# The Starboard Side Report

**The week ending July 25, 2014**

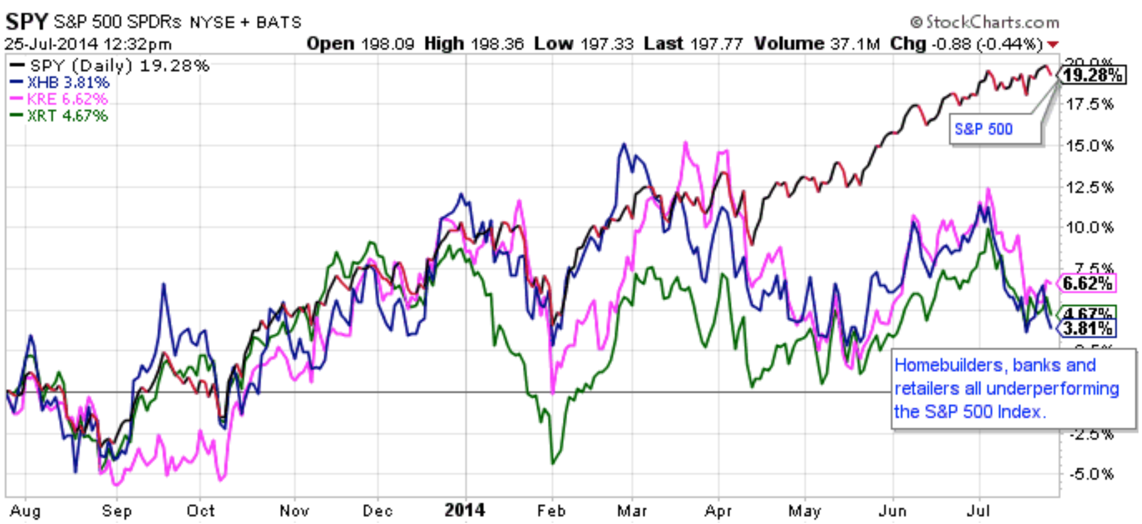
The interest sensitive sectors of the US economy are still being affected by last years big interest rate spike. Homebuilding, retailing and regional banks are the lifeblood of the debt and consumer centric US economy. The trap that the post-financial crisis market finds itself in is that when interest rates rise too much, this core part of the economy appears to seize-up. The faster we solve the debt overhang by removing entrenched financial special interests and abandoning the policy of trying to solve a debt crisis with more debt, the quicker the economy will be allowed to heal and reinvent itself. Until then, we expect this structural trap to continue. The homebuilding sector, the retail sector and the banking sector have all been very weak since last summer when measured on a relative basis to the S&P 500. The four charts below spell this out pretty clearly.

Retail vs. S&P 500 (1year chart)


Regional Banks vs. S&P 500 (1year chart)

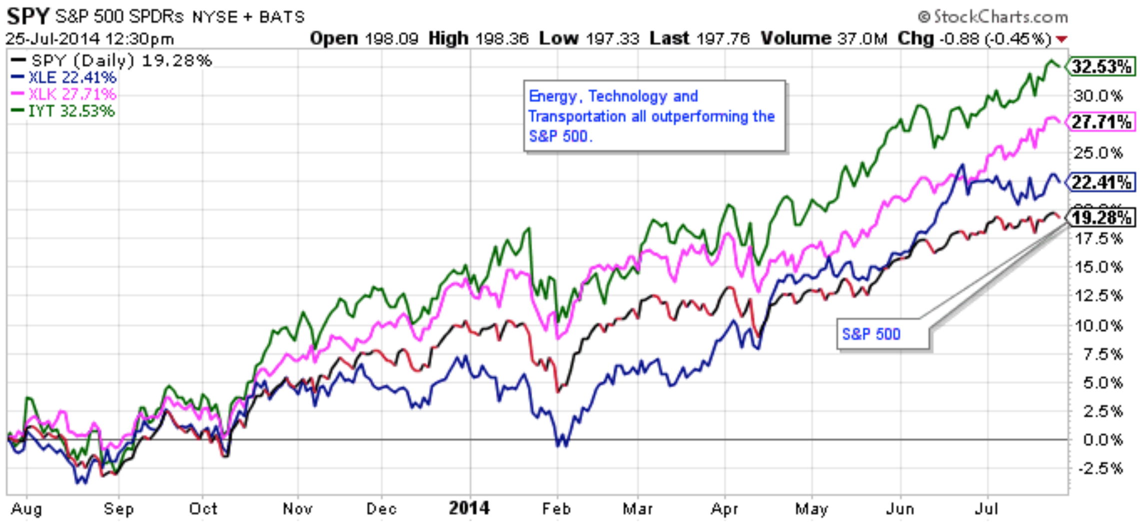
Homebuilders vs. S&P 500 (1year chart)


