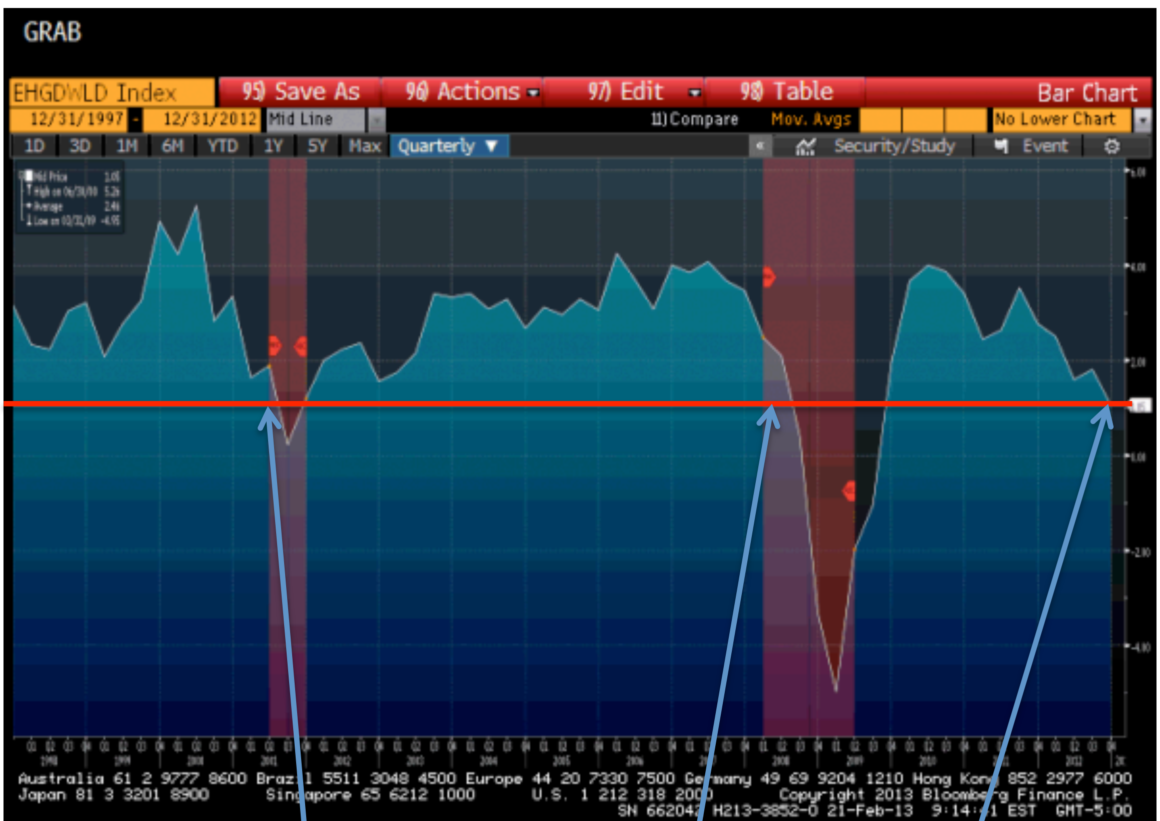
The Starboard Side Report

The week ending March 1, 2013

The market is currently "all-in" with the thinking that Federal Reserve liquidity is going to indefinitely bail them out. What could possibly go wrong in a system that incentivizes risk taking over prudent allocation of capital? The same group of people that thought real estate prices could never go down are now convinced that the stock market can never decline as long as the Federal Reserve is printing money and pegging rates at zero. Global economic fundamentals continue to dangerously disconnect from the US equity markets as we see below.

Annualized World GDP Growth (1999 – Present)



