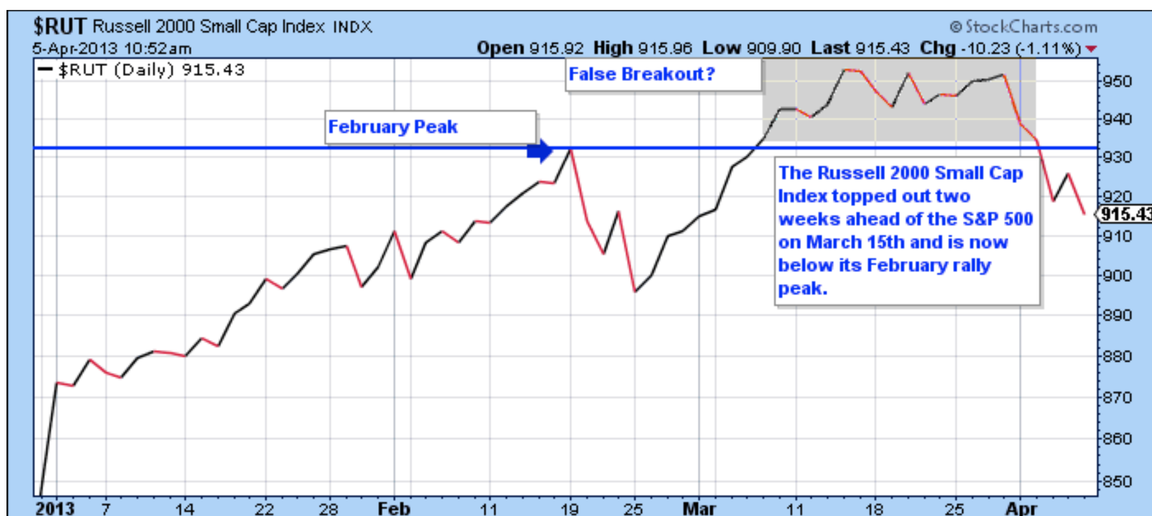
The Starboard Side Report

The week ending April 5, 2013

Last week we discussed the key divergences taking place in the market between the US and Japan (the money printers) and the rest of the world. The global economy has been weakening since February according to the asset markets that we looked at like China, Brazil, Europe, South Korea, commodities etc. This week we have really started to see some of these negative divergences showing up beneath the surface in the US market with the most highly economic sensitive areas of the market starting to roll over ahead of the broad market indices like the Dow and S&P 500. It appears that low volatility sectors like consumer staples and healthcare are holding the large cap indexes up on a relative basis. The economically sensitive areas of the market that are showing divergences are pictured below.

US Small Cap stocks are often where aggressive traders invest in order to get more leverage to economic growth. As such, it is telling that this group topped out a full two weeks before the S&P 500 and is now below its February peak. It appears as if the "breakout" to new highs in early March may in hindsight turnout to be a big false breakout or "fake out".

Russell 2000 Small Cap Index (Year-to-Date 2013)



Much like the small cap stocks, the Industrial Sector of the US economy is showing signs of a fake out rally in early March. The market is a cruel mistress sometimes and tries to suck in

unsuspecting investors at key inflection points. As you can see below, the economically sensitive US Industrial sector is now back below its February peak.

