The Starboard Side Report

The week ending January 11, 2013

It is no secret that we like to study history in order to help us make informed investment decision. Since we believe that the US market is very close to the end of the cyclical bull market that began in 2009, we decided to look back at the last major top in 2007 to see if we can find any similarities. Lo and behold, there is a very similar pattern that has developed.

S&P 500- Final Six Months Before the Final Top in 2007

S&P 500- Past Six Months at Present

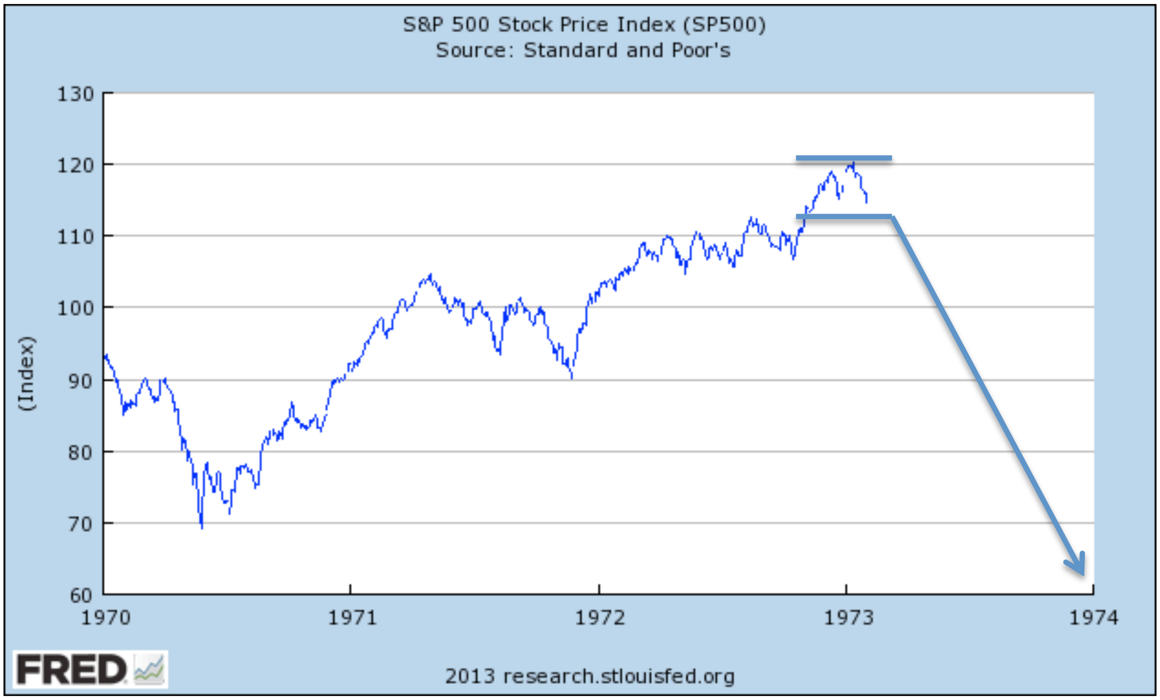
In the next chart, we fast forwarded the 2007 example above and added the next twelve months of trading through October 10, 2008. This clearly shows the euphoria surrounding that new multi-year high was very short-lived and ill timed. In fact, the market rallied for only another few sessions before rolling over and heading lower for the next fifteen months.

