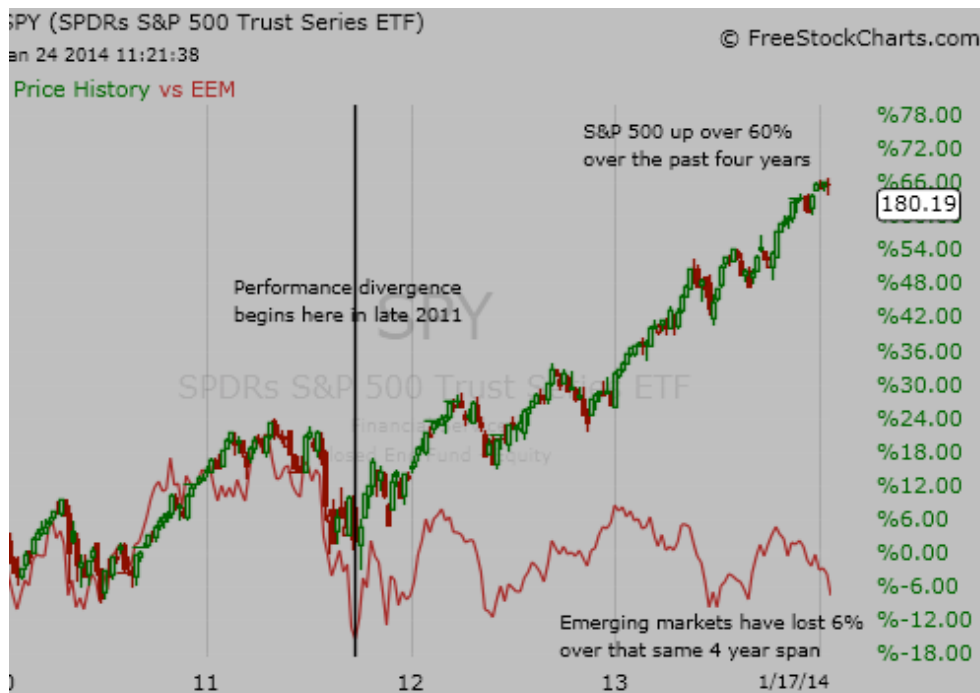
The Starboard Side Report

The week ending January 24, 2014

It was a rough week for the financial markets (especially in the emerging world). The financial crisis in 2008 was born in the western developed world and eventually spread to the eastern and emerging world. The next crisis may be the polar opposite in that it will be born in the east and the emerging world and spread to the western/developed world. Over the past four years, the chart of the emerging markets index has been one of listless performance. Money has shunned China, India, Brazil and other high growth countries in favor of the US and its friendly money printing central bankers. Since 2010, the S&P 500 is up over 60% versus a -6% decline for emerging market stocks. This emerging world weakness could be a harbinger of financial crisis.

S&P 500 Index vs. Emerging Market Stock Index (Jan 2010 – Present)



Emerging Market Stock Index (Jan 2010 – Present)

It is not just emerging markets that have had a tough time since the start of 2010. Any major diversified asset class has lagged the US over the past four years. We think the following table is interesting.

Asset Class	Four Year % Change	
US Small Cap Stocks	87.47	
US Large Cap Stocks	63.97	
Precious Metals	14.97	
Emerging Market Bonds	6.25	
US Bond Market	4.03	Average
European Stocks	0.94	2.75
Cash	0.35	
Commodities	-1.9	
Emerging Market Stocks	-5.37	

Since January of 2010, the seven diversified assets listed above in black font are up on average 2.75% in total. This compares to a blended average of 75% for US large and small cap stocks. This is an enormous disconnect that can't be explained away by fundamentals alone. There is clear support being given to US stocks by the US Federal Reserve's quantitative easing policies. Now that they are starting to unwind that stimulus, we are expected to believe that the US will continue to outperform going forward. When all is said and done, we believe 2014 will be the year that volatility returns to the US stock market in a big way.

Here is one example of how quickly a speculative market can turn down. Turkey was one of the strongest performing stock markets in the world at this point last year. Below we have the anatomy of its collapse drawn out to see how quickly it can all come apart when driven by momentum and liquidity. Two years worth of gains have been wiped out in just eight months.

