The Starboard Side Report

The week ending May 24, 2013

"We are at a wonderful ball where the champagne sparkles in every glass and soft laughter falls upon the summer air. We know at some moment the black horsemen will come shattering through the terrace doors wreaking vengeance and scattering the survivors. Those who leave early are saved, but the ball is so splendid no one wants to leave while there is still time. So everybody keeps asking – what time is it? But, none of the clocks have hands."

… "The Money Game" by Adam Smith

The black horsemen seem to have made their first appearance this week in Japan. The Nikkei 225 Index started higher on Thursday morning only to get whacked by 10% in the second half of the trading day. The chart below shows the magnitude of the downdraft.

Nikkei 225 Stock Index One week Through Thursday

Investors in the Japanese stock market got a taste of what Yves Smith referred to as "The Musical Chairs Theory of Markets." This is based upon a July 2007 statement by Citigroup CEO Chuck Prince right before the credit markets started to seize-up from the popping of the subprime mortgage market bubble. In an interview with the Financial Times, Prince said; "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing." Here is how that game of musical chairs played out for Prince and his company's shareholders.

Musical Chair Theory- Citigroup Stock Price July 2007 – Mar 2009

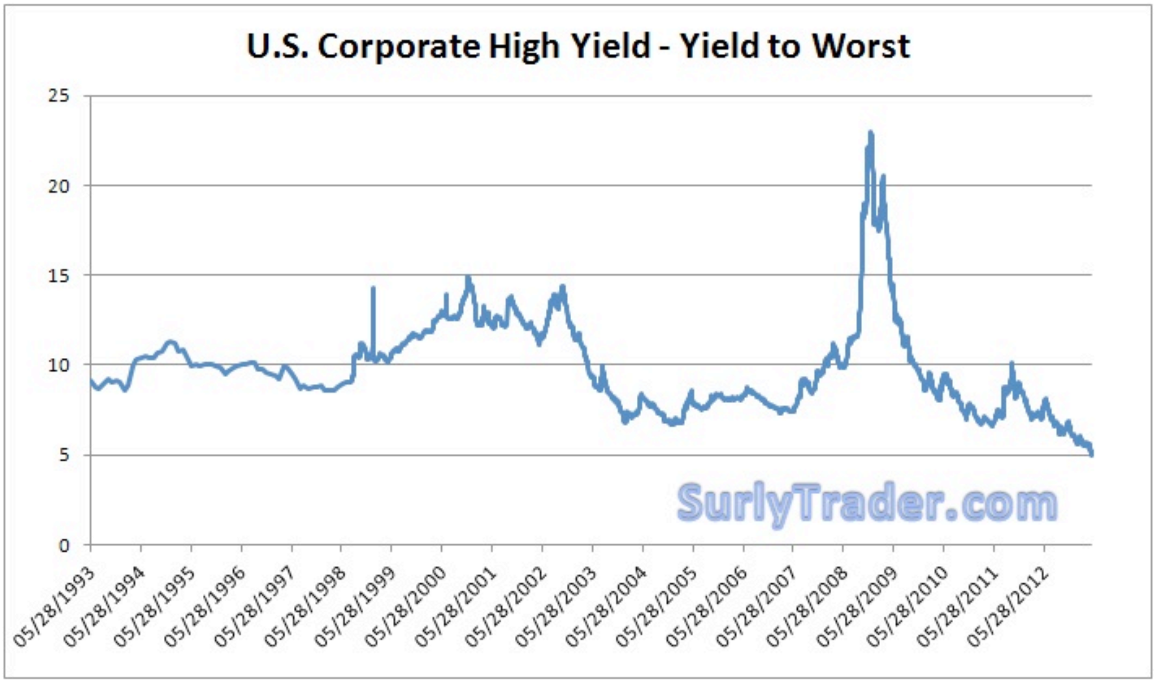
Playing games with liquidity and leverage is a deadly recipe that is playing out once again in this economic cycle. While things can go on longer than a rational investor could ever anticipate because in the words of Yves Smith:

"From everything I have seen, most market participants, and I mean that in the broad sense, hedge funds, private equity firms, money managers, and the lenders and advisors to them, are going to keep going full bore as long as they can, until conditions become untenable.

