The Starboard Side Report

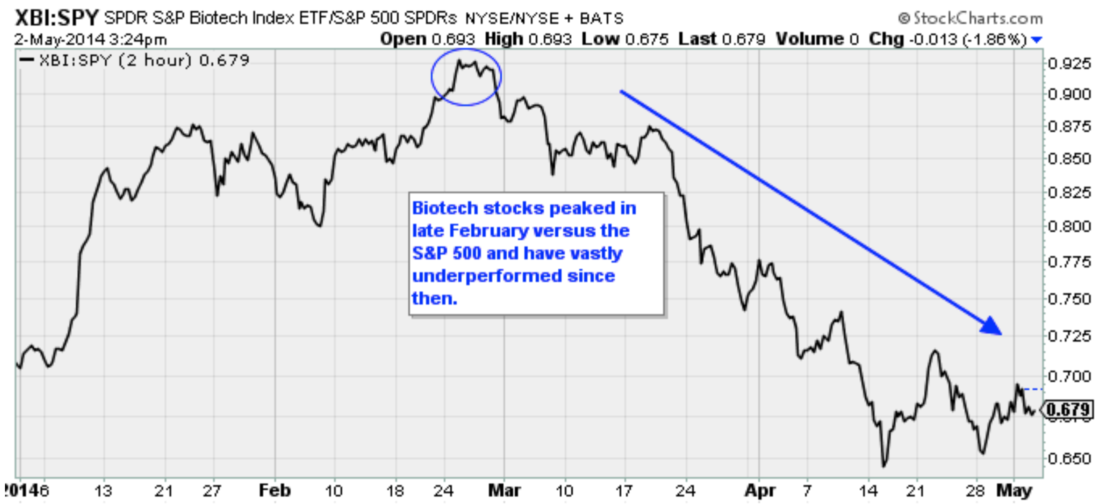
The week ending May 2, 2014

2014 continues to present some interesting divergences in those areas that had been the leaders of the market since the last big correction in 2011. 1) Housing and retail were joined at the hip on the upside move as sub 4% mortgage rates and cheap commodity prices launched a nice up cycle in real estate and consumer spending. 2) Another strong area of leadership off the October 2011 low came from the technology sector; specifically biotechnology and a new wave of internet stocks in the social media and web services space. 3) Finally, small cap stocks were a leadership area as investors chased the riskiest stocks in 2013. However, since early March it has been a relative meltdown in small cap versus the S&P 500   Let's take a look at the relative strength charts to see the deterioration in these key areas if the market. All of these charts that follow are year-to-date 2014 and all except the last three commodity price charts are relative strength charts versus the S&P 500 Index.

