The Starboard Side Report

The week ending February 22, 2013

The S&P 500 crossed the key 1,525 level this week and than started to correct. We believe that this week could have signaled the first shot across the bow for the market in what may prove to be a lengthy topping process (of about six months). Using history as our guide, we will see below that this is exactly what happened in 2000 and 2007 after 1,525 was surpassed. In a market with this much upside momentum, it is unusual for stocks to immediately crash lower. Instead, <u>the highest percentage outcome</u> is that the major indexes like the Dow and S&P 500 have a series of rolling 8-10% corrections and take a couple more runs at the recently established highs in the process. So, while we believe this week marks the first correction in the topping process, it may be as long as six months before a vicious (30-50% downside type) bear market fully ensues. Here are examples of the last two tops in the S&P 500 and then the big picture view that incorporates both of these volatile back and forth periods.

S&P 500 Topping Process (October 1999 – December 2000)

S&P 500 Topping Process (January 2007 – March 2008)

Now, let's step back and look at these two periods on a big picture chart.

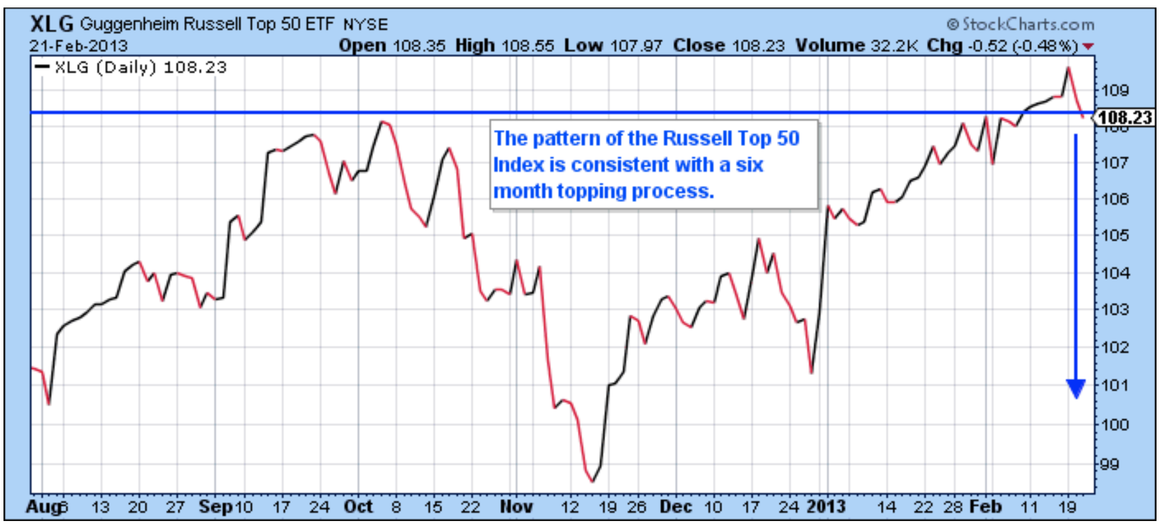
S&P 500 (2000 – Present)

In 2000, the market moved above 1,525 for the first time in March and then proceeded to jockey back and forth between 1,550 and 1,350 for the next six months. This topping period frustrated both the bulls and the bears alike. In 2007, the market moved back above 1,525 in late May and then proceeded to jockey back and forth between 1,550 and 1,400 for the next six months. The main difference in 2007 was that it took two months of mini 2% type back and forth corrections and rallies (kind of like what we got this week) before the first big 10% drawdown. In 2000, the process was much quicker and the market corrected 10% within days of getting above 1,525. However, in both instances, fewer and fewer stocks participate during each rally back in a "culling of the herd".

One of the interesting things that we have noticed about the recent rally is that there are two major stock indices that have not confirmed the recent highs in the market. The Nasdaq 100 Index and the Russell Top 50 Index (an index of the largest 50 stocks in the US market) have not decisively broken out above their September highs. Therefore, the argument can be made that these blue chip indices have actually already gone through their six-month topping process as discussed above. When the blue-chip stocks are not keeping up with the rest of the market it calls into question the quality of the rally off of the November lows. We see this as a lower probability outcome given the underlying strength in the rest of the market since November. Nonetheless, it's something worth watching as we move forward.

