The Starboard Side Report

The week ending February 7, 2014

Ever since the very early stages of the US financial crisis in 2008 there has been a very important dynamic at work in the global financial system. We have noticed that every time the US dollar enters a positive momentum cycle (which usually last between 6-12 months) there has been some sort of financial crisis. Because it serves as the reserve currency for the world, strength in the US dollar tends to act as a de facto financial tightening mechanism on the global economy. A weak dollar indicates that excess dollar liquidity is plentiful. But when the cycle inevitably turns to dollar strength; it sucks excess liquidity out of the financial system. This creates problems for financial speculators that rely on leverage to maximize gains. In a normal healthy global growth environment, reigning in excess liquidity is not always a problem. However, given the fragile state of the global economic machine since the collapse of the US credit markets in 2008, this excess US dollar liquidity has proven to be very essential at the margin and so its withdrawal has been creating a series of rolling financial accidents. Below is a table that shows the four positive dollar monthly momentum cycles since 2008, the duration of the cycle and the corresponding turmoil that ensued.

US Dollar Positive Monthly Momentum Cycles since 2008

Start	End	Months	Crisis
Jun-08	Feb-09	9	Lehman Blow-up/US Financial Crisis
Jan-10	Aug-10	8	Flash Crash, Greek Debt Blow-up
Aug-11	Aug-12	13	Debt ceiling crash, Escalation of Euro Debt Crisis
Feb-13	Jul-13	6	Gold Crash, Global Bond Market Panic
Feb-14	?	?	Escalation of Emerging Market Crisis???

US Dollar Index Momentum Cycles (2007 – Present)

The chart above clearly shows the US Dollar Index price rallies during these positive momentum cycles. We have also labeled the problems that hit the market during each timeframe highlighted. Each of the major episodes of turmoil occurred while the dollar was heading higher and vacuuming up global liquidity. In the first cycle, Lehman Brothers blew-up and almost took down the entire financial system. In the second cycle, Greece's stock and bond markets imploded. In addition, the US stock market experienced the "Flash Crash," a high frequency computer "glitch" that sent the Dow crashing 1,000 points lower in a matter of *minutes*. The third positive dollar cycle was the longest at 13 months. This was when the Euro crisis intensified and jumped the tracks from Greece, Ireland and Portugal to the major peripheral countries of Italy and Spain. Bond yields surged and stocks prices tanked throughout Europe. This phase also included a 20% US market decline in the midst of the first debt ceiling showdown. The fourth and most recent positive momentum cycle in the dollar was the shortest at just under six months. This period included the crash of the gold market in April of 2013 and an early summer bond market price meltdown (spike in yields). It was also when we started to see the first cracks in what might be the next crisis as emerging market currencies and bond markets came under severe pressure from lack of excess dollar liquidity.

The reason we bring this to your attention this week is due to the fact that if the US Dollar Index closes the month of February above $80.57, then we will have just started the fifth such positive dollar momentum cycle since 2008. While there are no guarantees as to the length of this cycle or even if another financial crisis will occur this time around, it would be irresponsible to ignore the potential for trouble ahead. The time to raise/stockpile US dollar denominated cash is when the cycle first turns from negative momentum to positive momentum (as it appears to be doing now) and liquidity is still plentiful. We want to be a cash/liquidity provider to desperate panic sellers after the next accident has occurs. For US investors, foreign assets become especially vulnerable in times of unusual dollar strength and should be protected against capital loss in the months ahead. Again, holding large cash positions (even though it yields zero) is the best strategy when the dollar becomes *an appreciating asset* on the global stage in case investors become starved for liquidity in a financial panic.

The most likely candidate to fall into crisis over the next few months would be the emerging market economies (EM). This asset class has been showing signs of stress ever since the Fed's first taper announcement last May. Although, it is also equally likely that the crisis might come out of left field and surprise the vast majority of market participants (like last year's bond market rout). One thing is for certain; excess liquidity often acts in odd ways and certainly cuts both ways. 2008 was a time when just about the whole ship went down together in the liquidity vacuum. Traditional safe have assets like the US dollar, gold, US Treasuries and the Japanese Yen were about the only assets on the planet to have a positive year in 2008.

Emerging Market Index Fund at a Critical Crossroad (2009 – Present)

The chart above of the Vanguard Emerging Market Index Fund shows an asset class at a very important crossroad. EM stocks have spent the past 2 ½ years consolidating in a narrow range as shown in the yellow box. This consolidation is close to reaching its boiling point. The US market is 70% higher over this same span, so the relative strength of emerging markets has been very poor. Whichever way this range breaks will have *enormous* implications for the global economy and markets. Since the US dollar appears poised to enter another rally phase, the odds unfortunately favor a downside resolution for world equity markets.

One final (optimistic) note about these positive dollar momentum cycles. The assets(s) that have been at the forefront of each crisis are obviously where the brunt of the losses have occurred. After investors have fled and liquidity has been sucked dry, there have been bargains in the wreckage to be exploited once the dollar momentum cycle turns negative again. US stocks were a good buy after the Lehman fiasco settled down and Europe was a good buy after the worst of the crisis past in July 2012. In addition, both bonds and gold appear to be on the mend after suffering much damage in the most recent positive dollar momentum liquidity vacuum. If in fact emerging markets are in the eye of this next storm, then we expect there to be bargains to be had across a variety of emerging country stock and bond markets once the dust from this next cycle settles. In general, the equity market valuation, debt and growth profile of the middle class in the emerging markets is much more attractive than the US. If it's not emerging markets that are the center of the next crisis, then we suspect that some other beaten-down asset class will provide an opportunity. Some off the radar areas of turmoil besides the emerging markets could be in no particular order: Japan, US corporate bonds, oil prices, Eurozone debt crisis flare-up and/or an unexpected US recession.