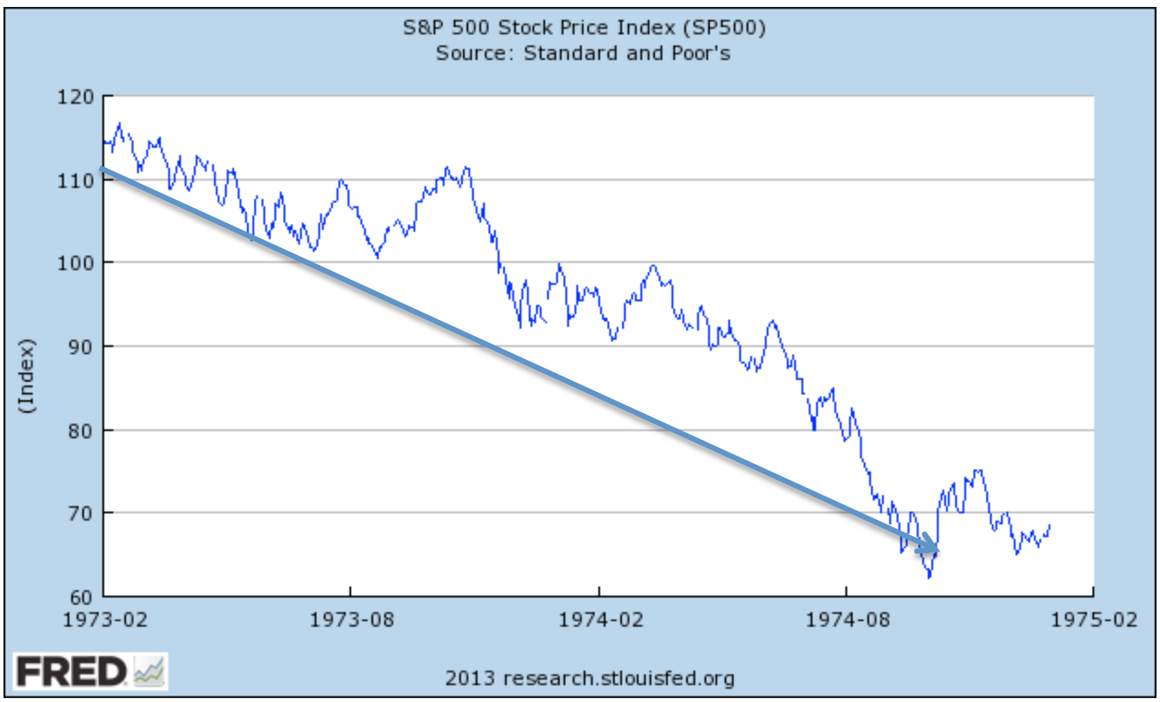
S&P 500 (April 2007 – October 10, 2007)

We are not guaranteeing that will happen this time around, only that you never know when an aging bull market will roll over and die. It is usually when people are least prepared for it and are feeling the most confident in further gains. Right now, bullish sentiment is quickly approaching an extreme in both equities and bonds. Major bull market *tops* are famous for sucking in the very last holdouts right before rolling over for good. This "oh what the hell, everyone else is doing it" investing approach can have catastrophic consequences on long-term performance. The key is to remain patient and not be one of the ones drawn in at the peak. Below are a few examples of market tops that fit the current profile (i.e. several years into a secular bear market with stocks at expensive valuations). More importantly, we show what the market did over the subsequent months.

The first two charts below show the January 1973 top that occurred two months after an incumbent was reelected president. The market broke out to a new high two weeks after the Nixon victory in November and rallied for two months (5.3% of upside) before topping out. Once it topped on January 11, 1973, the market gave back 48% over the next 20 months (second chart directly below). 5% of upside versus almost 50% of downside is not a very good risk to reward trade off to say the least. But, life sure appeared good for stock investors in those final two months and we would bet that many investors felt compelled to chase those final S&P 500 points so they did not to feel left out. Should stocks manage to break out here over the next few weeks, we see a similar best case scenario for the S&P 500 at about 5% upside (back to the old 2007 high) while the downside is similarly bad to 1973 (with a 50% drawdown possible).

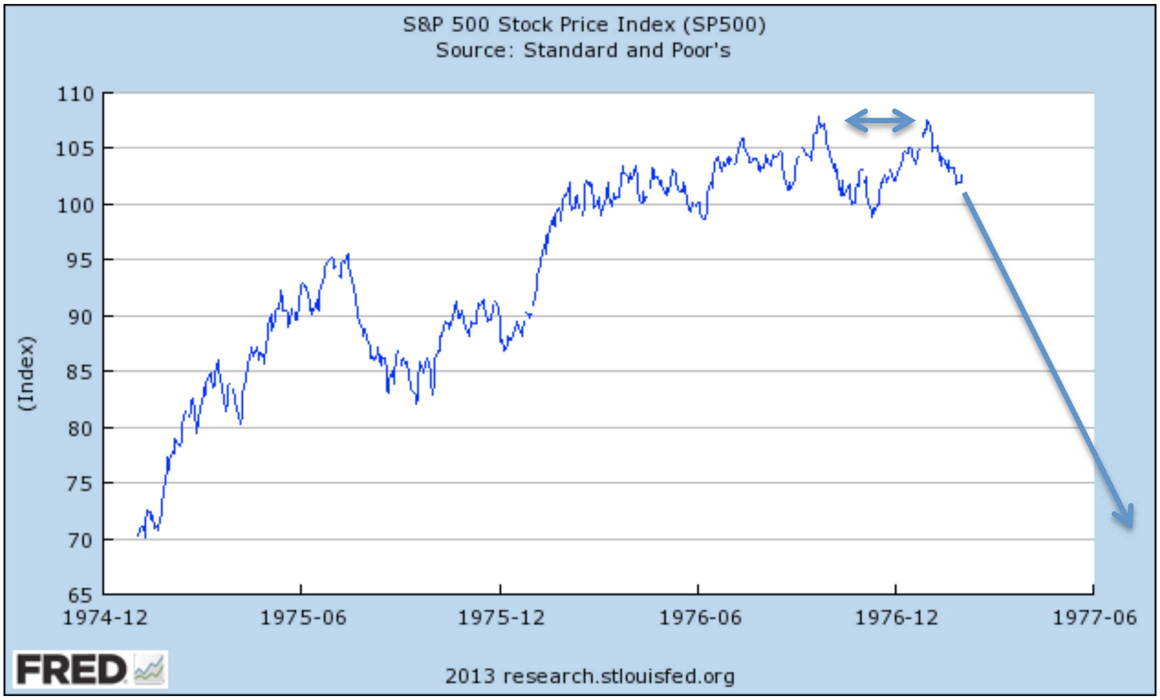
S&P 500 Index (January 1970 – January 1972) & Subsequent 48% Collapse