Nasdaq 100 Index Past Six Months

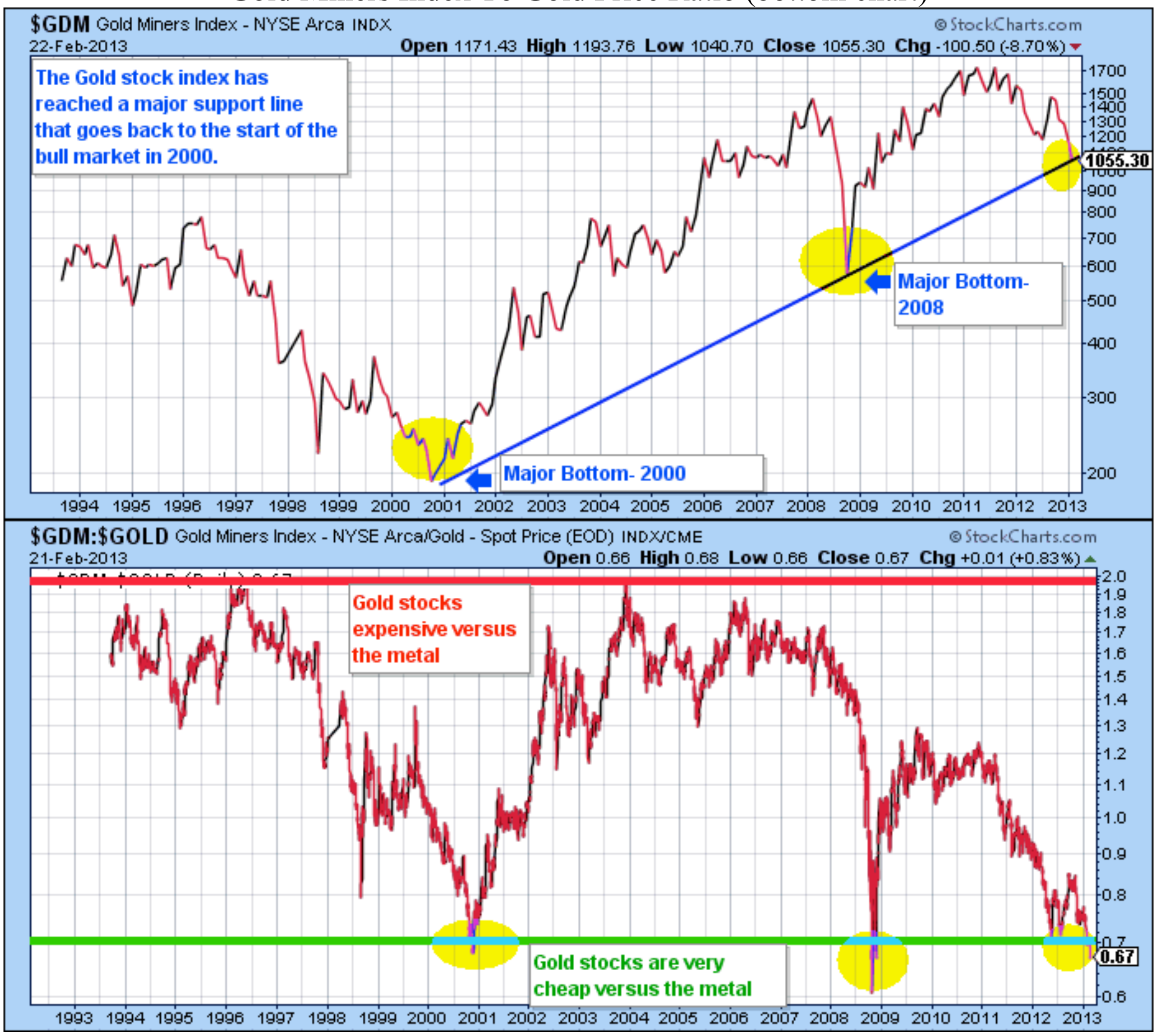
Russell Top 50 Index Past Six Months



In exact opposite to the S&P 500, we believe that there are several signs that show gold stocks being in the process of making a major *bottom* similar to what was observed in this sector in 2000 and 2008. As we discussed last week, it is not unusual for gold stocks to trade opposite to the S&P 500 at key inflection points. Here are a few charts to back up our view, along with some supporting commentary.

The first two charts show the Amex Gold Miners Index long-term uptrend superimposed on top of points when the Gold Stock Index was cheap relative to the price of gold (as measured by the Gold Miner Index to Gold Price ratio).