Price Performance Comparison (S&P 500 vs. Homebuilders, Banks and Retail)



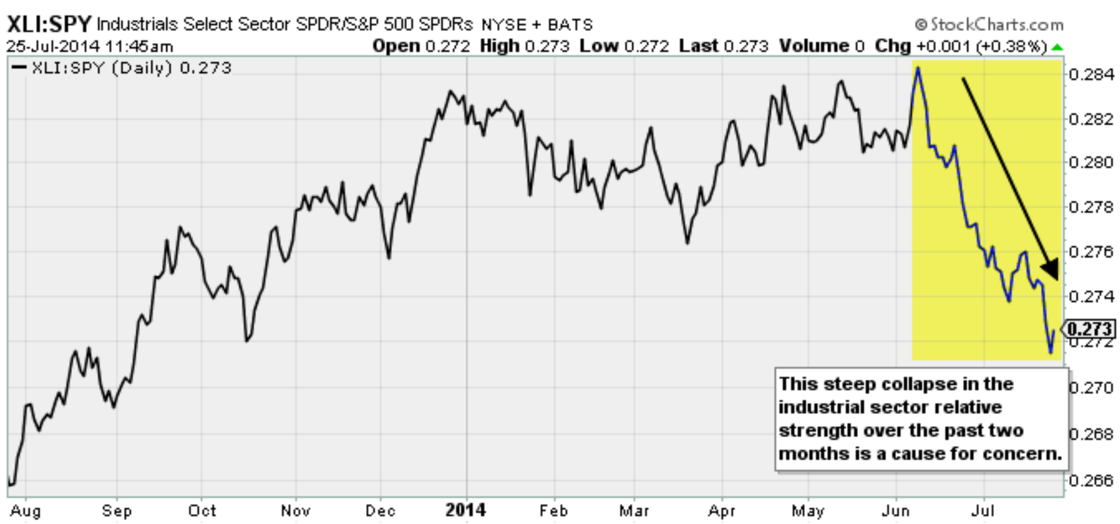

The heavy lifting in the S&P 500 since March of this year has been done by three sectors; energy, technology and transportation. The next chart below shows all three sectors gaining more than the market over the past year.

Price Performance Comparison  (S&P 500 vs. Energy, Technology and Transportation)




Industrial stocks had been part of the party, but have suffered a big deflation since early June. The chart below highlights in yellow the collapse of industrial stocks of late. The fact that the industrial sector is rolling over is cause for concern and could mean the weakness in the interest sensitive sectors is starting to spread.

Industrial Sector vs. S&P 500 (1year chart)



