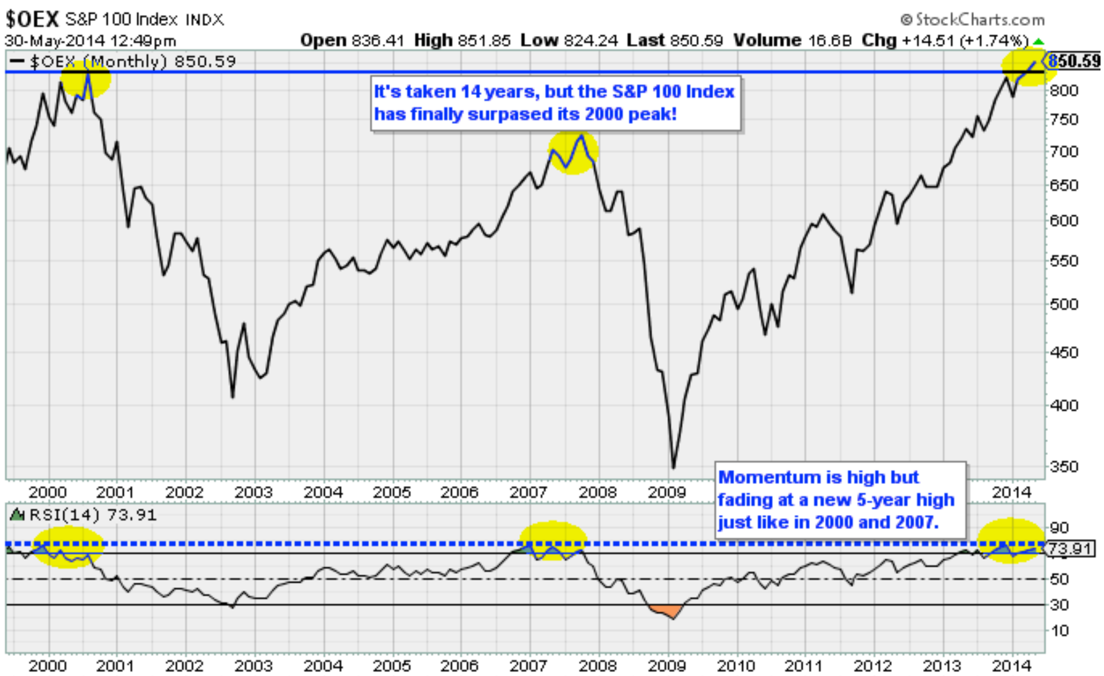
The Starboard Side Report

The week ending May 30, 2014

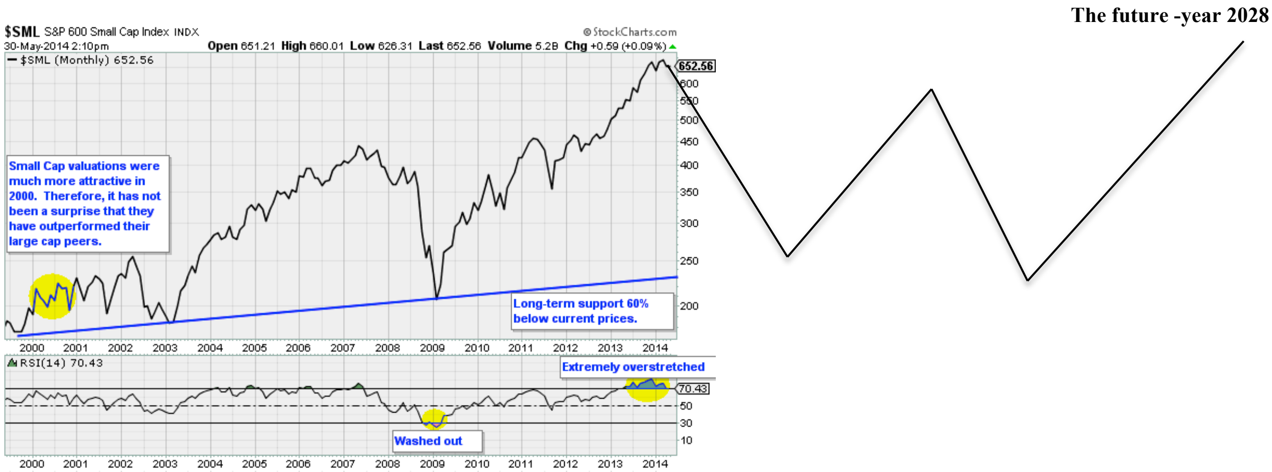
For those who think that valuation does not matter, we present the following chart of the S&P 100. This index represents the largest and most liquid stocks in the US market.

