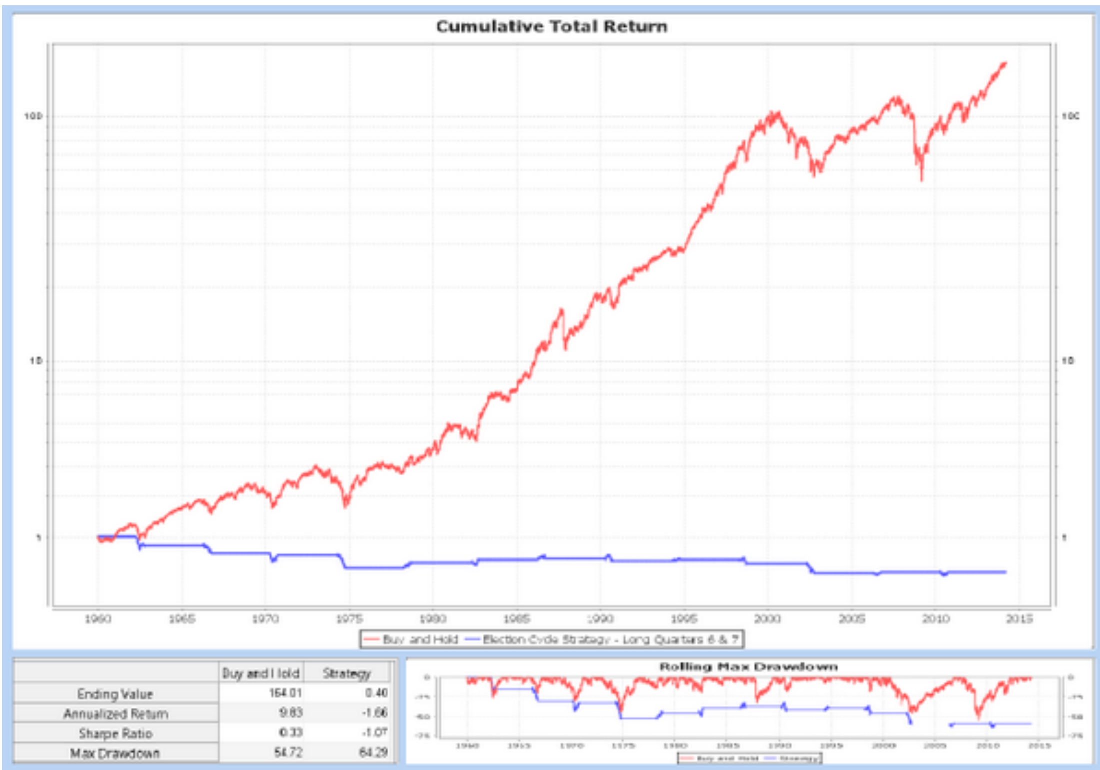
The Starboard Side Report

The week ending March 21, 2014

2014 is a mid-term election year. Mid-term election years are often very volatile times for the US stock market, especially during the second and third quarters of the calendar year. Bill Hester of the Hussman Funds recently posted an interesting chart that shows the power of the mid-term election cycle for the market. The chart titled "How to Turn $1 into 0.40 cents" is a stark warning for those heavily invested heading into the next six months of this year.

S&P 500 Total Return (1960 – Present)



The red line in the chart is the total cumulative total return for the S&P 500 since 1960. This "buy and hold" approach has resulted in a 9.83% annualized return. Now look at the blue line in the same chart. This is a hypothetical return if one was to have been fully invested in the market *only* during the second and third quarters of the 13 mid-term election years since 1960. The annualized return for this investor was **negative** 1.66% per year.

