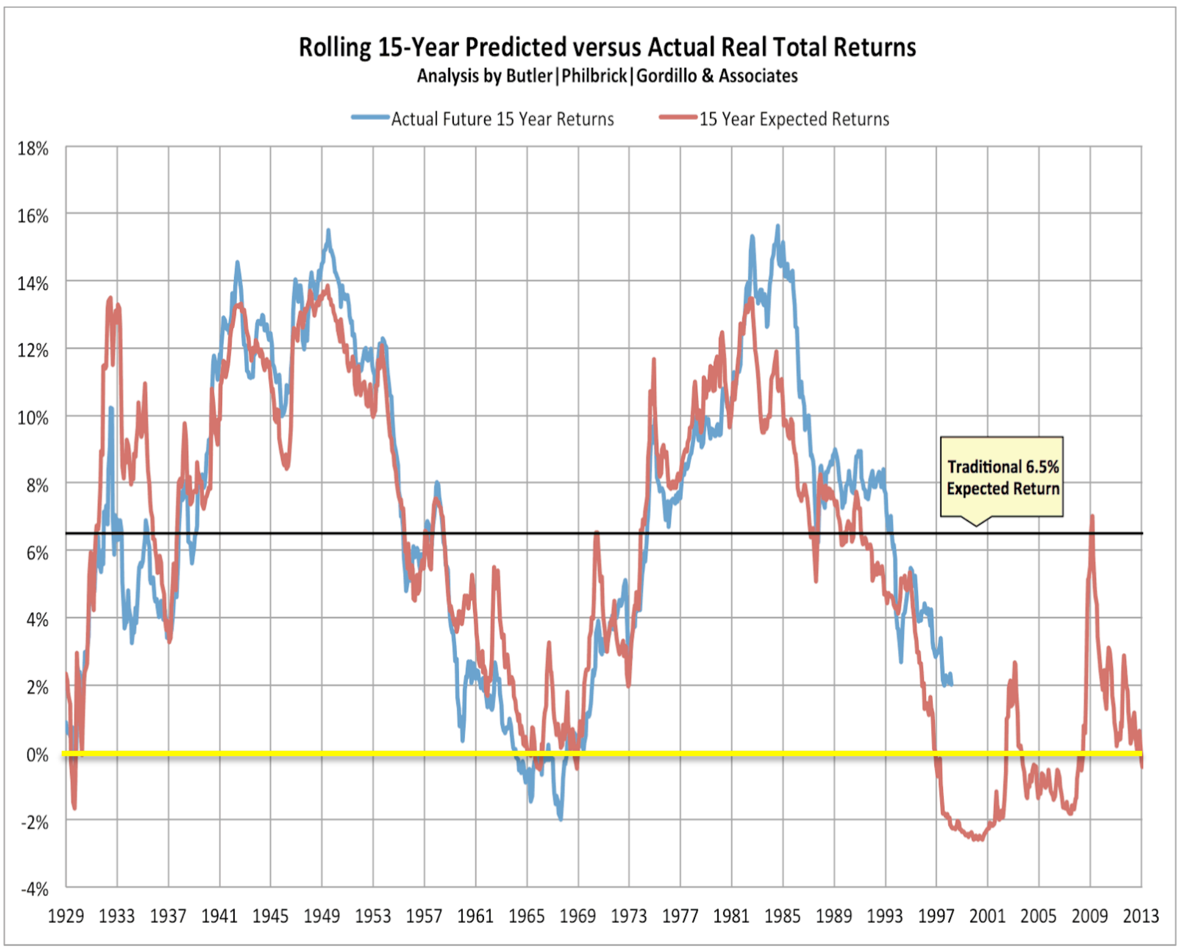
The Starboard Side Report

The week ending April 19, 2013

The broad US stock indices, which had been immune to the economic slowdown gripping the rest of the world, are now starting to roll over. We feel that US equities may have reached the very dangerous inflection point that we have been warning about. Below we explain why this may finally be the top to this US equity bull cycle that began in 2009.

Every year or so, the firm Butler, Philbrick, Gordillo and Associates (BPG) updates their very comprehensive study- *Rolling 15-year Predicted versus Actual Real Total Returns*. The data goes all the way back to 1929 to encompass multiple bull and bear cycles for US equities. The most recent version of the analysis is shown in the chart below.