In one sense, this isn't crazy. It's extremely difficult to call a market top. And in this competitive world with hyperactive deal and investment activity, someone who pulls back early looks like a moron. They will lose their place in the league tables and if they manage money, will suffer in performance rankings. It leads to a syndrome one manager called "the fully invested bear".

As difficult as it is to call a market top, the consequences of staying at the party too long can sometimes be *fatal* as Bear Stearns and Lehman Brothers found out. Citigroup was "too big to fail" so they were ultimately bailed out by US taxpayers. Yet, the stock still trades at a 90% discount to its musical chair playing share price. We want to be liquidity providers after the party is over and the black horsemen referenced above have wreaked their vengeance. This is the nature of cycles. No one wants to leave the festivities for fear of being left out. Yet, time and time again, it is the prudent investor who leaves the party early that makes out in the long term by having liquidity at cycle bottoms when it is most desperately needed.

Last week we started to address the question of where the catalyst for a down move in stocks could come from by looking at the US corporate high yield bond market (junk bonds). As a refresher, we discussed how yields are now the lowest since this asset class came into prominence in the early 1990's. As a result, junk bond prices (which move inversely to yields) are spiking higher in a parabolic fashion. This means that investors are getting paid an extremely small amount of income for the risk they are assuming. As a comparison, the yields on junk paper in early 2009 were north of 20% versus sub 5% today!

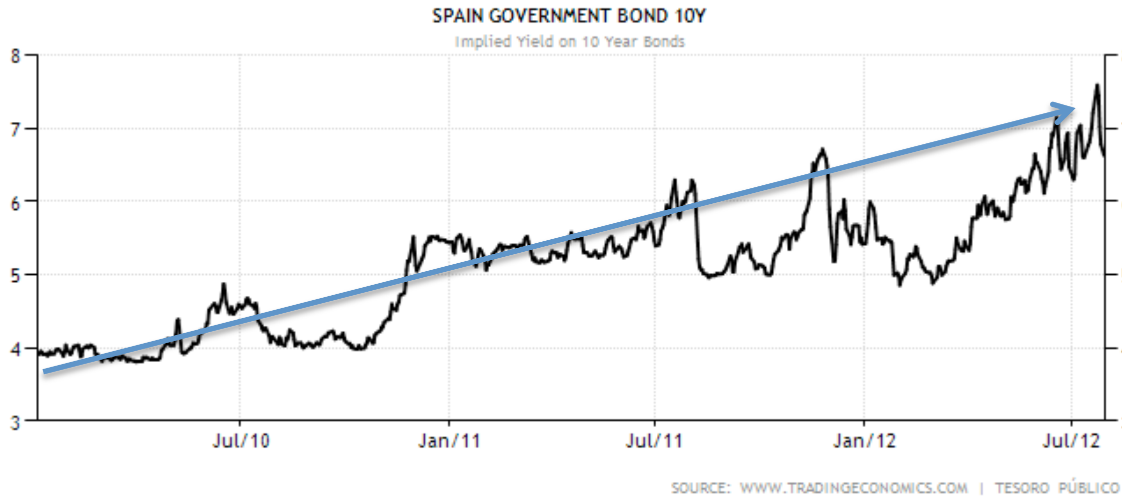


An accident in the government bond market (as opposed to the corporate bond market) is another potential catalyst that could trigger the end of this bull cycle that began in 2009. Peripheral European bond markets in Portugal, Greece, Italy and Spain were close to blowing up the financial system in 2010 and 2011, but they were saved by the European Central Bank (ECB) pledging to do "whatever it takes" to keep the Euro from falling apart. Essentially, this amounted to backstopping the debt of these bond markets with German taxpayer money. The problems in the European debt markets have not gone away and they are still simmering on the backburner as a potential trouble spot if the fears of contagion surface once again.

