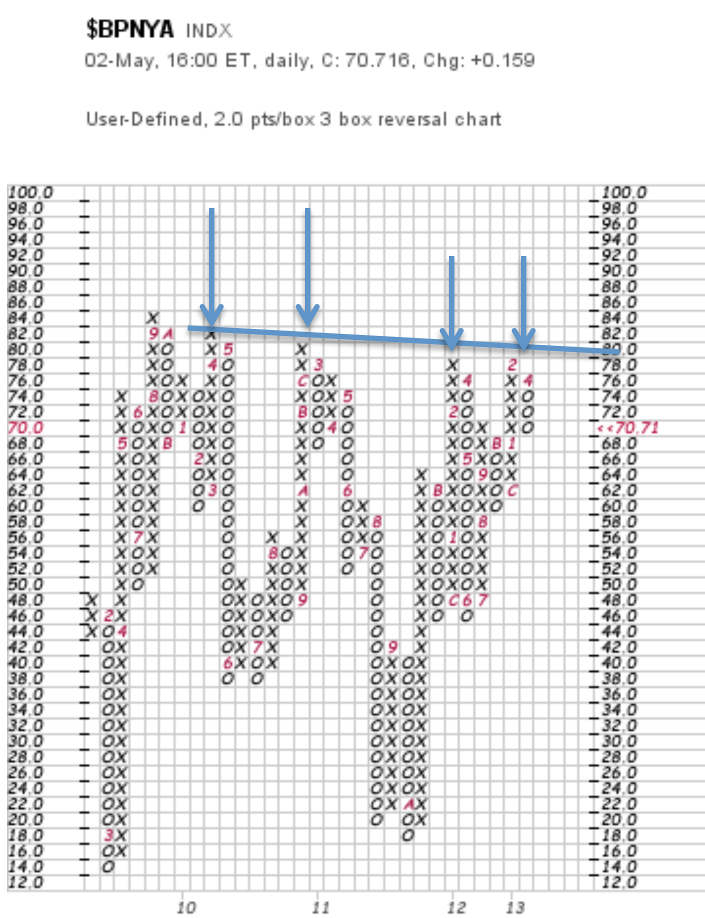
The Starboard Side Report

The week ending May 3, 2013

The NYSE Bullish Percent Index (NYSE BP) is one of our time-tested indicators that can be used to help sniff out trouble lurking around the bend. Risk levels are considered to be elevated when the NYSE BP index exceeds the 70% threshold and then reverses into a column of O's on its point & figure chart (which it just did two weeks ago). Caution is especially warranted when the reversal occurs in the spring before heading into the seasonally weak May through November period. A similar high-risk reversal set-up has occurred during the spring in each of the last three years. In 2010, the NYSE BP peaked at 80% in May and was quickly followed by a 17% market correction over the next two months. In 2011, the index peaked at 80% in March and again at 76% in May. The market was able to hold-up in a volatile sideways consolidation in March and April as supply battled demand. The S&P 500's only managed to tack on another 2% above the original March top before supply ultimately won the war in early May. The S&P 500 shed 20% during this corrective episode that lasted until October 2011. Last spring, the NYSE BP had another key reversal in April from a peak of 78%. This was the beginning of an 11% correction over the next two months. The arrows in the chart below highlight these key inflection points.

NYSE Bullish Percent Index (2009 – Present)



