



The Starboard Side Report

The week ending January 17, 2014

Never in a million years did we think that the market would fall victim *yet again* to the US Federal Reserve's desire to generate another reckless asset boom; yet here we are in full-blown bubble territory again. The first two booms ended in misfortune for investors that were sucked into the seductive theory of infinitely expanding asset prices. The old saying "fool me once shame on you, fool me twice shame on me" needs to be amended to include a third verse for the latest boom cycle. Not only are the exact same policies that led to the last two boom-bust cycles being tried again, but they are being carried out to an even greater degree. It is all a grand experiment being carried out by 12 *unelected* academics at the Fed; the majority who have never worked in the private sector. They have the audacity to believe that they can massage and manipulate the once free market into a path of their choosing. The chart below shows the boom-bust cycle that activist central banking has produced in the US market over the past two decades.

S&P 500 BOOM – BUST Economy (1995 – Present)



The first boom was the technology bubble that saw the S&P 500 advance 250% over a 62-month span. The bear market that followed knocked off 50%. The second boom was the housing bubble that saw the S&P 500 advance 105% over a 60-month span. The bear market that followed knocked off 58% and left boatloads of debt behind that will never get fully repaid. The current boom is what we refer to as the Federal Reserve confidence boom. QE (quantitative easing) policies carried out by the Federal Reserve have led to a very dangerous false confidence in the ability of central bankers to take the risk out of markets. This is perhaps the most dangerous boom cycle of all because it is built on false hopes, excessive leverage *and* shaky fundamentals. Using the prior two cycles lengths as our gauge, we should see the top of this

boom phase at some point during the first quarter of 2014. Whether that is next week or late March we cannot predict. As we learned with the top of the technology bubble, a market with this much momentum and liquidity can have a final spectacular rally before it flames out. Whether this one has enough gas in the tank to rally one last time remains to be seen.

One of the arguments against one final leg higher is the breakdown that we are seeing in the retail sector. This is important because the US consumer is the most ferocious in the world and makes up 68% of the entire US economy.

Directly below is a sampling of some core stocks in the discretionary retail sector that are starting to melt down due to disappointing earnings.

Best Buy Co, Inc. (1 year Chart)



Bed Bath & Beyond (1 year Chart)

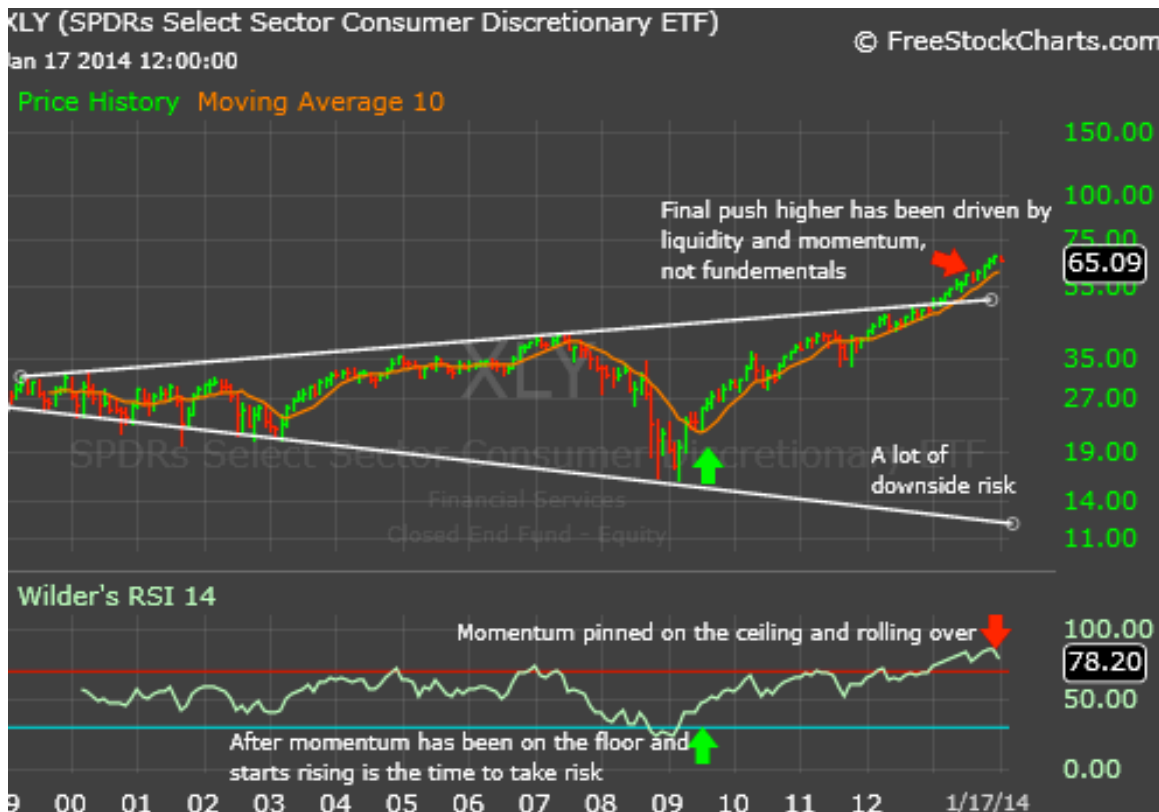


PetSmart, Inc (1 year Chart)