The chart is simply broken down into two lines and a percentage return number on the y-axis. The red line is BPG's predicted *annualized* return (after inflation) over the past eighty-four years. This red line goes from 1929 up until the present day. BPG's computation for estimated returns varies greatly over the years from a high of almost 14% in both 1949 and 1982, to a low of -2.5% at the top of the equity bubble in 2000. The blue line is the actual return for the market overlaid against the red predicted return line. The fact that the two track so closely is a testament to the accuracy of this study (there is an *80% correlation* between predicted and actual returns). The blue line only goes through 1998 because 1998 is 15 years behind 2013. Therefore, 1998 is the most recent date for which we can see how accurate the performance estimates are to reality. For all of its visual simplicity, the really great thing about this study is the fact that its data incorporates various inputs to reach its conclusion. By this we mean most long-term valuation studies just look at one variable like earnings or trend lines. The BPG analysis is more comprehensive. According to the authors, the study is derived from four distinct facets of the financial markets: 1) the earnings statement; 2) the balance sheet; 3) corporate value as a proportion of the size of the economy; and 4) deviation from price trend (a technical price series). Taken together, they capture a wide swath of information about markets.

Now that we have given a bit of background on this important data series, let's analyze what it is saying about the present valuation of the market. First, the most recent update calculates the current predicted annualized return for the US market over the next 15-years at **negative** 0.48% (after inflation). By studying where the red line falls on the y-axis you can clearly see the low level of expected return at present. We have drawn a yellow horizontal line at the zero percent return level for visual effect to emphasize how infrequently this threshold of extremely poor returns has been breeched throughout history. 1929, 1966, 1969 1998-00 and 2004-2007 are the periods before now that the predicted annual return over a fifteen year period was less than zero. The first three dates were very close to a market top, whereas the last two saw the overvaluation remain for a few years. Just because the market is overvalued does not mean that it has to immediately go down. However, the average decline of these five sub zero return scenarios was 48% for the Dow Jones Industrial Average once the cycle turned. Since this is not an exact tool for picking tops, we decided to pare it with a trend line analysis to see if we can better estimate the topping point during these overvalued stretches.

We start our analysis with a chart of the Wilshire 5000, the broadest US index there is. We chose this because it is a good measure of large, medium and small caps all wrapped up into one big package.

Wilshire 5000 Index Megaphone Pattern (1995 – Present)

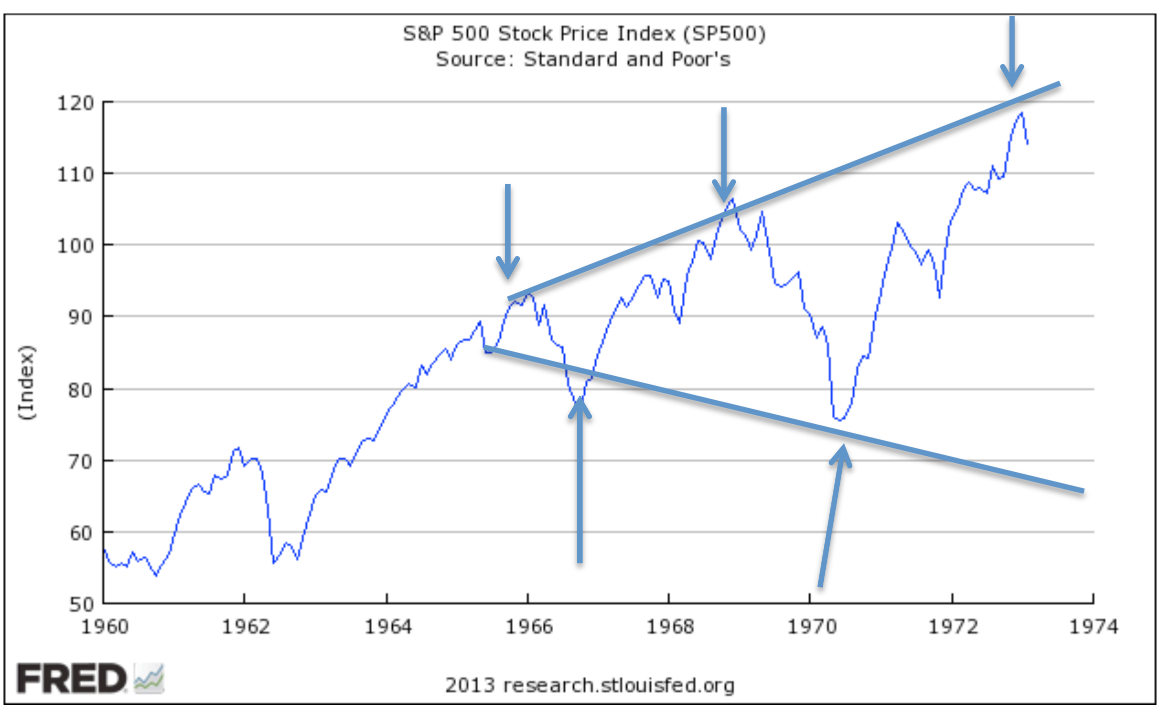
There are a couple of items that we want to point out on the chart above. We have drawn two distinct trend lines that intersect the recent secular bear market tops and bottoms. The top blue trend line shown is drawn through the cycle tops in 2000 and 2007 and ends right at the present level. The bottom blue trend line is drawn through the two prior cycle bottoms in 2003 and 2009 and extends to a projected level in the future (way below current prices). This gives us what is called a megaphone pattern on the chart with the top line trending up through a series of slightly higher highs each cycle and the bottom line trending through a series of slightly lower lows. As you can see, the recent market rally in the first quarter has brought the broad market back right in line with its top trend line. Since trend lines act as resistance and support, hitting the trend line becomes a natural area of resistance that may mark this cycle's top.