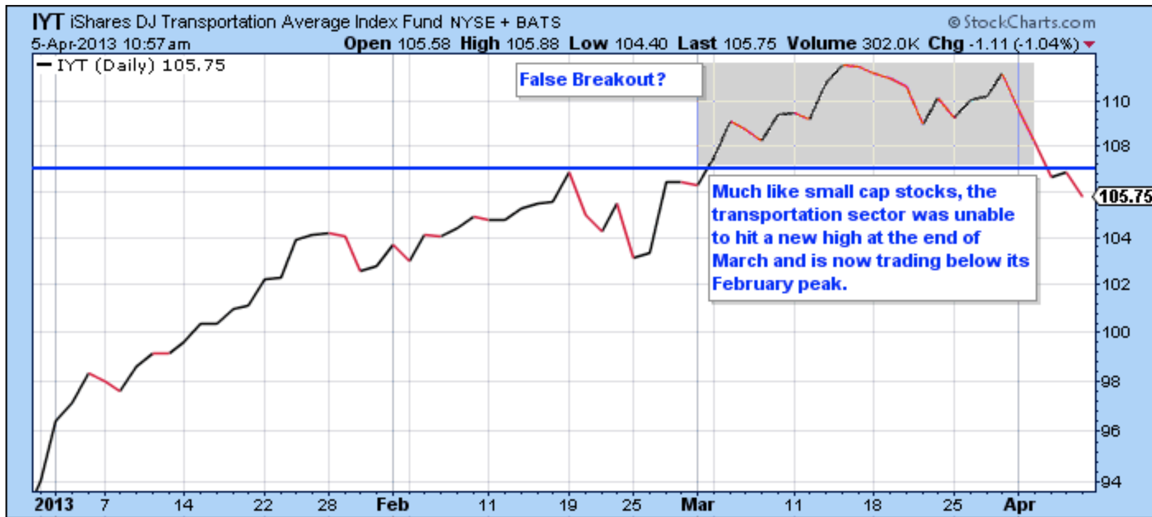
S&P Industrial Sector Year-to Date 2013

Semiconductors are the next highly cyclical sector that is pointing towards a slowing economy. They are painting an even more negative divergence than small cap or industrial stocks. The S&P Semiconductor Index topped in February and was not able to break above that peak in early March with the rest of the market. It is now 7% below its February high.

S&P Semiconductor Index (Year-to-Date 2013)

The Dow Jones Transportation Index is another economic sensitive area of the market that is not confirming the new high that the S&P 500 hit on the last day of March.

Dow Jones Transportation Average Index Fund (Year-to-Date 2013)



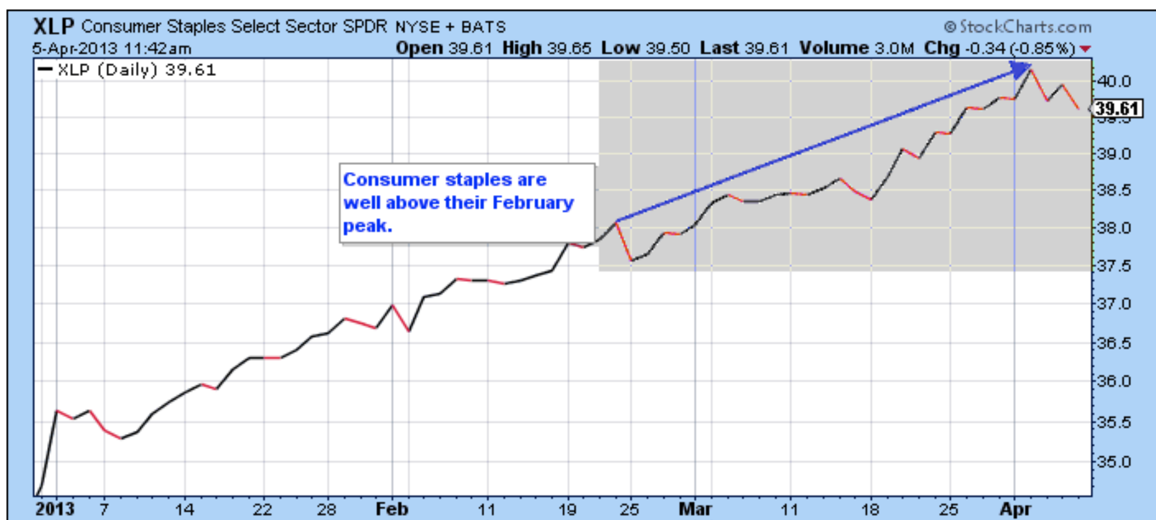
Last week we mentioned that copper, one of the most economically sensitive commodities, was breaking down. Let's look at the divergence in copper versus the S&P 500 to see what it is saying about the US market. Since the February peak in the global economy, copper is signaling another slowdown around the bend, while the S&P 500 is running higher. We believe that cyclical sectors of the US economy are starting to play catch-up with the reality of a renewed global slowdown and the indexes non-cyclical components are masking the problems.

