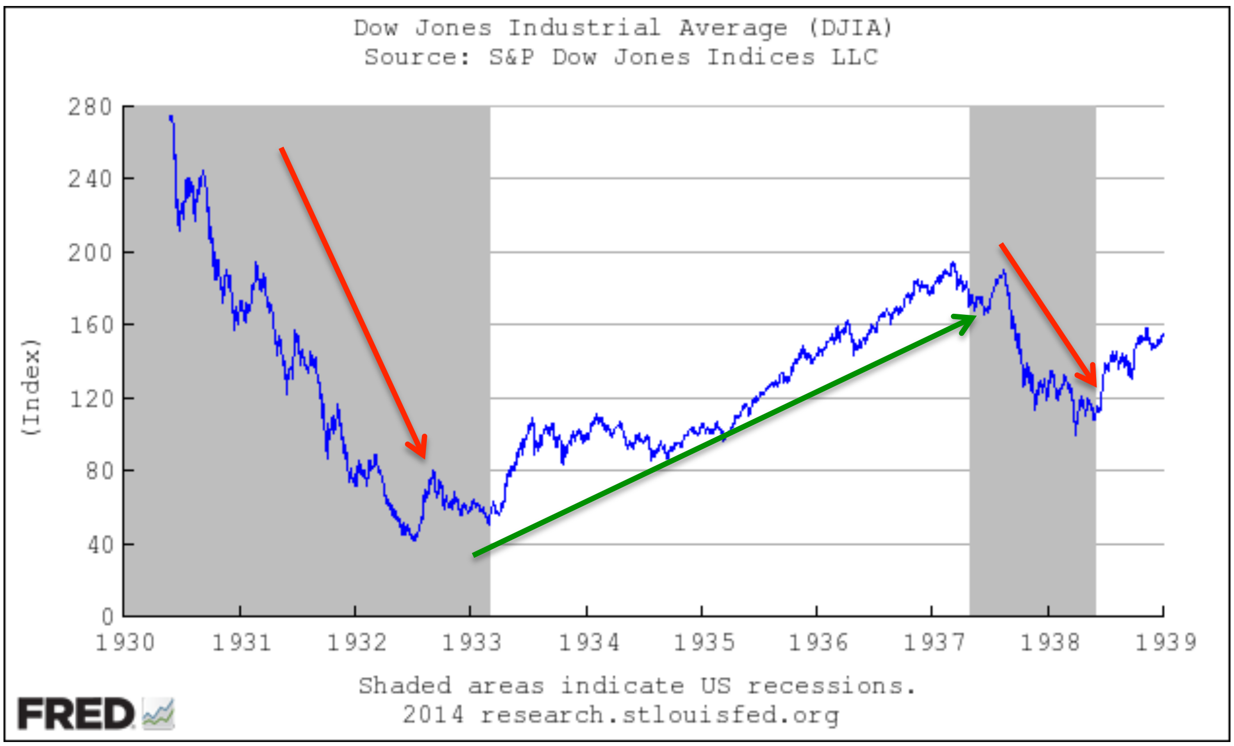
The Starboard Side Report

The week ending January 31, 2014

The million-dollar question is whether this poor start to the year is simply the beginning of another healthy 5-10% correction that will lead to higher levels in a few months time or if it's the start of a new cyclical bear market. It is still too early to make the determination, but if this is the start of a new cyclical bear market, then it means that the 16,500 level on the Dow could very well be the high-water mark for the next several years as opposed to the high level for just the next few months. Let's look at two charts that show what we mean by that.