The other item that we have added to this chart incorporates the BPG *Rolling 15-year Predicted versus Actual Real Total Returns* study discussed above. The numbers on the chart indicate the predicted 15-year return at that given moment in time. It is not a coincidence that the predicted return for the market was negative before each of the prior two cycle tops since 2000. In 2000 the predicted return was -2.5% and the Wilshire 5000 Index corrected 48% over the next three years. At the 2007 top, the predicted 15-year annualized return was -1.8% and the Wilshire 5000 corrected 56% over the next two years. Here we are again four years into an economic expansion, at the top trend line's resistance point, with terrible forward-looking return prospects of -0.48%.

Now let's look at the annualized return predictions at the bottom of the past two cycles. These are the numbers below the bottom trend line. At the bottom of the market in 2003, the 15-year return prospect was only +2.5% despite a 48% market pullback. That told us that this bear market had a lot of life left. At the bottom of the market in 2009, the predicted annualized return improved tremendously (all the way up to 7%) due to the 56% decline and the fact that we were nine years into the bear market. One thing that happens during long-term bear markets is that the market actually gets cheaper during each major decline episode because profits have had x number of years to catch up with prices. Bear markets finally end when return prospects get so enticing that it no longer makes sense to play the big roller coaster ride cycles because the market no longer becomes extremely overpriced at the top of the cycle. You will notice that we have circled the end of the trend line and put 10% with question marks. If we get the decline that history predicts is coming our way and retreat to that point on the downtrend line, it would amount to a 56% peak to trough decline for the Wilshire 5000 Index (16,800 peak hit on April 11th to the 7,000 downtrend support level). We believe that would be the point that the US market finally becomes priced to produce the double-digit returns that are the hallmark of ***all*** bear market bottoms. Again, at the bottom of the 1930's and 1970's bear markets, 15-year predicted reached 14%. We are a long way from that that at -0.48%.

Jeff Copper of the *Minyanville* trader network recently drew our attention to the fact that this is not the first time we have seen a megaphone pattern like the one shown on the Wilshire 5000 above. In fact, between 1966 and 1972, there was an almost identical pattern going into the 1973 top. Our records on the Wilshire 5000 don't go back to the 1960's, but the S&P 500 is a highly correlated index that will suffice for the purposes of this exercise.