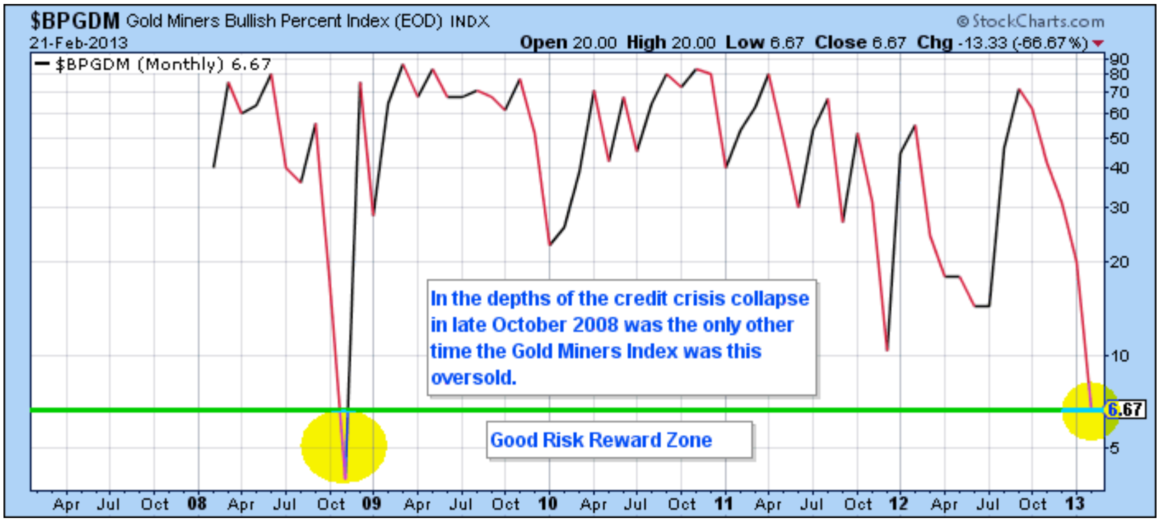
Gold Miners Index 1993 – Present (top chart)
Gold Miners Index To Gold Price Ratio (bottom chart)



The first chart highlights that the Gold Miner Index has reached a major technical support line that goes all the way back to the start of the bull market in 2000. This uptrend line has been reached at the same time that the Gold Miner to Gold Price Ratio has fallen under the 0.70 level marked by the green horizontal line. During the prior two major bottoms in 2000 and 2008 are the only other times that we have reached this extreme level of panic in gold stocks. This ratio has been as high as 2.0 (indicated by the red line at the top of chart 2) on a number of occasions over the past two decades. From current price levels, the Gold Miner Index would have to double and then double again to get back to a ratio of 2.0 times the price of gold. This illustrates the value in this sector at the moment.

Next we show that gold stocks are now as oversold as they were in the depths of the 2008 credit crisis. The Gold Miners Bullish Percent Index has fallen to 6.67%. This is the lowest reading since late October 2008. Only 2 of 30 stock charts in the Gold Mining Index are on a point & figure buy signal. This Bullish Percent Index is a contrarian indicator that is clearly washed out and set-up attractively from a risk-reward perspective.

Gold Miners Bullish Percent Index



The final two charts show that when gold stocks make major bottoms, the S&P 500 tends to have a major correction. This illustrates the contra nature of these two assets.

Gold Mining Index 2000 Bottom

Gold Mining Index 2008 Bottom

In summary, we feel that it is not a coincidence that the S&P 500 has started a correction process once it passed the 1,525 level. This is exactly what happened in 2000 and 2007. This week's correction is quite possibly the start of a volatile multi-month topping process whose range may be a great as 200 points (roughly 3% on the upside and 10% on the downside). Fewer and fewer stocks will most likely participate in the rally phases; so stock picking becomes more of a minefield going forward. There is an outside chance that the six-month topping process has just been completed (with the September 2012 high being the primary top). This view comes from looking at the blue-chip indices like the Nasdaq 100 and the Russell Top 50, both of which have not been able to decisively move above their September 2012 highs. Finally, we will conclude in the same manor as last week: Although we feel that the S&P 500 is in the process of making a major top, gold stocks appear very close to making a major bottom like the ones that occurred in 2000 and 2008. Precious metals offer the best risk reward set-up at this time due to their extremely oversold condition and the fact that they have historically been able to move counter to the S&P 500's direction. This should mean we are about to enter another period of strong relative outperformance for the gold sector versus the S&P 500.

Nothing on this Weekly Report should be interpreted to state or imply that past results are an indication of future performance. There are no warranties, expressed or implied, as to accuracy, completeness or results obtained from any information posted on this or any "linked" web-site. Any reference to specific securities is not considered a recommendation. Every investment strategy has the potential for profit or loss.

Please note: It is the Client's responsibility to notify us of any changes that would influence their financial needs.