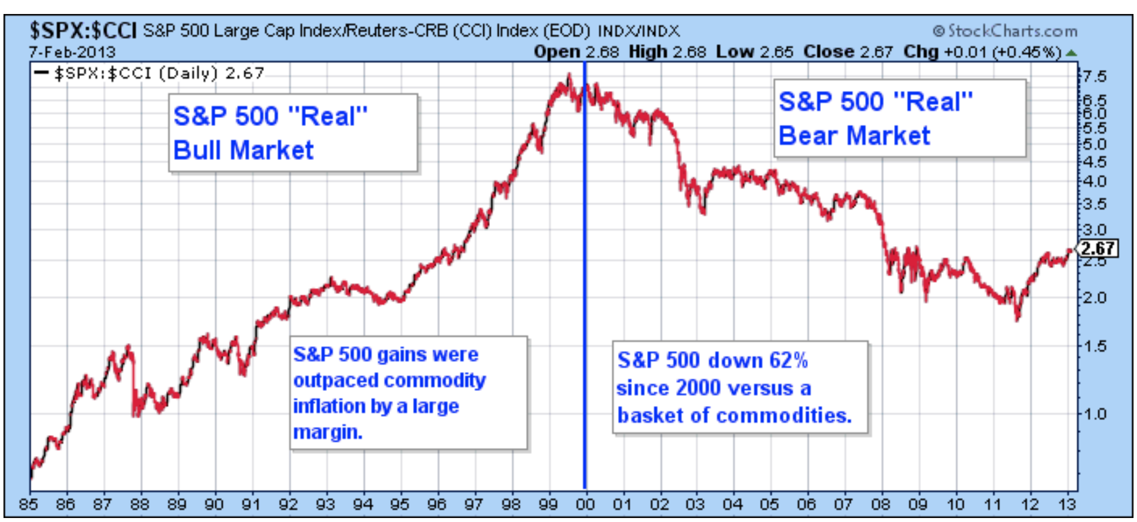
The Starboard Side Report

The week ending February 08, 2013

“Zimbabwe's stock market was the best performer this decade – but, your entire portfolio now buys you 3 eggs” Kyle Bass

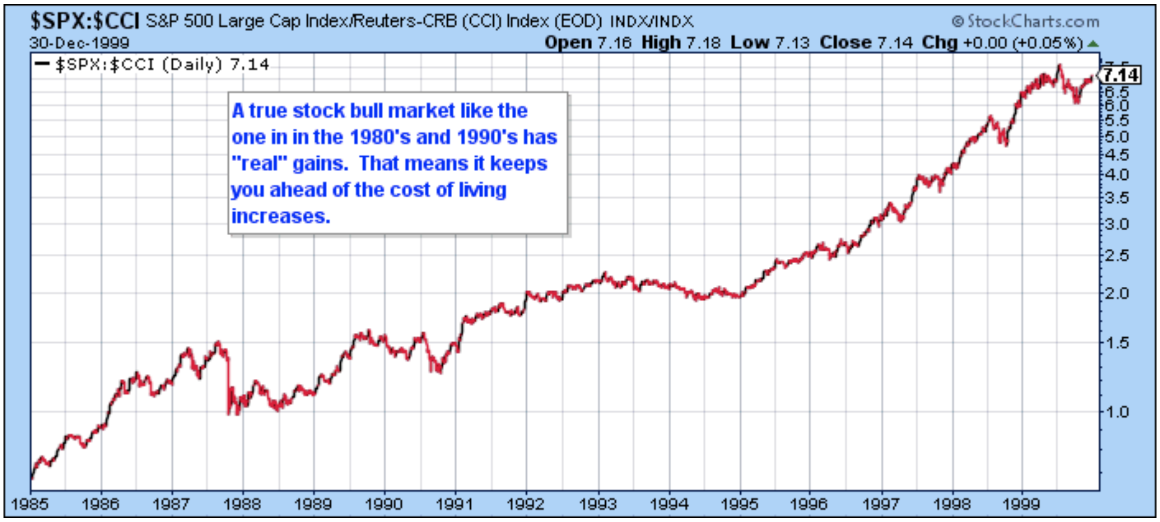
The above quote by well-respected hedge fund investor Kyle Bass is used this week to illustrate that it is critically important to focus on the inflation-adjusted returns of an investment portfolio. If the everyday cost of living is growing faster than the market, than your investment gains are largely illusionary. **Nominal prices** are those that we see flashed brightly across the financial news ticker tape every day (i.e. 1,500 on the S&P 500). **Real Prices** are those that exist after the effects of inflation are stripped out. Inflation can be measured in many ways such as the government generated Consumer Price Index or through a basket of essential commodities such as the CRB Commodity Index. *The difference between nominal and real prices could not be more important for investors to study, yet, most are oblivious to the distinction and pay it little mind.* Obviously, this Zimbabwe example above is an extreme case, but it helps get the point of nominal versus real returns across nicely. On a day-to-day basis this difference is hard to measure, but in the big picture it is easy to see the compounded effect of inflation on an investment portfolio. The first chart below shows the S&P 500 divided by the CRB Commodity Index. We have broken up the past twenty-eight years into two distinct time periods. The area on the left is a roaring bull market in both real and nominal terms for the US stock market. Investor portfolios soundly outpaced inflation (as measured by the CRB Index). This was a period of true wealth creation unrivaled in US history where the S&P 500 grew tenfold versus commodities. The area on the right of the blue line on the chart is our current environment. It tells a very different story of “real” wealth *destruction*. Even with a recent rally in real terms, the S&P 500 has lost 62% of its purchasing power since 2000 versus a basket of commodities.