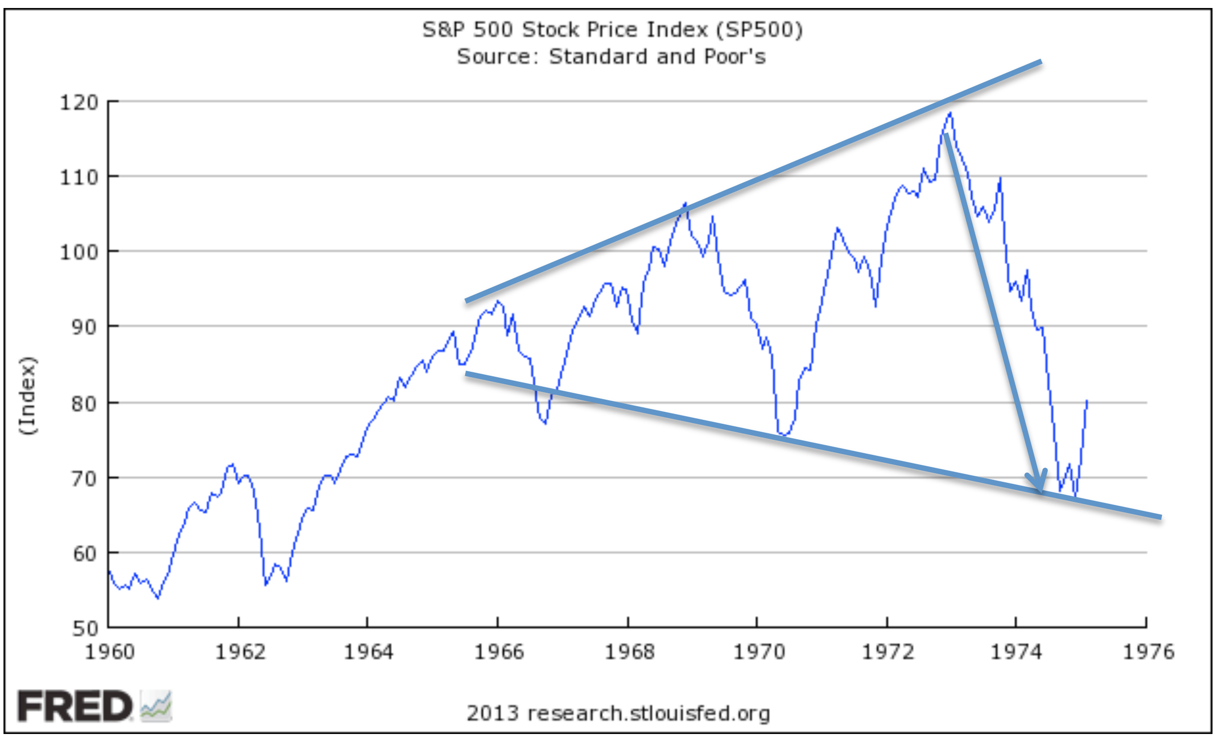
S&P 500 Megaphone Topping Pattern (January 1960 – January 1973)



Again, this chart is broken up with a slightly up-sloping top trend line and a downward-sloping bottom trend line to form the megaphone pattern. We have added arrows to indicate the points of intersection with the trend lines. For comparison, at the top arrows, the respective predicted returns were -0.5%, in 1966, -0.0% in 1969 and +2.0% in 1973. At the bottom arrows, this bear market had predicted annualized 15-year returns of 3.5% in 1967 and 6.5% in 1970. These are very similar return numbers to the Wilshire chart shown above for this current bear market. The main difference is that the current market is actually more overvalued with a -0.48% prospective return versus +2.0% at the top of the cycle in January 1973.

According to this chart of the S&P 500 in early 1973, the megaphone pattern shown would have predicted that the index would eventually need to fall to under 70 to complete the pattern (a decline of 42%). Well let's take a look at how the next two years played out by filling in the blanks.

S&P 500 Megaphone Topping Pattern w 1973-74 Bear Market Extension
(January 1960 – December 1974)



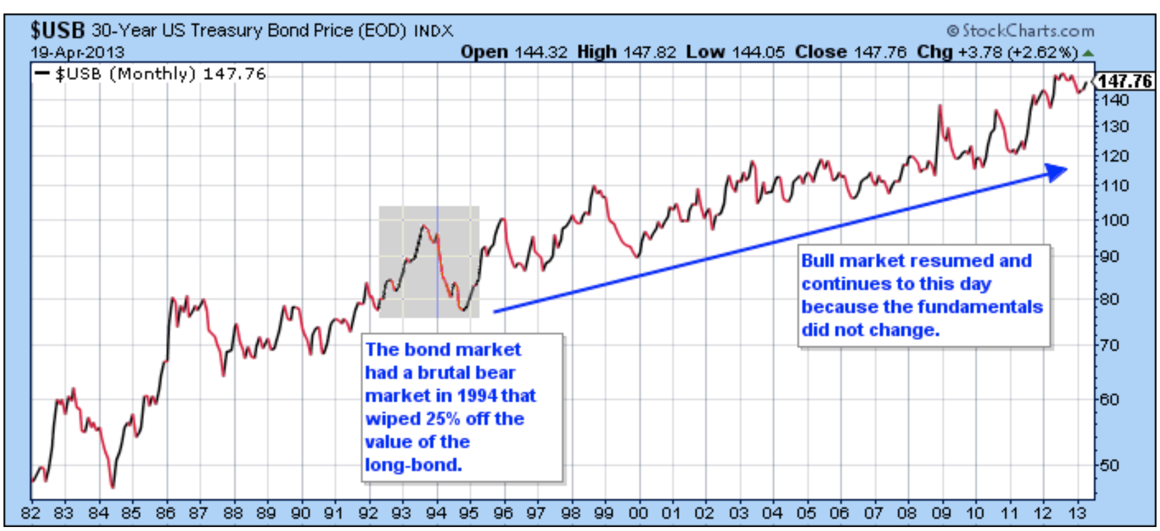
The pattern played out and the target price was achieved. The market found support right at the trend line in late 1974 and bottomed around 65. This 48% correction caused the predicted annualized returns to jump from 2% to 11.8%! We believe this is what long-term risk management is all about. Nothing is guaranteed in markets, but it sure helps to put the odds in your favor. Right now the odds are firmly stacked against the prudent long-term investor.

