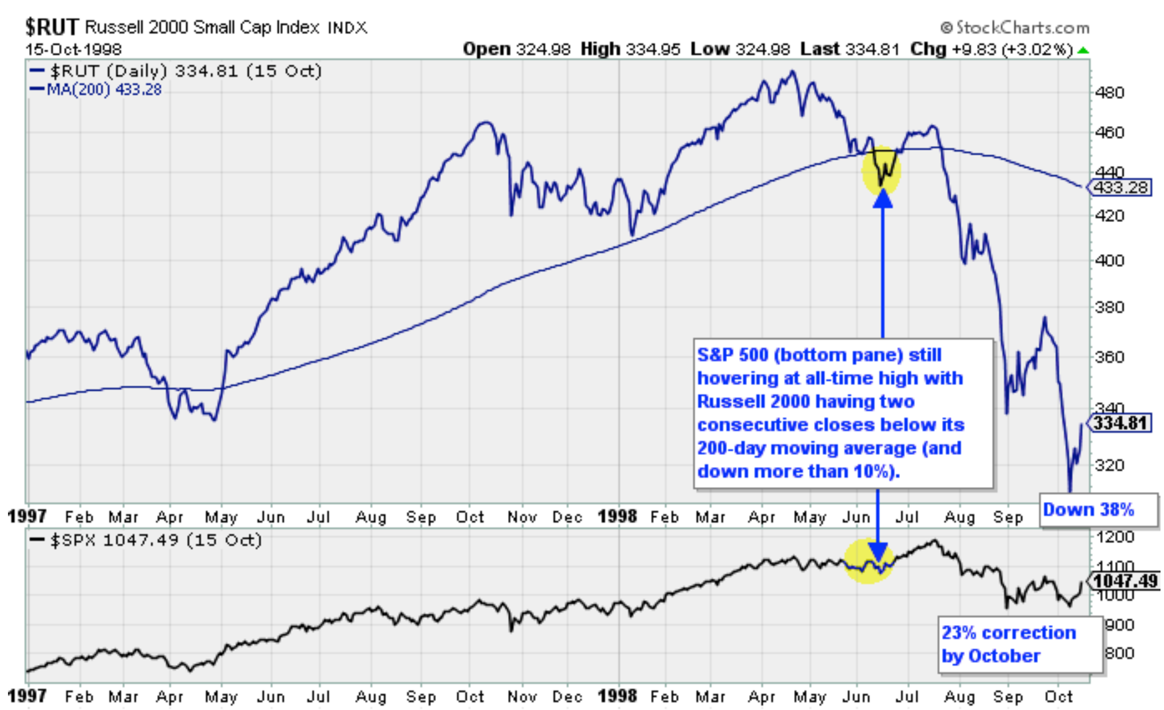
The Starboard Side Report

The week ending May 16, 2014

An interesting exercise that we like carry out every now and again is to try and match the trading patterns of the current year with a similar year from the past. While not an exact science by any means, it can be helpful in providing a baseline template from which to work. With that said, the year that 2014 reminds us of the most is 1998. There are several interesting parallels that we will try to spell out here.

