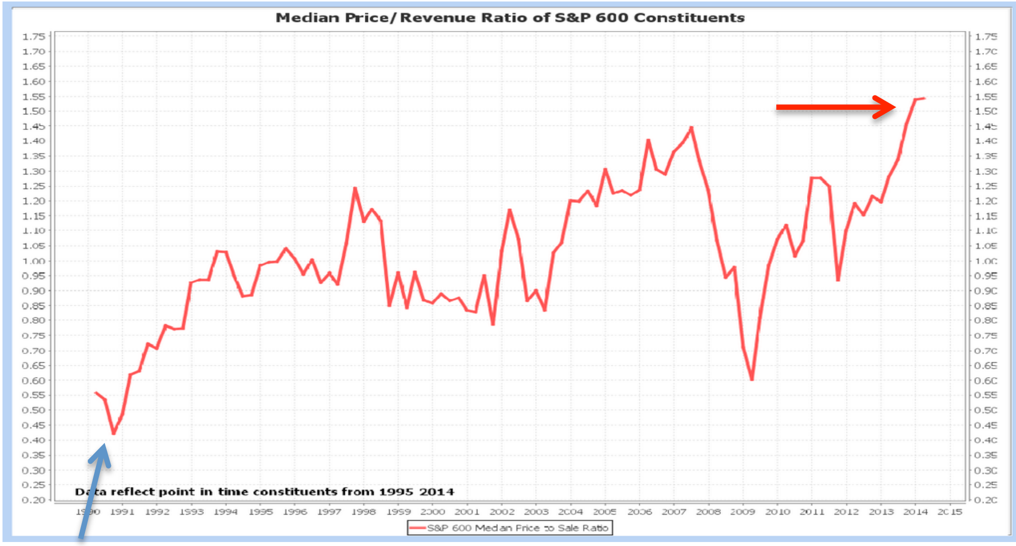


We can now see why it is so important that the small cap segment of the market has started to diverge from the rest S&P 500 benchmark index. It is far and away the most overvalued pocket of the market and the one area that we believe will be the leading asset class of the next cyclical bear.

Although we have covered this extensively over past reports, we have decided to show a chart montage of why the small caps are expensive and hence most vulnerable. Just because the S&P 500 Index is still near its all-time high is no reason to abandon the crusade to warn of the dangers of small caps, just as we kept pounding the table on the dangers of banking stocks going into the 2007 top.

At 1.55 times revenues, the median small cap is now trading at an all-time high valuation that is 100% more expensive than in 2000 and 7% pricier than the 2007 market top. To illustrate how far this ratio has come, the median small cap stock in the S&P 600 traded at just 0.40 times revenues in 1990; a 75% discount to today's lofty valuation levels.

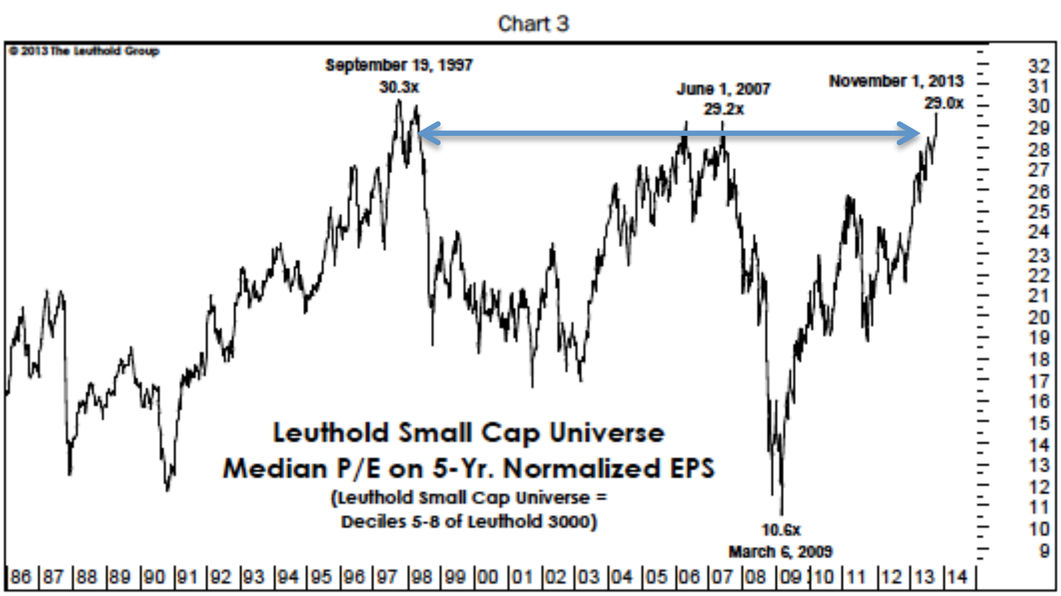
Median Price/Revenue Ratio of S&P 600 Constituents (1990 – Present)



0.40 times sales in 1990 Source: Bill Hester Hussman Funds

The next chart from the Leuthold Group was produced in the fourth quarter of 2013, but is very instructive as to why the small segment of the market has started to underperform. A bear market in small caps began within months of reaching the same valuations we observed in small caps late last year. 30 times 5-year normalized earnings per share seems to be the magic number where the market refuses to pay more for small stocks. The decline of the Russell 2000 Index in those prior overvaluation episodes cited was 38% and 60%.

