The Starboard Side Report

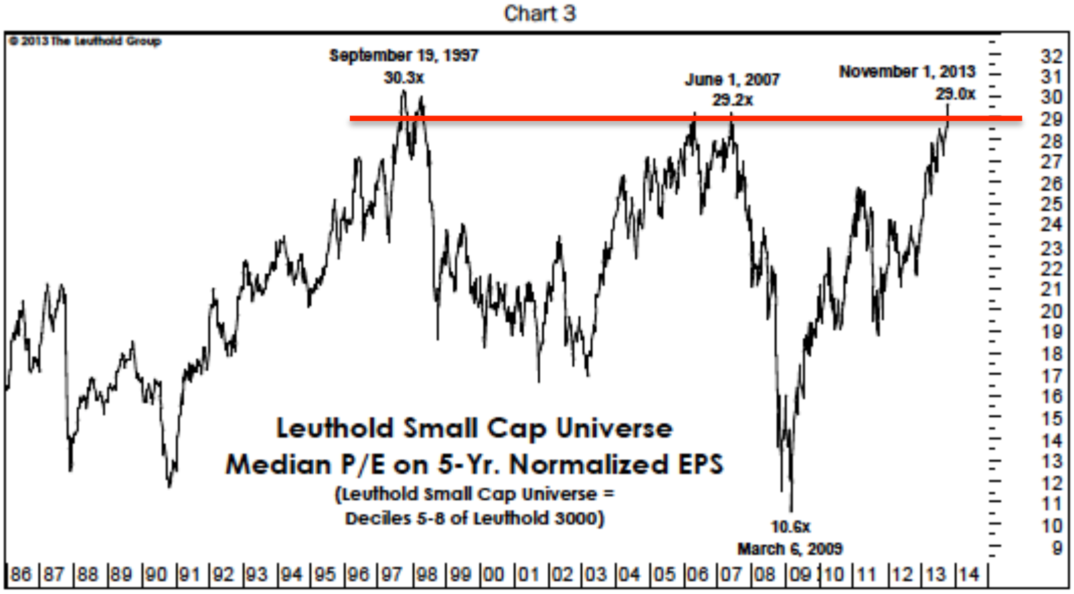
The week ending February 21, 2014

The focus of this week's report is the historic overvaluation of the small cap segment of the US market. According to Investopedia, "small cap refers to stocks with a relatively small market capitalization. The definition of small cap can vary among brokerages, but generally it is a company with a market capitalization of between $300 million and $2 billion." This is the "meat" of the tradable US equity markets due to the sheer volume of companies that comprise this category. According to Jonathan Langsdorf of Demand Media, of the 5,000 stocks that comprise the bulk of the US market, 85% of them fall within the small or micro cap category. The other 15% consists of more familiar large cap and blue chip mega cap stocks that are in the S&P 500 and Dow.

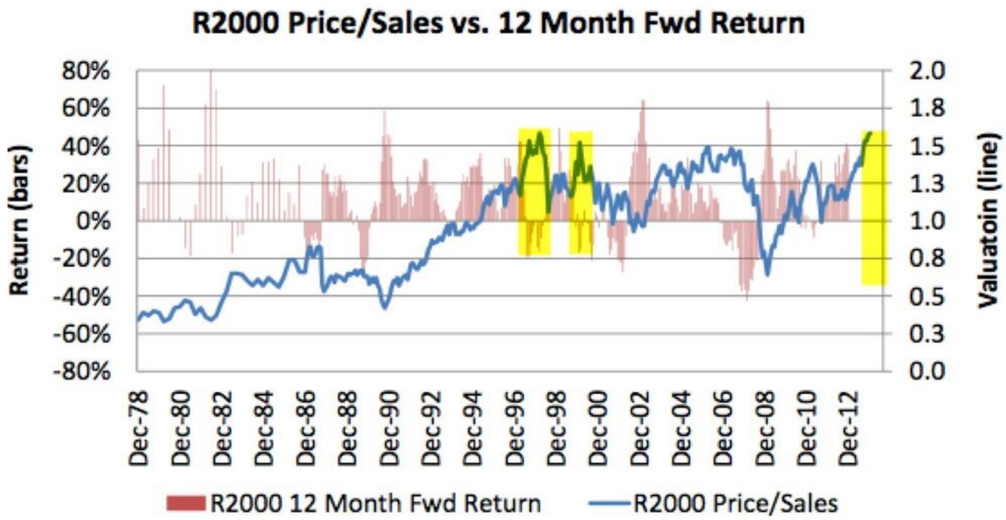
We don't have as rich a history on small caps as we do the large stocks. Nonetheless, we can get a very good read on whether this segment of the market is a good value. The first chart below from Leuthhold Group shows the Median 5-Yr Average P/E ratio of their Small Cap Universe going back to 1986. As you can clearly see, this November marked only the third time in three decades that the 5-Yr. P/E breached the 29 level. The other two times were in September 1997 and June 2007. As we will see later, these were both *very* poor times to be invested in stocks.

Leuthold Small Cap Universe Median P/E on 5-Yr, Normalized Earnings (1986 – Present)

Chart 3



The next chart that shows the overvaluation of small caps is this chart from Credit Suisse. The yellow highlights on the chart show that the Price/Sales Ratio of the Russell 2000 Small Cap Index has gone above 1.5 for the only the third time in its history. As the highlighted yellow text bottom of the chart mentions, small caps were down 12 months later in both of the other instances.