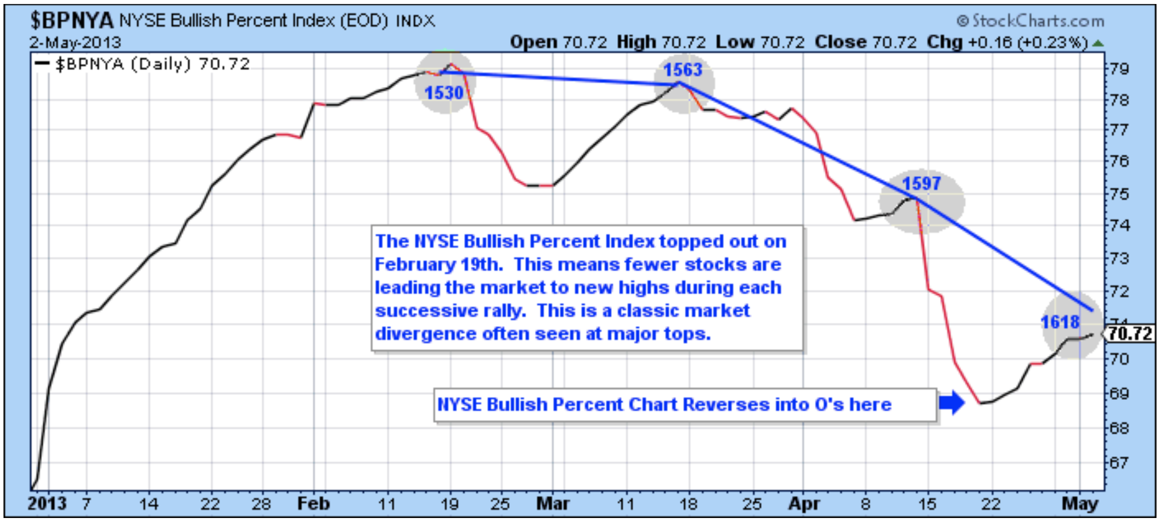
The best-case upside of each of these three prior episodes was 2% in 2011 as the April rally exceeded the March S&P 500 peak by 30 points (1340 to 1370) and the best-case downside was 11%; not very attractive risk reward in our book. The 2011 pattern appears to be what we are going through now given that the S&P 500 has just recently exceeded its prior peak by 1%. Another 1-2% upside from here would not be out of the question if the 2011 analogy holds. The chart below shows the price action of the S&P 500 during the past three years. The gray shaded boxes are the correction episodes that followed the spring NYSE BP reversals (indicated by the blue arrows).

S&P 500 with NYSE Bullish Percent Reversals from above 70% since 2010

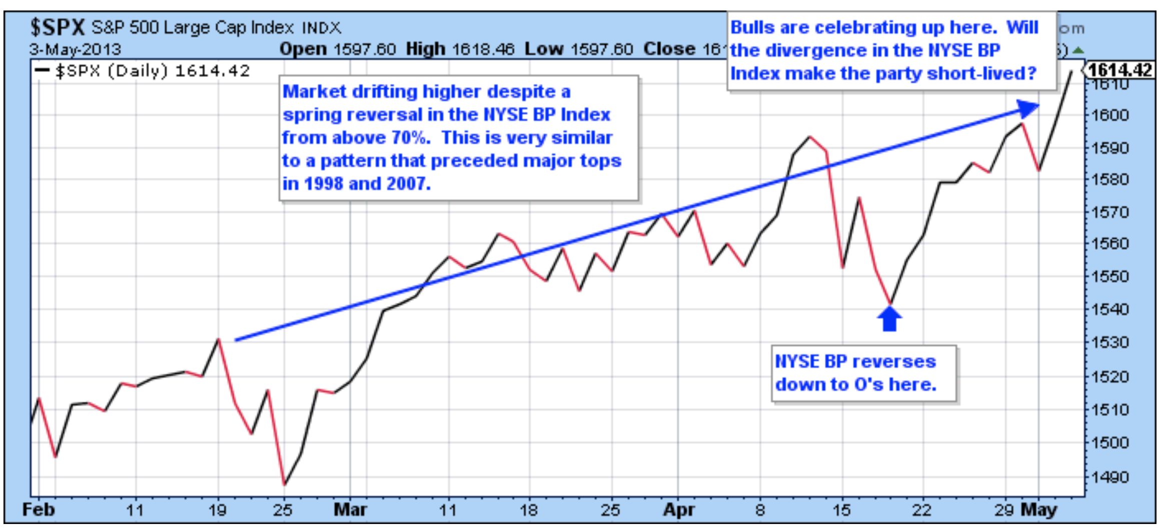
As a refresher, the Bullish Percent of a sector or a market index is simply a compilation of the percentage of stocks in that sector/index whose charts are on a Point & Figure (P&F) buy signal. When the chart is in X's that means demand (buying power) is in control; when the chart is in O's then supply (selling power) has taken over. We like to use bullish percent indexes as contrarian indicators to help measure the amount of bullishness and bearishness towards a given area of the market. The higher the percentage of stocks in an index on a P&F buy signal, the greater the downside risks when things turn and vice-versa. When over 70% of stocks in a sector are on a buy signal it raises the caution flag (especially when supply takes over and the chart reverses into O's). When fewer than 30% of stocks in a sector are on a buy signal, it is usually time to start putting a shopping list together for when the asset market in question eventually bottoms and turns-up.