Dow Jones Industrial Average (1930 – 1938)



Great Depression

Huge 56-month rebound rally

Secondary depression with 50% decline

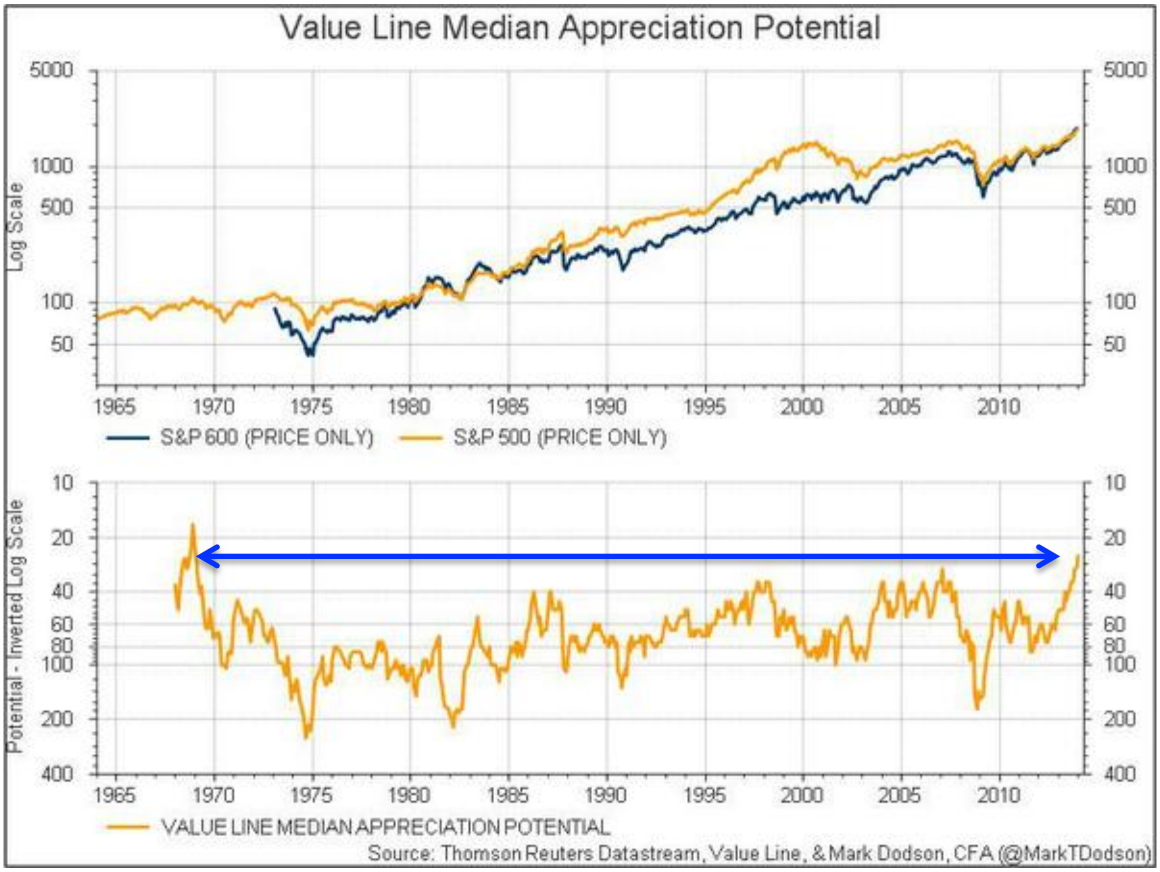
There was a lot of commentary during the depths of the financial crisis in 2008 that the economic carnage was the worst since the Great Depression of the early 1930's. Interestingly, the current 59-month stock market rebound off of the 2009 low has been one of the strongest rallies since the huge 56-month bull market that followed the Great Depression bottom. We have clearly pictured this 1930's rally with the green arrow on the chart above. Yet, the important arrow to focus on is the last red arrow on the far right of the chart that shows a secondary depression hitting the markets after the New Deal stimulus wore off. This led to a severe 50% correction that wiped out the majority of the gains from the prior bull cycle in only 13 months. The 200 level that the Dow approached at its peak in March of 1937 was not seen again for another nine years! This is why we begin the report by posing the very important question as to whether this is a typical correction in a bull market that has more to go (then a new Dow high will be seen within a few months) or the end of the road for the powerful cyclical bull market that began in 2009 (it could be a decade until a new Dow high is seen again). Here are the ten years following that 1937 peak.

