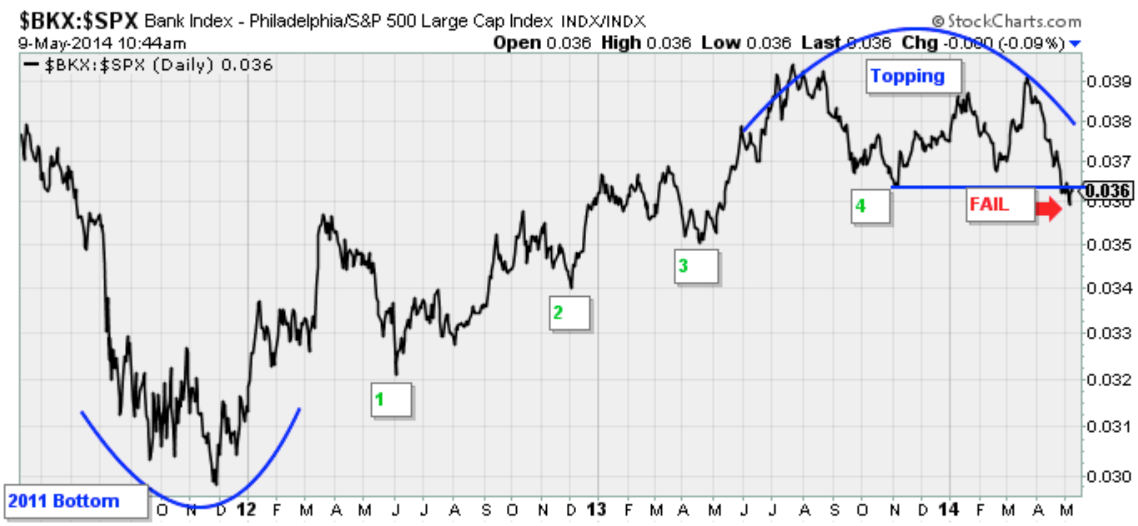
The Starboard Side Report

The week ending May 9, 2014

One of the key groups that we left out of last week's report about sector rotation was the financials. As you can see from the below relative strength chart, the picture is not a very pretty one and it is yet another sign that the drivers of economic growth since 2011 have run into some serious headwinds during the first half of 2014. First housing, then retail and now the banks are showing a potential end to the mini-housing up cycle that developed off of the 2011 bottom. Again, we think the interest rate shock last year is still working its way through the system and it appears to have inflicted damage on an overleveraged and housing reliant economy.

KBW Bank Index vs. S&P 500 since May 2011



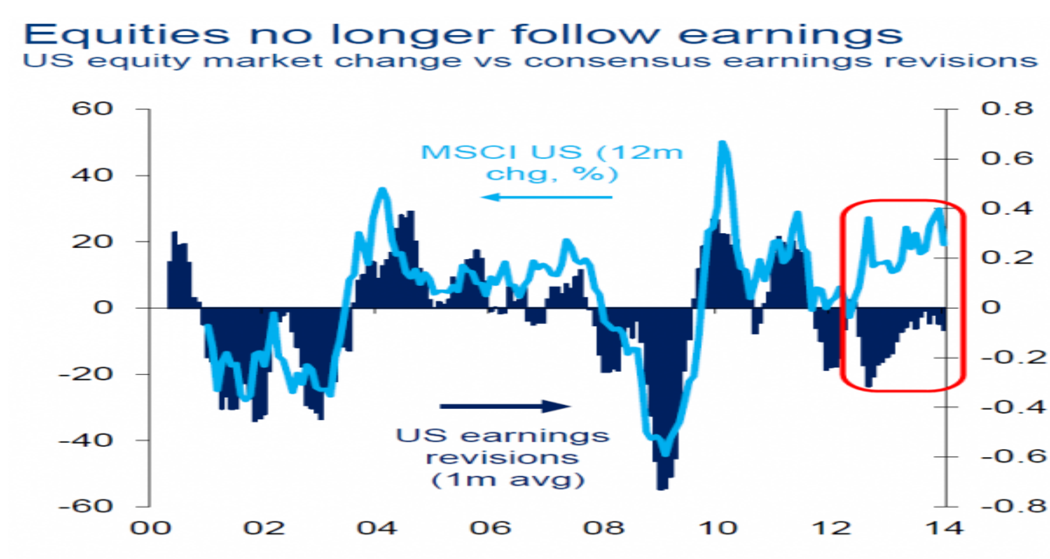
The chronology of the chart above shows a major bottom in the fall of 2011, a successive run of four "higher-lows" throughout 2012 and 2013 as housing recovered, a topping process that began after rates spiked last summer and now the failure of the trend with a breakdown below the February low (red arrow). Loss of leadership from the financial sector is a big red flag that often portends trouble ahead for the markets.