S&P 500 “Real” Bull Market vs. “Real” Bear Market



Here are the two distinct time periods on the chart above broken out separately.

S&P 500 "Real" Bull Market 1980's and 1990's



S&P 500 " "Real" Bear Market Since 2000

What is an investor to do in such an environment? First and foremost, since the year 2000, it has paid to be invested in the companies that benefit from higher commodity prices. Whereas the S&P 500 and the Dow Jones Industrial Average are just now approaching the peaks that they first hit thirteen years ago, an index of commodity producer stock prices, like the Morgan Stanley Commodity Related Equity Index, is 350% above its 2000 price levels!

Morgan Stanley Commodity Related Equity Index (2000-Present)

This outperformance for commodity stocks can be seen more clearly on the following chart of the Morgan Stanley Commodity Related Equity Index *versus* the S&P 500. The late 1990's were terrible for investors in commodity stocks as the S&P 500 entered its bubble phase. Then, in 2000, things made a dramatic turn and commodity stocks started a long period of relative outperformance versus the S&P. However, as the circles in the chart point out, it has not been a straight shot higher. In 2006, 2008 and 2011/2012, commodity stocks had a countertrend period of underperformance. These corrective periods were treacherous for commodity related stocks and cash was a better place to hide.

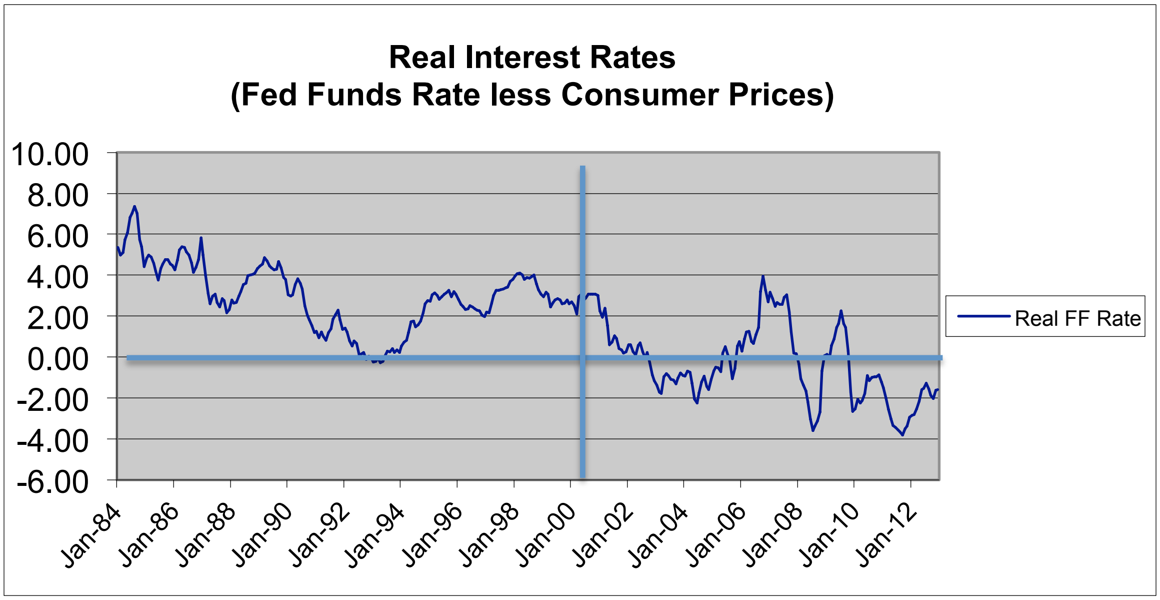
Morgan Stanley Commodity Related Equity Index **Relative** to the S&P 500 (1997-Present)