It is possible to have the sector/market index going up in price, yet have the bullish percent index trending lower. This is known as a negative divergence and means that fewer stocks are participating in each leg up. These divergences are a key thing to look for in order to try and gauge when a trend may be on its last legs. Below is a *line* chart of the NYSE Bullish Percent Index (versus the point & figure chart above) that is exhibiting a classic negative divergence with the S&P 500. The blue numbers are the S&P 500's rising price as the NYSE BP Index has been declining. As you can see, the price of the S&P 500 going higher (from 1530 to 1618) as the NYSE Bullish Percent falls lower from 79 to 69 is the divergence in question.

NYSE Bullish Percent Index Divergence with S&P 500 Prices (Year-to-Date 2013)

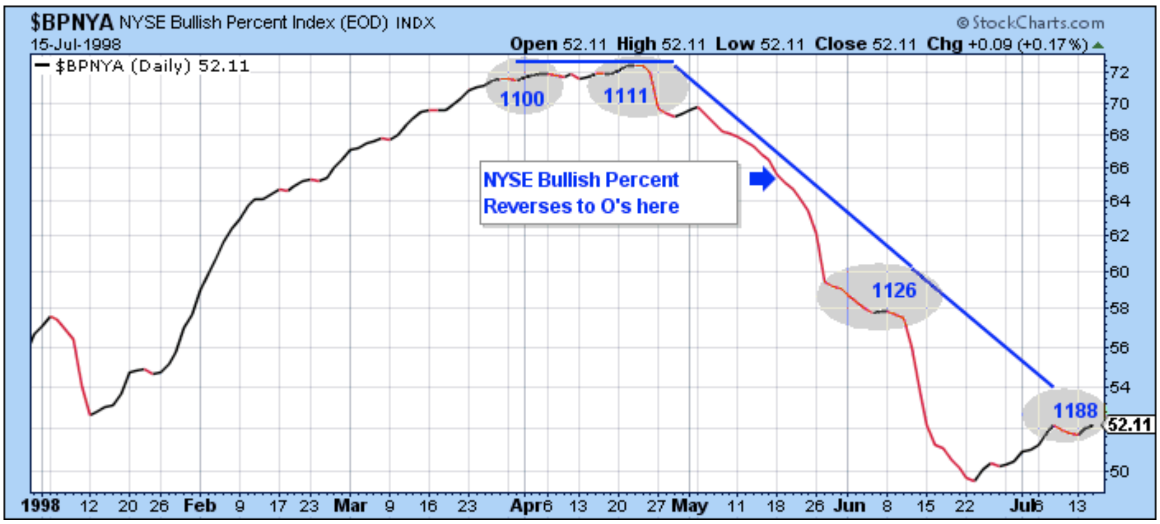


S&P 500 Index 2013 Topping Divergence



We mentioned above that spring reversals from above 70% on the NYSE BP are rather ominous for markets. This is especially true when the market is at an all-time high and forward-looking returns are forecast to be negative (as we discussed in our last report). The last two spring reversals in the NYSE BP that occurred from above 70% and coincided with the market at an all-time high (and negative forward looking returns) occurred in 1998 and 2007. Interestingly enough, both of those instances exhibited divergences similar like the one we have illustrated above. Below are the NYSE BP line charts and the corresponding S&P 500 chart for these periods.