This week we wanted to show an updated *big picture* of the Russell 2000 Small Cap Index. As we discuss in the chart below, price is starting to noticeably fail at the top of the long-term trend channel with long-term support over 60% below current levels. At the same time we are seeing this deterioration, we are also getting the type of momentum rollover that has been witnessed at prior peaks over the past two decades (bottom pane of the chart). According to FBN Securities, the average stock in the Russell 2000 Index is down more than 22% from its 52-week high! This confirms that price action is not healthy under the surface. The three prior Russell 2000 decline episodes in 1998, 2000 and 2007 averaged a loss of 47%, so risk levels are high.

Russell 2000 Small Cap Index (1994 – Present)

Now that we have spent the past few weeks laying out the weakening technical framework of the market, we wanted to look at the big picture fundamentals. As we will show, the valuations of the US market corroborate the fact that risk levels are high.

The first chart from Citi Research illustrates how a huge disconnect has formed whereby the market has been able to climb sharply higher in the face of a persistently weak earnings picture. The light blue line shows the 12-month percent change of the MSCI US Index. The dark blue area graph is the 1-month average of Wall Street analyst earnings revisions. This huge gap is not normal behavior and it illustrates how the majority of market gains since the 2011 bottom have been driven by momentum/valuation expansion and not earnings growth.

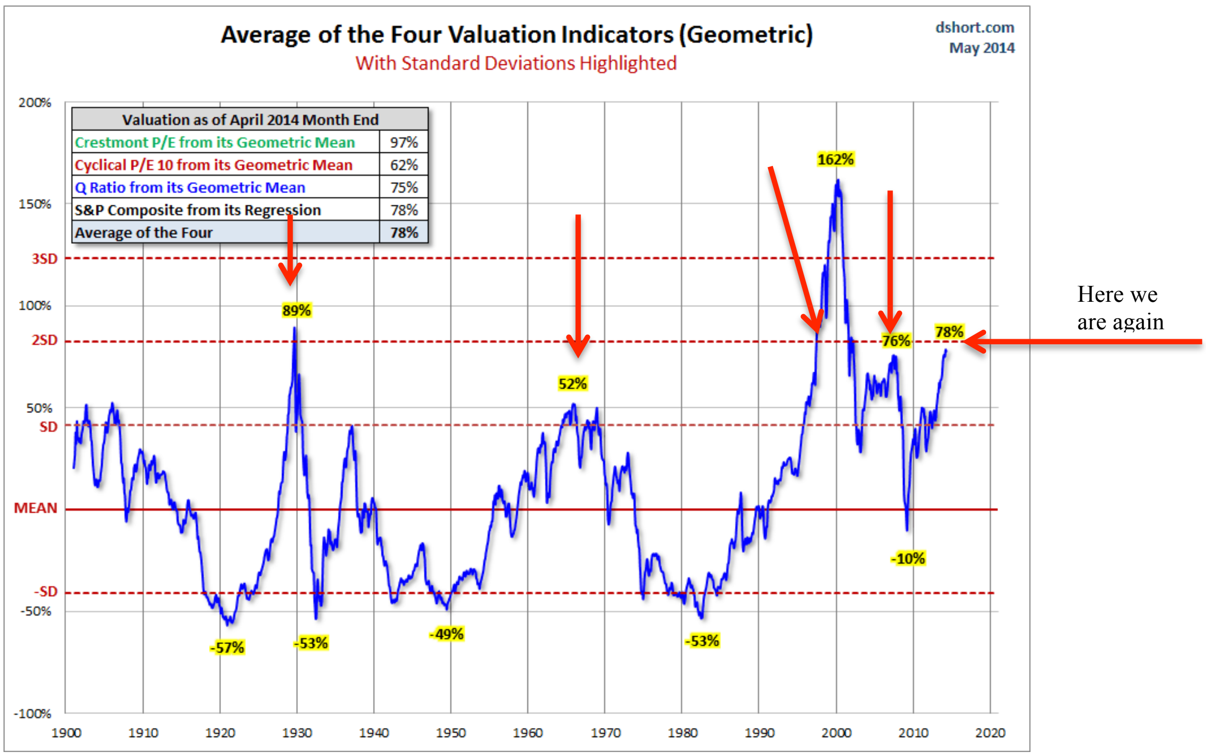


Source: Citi Research

With that in mind, let's see how this valuation expansion has led us to a market that is now back to one of its most expensive levels in history. Additionally, we'll show what has happened over the subsequent ten years after the market has gotten to similar extreme valuation heights.