Copper Price Overlaid against the S&P 500 Index (1-year)

The final two charts help prove that it is the defensive sectors of the market that are holding the S&P 500 price from reflecting the deterioration we are witnessing under the surface. Healthcare and consumer staples are less beholden to the whims of the global economy. Drugs, hospital visits, diapers, soap, toothpaste, soft drinks and food are staples that tend to attract money when investors see signs of global economic turmoil approaching.

iShares Healthcare Index Fund (Year-to-Date 2013)

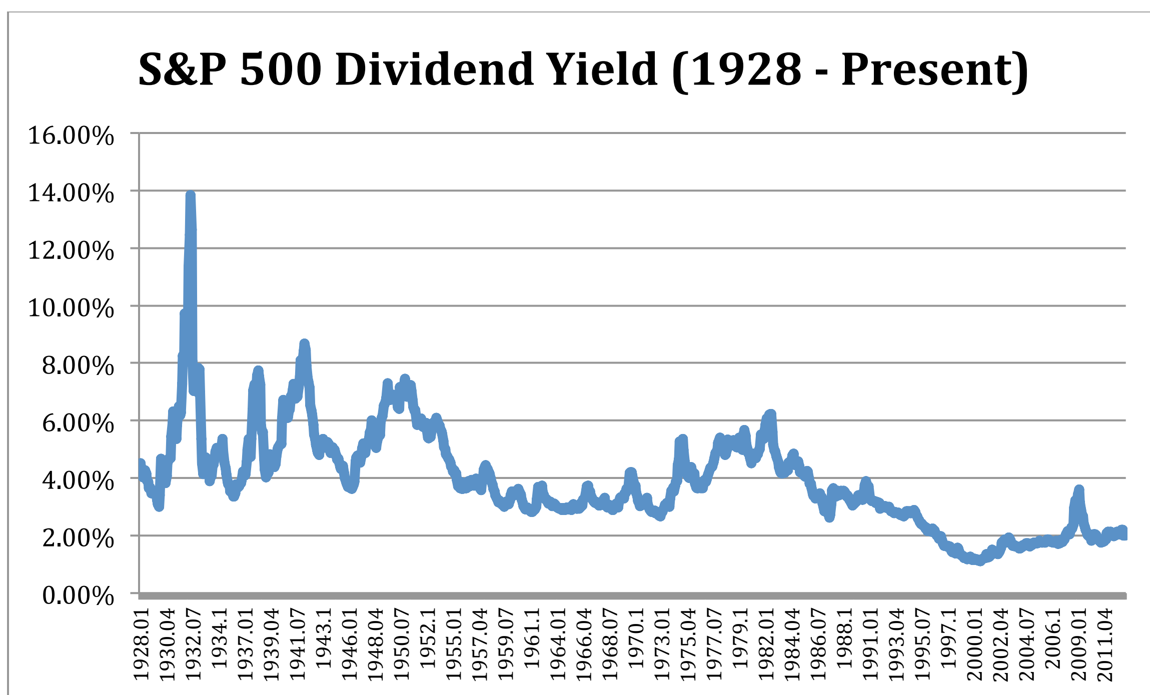
S&P 500 Consumer Staples Index (Year-to-Date 2013)



It is not bullish that these sectors are surging why the rest of the market is starting to fall by the wayside. It usually means that the market is trying to tell us that a period of sluggish economic growth is approaching. Eventually, these sectors get hit, but they are usually the last to fall and do not decline to the extent that the cyclical sectors do.

We have another entry in our continuing series that has been looking at the overvaluation of the US market. This week we thought we would take a historic look at the amount of income that investors receive in both the stock and bond markets. We think that this shows another reason why investors simply aren't getting paid near enough to take risk at this juncture. The good part of this analysis is that is it very straightforward and easy to understand. A good amount of investment income is a universal goal of all portfolios due to the stability of cash flows that this income provides. Income helps to dampen volatility and increase annualized returns. Quarterly dividends payments provide income to equity investors and semi-annual coupon payments provide income to bond investors.

