The Starboard Side Report

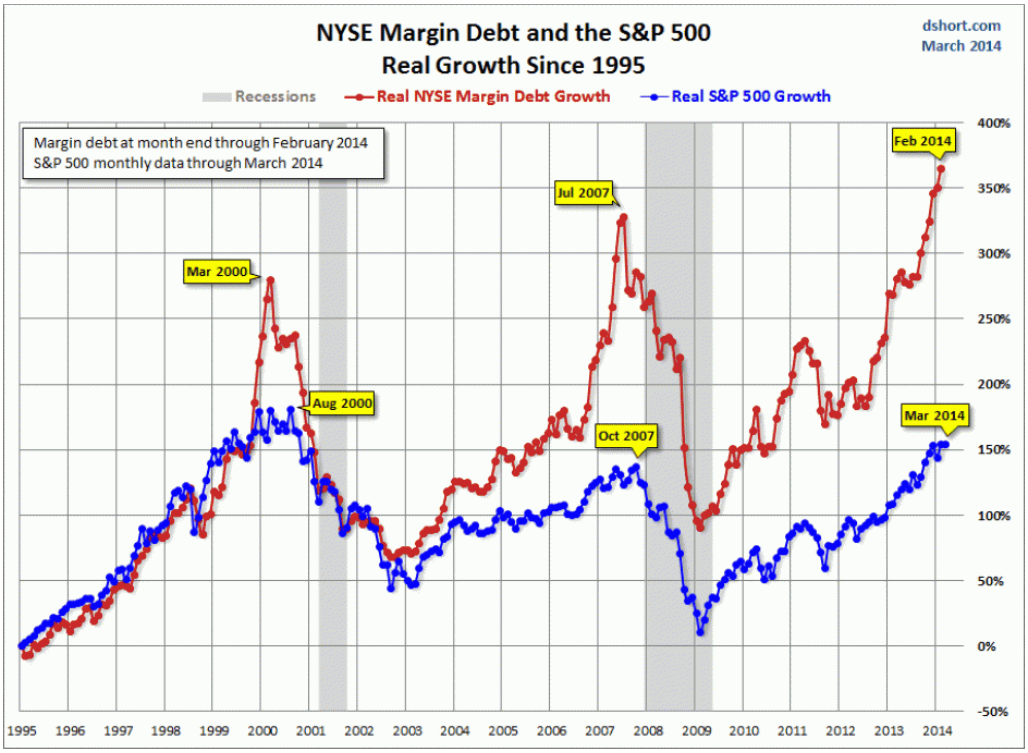
The week ending April 11, 2014

US stock market volatility has been relatively suppressed since 2012 by the Federal Reserve's quantitative easing program. That calm façade appears to be in the process of changing as the Fed tapers its stimulus and investors front-run the "sell in May and go away" axiom. Amazingly, the S&P 500 has just gone from an all-time high to negative for the year in the past five trading sessions.