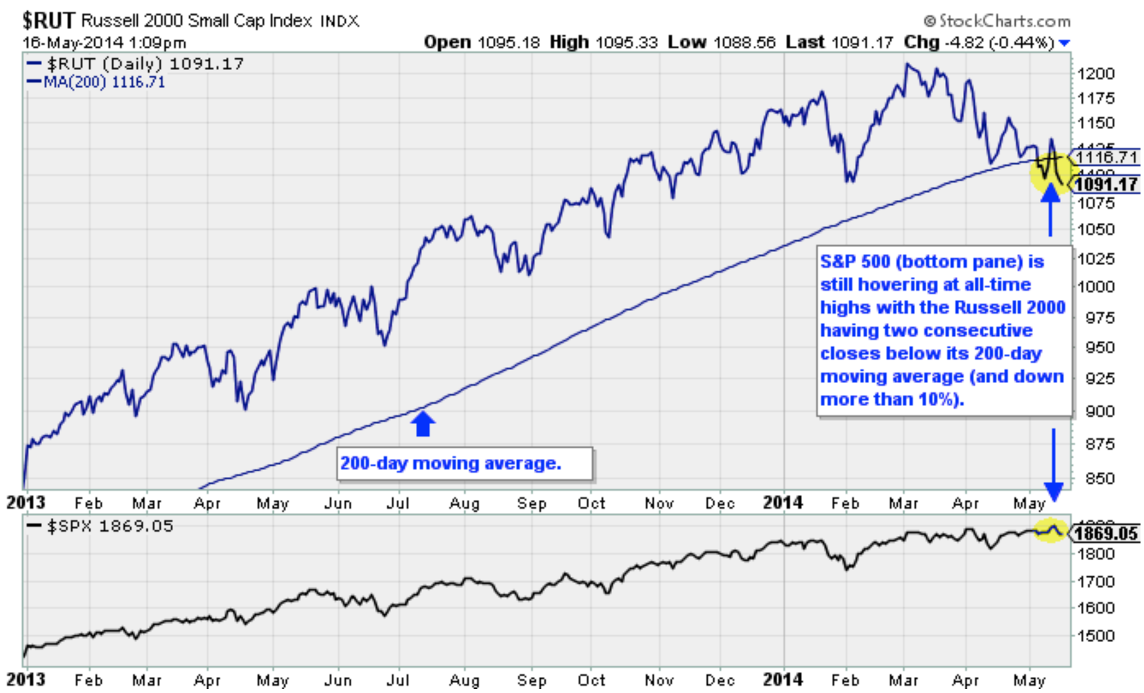
We have made numerous comments over the past few weeks about the weakness under the surface of the markets; especially in the small cap segment. To reiterate, the *average* stock in the Russell 2000 Small Cap Index is down 22% from its 52-week high, while the index itself has corrected 10% from its 52-week high. At the same time, the senior indexes like the Dow and S&P 500 remain near their all-time highs. This type of stark divergence between the small caps and their larger brethren in the S&P 500 is very rare. How rare, you ask? Combing through over 20 years of history, we discovered that last Wednesday (5/7/14) was only the second time in the last twenty years that the Russell 2000 had two consecutive closes below its 200-day moving average while the S&P 500 still had not fallen 5% from its all-time high. The other occurrence was in our comparison year 1998 (6/12/98 highlighted in yellow on the chart below). Please notice the terrible price action that followed.

Russell 2000 Small Cap Index (January 1997 – October 1998)



The S&P 500 (bottom pane in the chart) actually held up for one more month and even went on to a slightly higher level in the first half of July before crashing hard in August. The Russell 2000 remained weak and was only able to retrace a small percentage of its losses. When all was said and done, the Russell 2000 lost 38% and the S&P 500 shed 22% by mid-October of 1998. Few knew it at the time, but the Russell divergence was warning about the impending blow-up of Long-term Capital Management, a deepening of the Asian financial crisis and Russian Sovereign default. Small cap stocks tend to be a riskier asset, so when they start to underperform in such a big fashion it usually means trouble ahead. What the market is sniffing out here in its flight from riskier assets will only be known in hindsight. However, make no mistake about it, this is a loud and clear alarm bell. The next chart below shows the similar set-up between today and June of 1998 (when the Russell first went below its 200-day moving avg).

Russell 2000 Small Cap Index (January 2013 – Present)