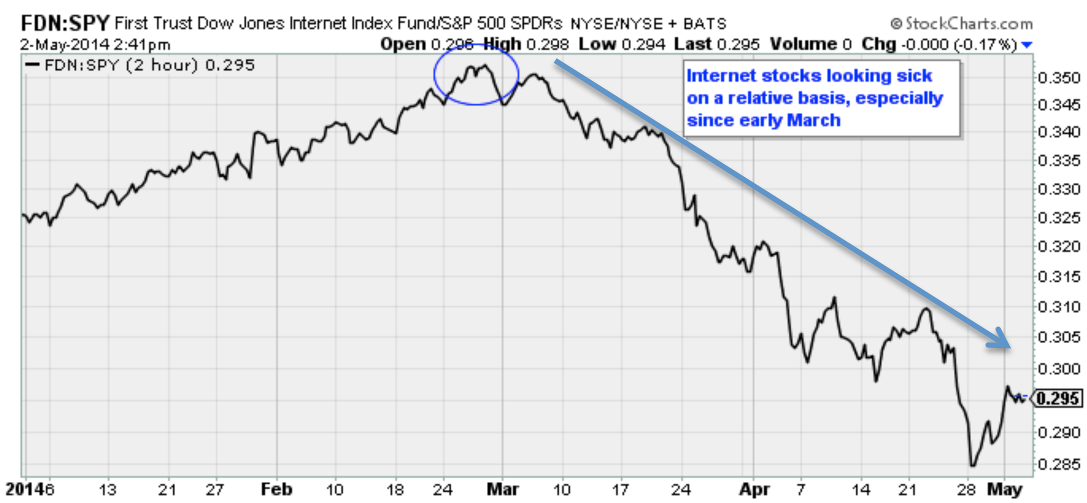
Homebuilding Sector vs. S&P 500

Retail Sector vs. S&P 500

Biotechnology Sector vs. S&P 500



Internet Sector vs. S&P 500

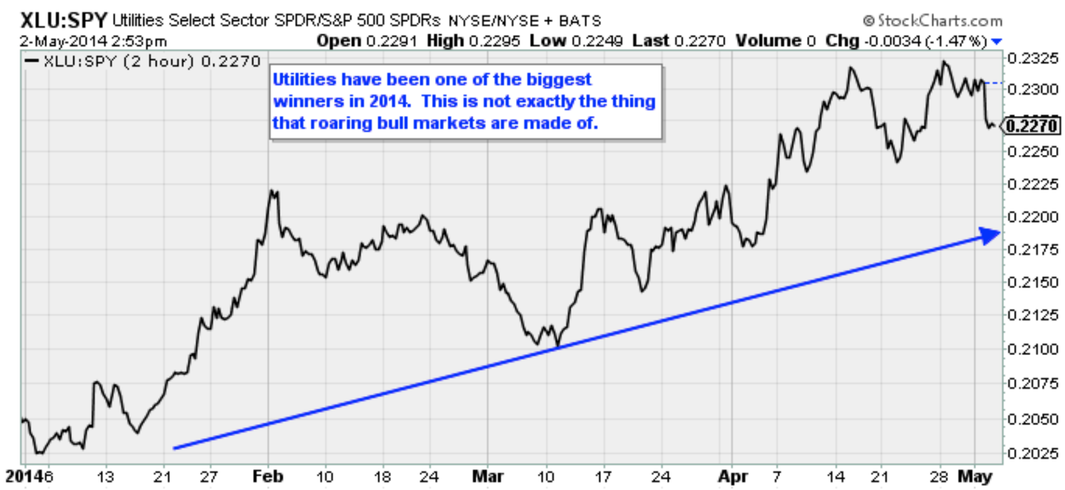


Small Cap Stocks vs. S&P 500

Portfolio managers that have a mandate to be invested are acting scared by hiding out in late stage cyclical sectors like energy or much less economically sensitive sectors like utilities and consumer staples. Below we show the rotation that has been taking place underneath the surface of the market even though the major indexes are trading near their all time highs.

Energy Sector vs. S&P 500

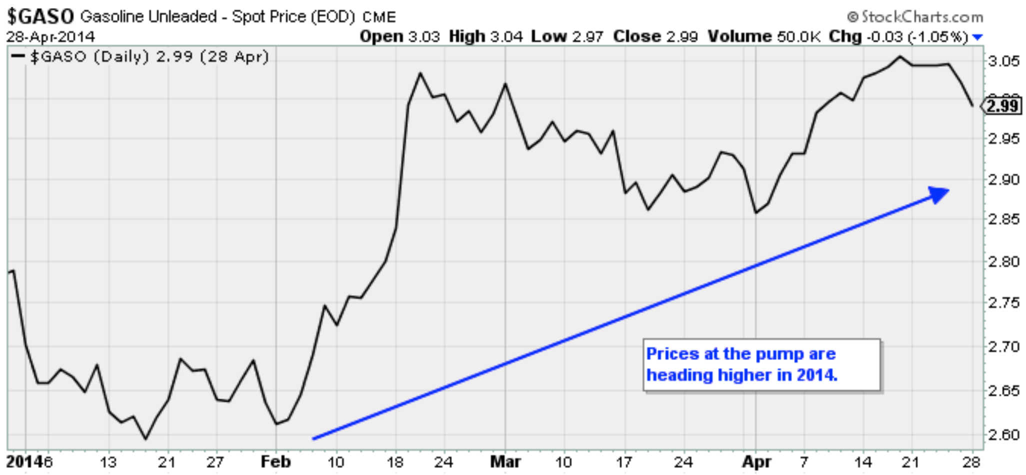
Utility Sector vs. S&P 500



Consumer Staple Sector vs. S&P 500

One of the things that could be hurting consumer spending is the big spike we have seen in everyday essential items like gasoline and food. The three-pack of charts below illustrate what consumers are up against as their cost of living rises.

Unleaded Gasoline Futures



Agricultural Prices

Livestock Prices

We think that the huge spike in interest rates last summer put the wheels in motion for an economic slowdown that is playing out in the market before our very eyes. The media is blaming the winter weather, but we feel that this slow patch was born when rates across the yield curve exploded higher between last May and September. Recent gains in essential food and energy commodities are now exacerbating the slowdown. Last week we discussed that the strong gains in long duration Treasury bond prices (decline in yields) since the beginning of the year may be signaling that the economy is slowing down faster than conventional wisdom would have us believe. The massive rotation out of multi-year leadership sectors *and* the more cyclical growth areas of the market into more defensive and late cycle plays only echoes that concern. Whether or not this price action is signaling a full-blown recession and new equity bear market will only be known in hindsight. However, beneath the surface of the market, we are definitely getting strong signals that 2014 is going to be very different and more challenging for US stock investors than the last couple of years have been.