The Starboard Side Report

The week ending May 17, 2013

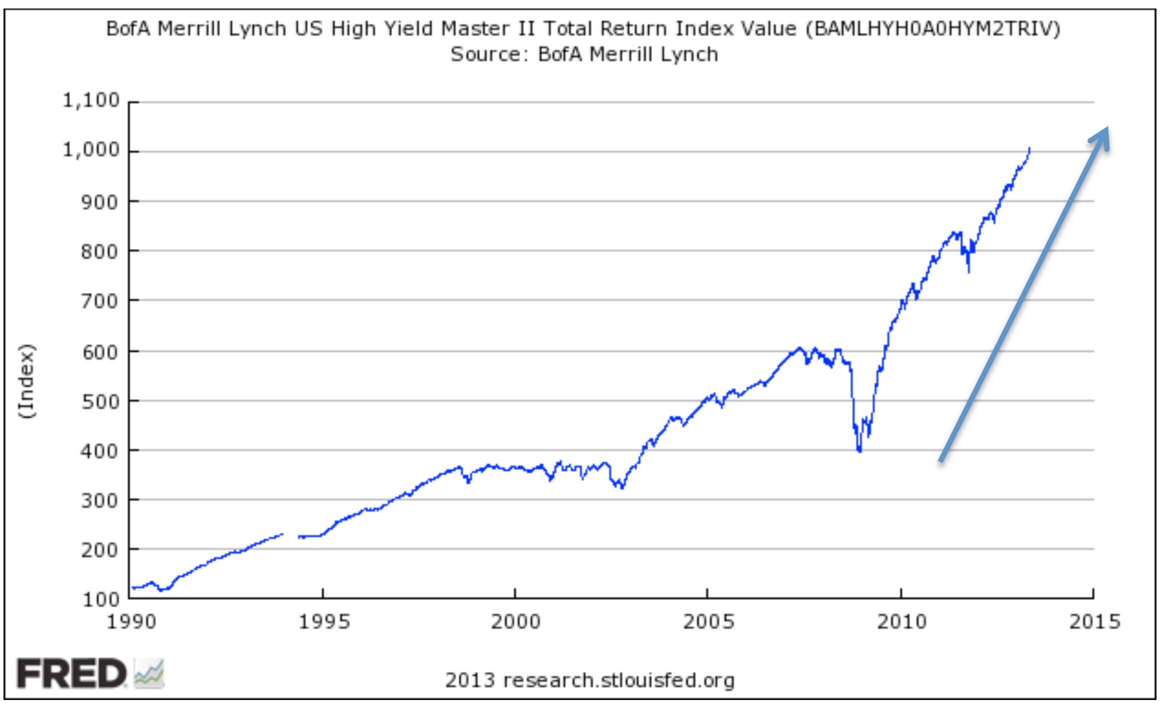
Two weeks ago we showed a chart of the bullish percent of the Amex Gold Mining Index sitting near zero to illustrate how oversold the gold sector was. This week we wanted to highlight a group on the other end of the spectrum, Consumer Staples. These are the defensive consumer companies that tend to be able to produce cash flow no matter the economic climate. As we see below, the bullish percent of the S&P Consumer Staples sector is currently residing at 100%! This leaves zero room for error in this group and very little in the way of buyers to drive stock prices higher from here. To borrow a phrase from poker, investors are currently “all-in” on large cap consumer staple companies.

It appears as if a bubble in perceived safety has developed. This happened in the last cycle as investors rushed into real estate after getting burned by tech stocks because they thought it safer.