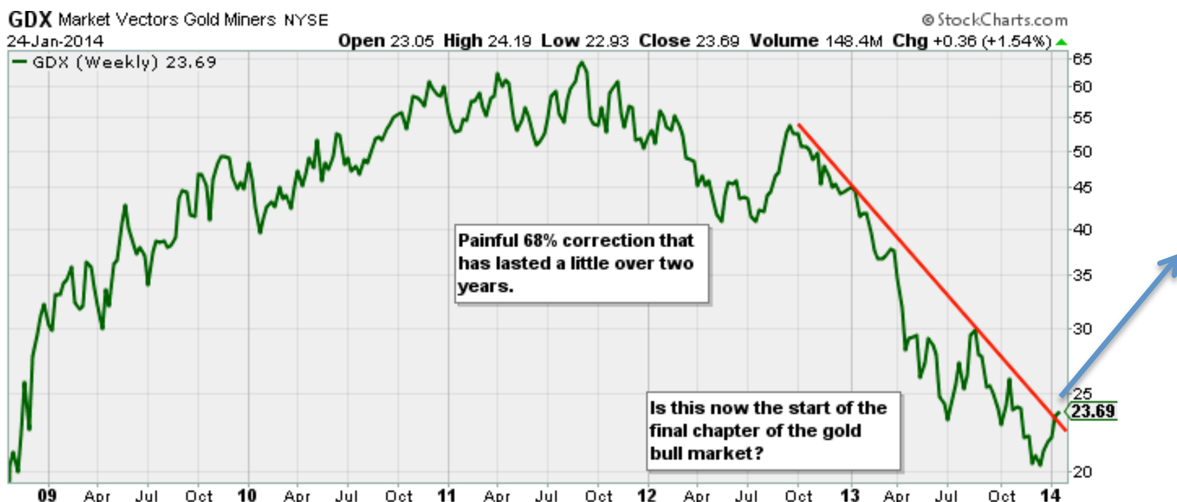
There was a 14% correction between late January and early March 2013, then a last chance two-month rally to a slightly higher high in May and then a huge liquidity vacuum when the Federal Reserve first announced they might begin to stop quantitative easing. This could be a template as to how the US market decline will play out over the next year. A big correction, one final rally attempt and then a big liquidity vacuum induced bear market.

Big Picture: Gold Mining Stocks in the 1970's Bull Market

Painful 68% mid-cycle correction that lasted two years.

Then a powerful 4 year close to the bull market

Gold Mining stocks since 2008 low



The charts above compare the gold mining stocks in the 1970's gold bull market with the current edition. As you can see, both have a 68% cyclical bear market correction phase that lasted just over two years. Between July 1974 and September 1976, the Barron's gold mining index went from 625 down to 195 (top chart above). In an interesting parallel, the Market Vectors Gold Miners Fund pictured above fell from 64 to 20 between September 2011 and November 2013. Two twenty-six month cyclical bear markets with just about exactly the same drop. The only question left is whether or not this current cycle will close with a powerful bull market as in the prior instance.

