The Starboard Side Report

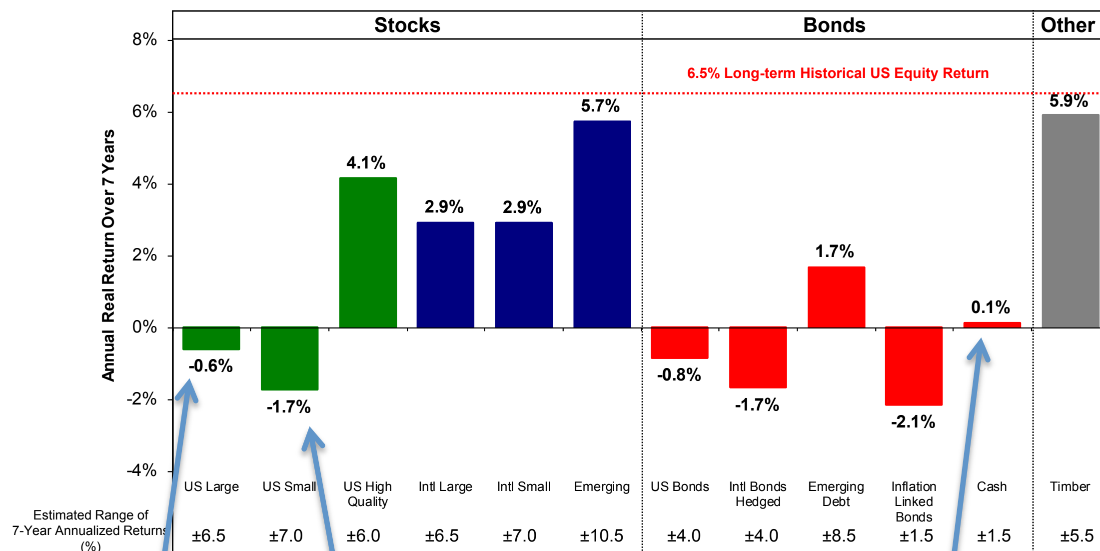
The week ending March 29, 2013

At the risk of sounding like a broken record, nothing about the new highs in the US market are making us change our tune as to the extreme risk that investors are taking to get their return. Our extensive studies into market history point the present environment being one of the most dangerous of all-time for investors in US stocks. We will continue to hammer at these risks until the time that they do not exist. Unfortunately, that point in time may be some 50% below present levels for the majority of stocks in the US market.

In our opinion, Jeremy Grantham of Grantham Mayo (GMO) is one of the best thinkers around in term of market valuations. Every month his firm publishes a study that estimates the annualized return that can be expected from a given set of assets classes. Below we have his latest report done at the end of February:

GMO 7-Year Asset Class Return Forecasts*

As of February 28, 2013



*The chart represents real return forecasts for several asset classes and not for any GMO fund or strategy. These forecasts are forward-looking statements based upon the reasonable beliefs of GMO and are not a guarantee of future performance. Forward-looking statements speak only as of the date they are made, and GMO assumes no duty to and does not undertake to update forward-looking statements. Forward-looking statements are subject to numerous assumptions, risks, and uncertainties, which change over time. Actual results may differ materially from those anticipated in forward-looking statements. US inflation is assumed to mean revert to long-term inflation of 2.2% over 15 years.

GMO
7YrForecasts

Source: GMO

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The overwhelming majority of the US stocks are priced to provide negative annualized returns over the next seven years!

Cash is forecast to return more than US bonds, foreign bonds, large US stocks and small US stocks.

The key to successful long-term investing is putting cash to work in periods when the projected level of annualized returns is *high*. That lessens the chance of a big drawdown inflicting a permanent loss of capital on one's portfolio. The two arrows on the left hand side of the chart above highlight that the large and small cap sectors of the US economy are priced to return *minus* 0.6% and *minus* 1.7% annually over the next seven years! The single arrow on the right shows cash is expected to outperform both US bonds (projected to provide a minus 0.8% annual return) and US small and large US stocks. The only category of US stocks poised to generate positive returns over the next seven years is US "High Quality". These are the mega blue chip companies like JNJ, MRK, MSFT, XOM etc. Even these are only projected to return 4.1% versus a long-term historical average of 6.5%. Emerging markets are the highest projected return at 5.7% annualized, but even that is not a tremendous risk-reward trade-off given their historic volatility. The fact that US small cap stocks are up 11.88% so far this year while emerging markets are down 4% means that investors are piling into the most expensive assets and shunning the cheapest.