S&P 500 Volatility Index since January 2011

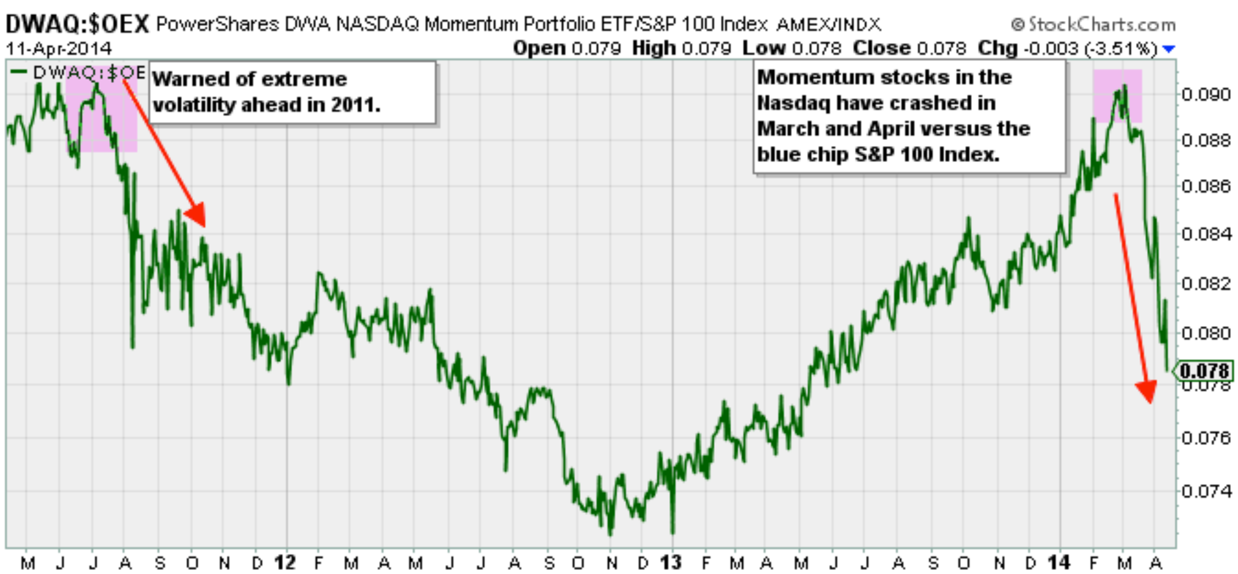
If the S&P 500 Volatility Index breaks above the ceiling shown on the chart above, then it could spell big trouble for the US stock market. 2011 was the last time we had any sort of big volatility episode. Volatility is a two-way street that cannot be suppressed for too long because it eventually creates imbalances that need to be unwound. One such imbalance we are seeing at present is a record high in New York Stock Exchange Margin Debt (first chart below). This chart doesn't really matter as long as the market continues to climb, but once the upside momentum is broken, high amounts of leverage greatly amplifies selling pressure. We showed two weeks ago that the momentum has started to break in the highflying Nasdaq and that situation has only worsened as the second chart below illustrates. It is only a matter of time before this carnage in Nasdaq momentum stocks spills over to the broader market.

NYSE Margin Debt (red line) and Inflation Adjusted S&P 500 Index (blue line) since 1995



Source: Doug Short

DWA Nasdaq Momentum Portfolio versus the Blue Chip S&P 100 Index (3 year Chart)

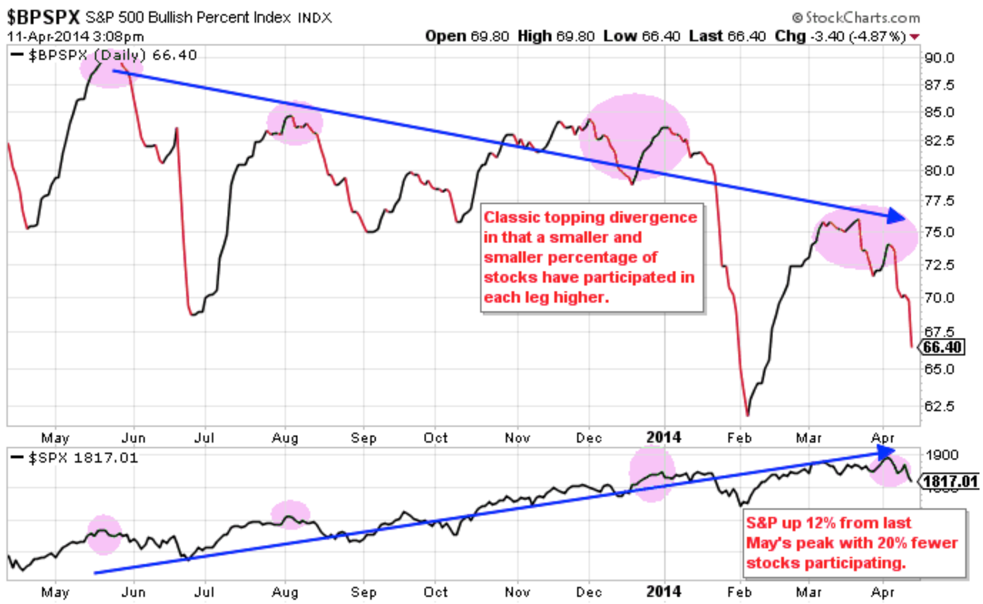


Our next analysis speaks to the current health of the market being weak when one looks under the surface. The chart pictured below shows the S&P 500 Bullish Percent Index overlaid against the S&P 500 Price Index. As a refresher, the S&P 500 Bullish Percent Index is a tool that measures the percent of stocks within the Index that are on a *point and figure chart* buy signal. At present this Bullish Percent Index shows a classic topping divergence, whereby a smaller and smaller number of stocks have participated during each leg higher over the past year. In May of