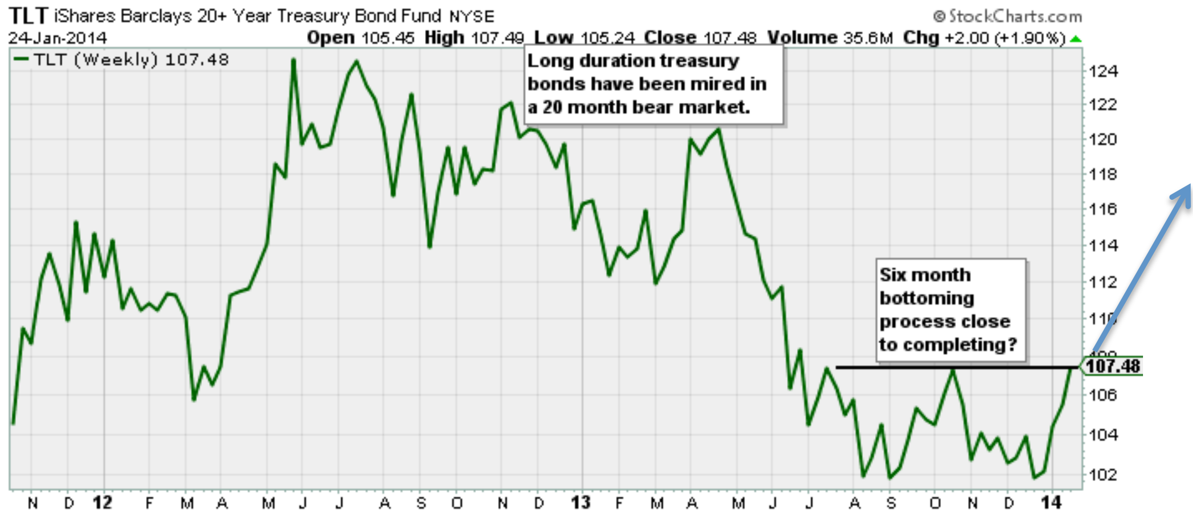
Gold and gold mining stocks both closed the week higher, which bodes well for the bottoming process that has been taking place in this beaten down sector. The rally in the mining shares this week allowed the sector chart to poke its head above the very steep downtrend line that goes back to the summer of 2012. That "green shoot" can be seen on the bottom chart. This adds further evidence to the bottoming thesis.

Much like the gold sector rallies of 1973-74, 1977-80 and 2001-02, we expect the next cyclical bull market in gold to rally in a countertrend fashion, with major stock indexes weak and gold strong. Gold is at its best as an alternative asset when it protects capital during cyclical bear markets in the equity markets. The major divergence in performance between gold and the Dow Jones Industrial Average over the past two years has set the stage for another significant countertrend cycle in which gold preserves capital during a stock bear market. The Federal Reserve's profligacy has only made this outcome all the more certain in our eyes.

The other asset that should preserve capital in the event of another US equity bear market is long duration US Treasury Bonds. Like gold, this asset class has been in a multi-year bear market (twenty months in this case), but has been showing signs of bottoming. As long time readers of this report know, we have been negative on US Treasury bonds for a long time, but have recently been warming up to this asset class due to the big decline in bond prices over the past year. At a yield of close to 4%, we feel that long duration US Treasuries currently provide better risk-reward than the US stock market (with lower volatility). As a result, we feel it is prudent to put *some* 0% yielding cash in this direction in order to provide deflation/economic recession insurance. Below is a chart that shows a close up of the struggle that bond funds have had over the past two years and the bottoming process that is playing out just as stocks appear to be getting top heavy.

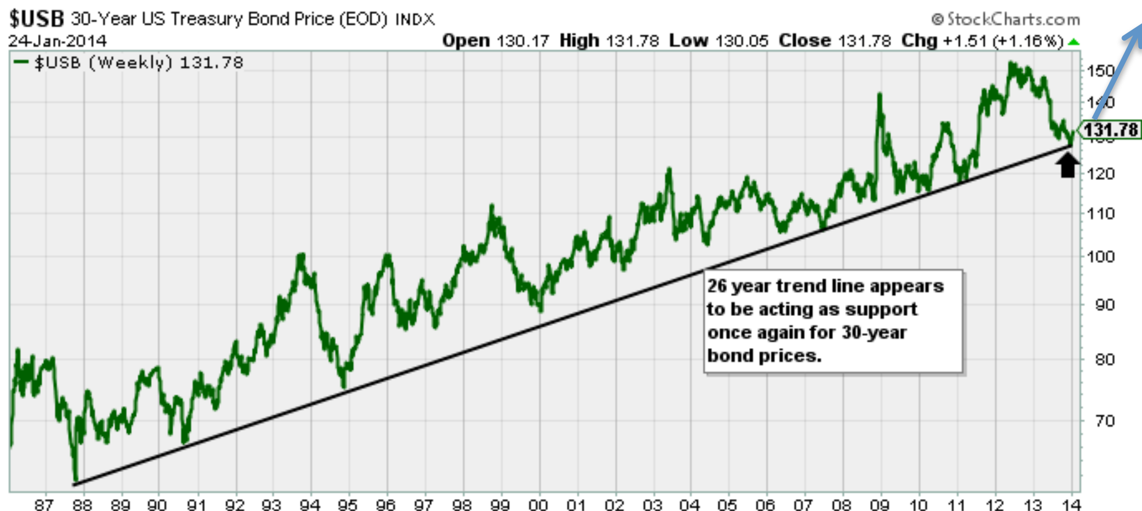
Cyclical Bear Market

iShares Barclays 20+ Year Treasury Bond Fund (October 2011 – Present)