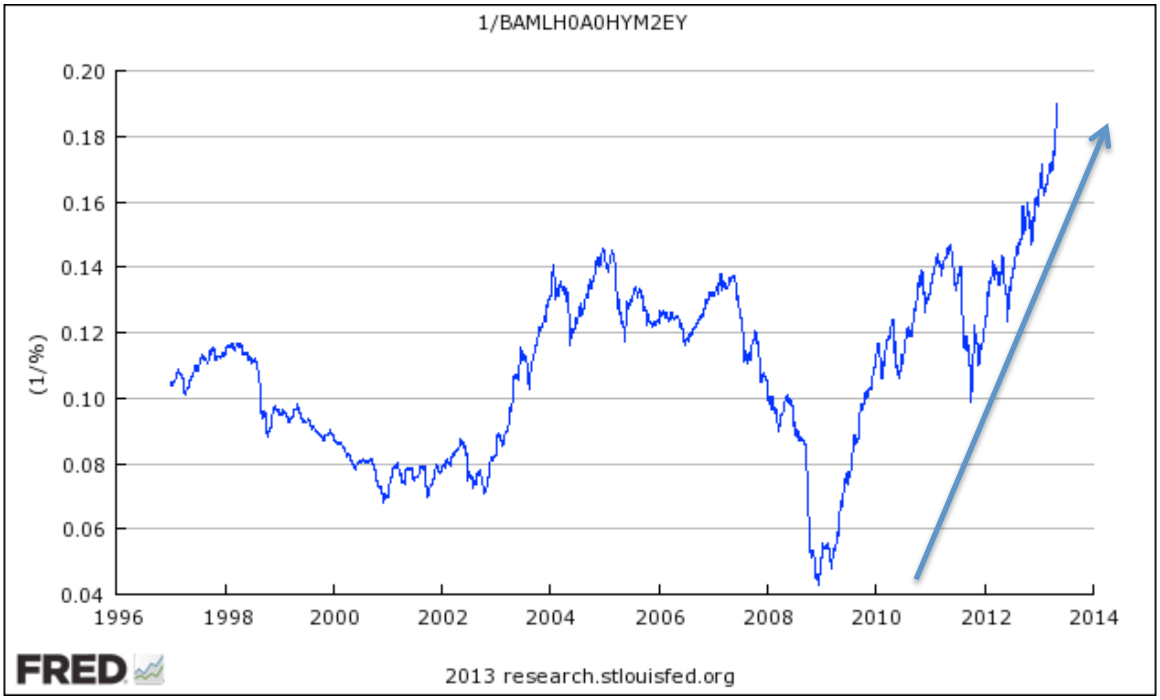
Now, without any regard for value, they are piling into defensive sectors like consumer staples or corporate bonds because they are perceived to be safer.

Based on the fact that the market is breaking out to another leg higher, the question becomes; what could possibly cause the market to turn down? In 2000, it was the popping of the technology bubble that brought down the economy and market. In 2007, it was the subprime real estate collapse. This time around, we suspect that it will be an accident in the area of the market with the most perceived safety, corporate high yield bonds (also known as junk bonds). **Since January 2007, investors have poured over $1.1 trillion into taxable bond funds while withdrawing $400 billion from domestic equity funds.** This has created another enormous pocket of excess in the financial markets on par with the tech stock and real estate bubbles. As we can see below, the problems are especially glaring within the confines of the high yield bond market.

BofA Merrill Lynch US High Yield Total Return Index (1990 – Present)



BofA Merrill Lynch US High Yield Index Reciprocal of Yield (1990 – Present)



The first chart above is the *price* for the BofA Merrill Lynch US High Yield Total Return Index. We appear to have entered a terminal blow-off phase in the search for income and safety. This is yet another bubble that is being driven by reckless Federal Reserve monetary policy. The Fed has driven investors so far out on the risk curve in search for yield that they have created the illusion safety in traditionally risky asset classes like high yield bonds. In the second chart above, we have taken the reciprocal of the *yield* to give another perspective of the excesses that are occurring in this corner of the bond market. Just like with AAA rated subprime mortgages in 2007, investors may be dramatically underestimating the perceived safety of junk bonds and their ability to get out ahead of everyone else. These charts make it apparent that yield chasers are not getting compensated nearly enough for the risks they are taking. An accident in the high yield bond market will surely have repercussions for the fragile US economy still recovering from the last credit bust.

Our final charts are being offered up to show the clear contrast between the risk/reward of the precious metals market versus the broad stock market. They are vitally important to where we go from here. Opportunities in the investment world are always coming and going. You catch some and you miss others. We have clearly missed a big opportunity over the past year to invest more aggressively in US stocks. However, that does not change the fact that we feel the precious metals market is setting-up to provide really good opportunities for us going forward. As crazy as that notion seems given more strength in US stocks and more weakens in gold this week, history tells us that US stocks may soon resume another down cycle at the same time that precious metals may be ramping up to resume their bull market that began in 2001.