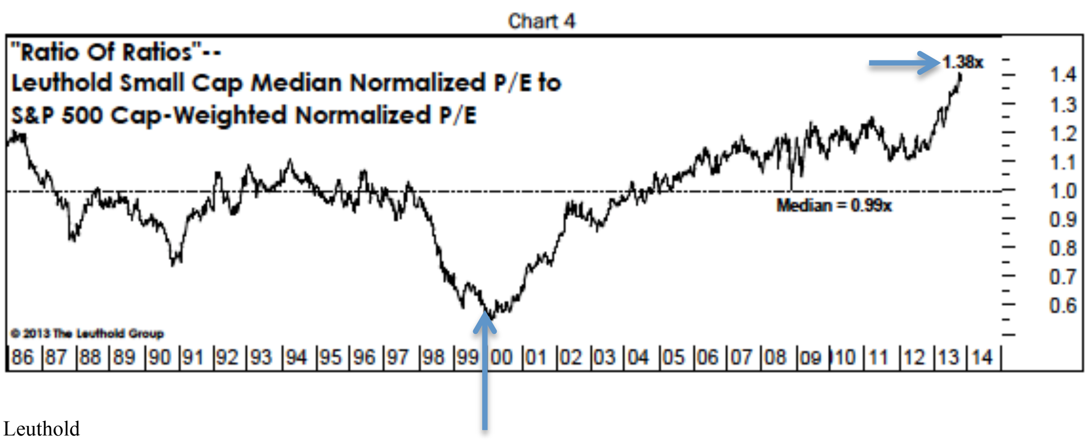
Median 5-year Normalized P/E on Small Cap Stocks (1986 – 2013)



Source: Leuthold

Given that the 38% premium to large caps is the most extreme on record as per the next chart below, we have the potential for an even greater dislocation in the small cap market than the prior two valuation peaks. As we discussed in our May 30th weekly report, the next bear market has the potential to be the polar opposite of the 2000 – 2003 bear in which small caps held up much better than the large stock segment. The reason that this occurred was due to valuation discrepancy of a contrasting nature; namely, small stocks traded at a 40% discount to large caps at that point in time. What a difference 14 years makes!

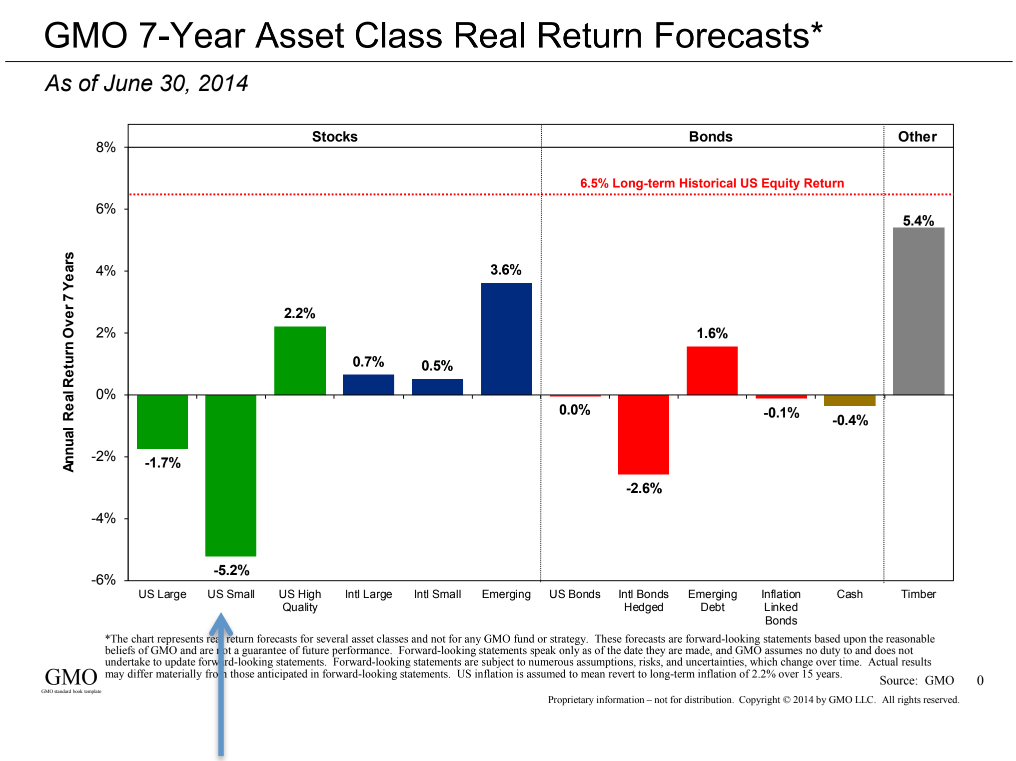
Small Cap Median P/E to S&P 500 Large Cap Weighted P/E Ratio (1986 – 2013)