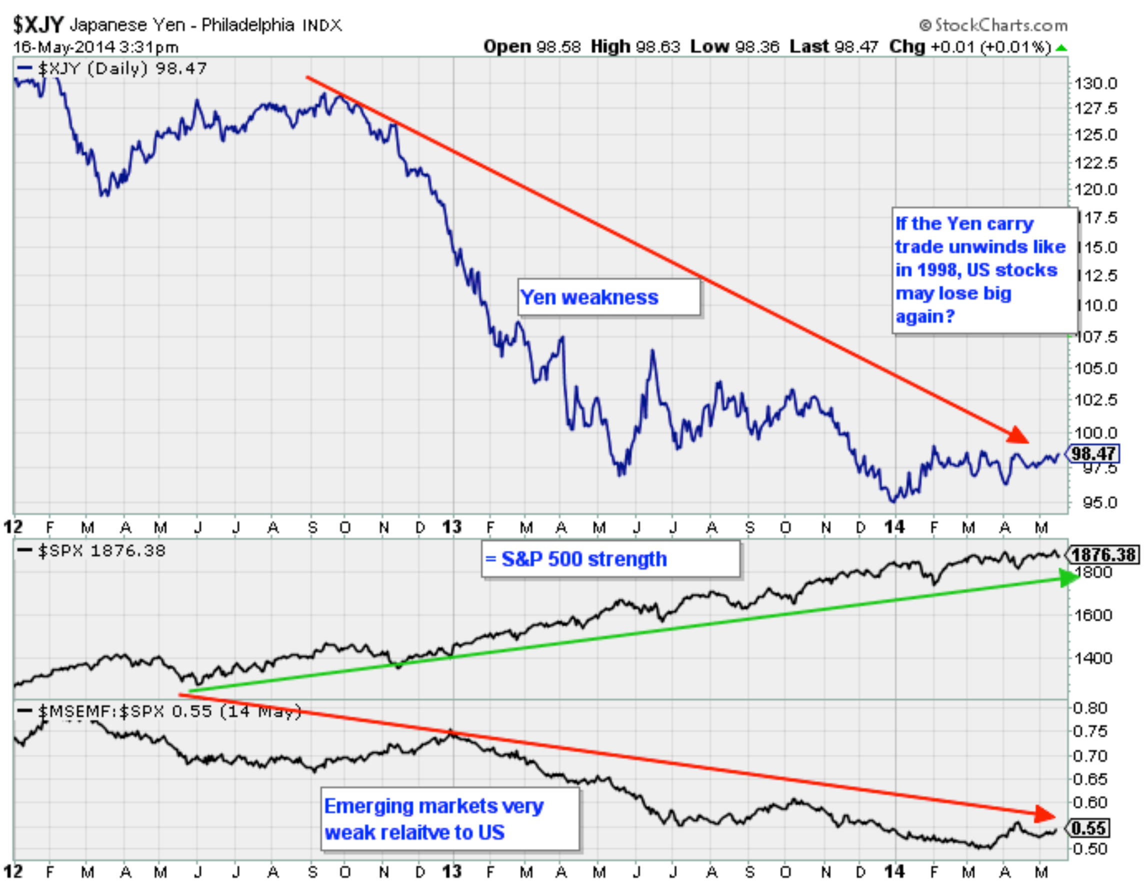


The next key parallel that 2014 has with 1998 is that both are mid-term election years in which the S&P 500 was up over 30% the prior year. In the post WWII era, 1997 and 2013 rank number one and number two in terms of the percentage gain achieved during Year One of the US Presidential cycle. Interestingly enough, these big Year One rallies were enough to place the 1998 market and the 2014 market in the 90th percentile in terms of historical valuation.

Another similarity between the 1998 period and today involves a well-defined set-up in the global markets. The two charts below illustrate: the Japanese Yen was falling due to its use as a carry trade currency (top pane); the S&P 500 was extremely strong (middle pane); and emerging market equities were severely underperforming the US market over multiple years (bottom pane)

Japanese Yen, S&P 500 and Emerging Market Index/S&P 500 **(January 1996 – October 1998)**

Japanese Yen, S&P 500 and Emerging Market Index/S&P 500 **(January 2012 – May 2014)**



On the far right hand side of the first chart you will see that as the Yen exploded higher in the summer of 1998, the unwinding of leveraged yen carry trades caused weakness in the S&P 500. A breakout higher in the Yen will be trouble for the market once again should it shatter its multi-year downtrend as it did in 1998. The persistent weakness in emerging markets during the years leading up to the big 1998 market sell-off was a sign that all was not right with the global economy. We believe emerging market weakness is telling a similar tale in this instance too; but the stimulus addicted US market refuses to listen.

In conclusion, let's review the uncanny resemblances between 1998 and 2014.

1998

- Mid-term election year
- S&P 500 up 30% during prior year with emerging markets *down* 13%
- Small Cap Divergence - Russell 2000 Index has two consecutive closes below its 200-day moving average (and 10% correction) with the S&P 500 still not having corrected 5% from its all time high
- Yen 28% lower over prior 2.5 years and a major source of carry trade funding

2014

- Mid-term election year
- S&P 500 up 30% during prior year with emerging markets *down* 6%
- Small Cap Divergence - Russell 2000 Index has two consecutive closes below its 200-day moving average (and 10% correction) with the S&P 500 still not having corrected 5% from its all time high. Only other time since 1998 that this had occurred.
- Yen 27% lower over prior 2.5 years and a major source of carry trade funding