The Starboard Side Report

The week ending March 14, 2014

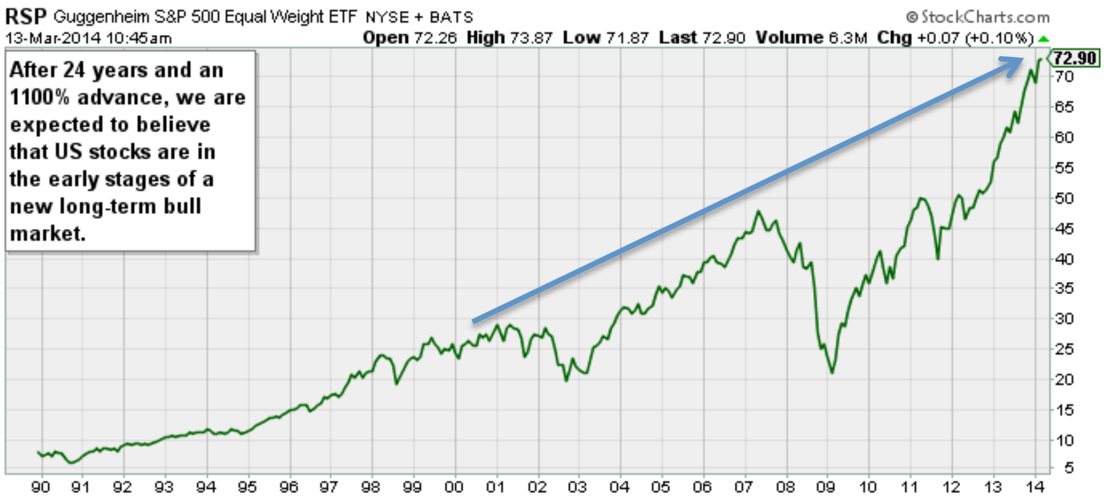
To consider the echo bubble that has developed in the US stock market, we think that there are a few charts that should be perused. We can talk about the historical overvaluation numbers until we are blue in the face (as we did again in our report dated 02-21-14), but sometimes it is good just to sit back and look at the pictures. The first thing we want to make clear is that we have experienced the "tale of two bubbles." The 2000 stock market bubble was primarily driven by the largest 100 stocks in the market (as measured by the S&P 100 Index) and by one sector of the market (technology stocks as measured by the Nasdaq Composite Index). The current echo-bubble is much broader in that it is being driven by the small and mid range stocks in the market (as best measured by the S&P 500 Equal Weight Index, the Russell 2000 Small-Cap Index and the S&P 400 Mid-Cap Index). On a sector basis, it is not surprising that there are more sectors involved this time around given the greater breadth of overvaluation. There are extreme excesses in a diverse swath of sectors from biotechnology to internet commerce/advertising companies to transportation stocks.

<u>Large/Mega Cap Stocks</u>

The above chart shows that the S&P 100 (which represents the 100 largest stocks in the US market) is just now reaching the levels that it hit 14 years ago. The main reason that this index is still below its old 2000 highs, while the small and mid cap segments have rocketed higher, is due to the fact that small and mid caps had much more attractive valuations in 2000. As a result of this relative undervaluation, they have had much more room to run over the past 14 years. However, as we have mentioned before, we now have the polar opposite situation whereby the

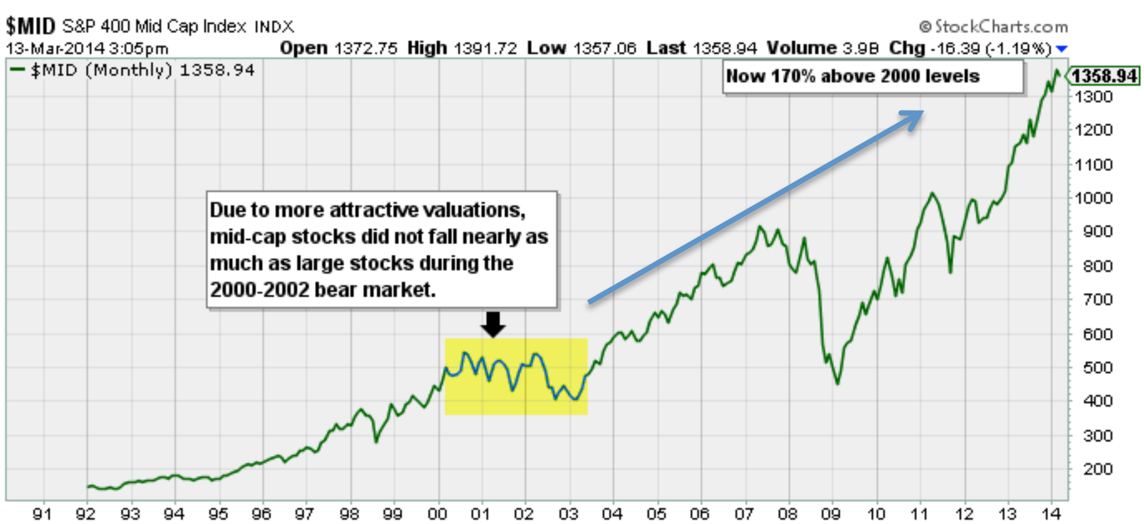
100 largest stocks in the market trade at more appealing valuations and the small and mid cap stocks are the ones that are at bubble-like levels. In general, this means that when big corrections occur over the next decade or so, the largest stocks should be the ones that go down less and should rally more coming out of the bear markets declines.