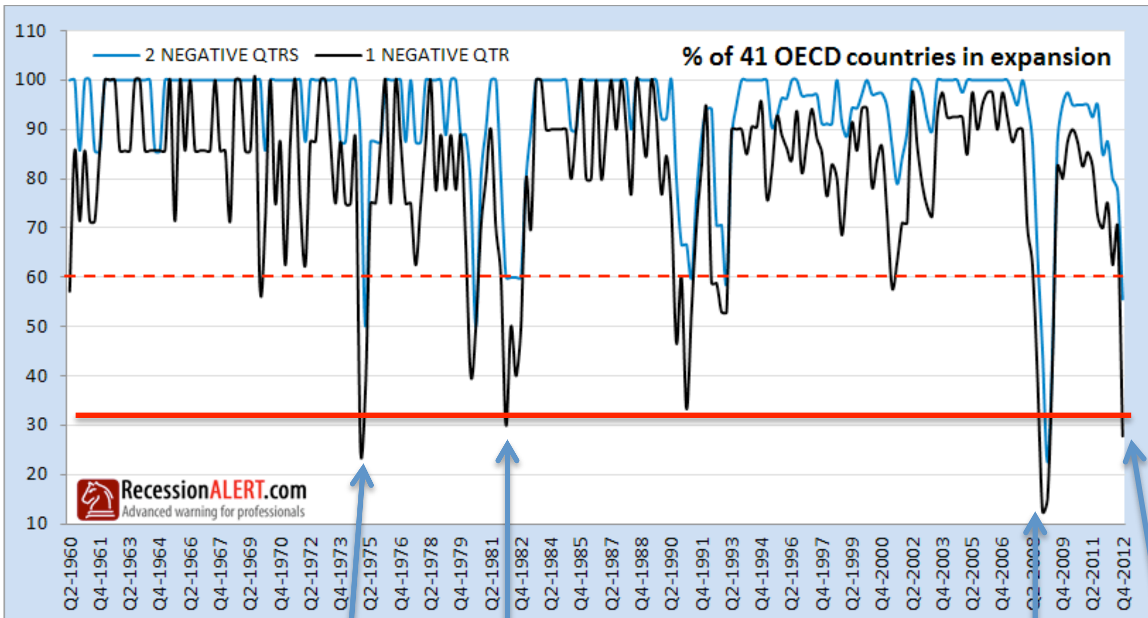
Source: Andy Lees

AML Macro Limited

For only the third time since 1999, World GDP Growth is about to fall below the 1% annual growth speed limit. This key level has been the point of no return that has defined global recessions and stock market routs over the past fifteen years, first in 2001 and than again in 2008. Is this time different? "The triple "puts" of the last eight months -- Bernanke's QE3, Mario Draghi's Club Med bond rescue, and Beijing's credit blitz -- have done wonders for asset markets but have not yet ignited a healthy cycle of world growth." (Andy Lees, AML Macro)

The next chart is a bit busy, but tells the exact same story over a longer time frame. Our focus is on the black line and the arrows that point to the four breaches of the 30% level (solid red line). A move below 30% means that less than 30% of the world's major economies are expanding. This type of big synchronized global contraction has been a very accurate indicator of global recessions and stock market pain.

Percent of Forty-One Global OECD Countries in Expansion (1960 – Present)



Source: Recession Alert

The fourth quarter of 2012 marked only the fourth time since 1960 that less than 30% of the global economy was expanding (1974, 1981 & 2008 were the other instances). The average S&P 500 decline during these prior episodes of global contraction was 45%.

It is very important to not loose sight of the fact that the global economy has been contracting for two years now. The downside pain in the markets is taking so long to play out because central bankers are propping up markets and not allowing true price discovery to occur. Investors chasing stocks higher at these levels have to convince themselves that this time is different. Economic history offers no example of market manipulation permanently defining the laws of gravity. Eventually the market will win out and the free lunch that many expect will be no more. The ultimate resolution of this grand experiment is yet to be determined. The risks are two-sided between runaway commodity and consumer price *inflation* on one side and asset price *deflation* on the other. Rampant inflation/dollar debasement is about the only way that the stock market resists the laws of economic gravity and does not have a major correction. As such, we have inflation hedges in the form of real asset producers and precious metals in case that outcome occurs. Our cash position and equity index hedges are being held at above average levels in case the more expected outcome of a 40%-50% market deflation/correction ensues. Again, this decline percentage is not a guess, but a range of expected losses based on market history.

Emerging markets have been the growth engines of the world over the past decade. They have done a much better job of reflecting the dire global economic outlook. The chart directly below shows that the main emerging market index is 11% lower since global economic growth started to roll over in early 2011 (illustrated in the chart on page one).

Emerging Market Index Fund (2010 – Present)

Furthermore, commodities are 20% lower since global economic growth peaked in 2011. They and emerging markets are clearly reflecting economic reality more so than the S&P 500.

CRB Continuous Commodity Index (2010 – Present)

The S&P 500 Index is 18% higher over the same span. How does one explain the disconnect of global economic contraction leading to falling emerging market stock prices, yet, at the same time, soaring US stocks prices? We believe the US Federal Reserve targeting higher stock prices is a large part of the reason. The bad news is that this manipulation will end badly as the US market eventually recouples with the rest of the world. Looking at these other global economic indicators, the S&P 500 would be about 400 points (26%) lower if the Federal Reserve had stopped printing money.

S&P 500 Index (2010 – Present)

US stocks prices are higher so why complain? The problem, as we see it, is that price fixing in a capitalist society always ends badly. Eventually the invisible hand of the market will take all of this away and then some. The only question is timing. If the Federal Reserve insists on printing as global economic weakness intensifies, commodities could very well start to catch a bid and pull out of their 2-year bear market. This would set up an inverse of the last two years whereby commodities rise as the S&P 500 sinks. This is defined as stagflation and it was rampant in the late 1970's.

The final chart of the week is a year-to date of the emerging market index overlaid on top of the S&P 500. As you can see, the divergence that we discussed above is reasserting itself. The emerging markets are down 2% whereas the S&P 500 is up more than 6%. Again, there is a major disconnect with the emerging markets pricing in the global economic weakness we are seeing and the US market remaining in money printing La-La Land. Again, once the fever breaks, we see the US playing catch-up with a vengeance on the downside.

Emerging Markets (top pane) & S&P 500 (bottom pane)

Year-to Date 2013

"This time it's different" are the four most dangerous words in the investment world. Those banking on the Federal Reserve to permanently supersede the laws of economics by disconnecting markets from their underlying fundamentals do indeed believe *that it is truly different this time*. But, as we found out with technology stocks and the housing crisis, the market always wins in the end. We patiently await the return to more sane valuations in US equities and the time when the Federal Reserve stops getting away with creating enormous distortions in the market's true pricing mechanisms. Our hope is that one day soon the market finally instills much needed discipline on our reckless central banking establishment. We will leave you with a good quote from Representative Scott Garrett of New Jersey that came out of this week's semi-annual meeting between Ben Bernanke and Capitol Hill lawmakers. "Sure, risk taking is appropriate. But, appropriate when there is actual price discovery. When you have a market that is distorted, as it is right now by the Fed's monetary policy, you really don't have true price discovery."