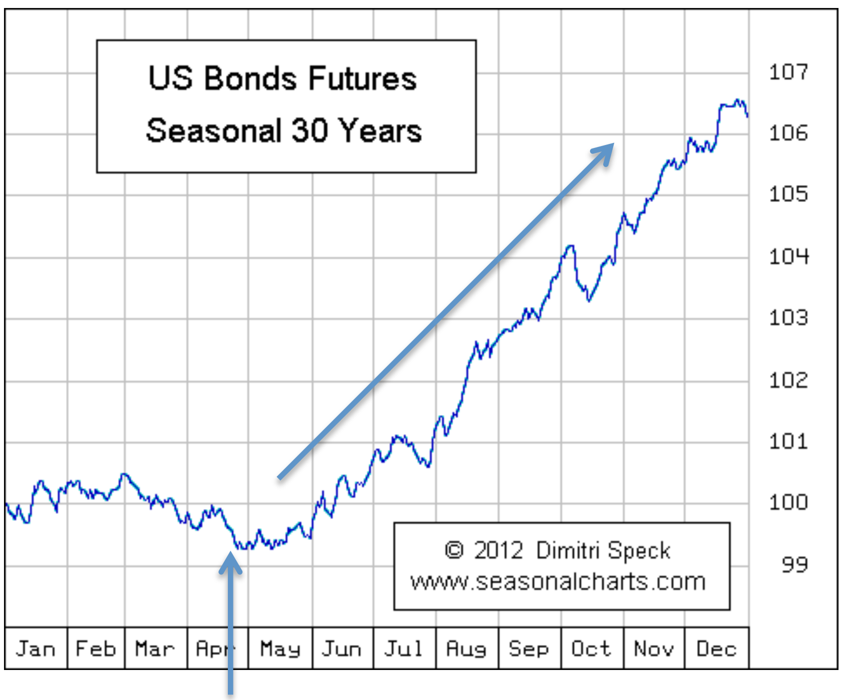
The Starboard Side Report

The week ending April 25, 2014

Seasonality always plays a big role in financial markets, but never is this seasonal pattern as prevalent as in a mid-term election year (also known as year 2 of the presidential election cycle). We have covered the "sell in May and go away" stock market seasonality many times before, but have never shown the opposite seasonal effect as it relates to US Treasury bonds. Due to their role as a safe haven and uncorrelated asset, US Treasury bonds actually do their best in the May through October timeframe when stocks tend to struggle.

US Treasury Bond Annual Trading Pattern (past 30 years)



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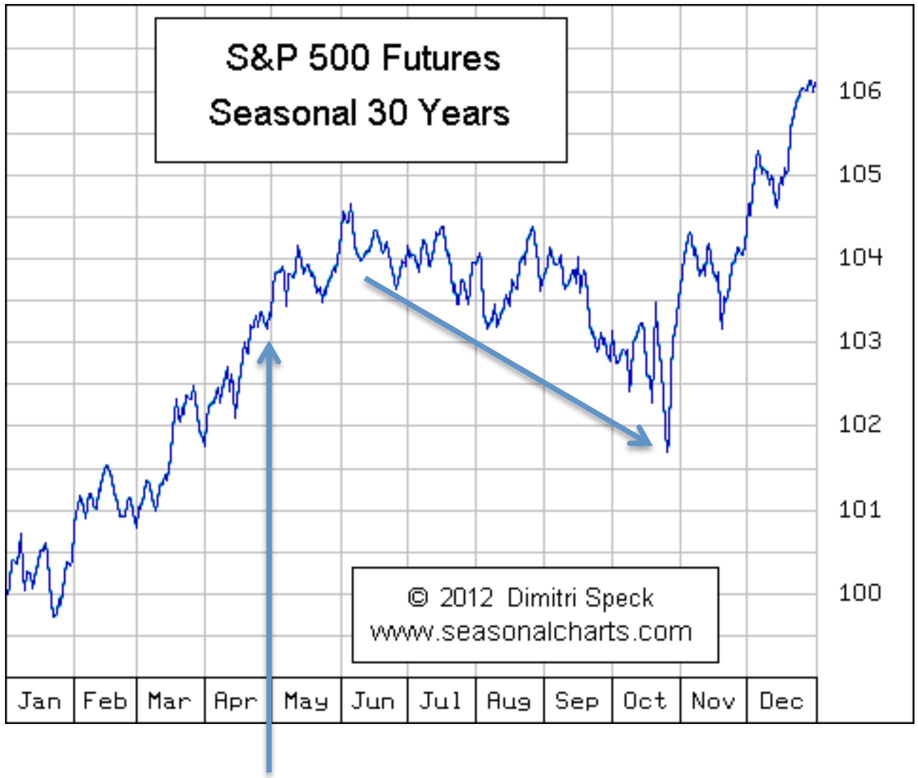
The above chart shows the average annual *price* path of the US 30-year Treasury bond over the past 30 years. As you can see, it typically performs poorly in the first five months of the year and then exhibits strong price performance over the remainder of the year. In contrast, the S&P 500 stock index is about to enter the six-month period where it traditionally struggles. Notice on the chart below that the next six months of the year have exhibited a very choppy-to-down pattern on average over the past thirty years.