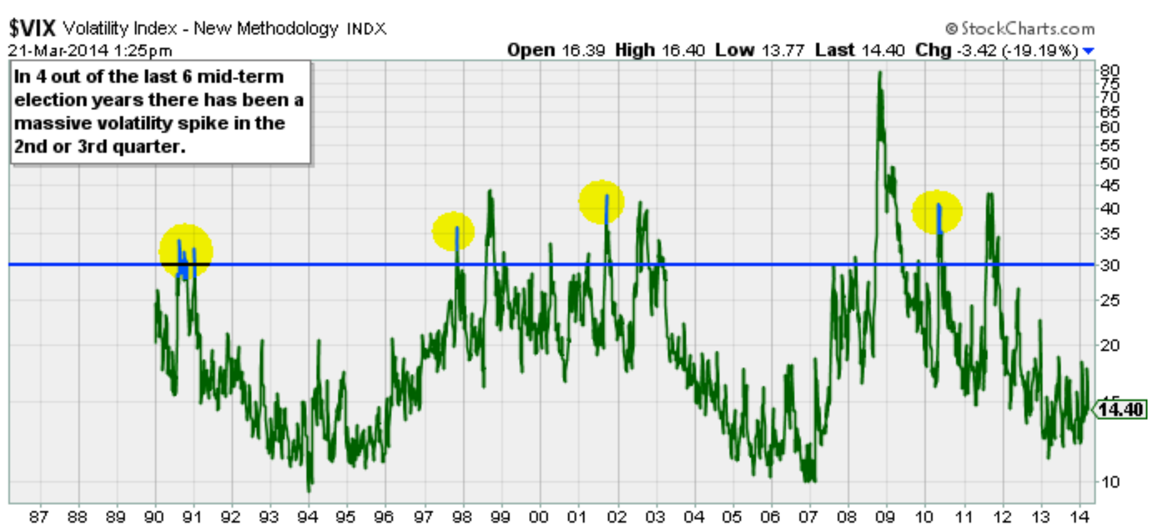
We take Hester's analysis one-step further in the table below. It shows the maximum decline for the S&P 500 during each of the mid-term election years since 1960. As you can see, the average decline was just over 20% and there was a double-digit drawdown in 11 out of 13 years! The odds definitely favor a much better opportunity to put money to work than at the present.

S&P 500 Declines in Mid-term Election Years since 1960

Mid-term Year	Max Decline
2014	??
2010	-17.2%
2006	-8.1%
2002	-34.7%
1998	-22.5%
1994	-9.7%
1990	-20.5%
1986	-10.2%
1982	-19.7%
1978	-13.6%
1974	-38.0%
1970	-19.7%
1966	-22.0%
1962	-26.9%
Avg.	-20.2%

It's only one week from the start of the second quarter of a mid-term election year with the S&P 500 sitting at an all-time high and within spitting distance of valuations that have preceded the most vicious declines in history. Add to that the Federal Reserve removing stimulus, the geopolitical hotbed in Ukraine/Crimea/Russia and China's credit bubble troubles and we have all the ingredients for a toxic witches brew of volatility over the next six months. It amazes us how complacent the market is right now; maybe everyone thinks that they will be able to find the first chair when the music stops. If history has taught us anything it's that this is a dangerous game to play when real money is at stake. In four our of the last six mid-term election years there has been a massive volatility spike in the 2^{nd} or 3^{rd} calendar quarter. This can be observed on the chart below with S&P Volatility Index spikes above 30 in 1990, 1998, 2002 and 2010.

S&P 500 Volatility Index (1990 – Present)



In these four mid-term years, the S&P 500 had an average decline of 24% during the 2nd and 3rd quarters during the volatility spikes highlighted in yellow on the chart.

