The Starboard Side Report

The week ending January 18, 2013

We are going to keep things pretty simple this week because we feel that our message is very important. In studying over one hundred thirty years of US market history, we are challenged to find more than a handful of times in which the risk-reward profile has been as unattractive as the present. In the words of money manager John Hussman, we are in the ***Late-Stage, High-Risk*** phase of the market cycle, also referred to as a virtual "Who's Who of awful times to invest."

S&P 500 (1998 – Present)

MoSnth	S&P 500 Price	1 mo	3 mo	6 mo	1 yr	2 yr	Max Upside	Max Drawdown
Mar-00	1498.6	-3.08	-2.93	-4.14	-22.57	-23.4	3.4	-48.8
Aug-00	1517.7	-5.34	-13.35	-18.29	-25.3	-39.6	0.8	-49.4
Apr-07	1482.35	3.23	-0.57	3.28	-6.5	-41.1	6.3	-55
May-07	1530.6	-1.78	-3.7	-3.23	-8.5	-40	3.0	-56.5
Jun-07	1503.35	-1.96	1.56	-2.33	-14.9	-38.9	4.8	-55.7
Sep-07	1526.75	1.48	-3.82	-13.4	-23.61	-30.8	3.2	-56.4
Oct-07	1549.4	-4.4	-11.03	-10.57	-37.5	-33.1	0	-57
Nov-07	1481.15	-0.86	-7.66	-5.45	-39.5	-26	2.8	-55
	Average +/-	-1.59	-5.19	-6.77	-22.30	-34.11	3.04	-54.23

The chart above of the S&P 500 and the supporting data directly below are very important to understand. They show that we are at price levels that have produced abysmal forward returns for the S&P 500. There have been only 8 out of the past 156 months since the year 2000 that the S&P 500 has closed the month above the 1481 closing price hit on Thursday. Those months are highlighted by the small blue boxes at the top of the chart. The data below shows the subsequent one-month, three-month, six-month, one-year and two-year returns. In addition, we have a max upside and max drawdown column to highlight the poor risk reward set-up. The average return

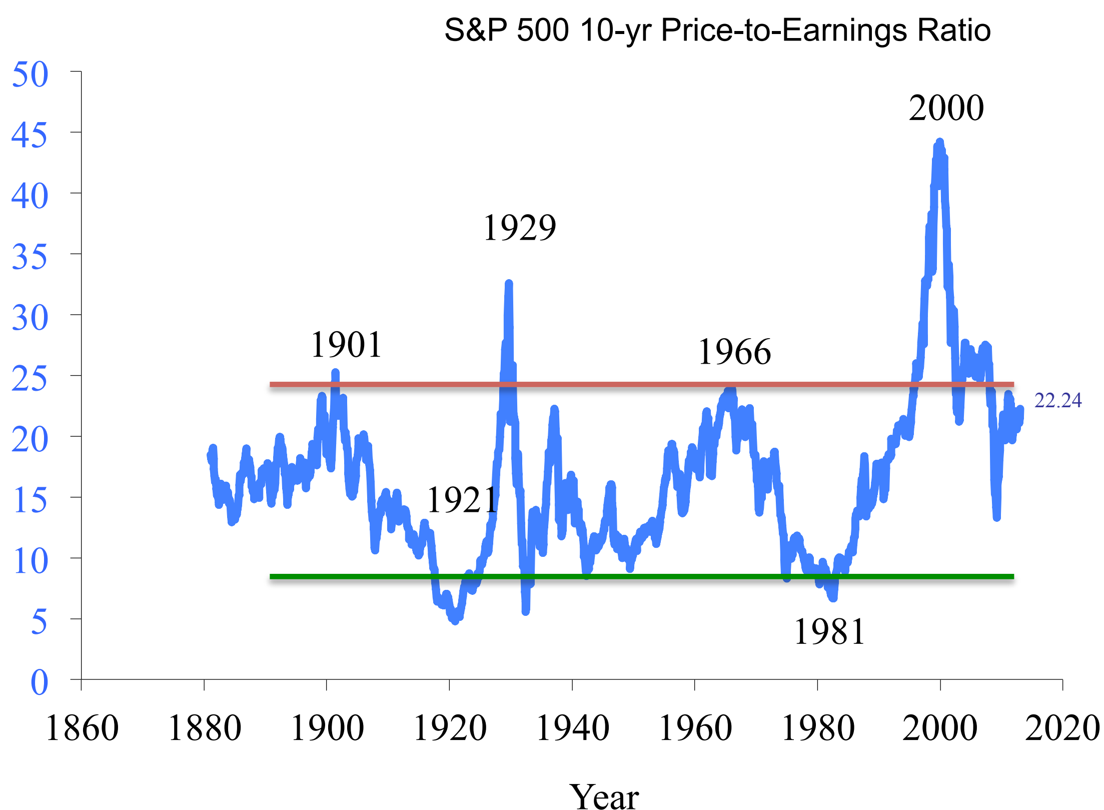
gets progressively worse as the time frame extends from -1.59% after one month to -34.11% two years out. Furthermore, since the bear market began in 2000, the S&P 500 priced at these levels has had an average maximum upside of 3.04% over the next six months and 54.23% maximum downside risk over the next two years. We do not know of many investors willing to risk a 50% hit to their portfolio value, yet here we are again with market participants willing to jeopardize their hard earned capital for a few more points of return. We refuse to be sucked into the final frenzy of a mature bull market even if that means watching the market hold up for another few months.