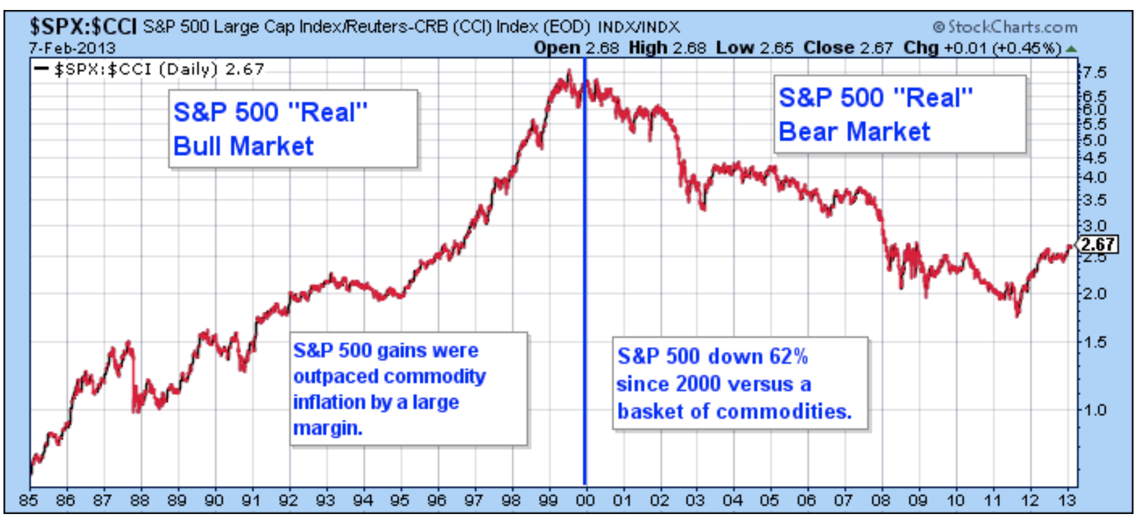
The next chart below is a close-up isolation on the furthest right circle above.

You can clearly see that commodity sectors of the equity market peaked in early 2011 and have not been very good at growing capital compared to the S&P 500 over the past two years. However, a slow bottoming reversal appears to be in the works. This is a sign that the commodity bull market that began in 2000 may be close to resuming.

Again, it is important to keep the big picture since 2000 in mind, not just the recent picture since 2011. The logical question becomes, can this be the end of the "real" bear market for US stocks and the start of a 1980's/1990's "real" bull market for the S&P 500? Additionally, is the severe underperformance that has plagued commodities since 2011 a new trend or just a blip in the commodity bull market that began in 2000? These are the important questions for investors to answer. Those that are chasing the S&P 500 higher here clearly believe that the commodity bull market is dead and that we are about to embark on a new and exciting "real" bull market in the S&P 500. Consider us in the other camp. We feel that the S&P 500 is about to top out on both a real *and* nominal basis as it did in 2000 and 2007. The $10 trillion printed by central bankers over the last five years will increasingly scare investors into hard assets like commodities for purchasing power protection. As such, we feel that commodity prices and the majority of commodity stocks are only in a short-term *cyclical* correction (granted two years seems to be on the longer end of the spectrum as far as these things go). In the event that there are any sizable S&P 500 gains from these levels, we remained convinced that those gains will solely be nominal in nature as inflation from Central Bank money printing starts to bite.