S&P 500 Stock Index Annual Trading Pattern (past 30 years)



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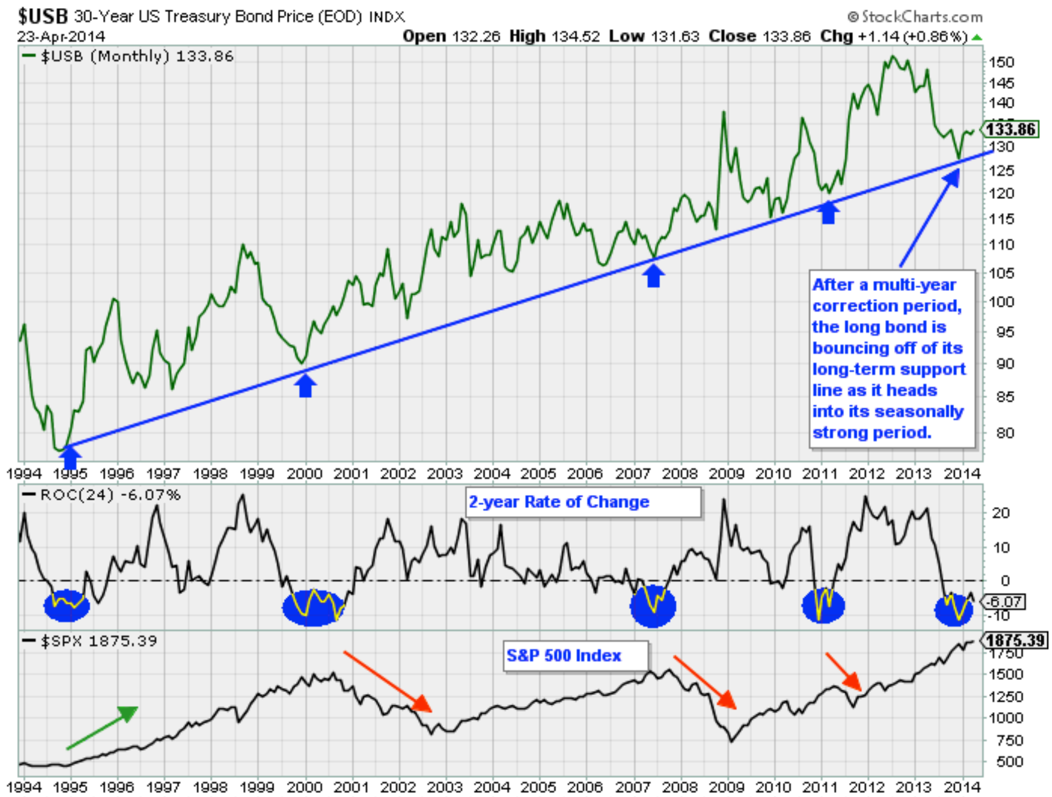
The reason that we are bringing bond seasonality to your attention this year is that we believe this season may be especially strong for long duration US Treasury bonds given the technical set-up we are seeing on the charts. 30-year US Treasury bonds have just come out of a two-year price correction and have started to rally off of the long-term support line. We have highlighted below the other periods where a similar pattern developed over the past 20 years. The blue circles on the middle pane correspond to the blue arrows on the price chart in the top pane. When the 2-year rate of change (middle pane on the chart) goes down to a loss of 10% and then reverses, it has been a great time to be overweighed the 30-year bond. For comparison sake, we have added the S&P 500 in the bottom pane to show that bond price rallies often correspond with stock price declines. In three out of the four episodes (which we have highlighted with red arrows) the S&P 500 has lost at least 20% (2000, 2007 and 2011) while bonds have rallied off of the bottom of their trend channel. The outlier was 1995 when both stocks and bonds had strong years.