Why do we expect this cyclical bull market to follow the other two that peaked in 2000 and 2007. Can't we just breakout of the range and start a new bull market? The reason we fail to see the market busting through the price ceiling all comes down to valuation. We don't expect a different outcome this time because doing so would be going against over one hundred years of market history. The fact remains that the S&P 500 is still at one of the highest valuation levels ever encountered. In order to say that stocks are going to break out of this thirteen-year trading range that was established in 2000, we must be convinced that stocks are attractively valued. Every single new bull market (without exception) has been born out of low valuations; because valuation is the ultimate driver of long-term stock returns. If we isolate one hundred fourteen years of market history prior to 1995 (when the central-bank led stock bubble really kicked into high gear), the current cyclically adjusted price-to-earnings ratio of the S&P 500 is in the top 5% of all recorded measurements (see chart below). Government deficit spending financed by the kindness of Asian exporters (and now the Federal Reserve) in conjunction with price fixing of interest rates appear to be the only things propping-up the market at these excessive levels.

We use market history/cycles and valuation studies to help make our big picture investment decisions. This is not the strategy chosen by most investment professionals because it is *very difficult to follow*. It requires the discipline to turn negative near market tops when everyone is bullishly projecting gains and big investment returns as far as the eye can see. In addition, it usually means turning the most positive on the market when things are at their worst and the world is falling apart. We were extremely bullish in late 2008 when the market was coming unhinged and everyone was fleeing stocks. While we certainly do not see the exuberance that existed at the 2000 and 2007 tops (especially amongst retain investors), there is a latent complacency beneath the surface of the institutional investment community that stock prices can never go down because the Federal Reserve will always be there to bail us out. The first market top in 2000 was the tech bubble peak and the second market top in 2007 was the housing bubble

peak. We see this current market top as a massive central bank confidence bubble twenty-five years in the making. Once this mother of all bubbles goes pop, it has the potential to once again wreak havoc on stock prices. Hopefully, this next market decline will cause a long overdue reboot of both the US economy and the financial system that has become its master. We need to get back to the pre-1990's mentality that the country should be run for the good of the people and not the good of financial special interests.

The final chart shows the extreme overvaluation of the US market by historical standards. The red line is an overvalued market (where bear markets start and portfolio losses have been in the 50% range) and the green line is undervalued (where new long-term bull markets began in 1921, 1950 and 1981). Buying stocks when they are cheap and avoiding being fully invested at high valuations is a very simple recipe for long-term portfolio success.



Source: Robert Shiller

The market is currently very close to the red line at 22.24. This is a similar level to the major market tops in 1901, 1929, 1966 and 2007. Hence, we should expect a similar outcome when the fever finally breaks and market rolls over as it always has. The average decline of these four

peaks just mentioned was around 52%. Once again, history points us to the possibility of a 50% drawdown over the next year or two. It is time for risk management over reward chasing.

It is never easy to call an exact market top and the end of a bull cycle. This is especially true when central bankers try everything in their power to keep the liquidity and good times flowing. Tops tend to be processes rather than events or one moment in time. The only thing to do is to remain patient, stick to your discipline and make sure you are fully prepared when the peak finally arrives. The large egos in the central banking community make them feel as if they are smart enough to repeal history and time tested concepts such as mean reversion. Ultimately, we think their attempts will be in vain and fail in a spectacular fashion.

One final note as it relates to our current cautious posture. We are actually positive on several areas of the market; the only problem is that proper risk diversification prevents us from being fully invested in solely these asset classes. Our gold position is probably several times larger than the average investment portfolio because we are very bullish on this one asset that will ultimately be one of the biggest beneficiaries of the $15 trillion and counting of global central bank money printing and market manipulation. We also have a constructive investment stance on oil and energy investments due to the fact that the world is running out of easily accessible oil reserves. Additionally, oil would be a prime beneficiary should the Federal Reserves grand money printing experience go haywire and lead to rapid currency debasement and inflation. Finally, we are always looking for opportunities to buy blue chip global franchises and emerging market equities on the cheap following corrections.

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