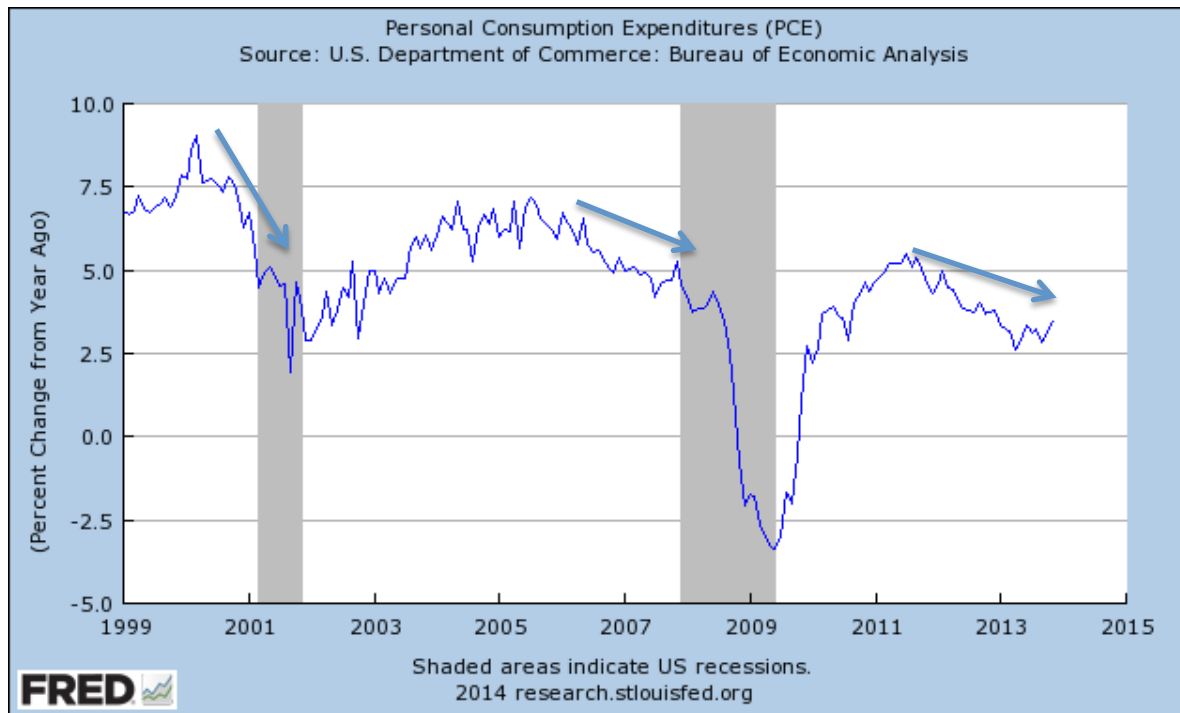
This is a troubling sign because the consumer sector has been the leading sector off of the 2008 market bottom. It is really an amazing comeback considering large swaths of the industry were on the verge of going out of business in early 2009. It speaks to the resilience of the American consumer; a resilience that is now being tested after a five year bull market cycle.

S&P Consumer Discretionary Fund (1999 – Present)



Not many are expecting a recession in 2014, but the following charts make us think that it is not a zero probability event as the market and Federal Reserve would have us believe.

US Personal Consumption Expenditures (1999 – Present)



The vertical gray shaded areas on the chart above indicate the recessions in 2001 and 2007. Notice how the Personal Consumption Expenditures (PCE) has been decelerating like it did before the past two recessions (see arrows on chart). The fact that important retail stocks are starting to crash in conjunction with this deceleration in US consumer spending is a recessionary red flag that occurred close to the stock market tops in 2000 and 2007. Surging interest rates, historically elevated gas prices and stagnant income growth appears to be finally catching up to the average American. The doubling of interest rates last year can't be overlooked as a major cause in the slowdown in the retail sector. The Federal Reserve has created an economy that is addicted to cheap credit, so to think that a significant increase in the cost of that credit would not cause some ripples is a bit of wishful thinking on the part of investors.

One final issue as it pertains to the risk versus reward of certain sectors in the market.