NYSE Bullish Percent Index Divergence with S&P 500 Prices (1998 Top)

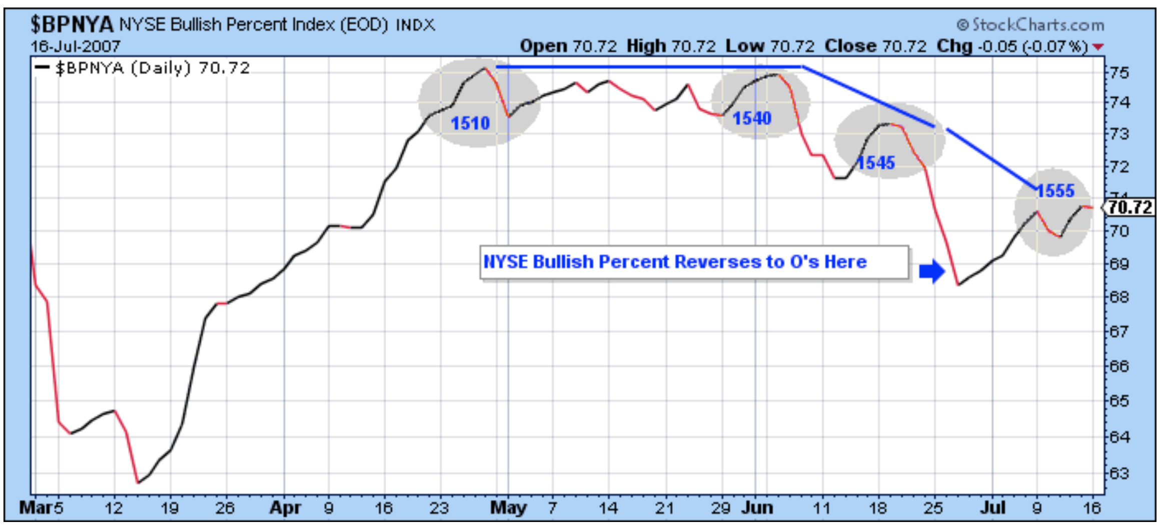


S&P 500 Index 1998 Topping Divergence

As the blue numbers in the first chart above illustrate, the S&P went from 1100 to 1180 (a gain of 7.2%) from April through mid-July 1998, even as the NYSE BP declined into O's and fell from 72% to 50%. This was a major divergence that served as a warning of the 22% decline that occurred during July, August and September 1998.

2007 was the other recent instance where we had a spring reversal in the NYSE BP Index with the Market at an all-time high. In June of 2007, the NYSE BP reversed, yet the market kept going higher for three more weeks before it finally topped out. When all was said and done the S&P 500 rallied another 3% (1510 to 1555) as the NYSE BP index fell from 76 to 68. This was not nearly as big a divergence as the one we saw in 1998, yet it was just as effective in signaling an impending top. The S&P 500 experienced a brutal 12% correction in under a month when it finally topped in mid-July. This decline was the first chapter in a brutal bear market that shaved 55% off the S&P 500 over the next two years. Both the 1998 and 2007 tops had something in common with the current environment. Namely, they broke out to a new high (like the S&P 500 did this week) just before the bottom fell out. This week's breakout to new highs is not a reason to abandon our cautious stance. History tells us there will be a much better opportunity to add stocks at much lower risk levels at some point in the next few months.

