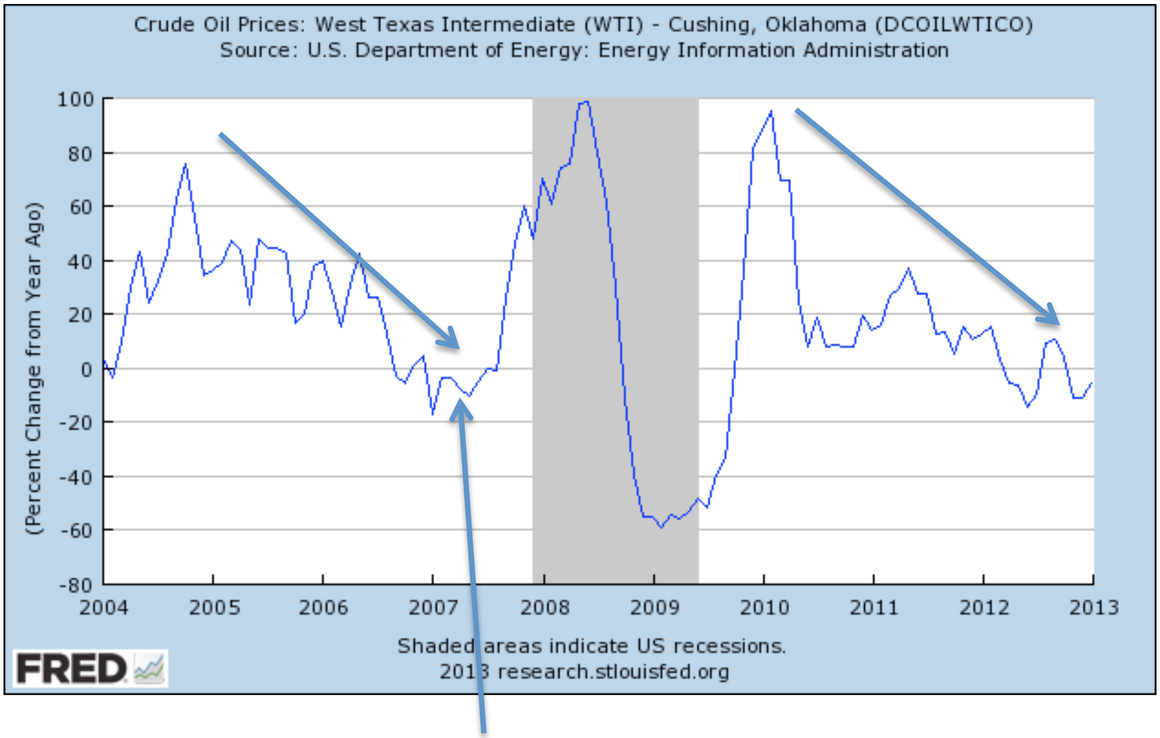
The Starboard Side Report

The week ending February 01, 2013

Here we are again closing in on $100 p/barrel oil. At what price does oil start to choke off the burgeoning global recovery? The last time the S&P 500 broke above 1500 for the first time in a liquidity driven frenzy was in May of 2007. Here is what oil did over the next 14 months.

Our main thesis has become one of markets no longer being driven by fundamentals, but rather by Central Bank liquidity. If global money printing can allow animal spirits to take stocks back to their old highs on weak fundamentals, it can surely send oil back to it's old high near $150 p/barrel. If this wall of money starts to spill over into the commodity markets in a big way as it did in 2007, then the recent equity rally will come to a grinding halt under the weight of increased commodity prices. The majority of the major economic contractions in the US since 1970 have all been associated with energy price spikes. This time may not be different and may take another oil super-spike to finally break the back of the S&P 500’s cyclical bull market that started in 2009. The US economy is very resilient, so the absolute price of oil tends not to be as relevant as the year over year change. Most major economic slowdowns and market crashes since 1970 have been associated with annualized oil price spikes above 80% (the 1973 recession, the 1987 market crash, the 1990 recession, the 2001 recession, the 2008 melt-down and the 2010 flash crash all occurred within months of oil advancing by 80% on a year-over-year basis). The last bull market cycle for US equities between 2003 and 2007 had a very similar pattern when looking at the price of oil on an annual % change basis. First, there was a big move higher for a year or so off of the prior recessionary trough. Then the year-over-year change of oil gradually stabilized and trended lower. This allowed the economy to adjust to the big move off the bottom and for the market to move higher.