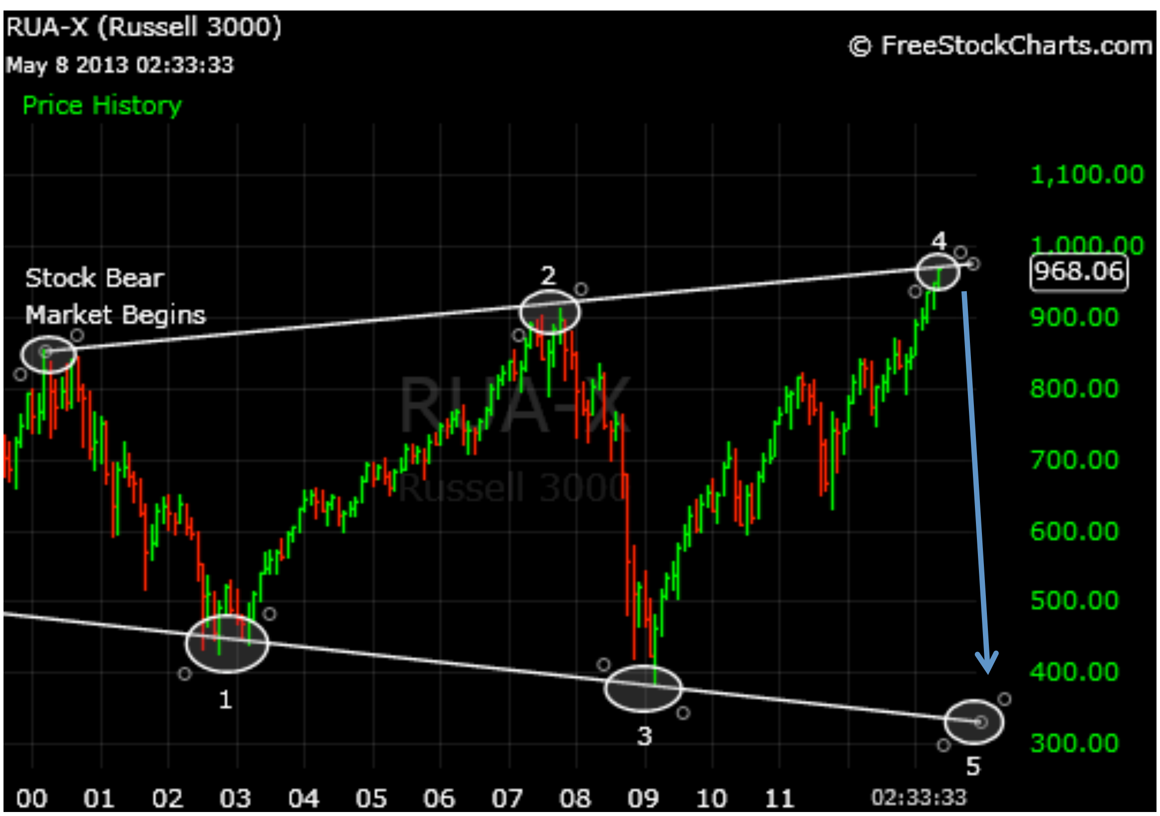
Gold- Long Term Bull Market
Bull Market Corrections since 2000