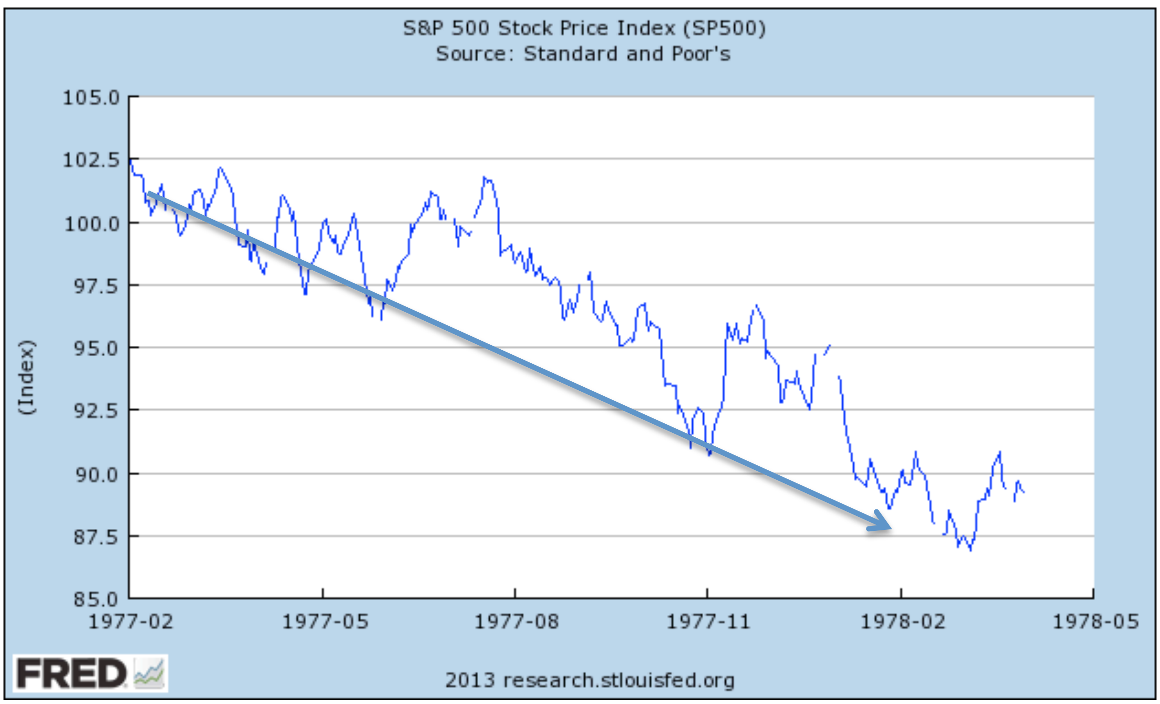




Another 1970's example that could fit the current market set-up is the top that formed in January 1977. Once again this major top occurred in the January immediately following a US Presidential election. This may fit even better than the 1973 top because we have the exact same pattern that we illustrated above; namely, a 36-day final rally that brought the market back to its prior multi-year peak. The market then proceeded to give back 20% over the next fourteen months. The market was much more attractively valued in early 1977, so the downside of 20% was provided by a valuation cushion that does not exist today.

S&P 500 Index (January 1975 – January 1977) & Subsequent 20% Correction





As we mentioned, these examples are by no means a guarantee that history will repeat. They are merely a template of how other markets have topped out after other cyclical bull runs like the one we've had since 2009. The important take away is that there is a very poor risk reward trade off in the market right now and signs that a major topping is in process. The Federal Reserve can only keep the market disconnected from its fundamentals for so long before reality hits. We remain cautious with client capital and patiently await the better prices that history says are forthcoming.