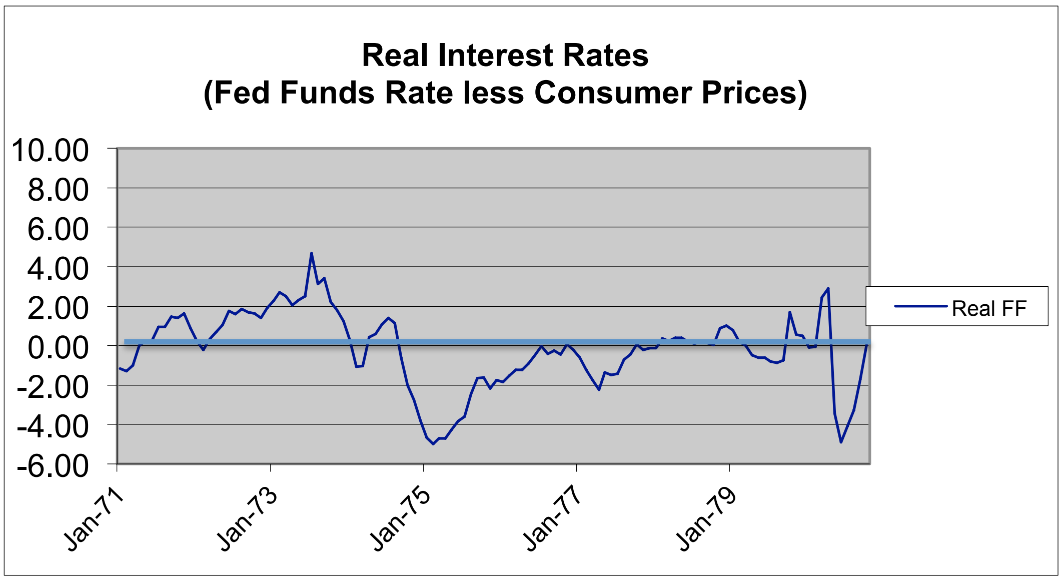
It is not just wishful thinking as to why we think the commodity bull market is not dead. Real interest rates are the first place to look when trying to decide if hard assets (commodities, gold etc.) or paper assets (stocks, sovereign currencies, bonds etc.) are in favor. Real interest rates (like real stock prices) are the level of interest after subtracting inflation. In the example below, we use the Federal Funds rate set buy the US Federal Reserve as our benchmark interest rate and compare it to the Consumer Price Index. It is very reveling to see the correlation between positive real interest rates and strong equity market performance. On the flip side, negative real interest rates are associated with US stocks losing purchasing power over a long period of time.