We think that the market is setting up for a 1973 – 1974 bear market due to the uncanny historical similarities. First, 1973 was the first year after Nixon was elected for a second term, just as 2013 is the first year of Obama's second term. The recent easing by the Federal Reserve appears to have just pushed out the timing by one quarter as the 1973 market topped on January 11th and this market may have just made a major top on April 11th. Second, 1973 and 2013 are both in the middle of a long-term bear market (one eight years in and the other thirteen). Even though we have been in a bear market longer in this instance, projected forward-looking 15-year return estimate is actually less at -0.48% versus 2.0% in January 1973. Finally, the megaphone pattern that exists in the Wilshire 5000 is almost identical to the one that existed in the S&P 500 going into the 1973 top.

Gold crashed last Friday and Monday with no real change to the fundamental picture. Last week we shared that the gold sector had a bad correction in 1975 - 76 before its final explosive move higher into the 1980 top. We decided it might be a good idea to add perspective and show the example of three other similar instances in recent history where a long-term bull market was interrupted by a crash without a meaningful change in the fundamentals. Not surprisingly, the result in all three cases shown below amounted to a blip in the big picture bull market for those who stayed the course.

The US Bond market was hit hard in 1994 when interest rates spiked. This caused a big shakeout that saw the price of the 30-year US Treasury bond fall by 25%. The long-term structural fundamentals remained in place and that bond bull market incredibly continues to this day.

30-year US Treasury Bond Price (1982 – Present)



The next instance of a bull market being interrupted by a crash was the US equity bull that ran from 1982 to 2000. In 1987, the S&P 500 stock index crashed by 20% on what is forever known as Black Monday. The chart below shows how those that stayed the course were rewarded handsomely because this was a market in a powerful long-term bull market with strong fundamentals.

S&P 500 Index (1982 – March 2000)

Everyone remembers that technology stocks staged a spectacular bubble in 1999 and the early part of 2000. However, what many don't recall is that the group was hit hard by the Asian financial crisis in 1997-1998. Below is a look at the semiconductor sector. The Philadelphia Semiconductor Index had a nasty 50% correction between July 1997 and October 1998 just before it blasted off on a fivefold advance. Once again, those that were not shaken out by the volatility were rewarded.

Philadelphia Semiconductor Index (October 1994 – March 2000)

The bottom line is that declines are part of what makes a bull market. Nothing grows to the sky without some sort of pullback. It has been said that a bull market's main purpose along the way is to try and buck as many people off of the wild ride as possible. The key is to try not to get ejected at the key emotional inflection points. The two most important things to ask when a crash happens are: 1) is the long-term trend still intact. 2) has there been any change to the long-term fundamentals. In the case of gold, the answer to each question is no. The long-term price trend has not been broken by the recent decline (although there may be some more downside risk in the weeks ahead). Additionally, one could actually make the argument that the fundamentals of the gold bull market have never been stronger. Japan has joined the US Federal Reserve's massive money printing operation and Europe's banking system is still hemorrhaging. The debt created during the credit bubble that popped in 2008 did not go away. It has just been transferred from the private sector to the government sector. We see little on the horizon that points toward central bankers backing off the printing presses and/or trying to reign in credit market speculation via higher interest rates. Additionally, a big driver of gold demand has been purchases from both emerging market central banks and Asian consumers. Both view gold as a store of value and the reports this week point to a clear willingness to use the recent pullback to add to their exposure. We feel the stage is finally set for gold to resume its *long-term bull market* after a twenty-month *cyclical* bear market. Conversely, we believe that the US stock market has reached a major inflection point that is consistent with poor forward-looking returns at best and a 40-50% decline at worst. That means the S&P 500 would be resuming its unfinished *long-term bear market* that began in 2000 and ending a four-year *cyclical* bull market.