S&P 100 Mega Cap Index (1999 – Present)



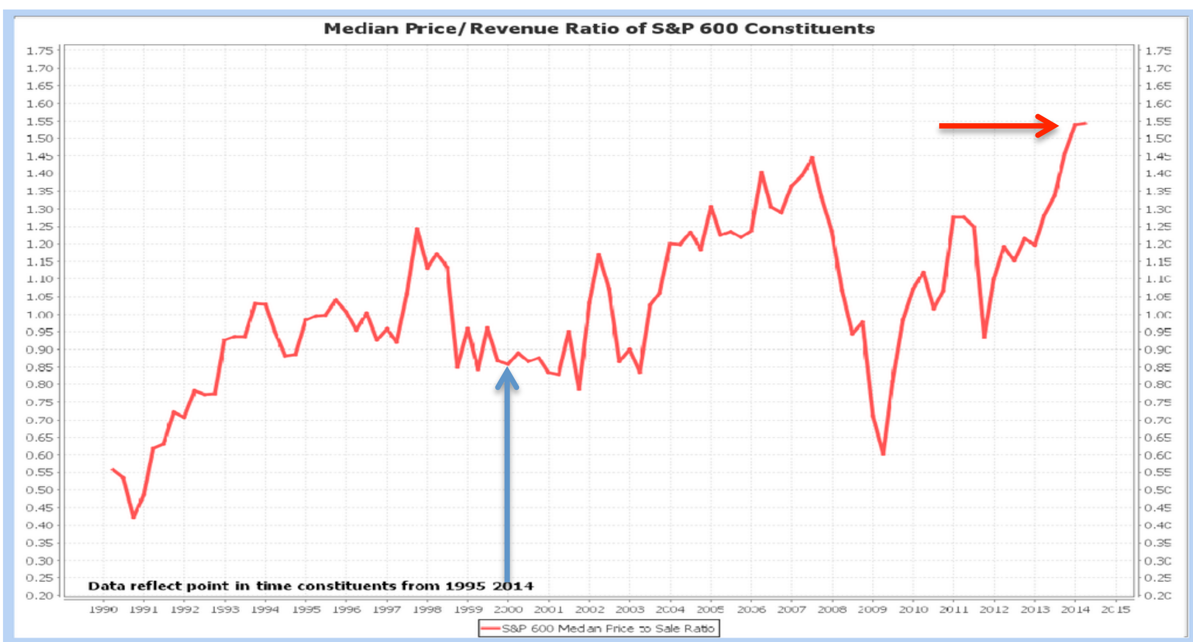
Back in 2000, large cap stocks as measured by this index were projected by valuation studies to return **nil** over the next 15-year period. At the time, given how bullish everyone was on the prospect of the technology revolution, many scoffed at the notion that stocks could go nowhere for 15 years. Yet, large cap valuation analysis showed this to be an extremely high probability outcome. Here we are 14 years later and the S&P 100 Index has finally just this week surpassed its 2000 peak. We draw this to your attention because we feel that we are in the midst of another extreme overvaluation that will leave stocks at similar levels years into the future. The major difference that we have observed between this current overvaluation period and the one in 2000 is that the worst excesses have occurred in the small and mid-cap areas of the market. It would not surprise us if, 14 years into the future, the chart of small cap indexes look very similar to this large cap chart shown above. The S&P 600 is a popular index that measures the small cap segment of the market. In the chart below, we show the last 14 years and project what the next fourteen may look like if small cap stocks in the US follow the same pattern that large caps did from 2000 – 2014.

S&P 600 Small Cap Index (1999 – 2028?)



We have shown many of the overvaluation measures of small caps in this report over the past several months. One new analysis that we recently came across is relevant this week because it relates specifically to the S&P 600 Index.