Global Assets 2013 Year to Date Performance

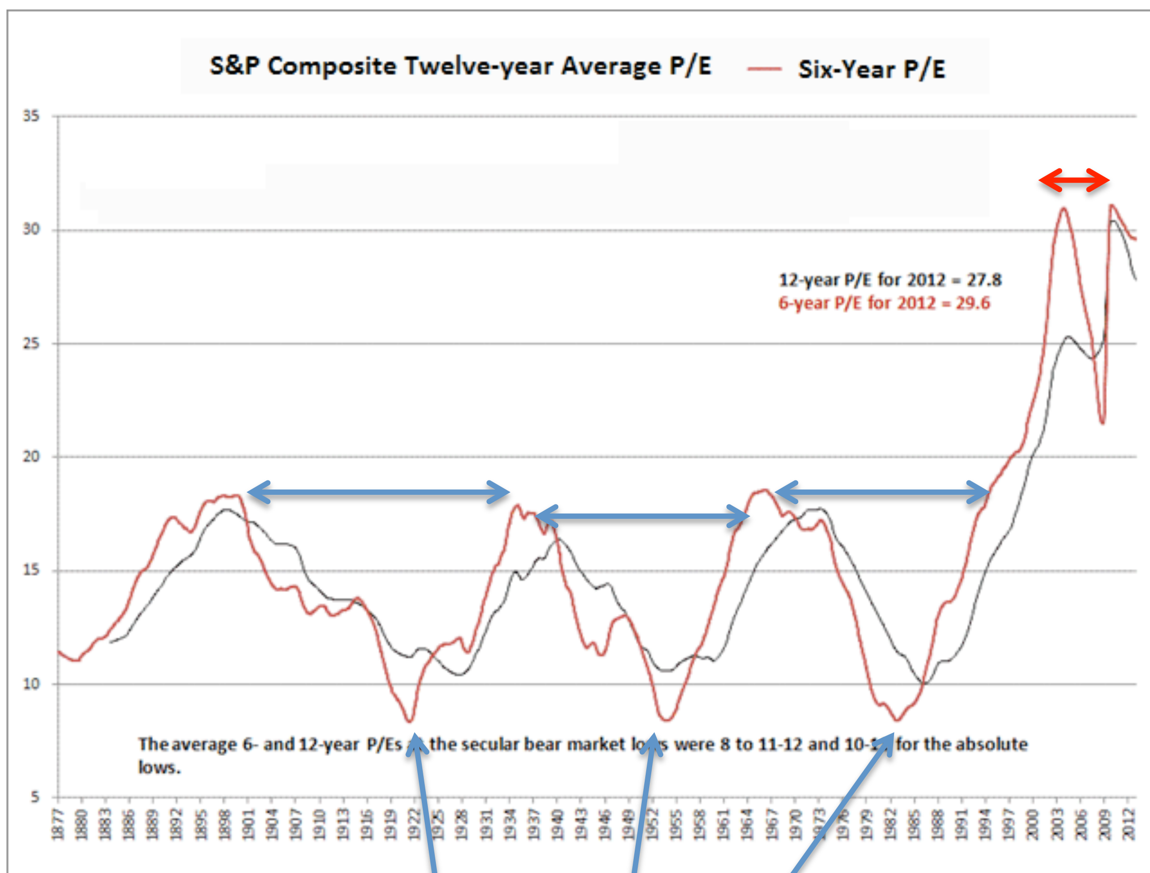
Symbol	Description	Asset Class	%Change YTD
RUT	Russell 2000 Index	US Small Stocks	11.88
EWJ	iShares MSCI Japan Index Fund	Japan/Developed Asia	10.97
SPX	S&P 500	US Large Stocks	9.58
XLG	Russell Top 50	US High Quality	7.99
EWH	iShares MSCI Hong Kong Index Fund	Hong Kong/Emerging Asia	0.88
UV/Y	Commodity Index	Commodity	0.55
EWC	iShares MSCI Canada Index Fund	Canada/Developed NA	-0.07
LQD	iShares Investment Grade Corp.	US Corporate Bond	-0.84
EWG	iShares MSCI Germany Index Fund	Germany/Developed Europe	-1.62
TLT	iShares Barclays 20+ Treasury	US Gov't Bond	-2.33
EWZ	iShares MSCI Brazil Index Fund	Brazil/Emerging	-3.06
GC/	Gold Continuous	Precious Metals	-4.11
EEM	iShares MSCI Emerging Markets Index	Emerging Market Stocks	-4.13
INP	iPath MSCI India Index ETN	India/Emerging	-4.15
FEZ	DJ EURO STOXX 50 ETF	Euro Stocks	-5.42
HG/	Copper Continuous	Commodity	-5.73
EWY	iShares MSCI S Korea Index Fund	Korea/Emerging	-6.00
EWP	iShares MSCI Spain Index Fund	Spain/Developed Europe	-7.07
FXI	iShares FTSE/Xinhua China 25 Index	China/Emerging	-7.66
RSX	Market Vectors Russia	Russia/Emerging	-8.06
EWI	iShares MSCI Italy Index Fund	Italian/Developed Europe	-12.86