Top Pane= 30-Year US Treasury Bond Price (1994 – Present)

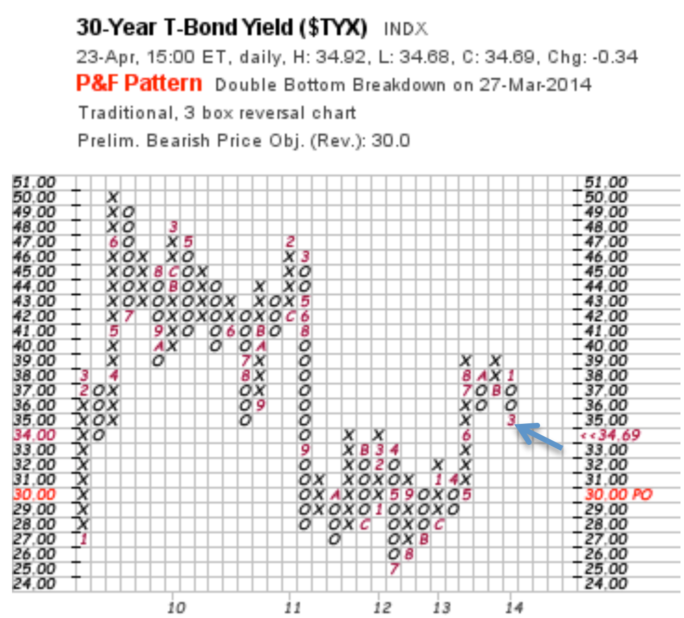
Middle Pane= 30-Year US Treasury Bond Price 2-year % Rate of Change

Bottom Pane= S&P 500 Stock Index Price



Bond yields move inversely to bond prices, so a move higher in the 30-year US Treasury Bond price would mean yields continue to move lower over the summer and possibly beyond. The point and figure chart for bond *yields* pictured below just went to a sell signal for the first time in over a year.

30 Year T-Bond Yield (Point & Figure Chart)



According to this analysis, the preliminary target we could conceivably see for yields on 30-year Treasuries is 3%. The bond market seems to be sniffing out some economic weakness in the months ahead. In addition, pension funds are most likely rebalancing portfolios from stocks (after a five year bull market) into long duration treasury bonds. Even though the 30-year treasury yields is around 3.5%, this is still higher than the S&P 500 yield of 2%, cash yield of 0% and GDP growth of only 2.6%. The final chart of bond yields is a big picture since the bull market started in the early 1980's. It shows a very orderly channel that lends more credence to the bullish set-up for bond prices (lower yields) in the months ahead and it is why we have been accumulating a position in long duration treasury bonds since late last fall. While this bond bull market is getting very long in the tooth at over thirty years, we believe that we could be starting one more powerful move lower in yields before the bull is finally over. This clearly defined trend channel gives us a good risk reward set-up to exit this trade if we are wrong (i.e. yields decisively breakout above the top of the channel).

As a review, we are about to head into the seasonally weak period for US stocks, five years into a bull market and in a mid-term election year. This extremely poor set-up for stocks is why we strongly prefer 30-year Treasury bonds for the next six months at least.