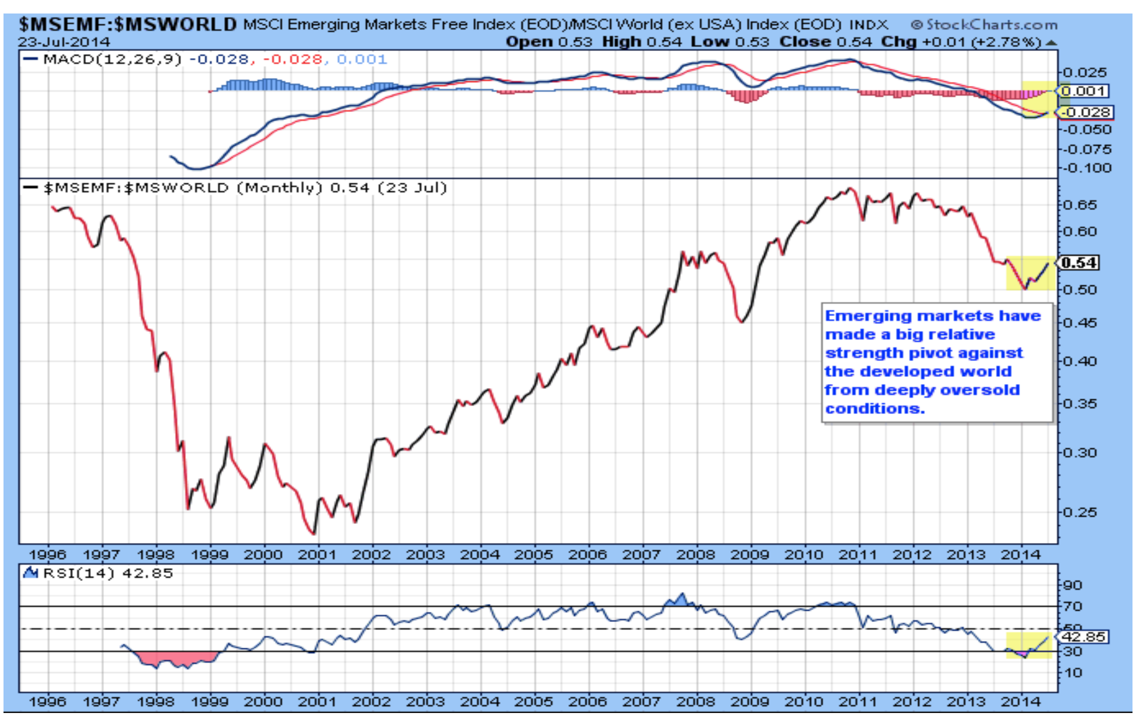

The other big shifting wind on our radar screen is the *broad based* relative strength we are seeing in the emerging world for the first time since 2011. It appears to us as if too many investors have piled onto the same side of the boat when it comes to the developed world. Over the past three years, investors have shunned emerging markets in favor of US, Japan and Europe. Those developed regions of the world have been the prime beneficiaries of central banks quantitative easing, as the next chart below helps illustrate.

**Price Performance Comparison**

**(S&P 500, Germany and Japan vs. Emerging Market Index, China and Brazil)**


QE has disproportionately found its way into the stock markets of the developed world with Germany, Japan and the US all up over 40% since the start of 2011. The emerging world's performance has been negative over this same span! But, a funny thing has started to happen over the past six months. We are starting to see a big pivot back towards emerging markets. The next chart below is a ratio chart of the emerging markets versus the developed world (excluding the US). We have highlighted in yellow where the monthly long-term chart shows a clear reversal in favor of the emerging world. This pivot higher for emerging market stocks is occurring at deeply oversold momentum levels (also highlighted in yellow).

**MSCI Emerging Index vs. MSCI Developed World Index (Ex-US) since 1996**



The final chart that caught our eye while conducting this analysis was the very nice breakout in the long-term price chart of the S&P Emerging Asia Pacific Fund. A backtest of the breakout line (about a 10% correction from here) would be a common occurrence that could play out this summer as seasonal weakness approaches. That would be an attractive entry point, should the test be successful.

**S&P Emerging Asia Pacific Fund (7-year Price Trend Chart)**


What we tried to show this week is that there are some significant changes taking place beneath the surface of the market, if you dig a little deeper. Something is not right with the consumption engine of US growth. The charts are pointing to the US consumer being tapped out. At the same time, the pool of liquidity that has been created by central bankers seems to be starting to herd away from some of the developed stock markets that have done so well over the past three years and towards the more beaten down/attractively valued areas in the emerging world. After a long painful three years for emerging market investors, we are finally starting to see some green shoots of spring in this asset class that has very exciting long-term growth potential. The final chart we will leave you with is one of emerging markets since the turn of the century. As mentioned in the chart, even with the three-year slowdown, this group has more than doubled the big three developed markets of US, Germany and Japan. Going forward, we see more value and better growth prospects as the millions of emerging world citizens continue to try and make a western middle class life for themselves.

**Long-term** Price Performance Comparison since 2000

(S&P 500, Germany and Japan vs. Emerging Market Index)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