The majority of the major asset markets in the world are either flat or down year-to-date except the two that are openly printing money (i.e. Japan and the US). We ultimately believe that this faith in the Federal Reserve will turn out to be severely misplaced and is creating a false sense of

security. Time and time again, history has proven that value is the final arbiter of price. Amazingly, those that think, “this time is different” have not learned the lesson of the past. We don’t know how many different ways we can warn of the hazards of buying stocks late in an economic cycle at very elevated valuation levels. There are considerable downside risks to US stock prices when this liquidity-fueled rally finally tops out.

In our last report, we discussed how market pundits that deem the market “cheap” are not looking at history of bear market P/E ratio multiple compression, nor are they factoring in the unsustainability of peak profit margins. One study that crossed our desk this week was another long-term look at how expensive the market is when you smooth out the earnings cycle instead of looking at just one year. Incredibly, we are still near all-time highs and back to 2000 levels already.

S&P Composite Index Twelve-year and Six-year Average P/E (1877 – Present)



Source: Bruce Carman

Historic bear market ending six-year average earnings trough= 8 (versus 29.6 at present).

The orange line in the chart above is the P/E ratio (Price-to-Earnings Ratio) of the market using 6-year average of reported earnings in the S&P 500 going back to 1877. The black line is the 12-

year average P/E over the same period. The first 117 years of this study show a very natural and rhythmic profit cycle that ebbs from over to under valuation over long cycles. These are what make up long-term equity bull and bear markets. Bull markets have always been born of low valuations (around 8 times the value of 6-year average profits) and then turn into a bear market once the 6-year average approached 18 times. In the mid 1990's the US equity market bubble turned history on its head and blasted to a new profit bull market profit plateau. At the peak in 2000, investors were willing to pay an astounding 30 times the six-year average P/E. So now here we sit, 13 years into the bear market that started in 2000 and one would expect investors to be a little shell-shocked. However, that is hardly the case. In fact, not only are investors not shell-shocked, but they have actually bid stocks back up to over 30 times the six year average P/E only twelve years after the prior bull market bubble high. This is unheard of in market history. We have added the blue arrows to show how long it has always taken for the market to go from one bull market peak overvaluation to the next. Between 30 and 35 years is the average of the past three stocks market cycles to get back to peak valuations. In each of these three prior instances, the market was only willing to pay 8 times six-year average earnings at the bottom of the bear market cycle. The S&P 500 would have to correct by 68% in order for stocks to be priced at that trough level of 8 times six-year average earnings (versus 29.6 at present). This historic market bottoming level is clearly observed by the arrows pointing to each trough at the bottom of the chart. This analysis, in conjunction with our profit margin analysis last report, points to a US market that is ripe for a big decline in the years ahead. We don't like being the harbinger of doom and gloom, but the fact remains that the overvaluation that existed at the top of the market in 2000 still has a long way to go before it fully reverts back to the mean. History points to a correction of at least 50% being needed to alleviate the overvaluation currently present in the market. The Federal Reserve can try to drive stock prices as high as they want, but if fundamental conditions of the global economy continue to stagnate it means trouble. Without an improvement in the underlying economy, it will take an even steeper decline in stocks prices (or much higher inflation) to ultimately achieve the low valuations needed for a new long-term bull market. Until then, the Federal Reserve is just creating a boom-bust economy based on hot money flows. In our opinion, this is a recipe for turning the once proud US capitalist system into a quasi-emerging market economy.