First let's look at the dividend yield of the S&P 500 throughout history. This is a good gauge of how much income an equity portfolio can expect to receive each year. More importantly, the higher the dividend yield, the more an investor is being compensated for the risk they are taking in owning stocks.



Source: Robert Shiller Yale.edu

A couple of things really jump out at us. First, until the mid 1990's stock bubble, the dividend yield of the S&P 500 had only fallen below 3% on two occasions; in 1972 right before the market fell 50% and in 1987 right before the 1987 great crash. 3% was the low end of the range and it really signified that an investor was taking on a lot of risk owning stocks. Well, that all changed with the 1990's bubble. At the top of the market in 2000, the dividend yield on the S&P

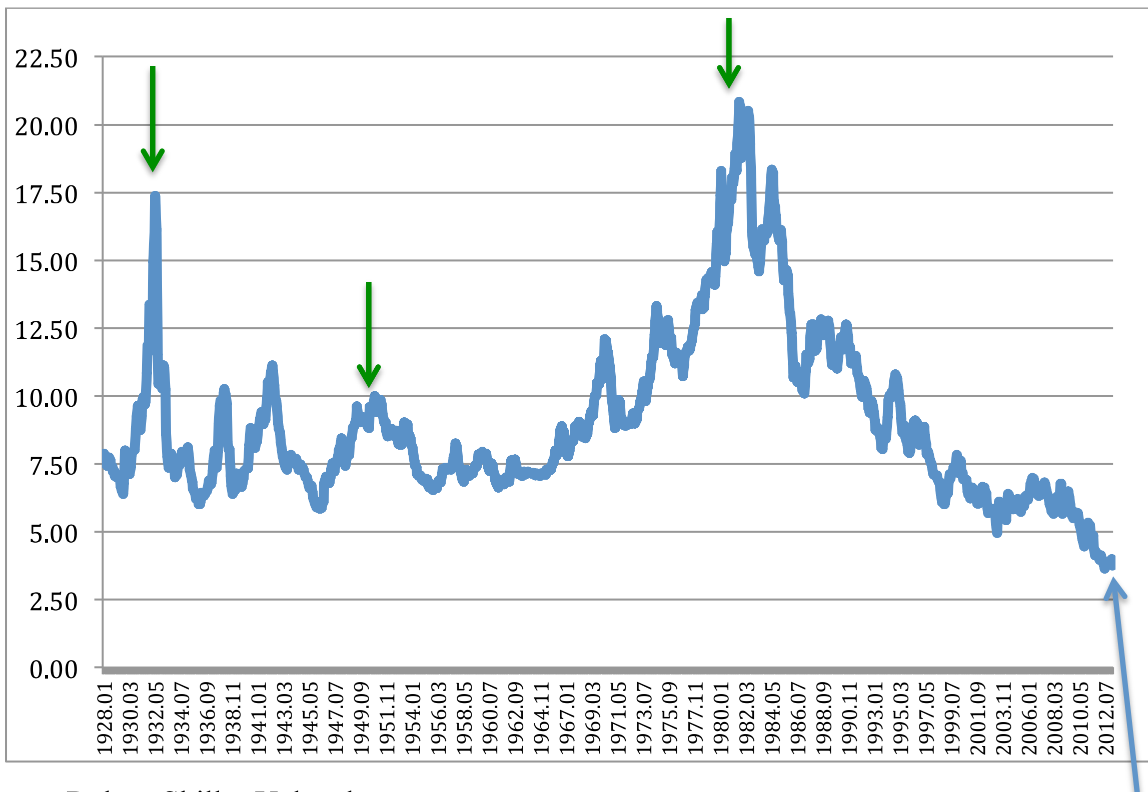
500 had fallen to a paltry 1.1%! Investors were clearly taking on an enormous amount of risk at that juncture. Fast forward 13 years and one would think that after two stomach churning 50% declines, investors would be demanding to be paid for their risk of owning stocks. Yet, here we sit with the dividend yield on the S&P 500 back at a measly 2%. The bottom of the market in 2009 only got the yield back to 3.4% (barely above the threshold that used to be considered a high risk).