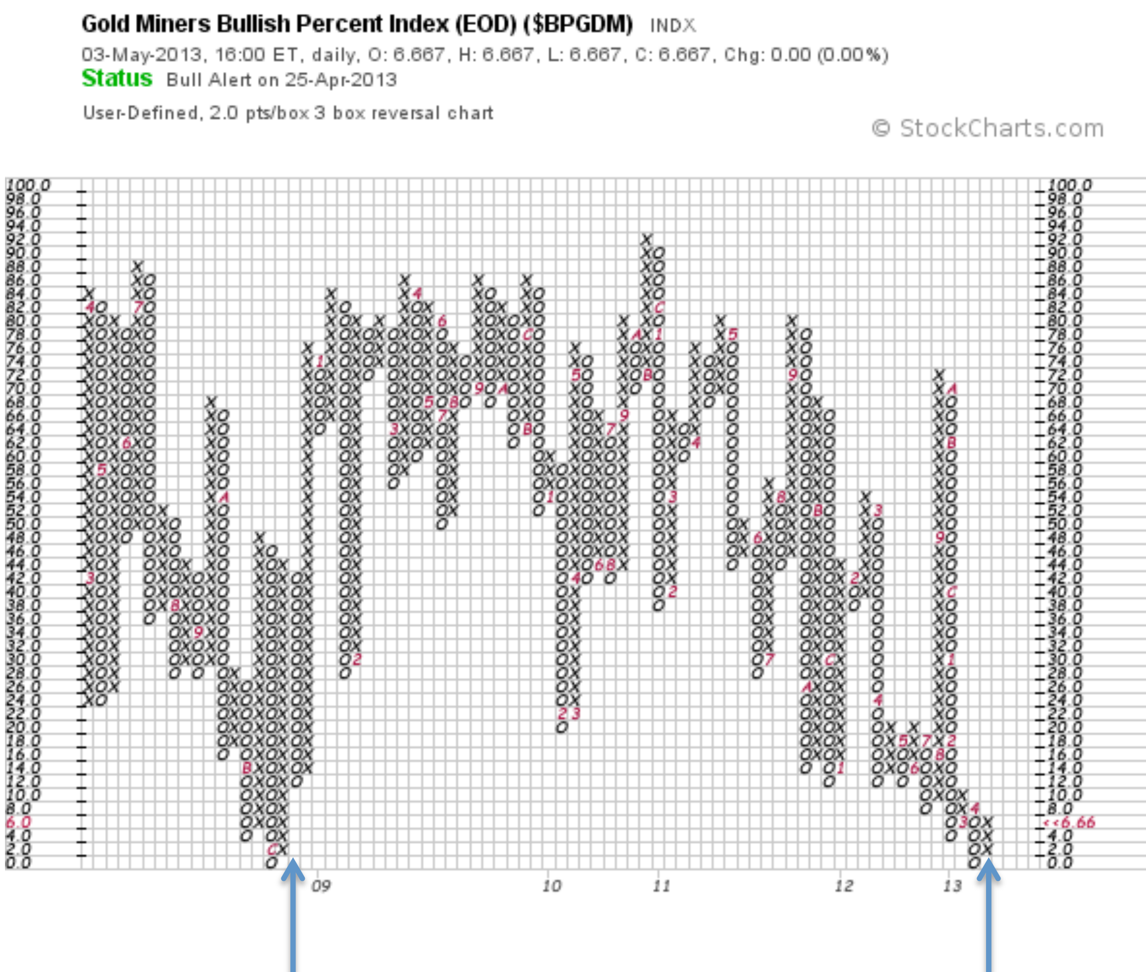
NYSE Bullish Percent Index Divergence with S&P 500 Prices (2007 Top)



S&P 500 Index 2007 Topping Divergence

As mentioned above, we like to use bullish percent indexes as contrarian indicators to help measure the amount of bullishness and bearishness towards a given area of the market. While our analysis above on the S&P 500 shows that there in a lot of risk in the stock market at present, this is certainly not the case with the gold mining stocks. The sector bullish percent of the Amex Gold Miners Index went all the way to ZERO last month and has just reversed back into X's. This zero bullish percent reading indicates washed out risk levels and the reversal to X's could be considered the first "green shoots" of buying interest.