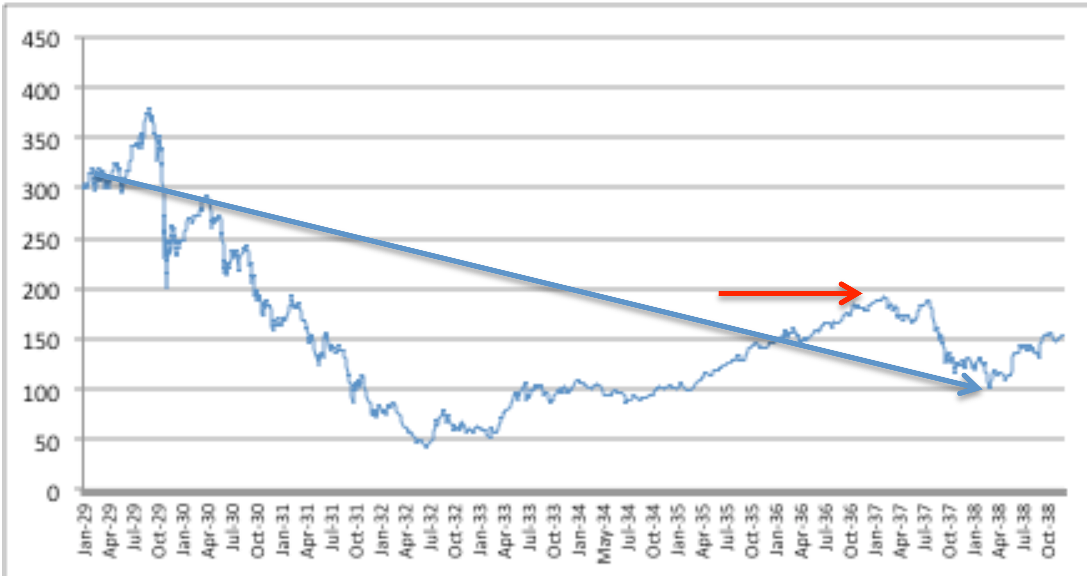
First is a chart from Doug Short of Advisor Perspectives that shows the average of four different US market valuation measurements going back to 1900 and how far they are from their long-term mean. This diverse mix of variables includes cyclically adjusted price to earnings (smoothed over 10 years), corporate balance sheet assets versus market value and deviation from long-term trend. As of the end of April, the S&P Composite Index was on average 78% above what would be considered historical fair value!

Distance of Key US Valuation Indicators from their Mean (1900 – Present)