We mentioned above the big divergence that has developed between the money printing countries (Japan and the US) and just about every other asset class. We will conclude this week with a chart montage to help illustrate the pervasive weakness in the majority of the world this year compared to the US and Japan.

With all the news of the Cyprus fiasco we thought we would start with the Eurozone. The first chart below shows that the Euro STOXX Index (the Dow Jones Industrial Average of Europe) has rolled over and is now down for the year. The European Central Bank juiced the market in the second half of 2012, but that rally appears to be running out of steam. The second chart is a big picture look at the Euro STOXX and it shows a bleak situation. Even with the big rally late last year, this index is still 40% below its 2007 peak and 18% below its 2011 highs. This is a sick picture that seems to be having no influence on the US market even though US multinational corporations get a large chunk of sales from Europe.

SPDR EURO STOXX 50 ETF (over past 12 months)

SPDR EURO STOXX 50 ETF (over past 6 years)

Asia also sees a good amount of their exports going into the Eurozone. That is starting to weigh on the shares of the big Asian exporters. The FTSE China 25 Index Fund is almost 8% lower year-to-date and the South Korean market is 6% lower. Not exactly a picture of booming global growth.

FTSE China 25 Index Fund (past 12 Months)

South Korea iShares Index Fund (past 12 months)

Copper is the one commodity that is a great proxy for growth in the global economy because it goes into so many products along the real estate and industrial production process. The chart below of copper since 2003 shows the high correlation to the global economic cycle. Copper tends to surge during the initial expansion phase, then consolidates as the growth rate slows and then collapses when and if the global economy goes into contraction. The chart shows this cycle quite clearly by comparing the 2003-2008 cycle to the 2009 to present cycle. We are coming up on the two-year anniversary the commencement of the slowing phase (although stagnating may be a more appropriate term this time around). The last global economic slowing phase lasted a

little over two years from May of 2006 to June of 2008. All hell broke loose in the second half of 2008 when copper officially broke down from the consolidation that it underwent in the slowdown phase.

Copper Global Economy Cycles 2003 – Present)

Above we mentioned that emerging market stocks are priced to return 5.7% per year according to the latest model from GMO. This compares to negative 0.6% for US large stocks. Despite this more attractive return potential, US stocks are up over 10% this year versus down 4% for the emerging markets. Additionally, over the past two years, emerging market stocks are 12% lower while the S&P 500 has rallied 20%. We do not expect this disconnect to remain in place much longer.

MSCI Emerging Market Index (past 2 years)

Our final two charts show the only two markets in the world that have had a good start to the year. While sign after sign point to another slowdown starting to infect the global economy, the US and Japan march higher on the back of money printing. Ultimately, all of this easy money

will be highly destabilizing to the global markets as was the case in 2000 and 2007. We don't know the trigger, but once the market global economy officially starts a global recession, Japan and the US won't be immune. In fact, given their debt loads, they may be the most vulnerable once the momentum shifts back to the downside.