2013, 90% of the 500 stocks in the S&P 500 had a bullish chart pattern. When the S&P 500 hit its most recent record high last Friday, there were only 73% of the stocks in bullish chart patterns. That means 20% fewer stocks were making investors money even as the S&P 500 climbed another 12%. Over the five trading session since last Friday, the S&P 500 Bullish Percent Index has slipped another seven percentage points to 66%. Once again, this indicates a very precarious foundation under the current market despite the major indexes being relatively close to all-time highs.

S&P 500 Bullish Percent Index (1 Year Chart) Top Pane

S&P 500 Price Index (1 year Chart) Bottom Pane



There seems to be a common misperception that the US market can't have another major bear market that erases 50% of its value because it has already happened twice in the past 14 years. Well one has to look no further than Japan to see that just isn't the case. We chose to compare the Japanese Nikkei Index and the Nasdaq Composite because they both experienced similar momentum bubbles ten years apart. The Japanese bubble burst in 1990 and the Nasdaq in 2000. As the first chart below shows, The Nikkei has had *three* corrections of greater than 60% since 1990 (and may be poised for another big decline). We have clearly labeled these three bust phases on the Nikkei chart below. The big difference between the Japan bubble and the Nasdaq bubble is that Japan's stock market top coincided with its real estate bubble top, whereas our real estate bubble obviously occurred several years after the stock market topped. That has created a different path for both markets following their bubble peaks, but ultimately the same legacy of debt and slow economic growth now exist in both instances. The US is now in a similar debt trap as Japan, so it makes sense that the Nikkei and Nasdaq stock markets should share some similar post bubble characteristics. We are choosing to bring this up now because the Japanese market has tended to have its big stock market declines every time the government and the Bank of Japan tried to normalize monetary policy. The US market and economy is at that point now as the Federal Reserve tries to do away with quantitative easing (QE). We see this stimulus unwind as being as unsuccessful as it was in Japan. Recall that a 20% correction occurred in the US in 2011 after the stimulus plan known as QE 2 was removed.

Tokyo Nikkei Average (1985 – Present)

Nasdaq Composite Index (1995 – Present)

Both charts shown above have a price chart in the top pane and a RSI momentum chart in the bottom pane. For the purpose of this exercise we are going to focus on how nicely the momentum peaks line up with the cycle price peaks. First, at the bottom left corner of each chart we have labeled the momentum bubble that took each index pretty much in a straight line higher for the final five years of the secular bull cycles (albeit 10 years apart). After those monumental momentum cycles finally burst, notice how each succeeding boom phase has ended once momentum climbed back to the 70 level and then reversed back down. We have labeled these points as "peak" on each of the charts. We can't stress enough how important it is that both the Nikkei and Nasdaq price charts have rolled over dramatically and started new bear markets each time the RSI momentum has hit 70 and reversed. Here we are once again with the Nasdaq's momentum faltering after recently achieving a level that had not been observed since the 2000 top. Much like the NYSE Margin Debt chart above, high momentum isn't in and of itself a bad thing. Again, it is only once it reverses from a high level (as it has just done) that investors need to become concerned. One final note is that the Nasdaq chart appears to be very rhythmic. This is the third bull cycle that has measured exactly 60 months. If the Nasdaq decline since March did indeed mark the top of this bull cycle then this pattern would be extremely uncanny. We have labeled these 60-month boom phases on the Nasdaq charts.

In conclusion, despite the S&P 500 and Dow having just reached new all-time highs last Friday, there are numerous topping signals that indicate turmoil beneath the surface and the possible end of the bull market that began in 2009. Whether this will be looked back upon as THE top of this bull cycle will only be known in hindsight, but it surely makes sense to remain cautious given all the red flags we are seeing at the moment.