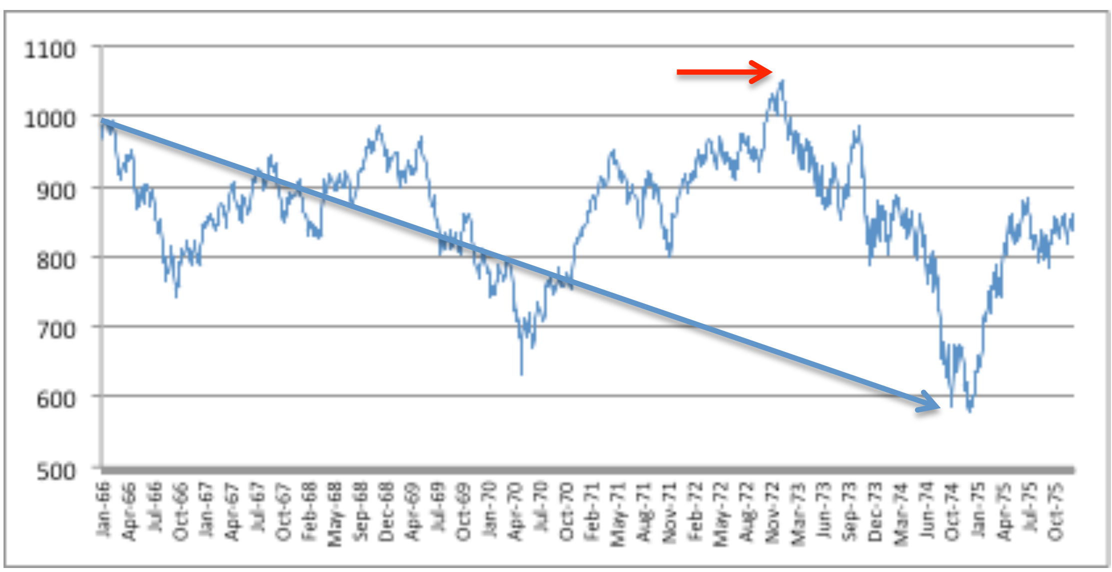


1929, 1966, 1998 and 2007 are the four other times in 114 year of history that the market has been this overextended based on these metrics (see red arrows). What follows next is a chart montage of the Dow Jones Industrial Average in the 10 years that followed those other points in time. If you are betting on additional market gains in the US market from here, you are betting on a repeat of the once in a generation bubble top that occurred in late 1999 and early 2000. The other three episodes were much quicker to enter bear markets. History has proven time and time again that high valuations lead to low future returns (due to bear markets).

1) Dow Jones Industrial Average (1929 – 1939)



2) Dow Jones Industrial Average (1966 – 1976)



3) Dow Jones Industrial Average (1998 – 2008)

4) Dow Jones Industrial 2007 – Present

(Now Seven Years into 10-year 2007 Overvaluation Cycle)

Valuation history puts the Dow between 6,000 and 12,000 between now and 2017.

All of these episodes show that prospective returns are extremely poor from current valuations and that investors should not be surprised if the Dow Jones Industrial Average is still at these same levels ten years from now. Furthermore, we are only seven years removed from the 2007 overvaluation episode and yet we find ourselves right back at another overvaluation peak. The red arrows in the Dow charts above show that 1937, 1973 and 2007 were points in the respective 10-year cycles where another valuation peak occurred following a huge mid-cycle rally. The Dow lost nearly 50% at some point during years seven through ten in all three instances. The long blue arrows signify where each ten-year overvaluation cycle eventually bottomed during the final three years of the ten-year cycle. Using those as a guide in the fourth chart, we could see the Dow anywhere between 30-65% lower by the end of 2016. That would equate to a price level of between 6,000 and 12,000 versus 16,500 at present.

The reason investors are throwing caution to the wind and ignoring such extreme risk is due to the main narrative that has infected the market since 2009. One of the foremost experts on market narratives is Ben Hunt, Chief Risk Officer of Epsilon Partners. In simple terms he defines narrative as "a set of widely held beliefs about *what everyone thinks that everyone thinks* (in game theoretic terms, "common knowledge") created by very public statements by very public people." Narratives are dangerous because they suck in unsuspecting participants and drive markets to excessive extremes.

In the late 1990's, the narrative focused on the "new economy" that was revolutionizing the world. This enthusiasm for a new world order drove technology stocks into the stratosphere and created one of the biggest bubbles in the history of financial markets. In the depths of the 2000 – 2002 bear market that followed the tech collapse, a new narrative was born. This one preached that stocks were a sucker's game and that something more tangible (houses) was the surefire way to long-term riches. After all, housing prices had never declined on a year-over-year basis and what could be better than an asset that was guaranteed to never decline in price. Well, we all know how that worked in the end. That takes us to the present day. We feel that the current narrative that has driven stocks to dangerous levels is an undying belief that the Federal Reserve will be able to prevent markets from going down and that everything that happens in the markets is the result of divine intervention on the part of Central Bankers. Hunt refers to this as *The Narrative of Central Bank Omnipotence.* We have heard numerous times from clients that "there is no way THEY are going to let this thing decline." This is the power of a narrative: yet, we believe that this time is NOT different and this narrative will eventually change and take the market down with it; as has happened throughout history.

In conclusion, both the near-term technical analysis of the market and long-term valuation studies seem to be indicating that the Federal Reserve omnipotence narrative is running out of runway. A narrative shift is often a very volatile time for markets. Studying charts is a great way to determine inflection points in these long standing narratives. Most importantly, when the shift occurs at record high valuations, as we are seeing at present, the subsequent losses in the assets that have benefited most from the prior narrative are often devastating. We remain extremely risk adverse at present valuation levels, seven years from the 2007 valuation peak and five years into a long-term narrative that appears to be on the verge of shifting. Additionally, we are overweight those asset classes that stand to benefit the most from a loss of belief in the Fed omnipotence narrative and hedged against losses in the assets most leveraged to its unwinding.