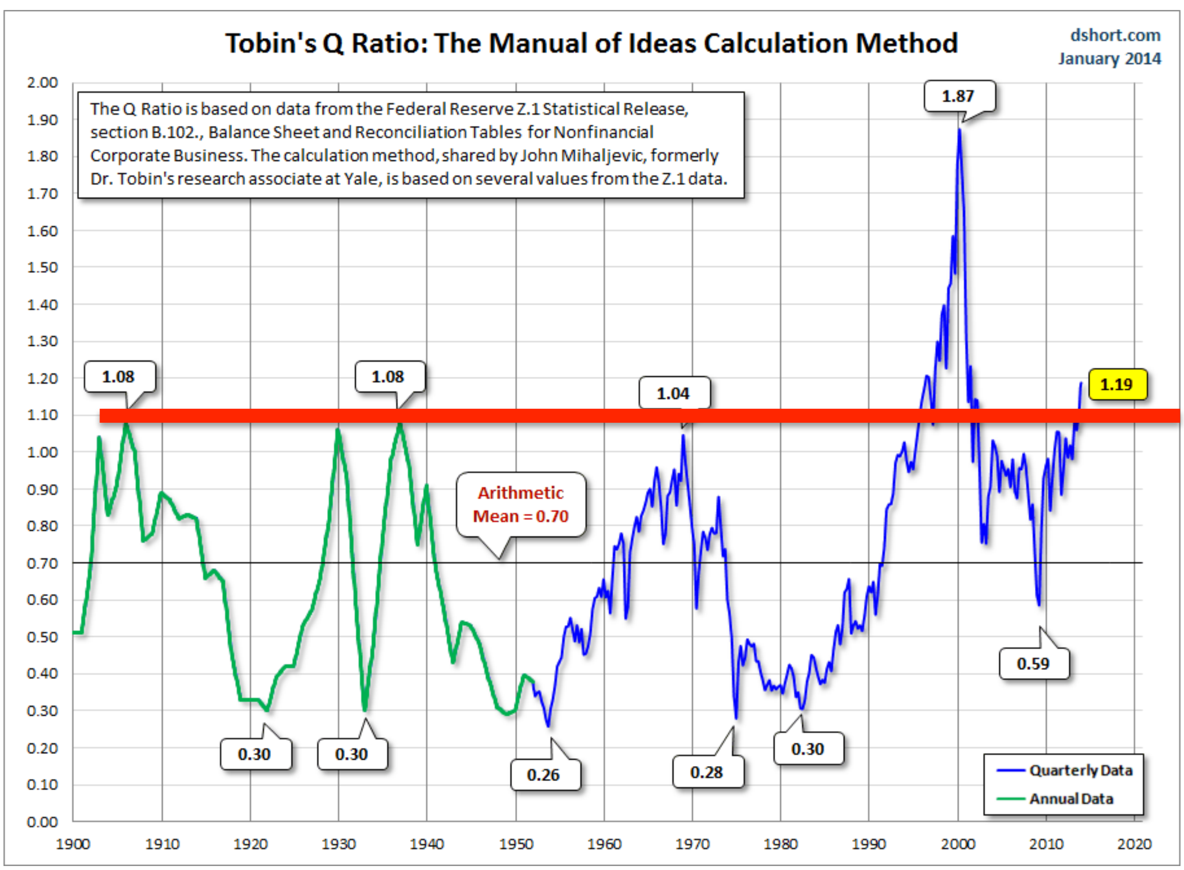
The Starboard Side Report

The week ending January 03, 2014

"The financial media regularly hand retail investors a rear-view mirror believing this will help to navigate the road ahead." Peter Atwater

2013 was an absolute gift to US equity investors. The majority of the 30% gain in the S&P 500 occurred without a corresponding improvement in company fundamentals (i.e. there was very little revenue or earnings growth). The unfortunate outcome of this big Fed driven rally is that it has simply stolen returns from the future. There are no free lunches in finance, so we feel strongly that the next few years will consist of a very painful downside mean reversion. The majority of fundamentally driven studies point to the S&P 500 being at or below this level ten years from now. This is the same thing that happened in the late 1990's and it is why the market was trading at lower levels in 2009 then it was in 1999. It also is the reason that the market was no higher in 1978 than it was in 1968 and no higher in 1939 than it was in 1929. Time and time again throughout history, whenever markets get to these expensive valuation levels, momentum eventually stalls out and downside mean reversion takes place.