Three-year stabilization of the year-over-year change in the price of oil between 2004 and 2006.

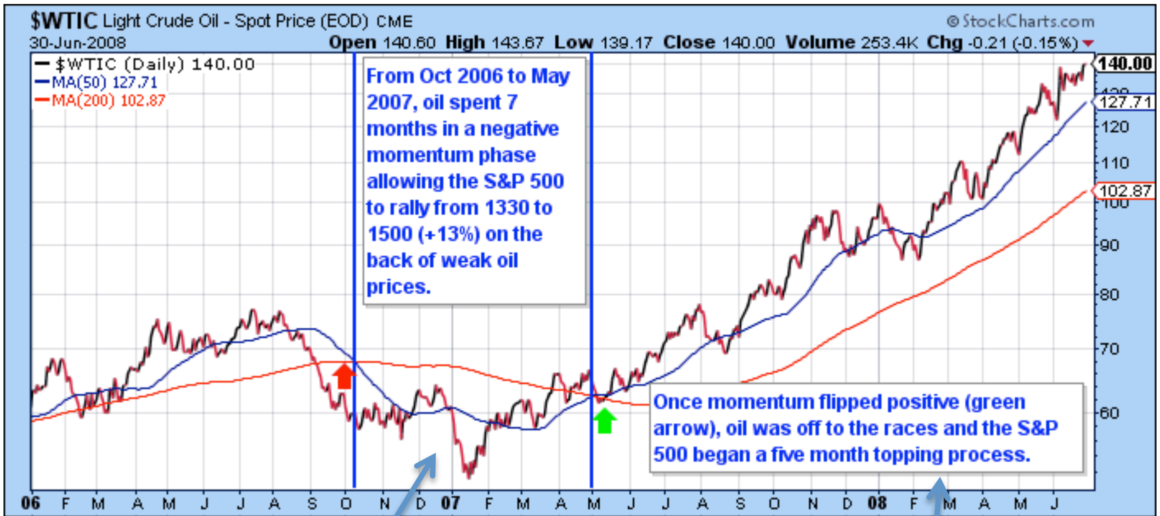
Followed by a huge surge in oil prices. You are here?

Gray shaded areas is the global recession partly caused by a super spike in oil prices.

Once again a three-year stabilization of the year-over-year change in the price of oil between 2010 and 2012.

We are seeing signs of strength in oil prices and a rotation into energy assets that could be market participants positioning for a new up leg in the energy patch. First we look back at 2007 to see the amazing similarity to today's relationship between oil and the S&P 500. From October 2006 to May 2007, oil prices spent seven months in a negative momentum phase. This can be seen on the first chart below between the red arrow and the green arrow. This oil price weakness was a key catalyst in the S&P 500 (dominated by consumer centric sectors that benefit from lower oil prices) charging from 1330 to at the time of the oil momentum weakness to 1500 by May of 2007 (13% gain). This coordinated move can be observed by following the arrow on the left hand side that connects the two charts.

Crude Oil (Jan 2006 – June 2008)



S&P 500 (Oct 2006 – Dec 2007)

Once oil price momentum flipped positive in May of 2007 (exactly as the S&P crossed 1500) oil prices really took off. That stressed the consumer dominant S&P 500 and resulted in a very volatile topping process over the next six months (shown by the right connecting arrow line linking the two charts).