Dow Jones Industrial Average (1937 – 1950)

Nine long years until the 1937 peak was reached again and
13 years until a move above that level was sustained.

The reason we are so concerned that this may be the start of a cyclical bear market (the kind that grinds lower for one or two years) is due to the fact that valuations are so stretched at the moment. Below is an interesting chart we came across this week that backs-up some of the other valuation work that we have discussed in this report over the past several months.

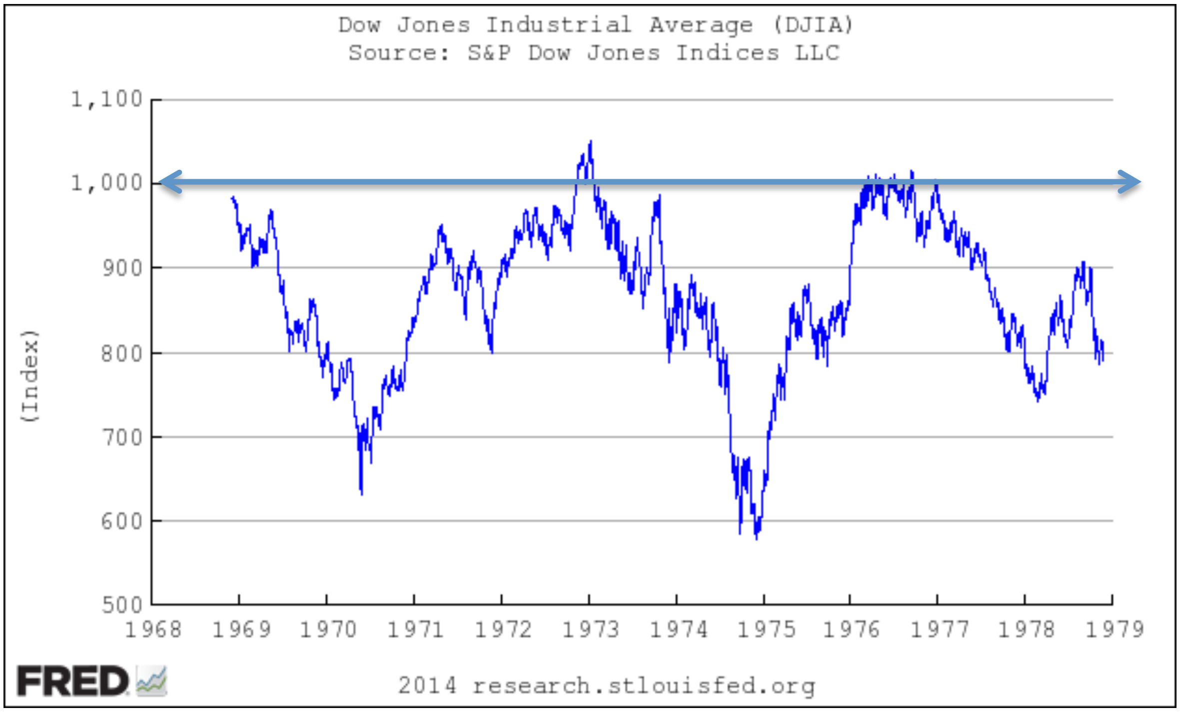
Value Line 3-5 Year Median Appreciation Potential (1968 – 2013)



Source: Mark Dodson

On the top pane in the chart above is the S&P 500 Index. We will focus on the bottom pane, which shows the Value Line Median Appreciation Potential (VLMAP). Value Line (a very well respected independent investment research firm) publishes an estimate for the median price appreciation potential of all 1,700 stocks they cover in the coming three to five years. This figure has had some pretty good "predictive power" and helps estimate how much value a wide universe of US stocks has to offer the long-term investor. A study by John Hussmann shows that if one subtracts about 55% from the VLMAP (due to the inherent optimism baked into analysts forecasts), the adjusted result approaches the actual subsequent four-year total return of the S&P 500. For instance, the current 25% projected total return would now become a negative 30% four-year total return. At the end of 2013, this indicator was screaming caution because you'd have to go all the way back to late 1968 in order to find another instance in which the VLMAP spent as long a period at 30% or below. Said another way, this 45-year low means that the market's potential upside over the next three to five years hasn't been this poor since 1968. Here is how the next 10 years played out after the market finally topped in December of 1968.