Divergences are something that every investor should pay attention to near major tops and bottoms. In this example we use the bullish percent index of the S&P Consumer Discretionary sector to see that the bullish percent index topped out in May (top pane in next chart), yet the price index kept going higher into the end of last year (bottom pane in next chart). This falling

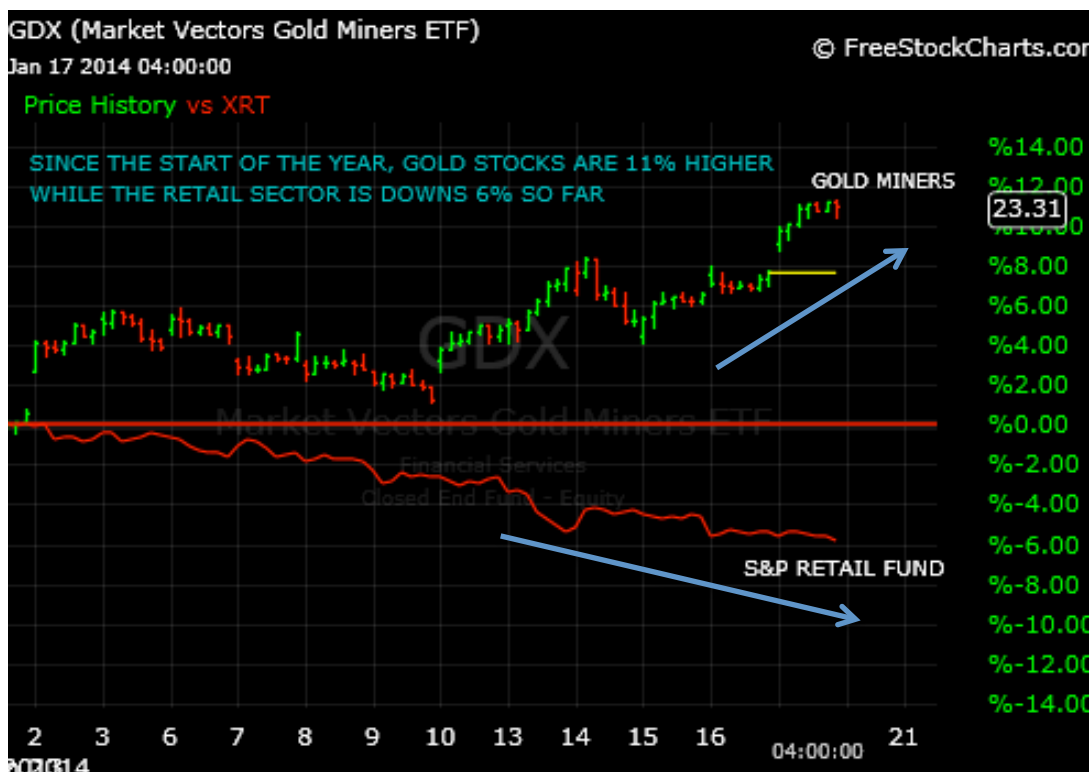
bullish percent index in the face of a still rising index price was a warning that the sector internals were weakening and vulnerable to a decline like the one that is beginning to play out.

S&P Consumer Discretionary Bullish Percent Index (1 year Chart)



In contrast to retail stocks in the US, the gold mining shares are having a good start to the year. As the chart below shows gold stocks are up 11% year-to-date versus a 6% loss for the S&P Retail Index. Three weeks does not a trend make, but it is an interesting start to the year.

Gold Miners vs. Retail Sector Performance (Year-to-Date)



The final chart shows where the PHLX Gold Miners Index stands from a longer-term perspective. It has obviously had a very difficult two-year bear market while US retail stocks have rocketed higher. Yet the current positioning for gold stocks looks very similar to retail stocks in early 2009 as they were making their *major cycle bottom* (see chart on bottom of page three). The RSI momentum in gold miners is turning up off of the floor just as the index has found its long-term support line. This presents a good risk reward set-up. It has been a very tough bottoming process since June of last year, but it appears to us that the ultimate bottom of this down cycle is very close to being in place (in fact, there is some good evidence that it has already arrived and the train is leaving the station). The reason we can say this with some level of confidence is that we are seeing *positive* divergences building across the sector. This is the opposite of the retail sector where *negative* divergences are being observed. The bullish percent index of the gold miners made its low in late June and has been steadily climbing since that time even though some of the stocks and indices have gone on to marginal new lows. The gold mining sector and the US retail sector appear to be mirror images of each other with the one making a major cyclical low while the other makes a major cyclical peak. The leadership status of the retail sector for much of the last five years makes the fact that it is starting to wobble all the more important.

PHLX Gold/Silver Index (1996 – Present)



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