The next chart below shows that the US retail sector went into free-fall versus energy stocks after May 2007 as higher gas prices started to take their toll in the consumer. That means energy stocks started to do the heavy lifting for the S&P 500 index once oil price momentum reversed higher.

S&P Retail Index vs. S&P Oil Services Index (May 2007 – June 2008)

The next two charts are the fascinating part. They show that the *exact* same price action exists between oil price momentum and the S&P 500 over the most recent seven months. Oil price momentum went negative (red arrow) exactly seven months ago (with the S&P 500 at 1330) and has just flipped back to positive (green arrow) as the S&P 500 crosses the key 1500 level (blue horizontal line). And, since the move of 1330 to 1500 was the exact same, the move over this seven-month period for the S&P 500 was also preceisly13%!

Crude Oil (Jan 2012 – Present)

S&P 500 Past Seven Months (June 15, 2012 – Present)

Additionally, consumer stocks are starting to break down versus oil stocks as they did in the first half of 2007. This next chart shows that the market may be in the early stages of sensing a gas price squeeze on US retailers.

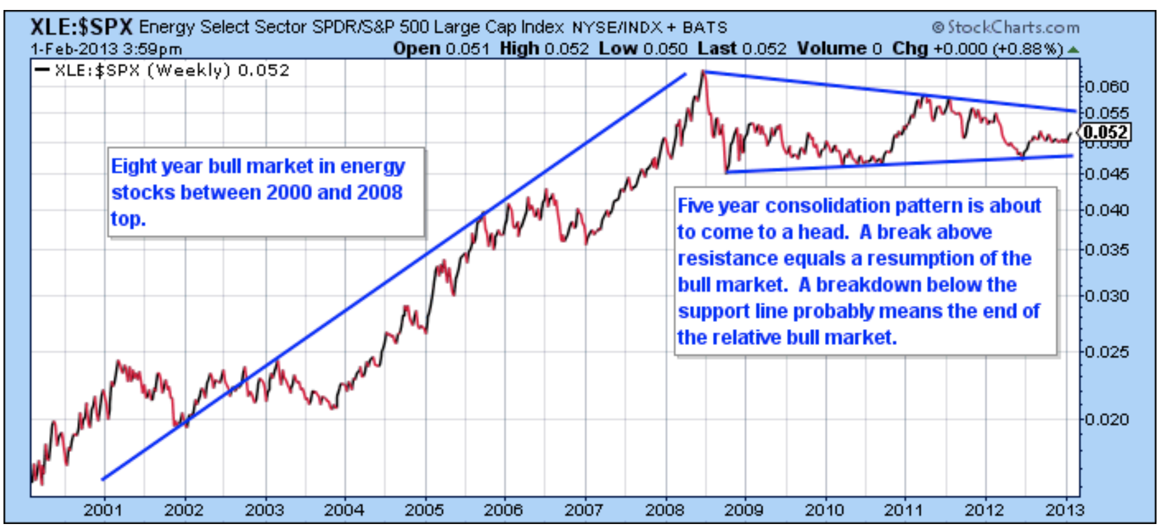
S&P Retail Index vs. S&P Oil Services Index (Past Six Months)

It has been a rough eighteen months for long-term energy investors like Starboard as the rest of the US market has really left the sector in the dust. The following chart shows the first green shoot of spring occurred last month with a break of the sector relative strength down trend line.

S&P Energy SPDR Index Relative Price Versus the S&P 500 Index (2011 to Present)

If we step back and look at the big picture of the S&P energy sector versus the S&P 500 we can see that the last five years have been a consolidation of a major eight-year uptrend move off the secular low in 2000.