Gold Miners Bullish Percent Index (April 2009 – Present)



November 2008 was the last time the Gold Miner Index Bullish Percent hit zero and then reversed back into X's

Hit rock bottom on April 15th and now back into X's

A Bullish Percent Index of zero means that none of the thirty stocks that make-up the Amex Gold Miners Index were on a point & figure buy signal as of April 15th. That means that there was very little supply left in the market to take the sector lower. More importantly, the move back to X's last week means demand is finally starting to return. Late October 2008 was the last time the Amex Gold Miners Bullish Percent Index went to zero. It took about a month of supply and demand battling it out before demand took control and lifted the index by 100% in only three months (see chart below).

Amex Gold Miner Index (June 2008 – Present)

In conclusion, we appear to be in the midst of an epic market topping process that is testing the resolve of even the most patient investors. However, 1998 and 2007 show that this is not the only time the market has been in a similar situation. This go around, investors continue to follow central bankers down the rabbit hole in a blind trust that is unfathomable to us. We do not see how this ends in any other way but pain for those chasing stocks higher at these nosebleed levels. Of course, we also understand that our calls for caution and prudence will be looked at with extreme skepticism until such time that this position is proven correct. Nonetheless, once everyone starts to run towards the exit at the same time, we believe that only the most nimble short-term traders will be able to walk away from positions at these levels with profits intact. As unlikely as it seems given all the good news swirling about in the financial media, bull markets die on euphoric news and are born of rampant pessimism. First, investors blindly put faith in technology stocks, then home prices and now central banker printing presses. To quote *Pater Tenebrarum of www.Acting-Man.com, "This time we believe that the coming bust will shatter the last bastion of investor faith: the illusion that central banks are omnipotent and can 'fix' the economy and markets by waving their 'magic wand' in the form of the printing press."*

While it seems counterintuitive, our main goal at this juncture of the market cycle (with the S&P 500 up 142% since its March 2009 cycle bottom) is the return *of* capital, not the return *on* capital.

Chasing stocks into a major cycle turning point has proven to be a recipe for long-term capital destruction. We prefer to be fully invested when everyone hates stocks and the forward-looking return prospects are much more constructive than they are at present. Gold stocks seem to be the only asset class that fits this profile at the moment, so we remain bullish in this sector. It would not be the first time that the precious metals sector acted as a store of value during a stock market correction. When that belief in central banker's omnipotence is finally shattered, precious metals will be one of the main benefactors.

There is a rare confluence of red flags warning of the potential for a major top in the market. To reiterate, that confluence consists of: 1) several long-term valuation studies that we track are projecting *negative* forward returns for the major US indexes over the next seven to fifteen years. We discussed one of these in detail in our prior weekly report; 2) The market is now at an all-time high; 3) The NYSE BP Index has reversed into O's from above 70% near the start of the seasonally weak May through October period. 4) The NYSE BP Index is showing a very serious negative divergence with the S&P 500 Index and as a result is not confirming the breakout to new highs that we saw this week. 1998 and 2007 are the only other episodes over the past 58 years where we can say that all four of these factors have been present at the same time. In 1998, the S&P 500 had a brief 5% shooting star rally, but then corrected 22% over a three-month span. US small cap stocks never even joined the rally and then fell 40% once the S&P 500 ran out of gas in July of that year. In 2007, there was a nasty 12% correction in just three weeks, followed by a recovery, and then a 55% bear market decline. We remain extremely wary of the breakout that was achieved this week and wait patiently for a better opportunity to deploy client capital.