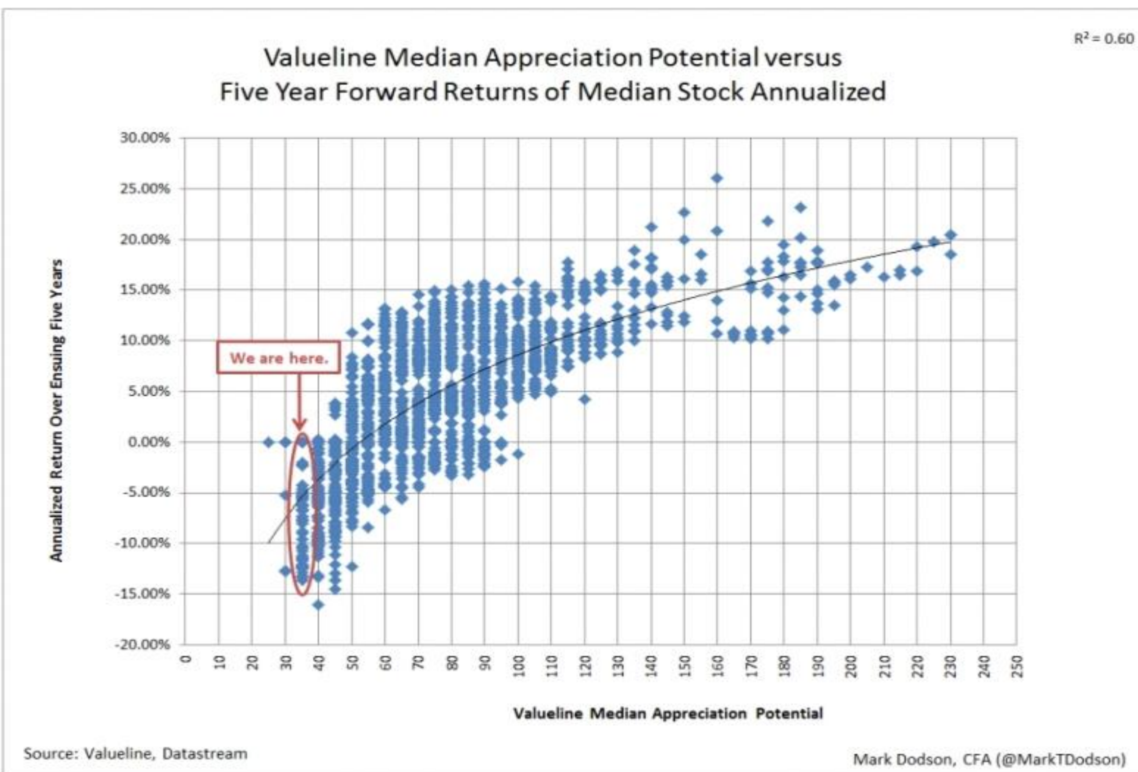
Source: Leuthold

Small caps at 40% discount to large at 2000 top.

Next we see a familiar chart from the sharp minds at GMO. The arrow at the bottom shows GMO projecting US small stocks to return negative 5% after inflation. I realize that zero percent money market funds are frustrating, but why take the risk in US stocks at these projected returns.



Finally, here is a scatter plot graph from Mark Dodson that does a great job of illustrating the poor return prospects that the market faces over the next five years. Value Line (a very well respected independent investment research firm) publishes the median 5-year price appreciation potential of all 1,700 stocks they cover in what's known as the Value Line Median Appreciation Potential (VLMAP). While it looks complex, the graph is actually a very simple look at the Value Line Median Appreciation Potential (VLMAP). This figure has had some pretty good "predictive power" and helps estimate how much value a wide universe of US stocks has to offer the long-term investor. The x-axis is the VLAMP at any given time and the y-axis is the actual level of 5-year annualized return of the median stock from that level of predicted return. Said another way, this data captures every rolling five-year period of performance since 1969 and tells us what the VLAMP was at the start of that five-year period. This indicator is screaming caution because the median stock in the US market has **never** produced positive annualized returns for investors from these overvalued levels (as shown by the red circle). This is just another data point that backs up the poor return prospects of the average stock in the market.



Mark Dodson, CFA

"Valueline Median Appreciation Potential implies best case scenario of 0% annual return for average stock over the next five yrs."

In conclusion, once one determines the most overvalued and vulnerable area of a given bull cycle it becomes essential to search for the point in time when that asset in question starts to meaningfully diverge from the S&P 500 Index. We believe that small caps stocks in the US are the area that will be the leading loser on the downside given the valuation concerns we spell out above. Furthermore, the small cap divergence that has developed since March is a major red flag that the next bear market may be fast approaching. Much as celebrating bulls ignored the warnings from financial stocks in 2007, those that are ignoring the message from small cap stocks at present are doing so at their own peril.