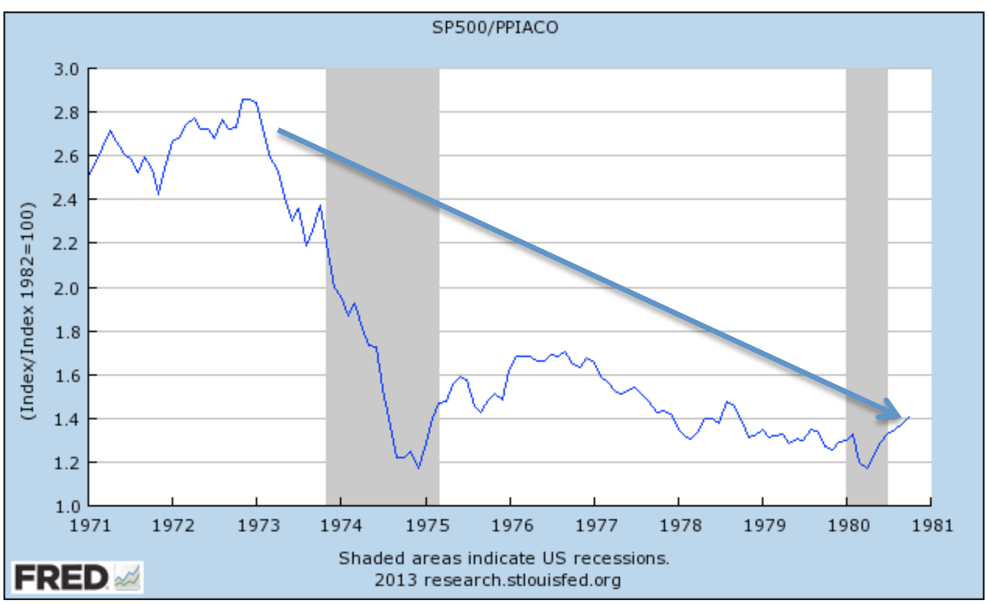


A horizontal line and a vertical line divide the first chart above. The vertical line marks the beginning of S&P 500 “real” bear and the horizontal line is the level of zero real interest rates. It is not a coincidence real interest rates were positive during *the entire* S&P 500 bull market in the 1980’s and 1990’s. Since 2000, real interest rates have spent much of the time in negative territory below the zero line. Again, the purchasing power of the S&P 500 has lost 62% versus commodities over this span. Negative interest rates are extremely destructive to the purchasing power of investors. As a result, when real interest rate are negative, investors should design their portfolios to hold a larger amount of assets like commodities and precious metals that preserve purchasing power. The Federal Reserve has promised to keep interest rates suppressed for the next few years, so we see no reason to expect positive real interest rates anytime soon. Especially, if inflation (the denominator of the real interest rate calculation) starts to accelerate as we expect.

One final data point to back up our thesis that negative interest rates are bad for the purchasing power of an S&P 500 based investment portfolio. The first chart below shows that real interest rates spent a good amount of time in negative territory in the 1970's (another decade of poor relative performance of US stocks versus commodities). The second of the two charts shows another corresponding loss of purchasing power for the S&P 500 versus commodities.



S&P 500 " "Real" Bear Market in 1970's



The purpose of this report is to say that we think the counter-trend rally that stocks have undergone against commodities since 2011 is about to run its course. Any gains from these levels for the S&P 500 will most likely be ***nominal*** only and not ***real***. Therefore, as we move forward from this point, assets that act as inflation protection should start to add a net benefit to a portfolio instead of acting as a hindrance, as they have been for the better part of two years. We raised large amounts of cash in late 2011 in anticipation of a period of lackluster returns for commodities; and we got it. Even if we stayed fully invested at that time, we would have an underperforming portfolio because gold and commodities have done so poorly relative to the Dow and S&P 500. Obviously, if we had been able to forecast how well the traditional S&P 500 sectors like consumer retailers and banking would do over the last year, we would have tried to rotate more aggressively in that direction instead of keeping the money in cash waiting for commodities to bottom. We can't change the past and can only control the opportunities that are presented from this point forward. As such, we expect to see more of our cash going towards commodity producers now that the correction is two years old and appears to be forming a bottom. This strategy should help protect portfolios from loss of purchasing power caused by any inflation coming down the pike. It should be noted, all commodities do not uniformly move in tandem at all times. We feel that commodities whose demand is driven by emerging markets consumers in Asia (think agriculture for a more advanced protein rich middle class diet and petroleum for more cars on the road) will fare better in the next phase of the commodity bull market than those geared towards industrial production (think copper and steel for building). Additionally, the entire market is very overbought right now (with the exception of gold), so we plan to remain *selective* buyers of commodity producer stocks and wait for price corrections before getting too aggressive.

Finally, negative real interest rates are not the only thing that points to the commodities bull market making a comeback. We believe the $10 trillion printed by Central Banks since 2006 will increasingly start to leave the more traditional sectors of the global equity markets and seek shelter in hard assets that better protect against currency debasement. This will benefit both commodity prices and the producer company stocks. It is a big stretch to say we are going to go down the hyperinflationary road like the one that recently plagued Zimbabwe or the one that hit Germany in the 1920's. However, there is strong historical precedence for a period of very uncomfortable inflation still to come. We believe investors should be prepared for this if they want to maintain their portfolio's purchasing power in the years ahead.

One more look at the big picture bull market for commodities as observed through the price of the CRB Index since 2000 overlaid with an isolation view of the correction of the past two years. Hopefully, this will help overcome some of the discouragement that comes with the poor relative performance of the last two years.

CRB Commodity Index (2000 – Present)

CRB Commodity Index Past Two Years

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