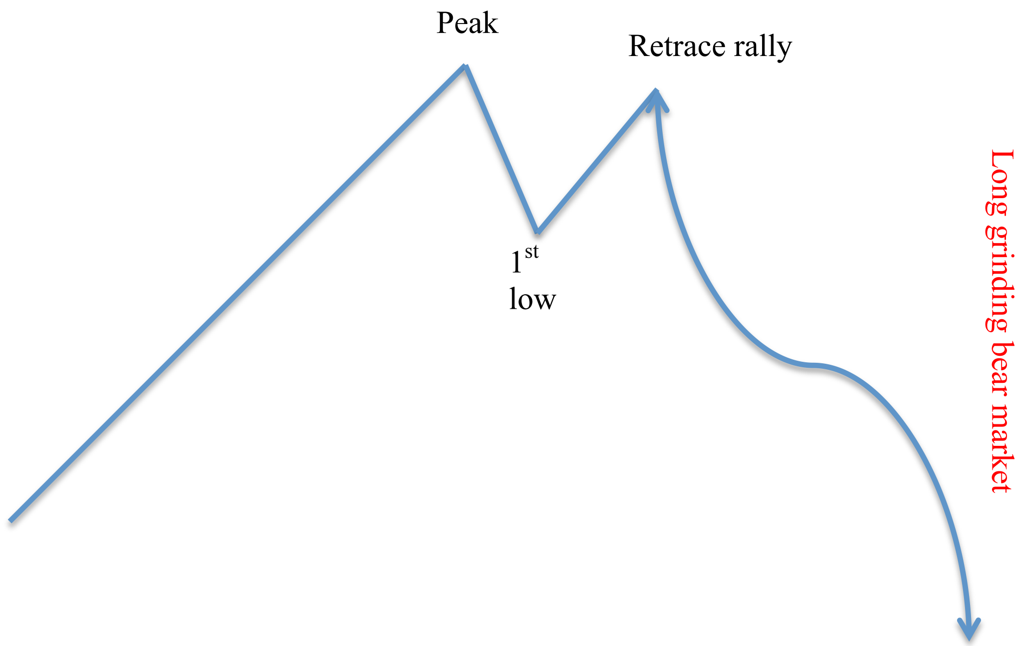
Dow Jones Industrial Average in the 10 years following only other VLMAP move below 30%



Please notice how it looks remarkably similar to the 10 years that followed the 1937 peak that we showed above. In this instance the 1,000 level served as the ceiling for the Dow over the next decade with two cyclical bear corrections of 35% and 50% encapsulated in this period. On the flip side, the VLMAP has been very good at identifying great low risk buying opportunities. In 1974, 1982 and 2009, the VLMAP was predicting close to around 200% returns over a 3-5 year period. Not surprisingly, those were the three greatest buying opportunities of the past four decades.

There is an old saying, *as goes January so goes the year*, which does not bode well for 2014. If a new cyclical bear market has in fact begun, there will likely be a pattern as to how it plays out. Below we show how the majority of cyclical bear markets evolve. There are usually three waves: 1) the first big move down that shaves between 10-20% from the major indexes like the Dow and S&P 500. 2) A retrace rally in which the optimists mistakenly feel that a buying opportunity is upon them and that the bull market is set to resume. This rally usually lasts 1 or 2 months and frequently retraces between 50% and the entire first decline. 3) The third wave is the most dangerous because it takes down even the strong stocks and grinds unmercifully lower for much longer than most can tolerate (think gold stocks in 2013).

Anatomy of a Cyclical Bear Market (Average Duration 18-24 months)



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