S&P 500 Index (past 2 years)

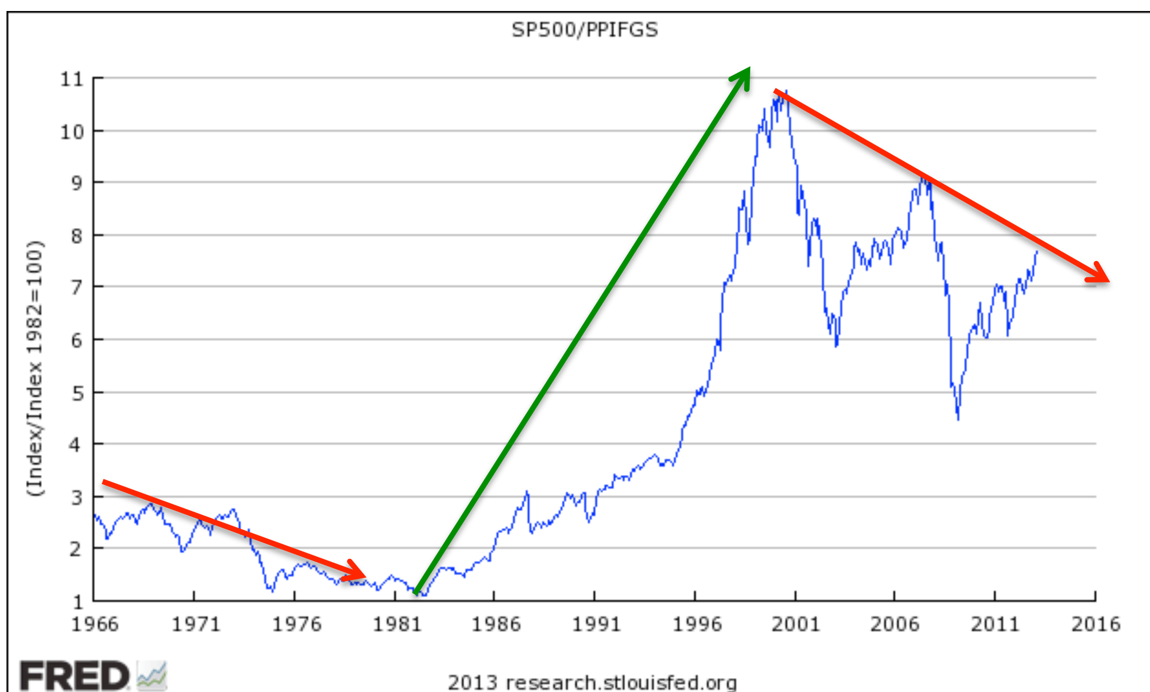
Japan Nikkei (past 2 years)

Money printing from the US and Japan is creating a currency war that is not a zero sum game. These desperate and highly indebted countries are starting to siphon growth from the rest of the world. Cannibalizing growth from the growth engines of the world is setting the stage for a global recession that will no doubt eventually hit the profits of many of the companies that make up the US stock market. US companies are in a sweet spot that is running on its last legs. All of this would simply be "noise" if not for the fact that US stocks are at one of the most overvalued levels in history. US investors are being lulled to sleep by the easy money policies of the Federal Reserve and are ignoring many stop signs being posted by the major players of the global

economy. We remain patient for a better more low risk opportunity before we become an aggressive buyer of US stocks.

In honor of the nominal S&P 500 closing the week at a new all-time high, we are adding one final bonus chart. It is the nominal S&P 500 new record closing price divided by the Producer Price Index (PPI). This gives us an inflation adjusted (or real) value of this key US stock price index. The key take away is that the US market is still some 25% below its all-time high when we factor in inflation. This chart is why to most it does not feel like a new record high has just been achieved. Furthermore, the recent rally in the market has simply taken the S&P 500 back to the downtrend line from the 2000 top. The red arrows show that bear markets are defined by never being able to recapture the top of the cycle when inflation is taken into account. Conversely, you can see how powerful the 1982 – 2000 bull market was in terms of inflation-adjusted gains (green arrow). Each market rally phase ended with a new inflation adjusted high and investors felt a real wealth effect. We feel that there is one more major leg down in this chart before we can start talking about the S&P 500 being in a new lasting bull market. Given the Federal Reserve's insistence on printing money, it is quite possible that this final leg down will consist of one part stock price declines and two parts inflation. That is why portfolios should have inflation protection in the form of precious metals and commodities (despite their underperformance over the past two years).

Inflation Adjusted S&P 500 (1966 – Present)



Bear Market
1966 - 1982

Bull Market
1982 - 2000

Bear Market
2000 – Present

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