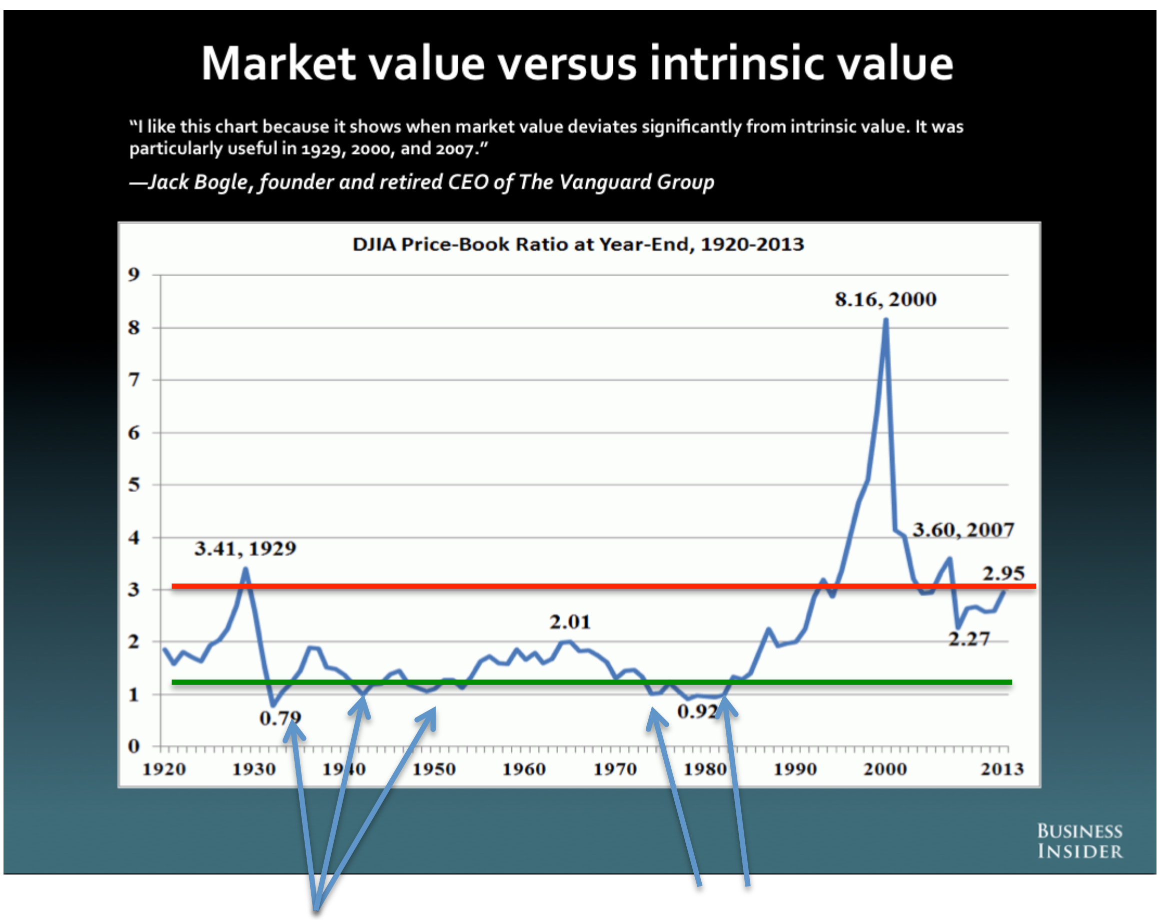
Tobin's Q Ratio (1900 – Present)



The first chart above has been shown many times in this report. It is the Q Ratio and it gives a measure of the total price of the market divided by the replacement cost of all its companies (excluding intellectual property). This is a unique long-term look at the valuation that the market places on the aggregate US corporate balance sheet. As you can clearly see, the most recent update as of the end of the year comes above the red line drawn at 1.10 for only the second time in history. Only the final months of the technology bubble in early 2000 registered overvaluation readings above where we are at present.

The next chart from Vanguard founder Jack Bogle shows the price-to-book ratio of the Dow Jones Industrial Average. Going into year-end this figure stood at 2.95. The only other times in history above 3 were 1929, 1999 and 2007. The average bear market decline once these markets ran out of gas was 65%! Good *sustainable* long-term buying opportunities in history have only occurred with this ratio below 1.0. This level was hit on three separate occasions during the 1929-1950 bear market and twice during the 1968 – 1982 bear market. During this bear market that began in 2000, the lowest the ratio reached was 2.27 in 2009.