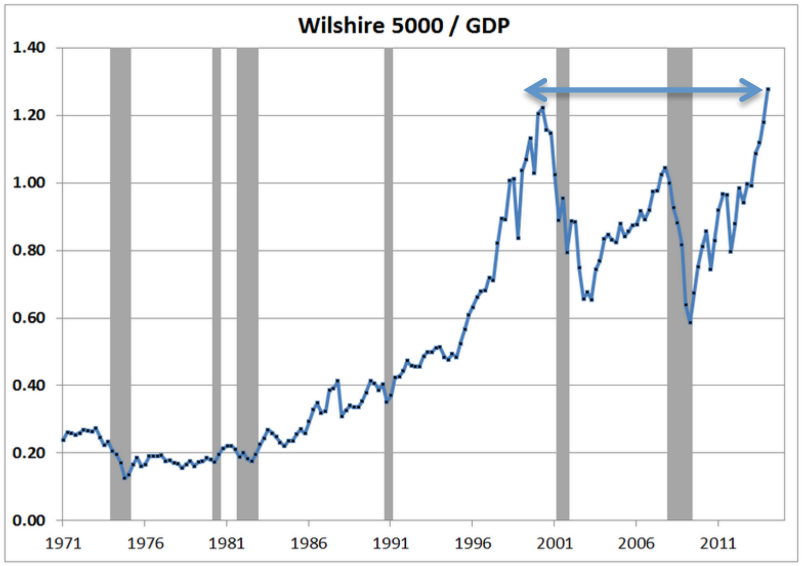
- Small caps have never been up on a 12 month forward basis when crossing the 1.5x price to sales barrier, as it did in December 2013.

Source: Credit Suisse

Looking at both of these charts it becomes easy to understand why the value of stocks in the US has never been higher when measured against GDP. The next chart below was shown our January 11, 2014 report. It is the value of the broad Wilshire 5000 Stock Index versus US Gross Domestic Product (GDP). At that point we said the following: **Assuming economic growth comes in as expected in the third and fourth quarter of 2013, the late December equity rally has now made the US market, as defined by the very broad Wilshire 5000 Index, the most expensive in history versus the underlying output of the economy (GDP). This could be looked at as the ultimate price-to-revenue ratio for the entire economy (i.e. how much the market is willing to pay for each sales dollar generated by the publicly traded universe). As you can clearly see, it is now above the extreme peak that occurred in the first quarter of 2000 right before the technology bubble burst. In early 2000, that overvalued market was driven mainly by a select group of large stocks and the technology sector. This version is much broader in that wide swaths of small and mid sized companies are those that are the most expensive. Despite the fact that there may be one final surge higher at some point in the first quarter (as there was in 2000), risk levels are extraordinarily high as we start the New Year. We remained convinced that there will soon be an epic shakeout that will**

return security prices to more attractive levels and provide investors with a *much* better long-term opportunity to buy.

US Stock Market / US Gross Domestic Product (1971 – Present)



Sources: Bill Hester, Hussman Funds & Doug Short, dshort.com

We can say from these valuation charts shown above that 1998, 2000 and 2007 were the other times when the small cap market was as overpriced as it was at the end of 2013. The troubling aspect is that GDP was growing at 6% in 1998, 6% in 2000, 5% in 2007; but, it's only 3% in the current example. That actually makes this market twice as expensive on a price to growth rate basis. As you can clearly see on the next chart below, buying small cap stocks at historic overvaluation levels has proved to be a bad move.

Russell 2000 Small Cap Index Overvaluation (1998, 2000 and 2007)

From the blue dot that marks similar overvaluation to present levels, the average correction from the price peak has been 47%. Whether the Russell 2000 peaks here or 5% above here a month or two from now, the odds greatly favor a *major* correction cycle beginning at some point in the first half of this year.

All is not lost for investors who fear a bad outcome for US stocks over the next year or two. There should still be places to hide, which should allow us to protect and grow capital as we wait for more attractive valuations in US stocks. Last week we discussed the tremendous opportunity in the gold sector. This week we revisit a theme that we have been hitting on since October; namely, long-dated US Treasury Bonds. Below you can see that each of the severe overvaluation periods for US small caps was actually a major strategic buying opportunity in the 30-year T-Bond. The average gain of the 30-Yr Bond was 28.6% in each of the blue dot Russell 2000 overvaluation periods discussed above.

US 30-Year Treasury Bond Price (1998, 2000 and 2007 Buying Opportunities)

The next chart was used in our first report of 2014 to show this contrast between stocks and long-dated government bonds and the opportunity it presents going forward. US government bonds are traditionally a safe haven when stocks are overvalued and usually offer a port in the storm when volatility spikes. The only way in which bonds will fail as a safe have during a stock bear market is if inflation rears its ugly head. Insurance in the form of gold and commodity positions will be a good offset in the event that inflation does indeed make a surprise resurgence.

30-Year US Treasury Bond Price vs. Dow Jones Industrial Average (1998 – Present)

In summary, we continue to believe that a balanced defensive portfolio of gold, long-dated US treasury bonds and cash should outperform a pure stock portfolio in 2014. This is especially true if that stock portfolio is heavily weighted towards small cap securities. The risk reward chart below shows a 67% downside risk to the green long-term support line for the Russell 2000.

Risk vs. Reward Chart -----Russell 2000 Index (1996 – Present)