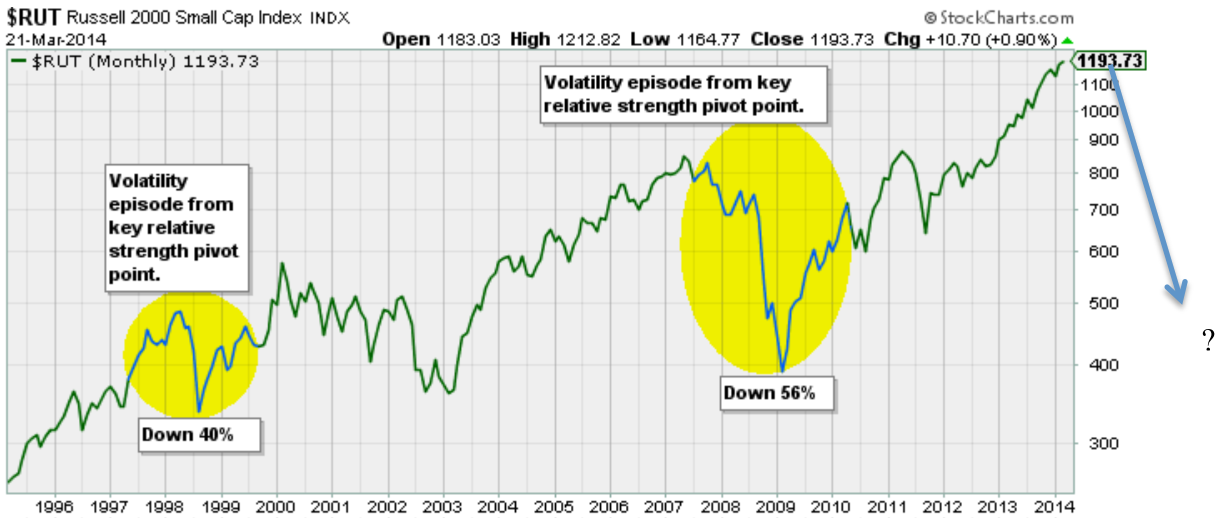
"Pivot Point" Chart(s) of the Week

A big part of what we do is trying to determine key pivot points in time when old trends are at their exhaustion phase and a new trend is about to develop. While sounding simple in theory, identifying these inflection points is actually an extremely arduous task that requires a constant focus on the interaction between money flow, valuation, momentum and price. This type of analysis is at the heart of the comparative relative strength and trend channel analysis that we often show in this report. Each week we try to include a chart or two that help highlight potential pivot points. A few of these that we have touched on so far this year are; uranium trying to make a major bottom, US Treasury bond *yields* topping out, US small cap stocks extremely extended versus US large caps stocks, gold mining stocks cheap versus the metal, oil service stocks potentially starting a new up cycle after a five year downturn and finally, gold being very cheap relative to the Dow Jones Industrial Average.

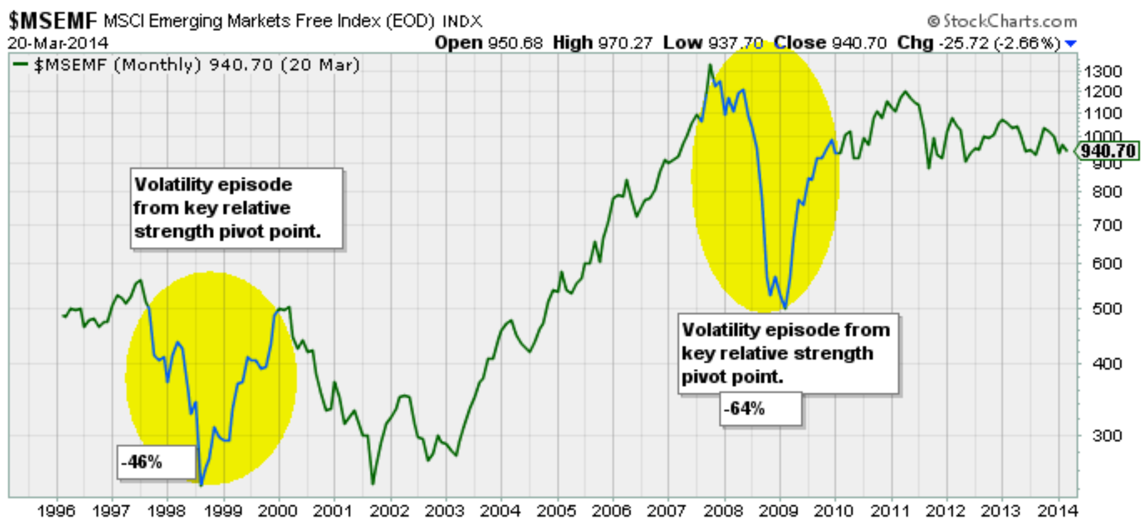
This week we wanted to show the remarkable divergence between two higher volatility assets, the Emerging Market Index and the Russell 2000 Small Cap Index. Since the start of 2010, the index of fast growing emerging market countries is *down* 7% versus a 91% gain for the Russell 2000! The bottom pane shows the momentum of the trend that is pictured in the top pane. As you can see, it is only the third time since 1996 that the trend has been stretched this far on either side of the momentum band. We can't say the exact date that the snap back will occur. However, using history as our guide, it could be soon and will occur with maximum volatility.

MSCI Emerging Markets Index vs. Russell 2000 Index (Relative Strength Chart)

Russell 2000 Index (Stand-Alone)



MSCI Emerging Markets Index (Stand-Alone)



The two stand-alone price charts above of the Russell 2000 and the Emerging Markets Index are the assets being compared versus one another in the first chart of the series. They are included to illustrate the type of intense sell-off that occurred following the prior two relative strength pivot points in 1998 and 2008. The Russell 2000 lost 40% in just six months the last time it was this overstretched against emerging markets in 1998. Emerging markets lost 64% in a little over one year after the rubber band snapped in early 2008. Once the volatility episode hits, both assets usually decline. However, the one that has been on the losing end of the trend (i.e. oversold on a relative basis) holds up much better in the decline because most of the sellers have already fled during the period of underperformance. On the other hand, the asset with all of the momentum gets pummeled as the crowd that has been chasing the trend higher heads en masse for the exits.

The bottom line is that risk levels remain high as discussed in the above analysis. Therefore, we patiently await a better opportunity (later in this mid-term election year) before we turn more positive on risk assets. Furthermore, once the dust settles after a volatility episode, our pivot point analysis has us thinking that emerging market stocks will provide a more attractive long-term investment set-up than small stocks in the US.