S&P Energy Sector Index Relative Price Versus the S&P 500 Index (2000 to Present)



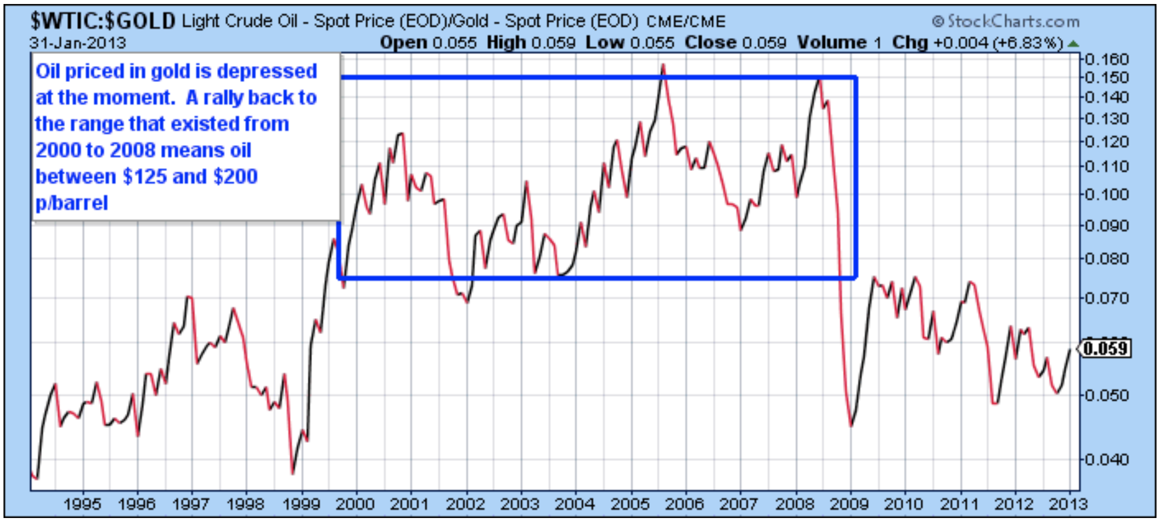
The question now ahead of us becomes: Is the energy bull market dying or is this five year consolidation just a pause that refreshes before another cyclical bull market begins? Time will tell, but we believe the fundamentals point towards a new normal of high oil prices that should support energy stocks for years to come. The world is running out of cheap and easily accessible oil. The majority of new discoveries (including the much publicized new oil shale discoveries in the US) need oil prices to keep rising in order to achieve maximum production. Furthermore, the messy geo-political strife in the Middle East always presents an upside price bias for oil. This all points towards the recent price consolidation for the energy sector resolving itself to the upside.

We will continue our thesis next week and expand our analysis to include other areas of the commodity complex to see if we are perhaps at the tail end of the cyclical bear market that is almost two years old. At some point, investors are going to get very nervous about the newly minted trillions of dollars sloshing around the system. This will cause investors to seek shelter in hard asset investments like commodities that hold purchasing power better during major currency debasement episodes. If commodities are about to embark on a new central bank liquidity driven cyclical upswing, then it could have profound implications for the markets over the next year.

CRB Commodities Index (2011 – Present)

The final two charts we will leave you with this week are the price of oil denominated in gold. This speaks to the undervalued nature of oil at present. The first 19-year chart shows the current ratio of .059 as well below the prior oil peaks in 2000, 2005 and 2008. So undervalued in fact, oil could trade double to $200 per barrel and still not be back to its prior cycle highs. The second 30-year chart is even more dramatic because it targets an oil price of $300 oil at today's gold prices (the blue circle is where oil priced in gold would have to go to get back to the top of its 30-year price channel).

19-year Crude Oil Priced in Ounces of Gold (1994 – Present)



30-year Crude Oil Priced in Ounces of Gold (1983 – Present)

The bottom line is that oil appears relatively expensive when priced in depreciating US dollars, but extremely cheap when priced in a stable unit of value such as gold. The US dollar based global economy appears to us to be very vulnerable to another nasty oil price shock at some point in the near future.