Great Buying Opportunities in History	Dividend Yield
Bottom of Great Depression Crash (1932)	13.8%
Bottom of Depression Era Bear Market (1950)	7.4%
Bottom of 1970's Bear Market (1982)	6.2%
Today	2.0%

At the end of the past two long-term equity bear markets in 1950 and 1982, the S&P 500's dividend yield was 6.24% and 7.30% respectively versus 2% today (and 3.6% at the market bottom in 2009). Even more incredible, the yield after the early 1930's depression crash was almost 14%. This chart showing the dividend yield of the S&P 500 is a very simple example of what we mean when we talk about getting paid to take risk. By fixing the Federal Funds rate at 0%, the Federal Reserve has driven yields so low across the entire asset spectrum that investors are being forced to reach for yield in riskier and riskier assets.

It is not just the equity markets where the meat has been stripped off the bone. Traditionally, the bond market has provided key diversification for equity investors. Not only have bonds historically provided much less volatility, but they also helped provided a steady steam of income. Our next chart shows the yield that an investor with an even 50-50 allocation to the S&P 500 and 10-year US Treasury Bonds is far and away taking the most risk in history. For this analysis, we simply added the yield on the US Government 10-year Treasury to the S&P 500 dividend yield shown above. This creates a total cash flow yield for a diversified equity and bond portfolio. Again, this is essentially a measure of how much investors are getting paid to take market risk.

S&P 500 Dividend Yield + US 10-year Treasury Bond Yield (1928 – Present)



Source: Robert Shiller Yale.edu

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The combined income available to an investor with the model 50-50 portfolio laid out above is presently at a record low 3.75%. In 1932, this yield combo was 17.36%, in 1950 it was 10% and in 1982 it was 20.51% (noted at by the green arrows). We consider these as the three best buying opportunities in the last 100 years; generational type bottoms. Just taking the average of these three moments in time, we get an average portfolio yield of 15.95%. That means for every $1,000,000 invested, this hypothetical 50-50 equity-bond mix would throw off almost $160,000 of cash flow each year. Today, that same million dollars earns an investor $37,500 or 76% less cash flow annually. Today's combined yield of 3.75% is almost negative after stripping out the official inflation rate.

Great Long-term Buying Opportunities in History	S&P 500 Div Yield + US 10 yr Bond Yield
Bottom of Great Depression Crash (1932)	17.36%
Bottom of Depression Era Bear Market (1950)	10.00%
Bottom of 1970's Bear Market (1982)	20.51%
Today	3.75%

Financial Repression is the formal name for the quagmire that investors find themselves in thanks to the policies of the US Federal Reserve. Everyone was shocked that Cypress "haircut" bank depositors in their banking system bailout last month. But, as Jim Rickards of Tangent Capital recently estimated, $400 billion dollars is being confiscated from savers every year by the Federal Reserve's financial repression program. Locking rates at 0% for the past five years and printing trillions to buy bonds amounts to a giant transfer of wealth from prudent US savers into the pockets of the "too big to fail" Wall Street banks.

How does one navigate this treacherous environment in which both bonds and stocks are extremely overvalued and the Federal Reserve is pick pocketing from savers? First, use cash as a tactical asset class while waiting patiently until portfolios can get paid a much more attractive income stream for taking risk. Secondly, we think the world's biggest investors will seek a haven in tangible assets such as commodities and/or gold in order to protect their wealth from being confiscated by governments around the world. It makes sense to have a portion of one's wealth in these asset classes. Thirdly, try to find world class US multinational companies that have a relatively high dividend yield and a long history of being able to increase their dividends no matter what the environment. We prefer to accumulate these blue chips after corrections, not near all-time highs like we are seeing today. Finally, increasingly look to foreign markets that have higher stock dividend yields and higher bond interest rates.

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