Equal Weight S&P 500



One of the best ways to observe this dynamic between smaller and larger stocks is to look at the S&P 500 Index with the 500 constituents weighted equally instead of weighted by size. This gives each company only 0.2% of the index and prevents the largest companies from dominating as they do in the traditional S&P 500. The top ten stocks in the S&P 500 account for 10 times the weighting of the top ten in the equal weight version pictured above. Therefore, the equal weight S&P 500 is a much better reflection of how the smaller stocks in the market are performing. After 24 years and an 1100% advance in the S&P 500 Equal Weight Index, are we really expected to believe that US stocks are in the early stages of a long-term bull market?

Mid Cap Stocks



The next chart above of the S&P 400 Mid Cap Index is another chart that shows the excessive exuberance that exists in the meat of the market. Other than the 2008 meltdown, mid-cap stocks have been in a roaring bull market for over twenty-years (up 930% since 1992). Recent price action appears to be more of a parabolic climax rather than the start of a new bull market.

Small Cap Stocks

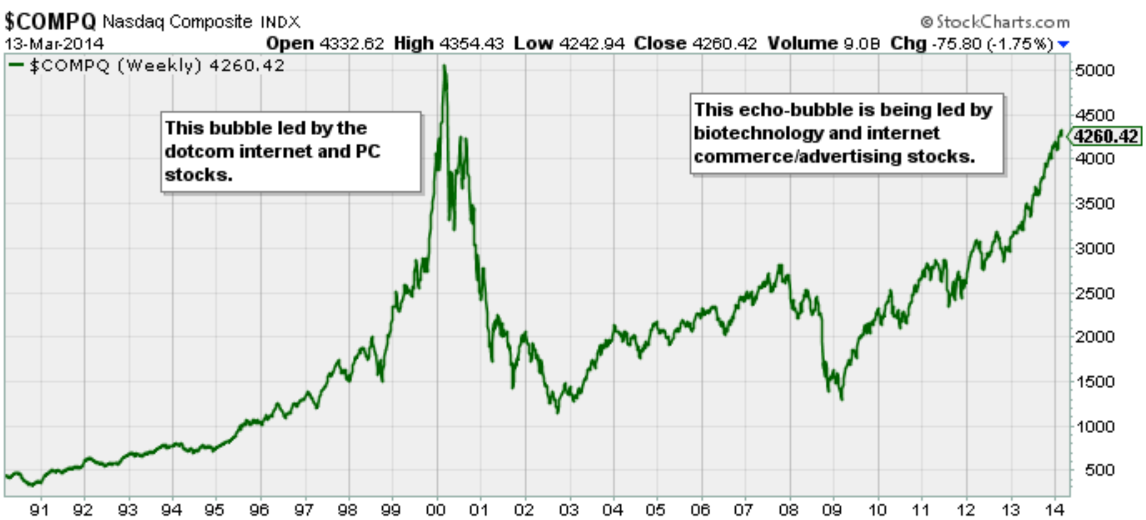
The chart above of the Russell 2000 Small Cap Index looks very similar to the Equal Weight S&P 500 and the Mid Cap Index. Again, other than the 2008 meltdown, small-cap stocks have been in a bull market for over twenty-years (up 850% since 1991). Recent price action is also more of a parabolic climax rather than the start of a new bull market.

Current historical valuation studies would point to the exact opposite situation in the future that has occurred over the past 14 years. Namely, there is a good possibility that the S&P 100 Mega Cap Index will be the stock index that is 100% - 200% above current levels and the asset class style that survives the next bear market(s) with relatively smaller percentage losses. On the flip side, small and mid cap stock indexes will likely be at or below where they are at present come 10-15 years into the future due to excessive valuation. This means much higher volatility and much bigger percentage declines during the bear markets. The potential for 50-60% type drops in the small cap & mid cap indexes is why we feel that it makes sense to hedge portfolios using small and mid cap inverse funds rather than large cap inverse funds.

If there is one sector that illustrates the froth in the market and how this five-year bull market that began in March of 2009 is on its last legs, it would be biotechnology. As we see on the following charts, this group has gone parabolic and is taking the Nasdaq Composite with it.

NYSE Biotechnology Index

Nasdaq Composite Index



The cyclical bull market turned five years old this week. That makes it very mature by historical standards. Those that were fleeing in panic in 2009 are now actively jumping back into the market. It is interesting that shopping for stocks is the lone retail pursuit in which people like to aggressively buy merchandise *after* it has gotten ridiculously expensive. We believe those chasing stocks higher at these levels (especially small and mid caps) will have severe buyers remorse when looking out over a timeframe greater than one year. We prefer to patiently wait for the great clearance sale before going on our US stock shopping spree.