US Equities- Long Term Bear
Bear Market Rallies since 2000

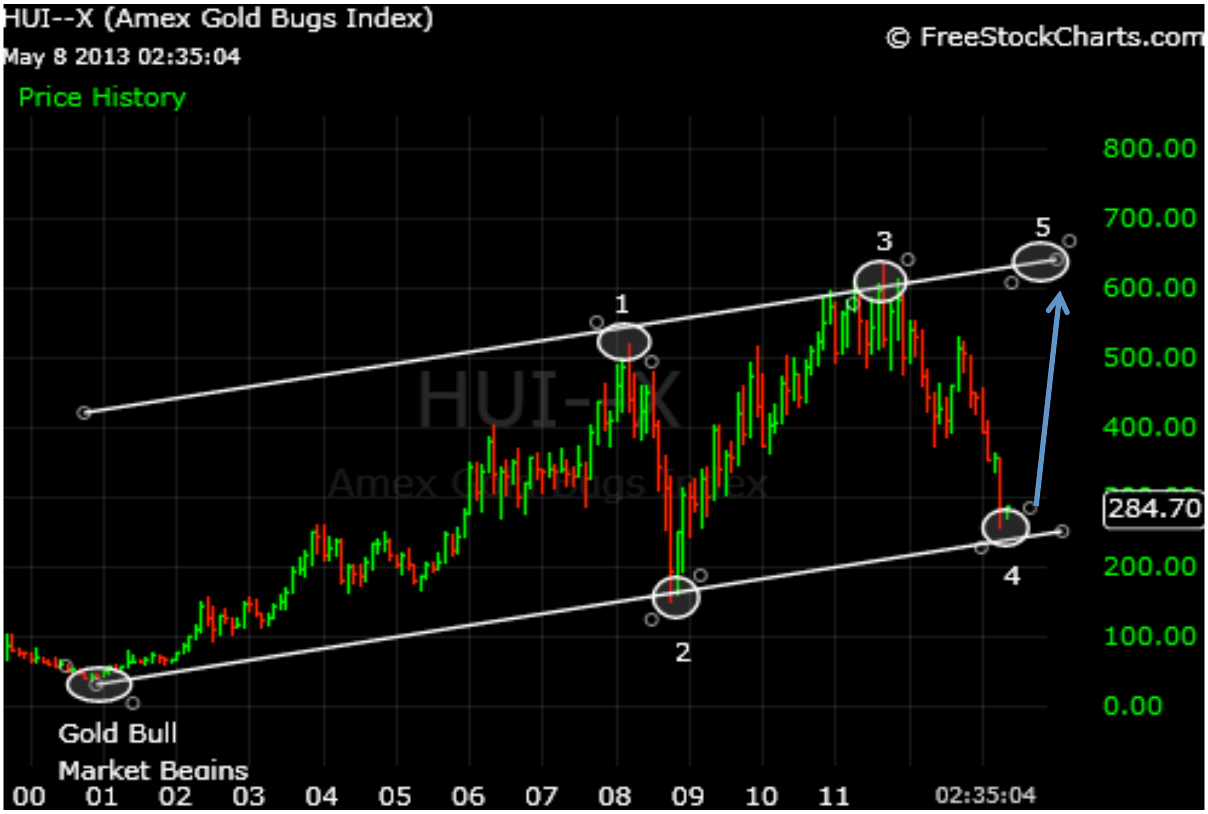
It is very important to understand that what is happening in the stock market is a rally within the confines of a long-term bear market (otherwise known as a "bear market rally"). This rally is in the topping phase as was the case in 2007. On the other hand, gold is undergoing a correction within a long-term bull market (bull market correction). This correction is in the bottoming phase like in late 2008. This does not mean that the S&P 500 can't head higher in a final shooting star rally and that gold can't retest its old April lows. It simply means that once the cycles turn, there is a big change of trend ahead that presents a major opportunity.

Finally, let's quantify this risk-reward in two simple charts. The first shows the bear market in the US stock market as seen in the Russell 3000 Index. This is one of the broadest indexes with 3000 of the most liquid US stocks. We have clearly numbered the key pivot points since the bear market began in 2000 and connected those numbers with trend lines. Trend lines are important because they provide key target prices that often act as resistance and support points. The bear market rally that began in 2009 is now facing stiff resistance at point 4. If we connect the dots down to point number 5, than we have the potential for a 65% of downside with maybe best-case upside of 10% in a true blow-off top through the top trend line. On the other hand, the gold stock index shows that point 4 is fast approaching at the bottom trend line. The risk-reward trade here using long-term trend lines is much more favorable with perhaps 10% downside and 135% upside to point 5.

Russell 3000 Long-term Bear Market with Key Pivot Points (2000 – Present)



Amex Gold Bugs Index Long-term Bull Market with Key Pivot Points (2000 – Present)



We have been saying for a while now that the precious metals market is *in the process* of making *a bottom* and the US stock market is *in the process* of making *a top*. Said another way, gold mining stocks are currently going through what we think US stocks will be going through in the next few years; it's just that they are doing it first. By getting it out of the way so to speak, the gold sector has largely already gone through its bear market and is setting the stage for a lasting recovery. We hope these last two charts show that we are fast closing in on the bang moment when the trends reverse and start going in the direction that we have been predicting. We remain positioned for the opportunity that this will present in terms of returns. Eventually, we want to be buyers of US assets from forced sellers near point number 5 on the Russell 3000 chart, not forced to buy US assets at point 4 because everyone else is doing it (like now). On the flip side, we believe the current forced selling in gold has almost run its course just above point 4 on the gold mining chart and we hope to one day sell our gold assets to forced gold buyers at point 5.

We know that this is a trying time as market bottoms are never fun (especially when it appears as if everyone else is having a party at your expense). But, bull markets follow bear markets as sure as day follows night and these bull markets are always born of rampant pessimism. We are pretty certain things can't get much more pessimistic in gold mining stocks and feel the stage is being set for a new bull market just as soon as the Dow and S&P 500 complete their parabolic buying climax.