If we drill out to the big picture, we can see that the 30-year bond in the US still appears to be in a long-term bull market uptrend that may have one final big push higher before the end of the road is hit.

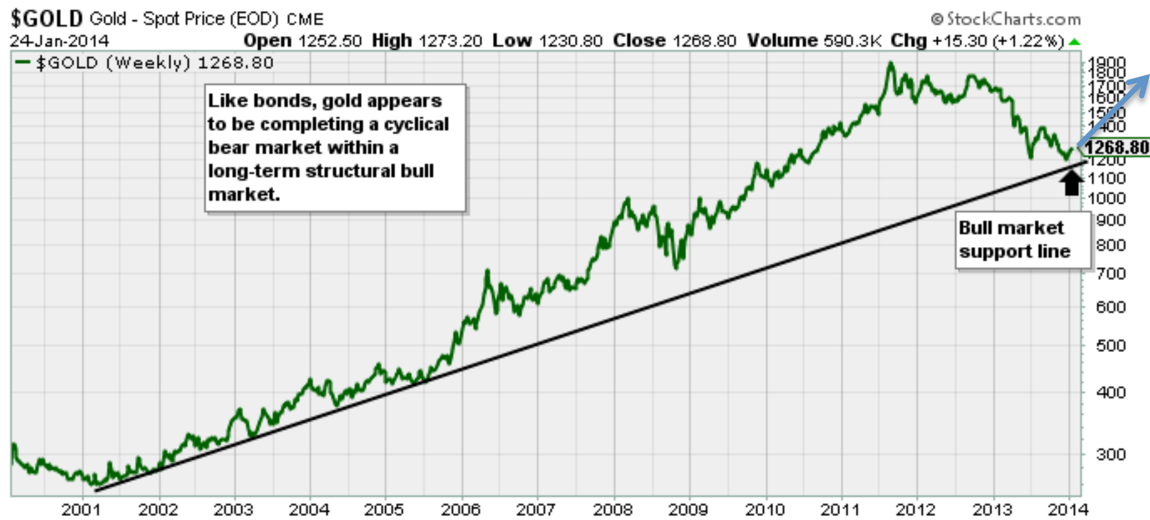
The Big Picture Bull: 30-Year US Treasury Bond Price Index (1986 – Present)



In conclusion, we see gold and long duration US treasury bonds as “safe haven” assets that are potentially coming to the end of multi-year *cyclical* bear markets that have run contra to the US stock market rally. Investors have poured money out of bond and gold funds in order to chase growth and risk through the equity markets. We feel 2014 will be a year in which those growth expectations will come under increased scrutiny if the emerging markets financial crisis that we mention above comes to fruition. Any flight from riskier assets like global stock markets will

likely create a U-turn in investor fund flows back towards these safe haven assets that are actually in long-term structural bull markets.

The Big Picture Bull: Gold Price (2000 – Present)



One final chart this week to contrast with the big picture gold and bond charts. This is of the S&P 100 Index, which consists of the 100 largest stocks in the US market. Please notice how the recent rollover in stock prices is occurring at the exact secular price peak first hit way back in 2000. This is the very essence of a grinding long-term structural bear market.

The Big Picture Bear: S&P 100 Index (2000 – Present)

The extremely strong, almost vertical, recent performance of this major US stock index has overlapped the nasty bear market declines in the gold sector and bonds discussed above. Again, we expect these polar opposite trends to reverse themselves in the months ahead as investors

come to grips with less Fed stimulus and a faltering global economic recovery. Therefore, the trading action that was observed this week with gold and bonds rallying, as stocks sold off sharply, could very well be a microcosm of how the big picture will eventually play out over the course of 2014.

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