Dow Jones Industrial Average Price to Book Ratio at Year-end (1920 – Present)



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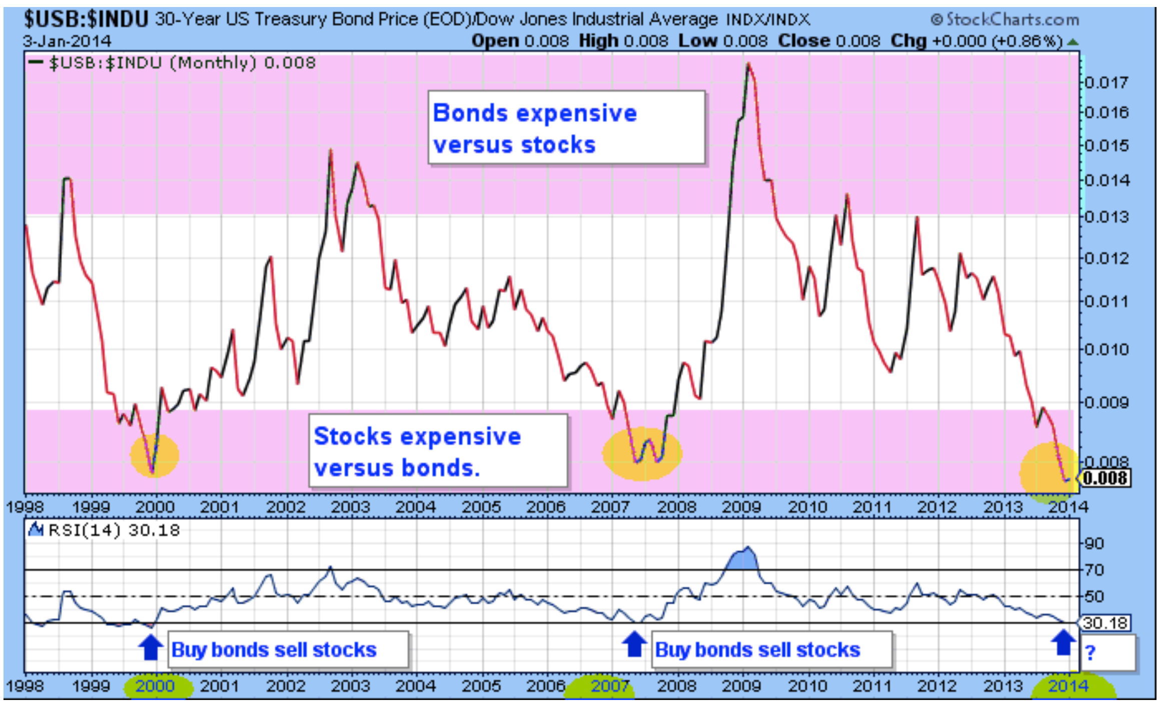
The stock market vastly outperformed the bond market in the US last year. The Barclay's 20+ Year Treasury Bond Fund was down 16% in 2013 versus a 30% gain for the S&P 500 Index. This is one of the biggest outperformances on record for stocks over bonds. One of the issues that may finally take the air out of this market is a big rotation of pension money from stocks back into long-term treasuries. The yield on the 30-year Treasury bond is closing in on 4% after a big spike higher last year. This is well above the prevailing economic growth rate, the going money market rate and the current inflation rate. The chart below helps to outline the case for rebalancing 2013 stock winnings into the long end of the yield curve.

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



Since 1998 this relationship pictured in the chart has followed an orderly pattern. A rising line means that bonds are outperforming stocks and a falling line means that stocks are outperforming bonds. The upper pink zone has tended to indicate points in time when bonds have been a poor relative value versus the Dow Jones Industrial Average (1998, 2003, 2009 and 2010). The lower pink zone (further highlighted with yellow circles) indicates those points (2000 and 2007) where bonds have been the more attractive relative value and rewarded investors that rotated into bonds from stocks. Will 2014 begin another period of bond outperformance to rival 2000-2001 and 2007-2008? Coupled with the extreme stock market overvaluation that the corporate balance sheet analysis shows above, we may start to see some downward pressure placed on stocks in the first half of the year as a great rebalancing occurs amongst pension funds. This rotation away from stocks on the part of big money players should send some money towards safe haven assets that were abandoned last year like US treasury bonds and gold. The momentum that exists in stocks right now makes this rotation/rebalance a process and not an event. Bond yields could still have a final spike higher (bond prices lower as bond prices move inversely to yields), especially if we have a final blow-off rally in stocks over the coming weeks. We expect the financial media's rearview mirror reporting to continue to help drive money into stocks by making everyone fear they'll be missing out on another year like 2013. However, we expect long-term forward looking and risk conscience investors to increasingly start to leave the equity party as 2014 unfolds. As in 2000 and 2007, this will create headwinds that are tough to overcome. Once momentum eventually starts moving in the other direction from pension investors selling stocks, the third cyclical equity bear market since 2000 may very well follow with a vengeance.