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



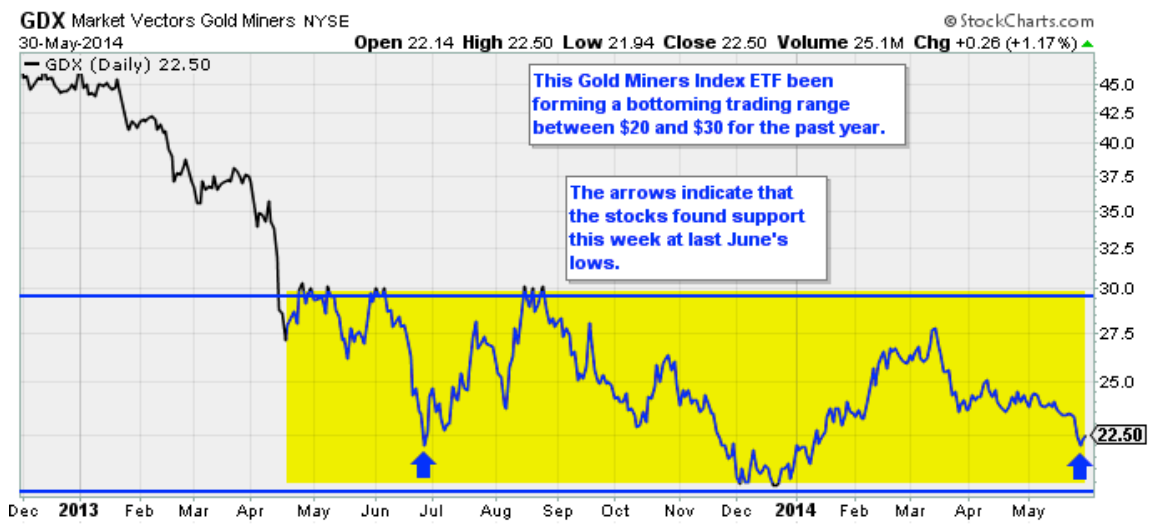
Source: Bill Hester Hussman Funds

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.

It has been a while since we discussed what has been going on in the gold sector. We still believe that gold made a major bottom last June and has been in the midst of a lengthy bottoming process since then. While one year is certainly a long time for an asset to spend making a bottom, gold is not a normal asset in that the traditional government apparatus that steps-in to bailout other asset classes like bonds and equities does not exist for gold. To the contrary, the *powers that be* do not want the price of gold to rise too much because it can undermine confidence in the faith based monetary system that has become so unwieldy over the past two decades. We have often said that gold is a great asset to own as insurance against a loss of confidence in Central Bankers. That mantra has never been more true because central bankers have never been so active meddling in the price discovery process.

The chart below of the Market Vectors Gold Mining Index (GDX) shows the clear $10 trading range that has housed the stocks over the past year. The GDX found support at last June's major low this week, but still has some more downside potential before the December low comes into play.

GDX- Market Vectors Gold Miners ETF (Past 18 Months)



The good news for gold bulls is that we are seeing a positive divergence as the bottom plays out. This means that even though the price of the index is back to the bottom of the trading range, the number of stocks within the index that are on buy signals continues to climb higher. This divergence can be observed in the following bullish percent chart of the GDX. As you can see, there were 0% of stocks on a buy signal last June, 10% at the December low and 30% at present.

Gold Miners Bullish Percent Index (Past 18 Months)

The next chart is being used to illustrate two things: 1) the gold stocks have been making this bottom along a major long-term support line that goes back over a dozen years; 2) there was a similar one-year bottoming process that took place at parallel levels in 2004/2005. The index doubled over the next twelve months after the final bottom in May of 2005. This fits the old saying "the longer the base, the higher into space." This is fairly self-explanatory in meaning that the longer a stocks spends building a bottoming base, the higher it should run once the base is complete.

Gold Miners Index (2001 – Present)

The picture of gold itself is similar to the gold mining stocks. The first chart below shows the bottoming process that has been taking place over the past year. The metal is also showing a divergence. Instead of showing the bullish percent index, we have included a RSI momentum gauge that also shows gradually higher momentum over the past twelve months. This is a good sign that lower levels are not in store (or if they are, they will be very short lived).

Gold Price (Past 18 Months)

The next gold chart is a big picture going back to the start of the gold bull market in 2001. This is a better picture than the mining stocks from a capital appreciation perspective given how much higher the metal is compared to 2005. The most important take away is that gold is still in a long-term uptrend and its recent bottoming process is also occurring above a very well defined long-term support line.

Gold Price (2001 – Present)

As long as these long-term support lines continue to hold, we like gold and gold stocks because their negative correlation to the S&P 500. This means that the gold sector is one of a select few asset classes that has the potential to make investors money should the US stock market enter another cyclical downturn. Duration of the bull market, excessive valuations and an increasing number of key negative divergences (like plunging US long-term bond yields and small cap underperformance) point to a US stock bear market being much closer than most are prepared for at the moment, so gold's moment to shine again may be fast approaching.