One of the reasons that the global markets were able to bounce back from the European bond market turmoil is that they are relatively small fish. It wasn't until Spanish bond yields crossed 7% last summer that the ECB started to step in more aggressively. The true impact of rising yields was felt in the Spanish stock market as we see below. Between January 2010 and July

2012, as Spanish 10-year government bond yields went from 4% to 7%, the Spanish stock market lost 50% of its value. This is the volatile nature of a highly leveraged economy.

Spain 10-year Government Bond Yield (January 2010 – July 2012)

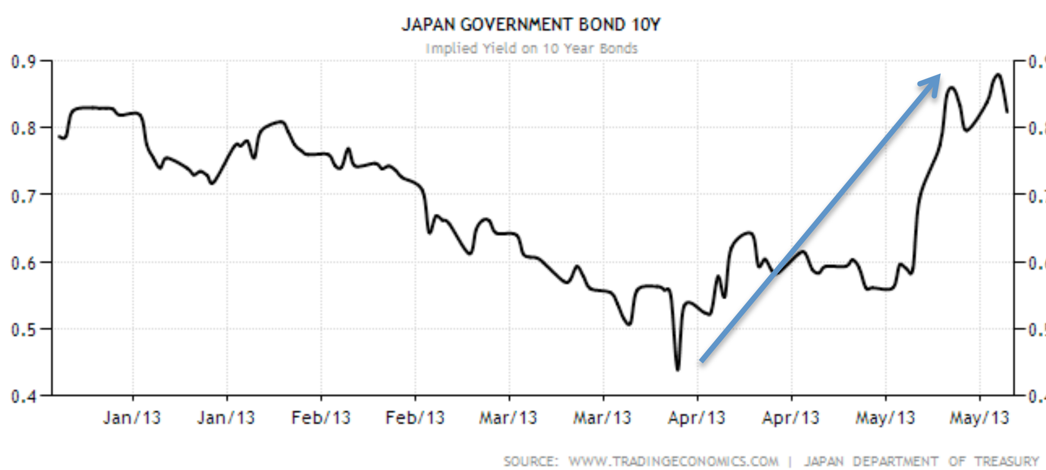


Spain IBEX 35 Stock Index (January 2010 – July 2012)

This relationship between a government funding crisis and stock market performance in an overleveraged economy is why we are so in tune with what is going on with the government bond markets in the US and Japan.

It is not a coincidence that the Japanese stock market's 10% crash on Thursday coincided with their bond yields spiking up to 1%. Below we see that yields on the Japanese 10-year government bonds has doubled over the past two months. This is an extreme move for the world's second largest bond market and may have major repercussions for global markets (many that will come to light over the next few months). With a debt to GDP ratio expected to climb to 245% by the end of the year (100% is considered high), a continued move higher in Japanese interest rates has the potential to blow-up the global economy in a way that Greece or Spain were never able to. The Japanese government bond market is three times as large as the *combined* bond markets of Spain, Italy, Portugal and Greece! Should rates on 10-year treasuries climb above 2.5%, the entire Japanese budget will be swallowed up by its massive debt servicing costs. According to Yasunari Ueno, chief market economist at Mizuho Securities in Tokyo, "a "bad" rise in yields, driven by fears of a loss of fiscal discipline rather than expectations of growth, could "ultimately strangle the economy." We would take that one step further and say that it could ultimately strangle the entire global economy. As Ken Courtis of Statfort Holdings recently wrote in the Wall Street Journal; "today, Japan's banks carry government bonds on their balance sheets totaling approximately 80% of the country's GDP, or $5.5 trillion. If the LDP inflation program is implemented alongside still more deficit funding, Japanese bond markets will fall substantially— and that would mean that the balance sheets of Japanese banks would crater, just as they did in the 1990s. The resulting bank bailout and sovereign restructuring would make the European financial crisis of the last few years look tame."

Japanese Government 10-Year Bond Yield (2013 Year-to-Date)

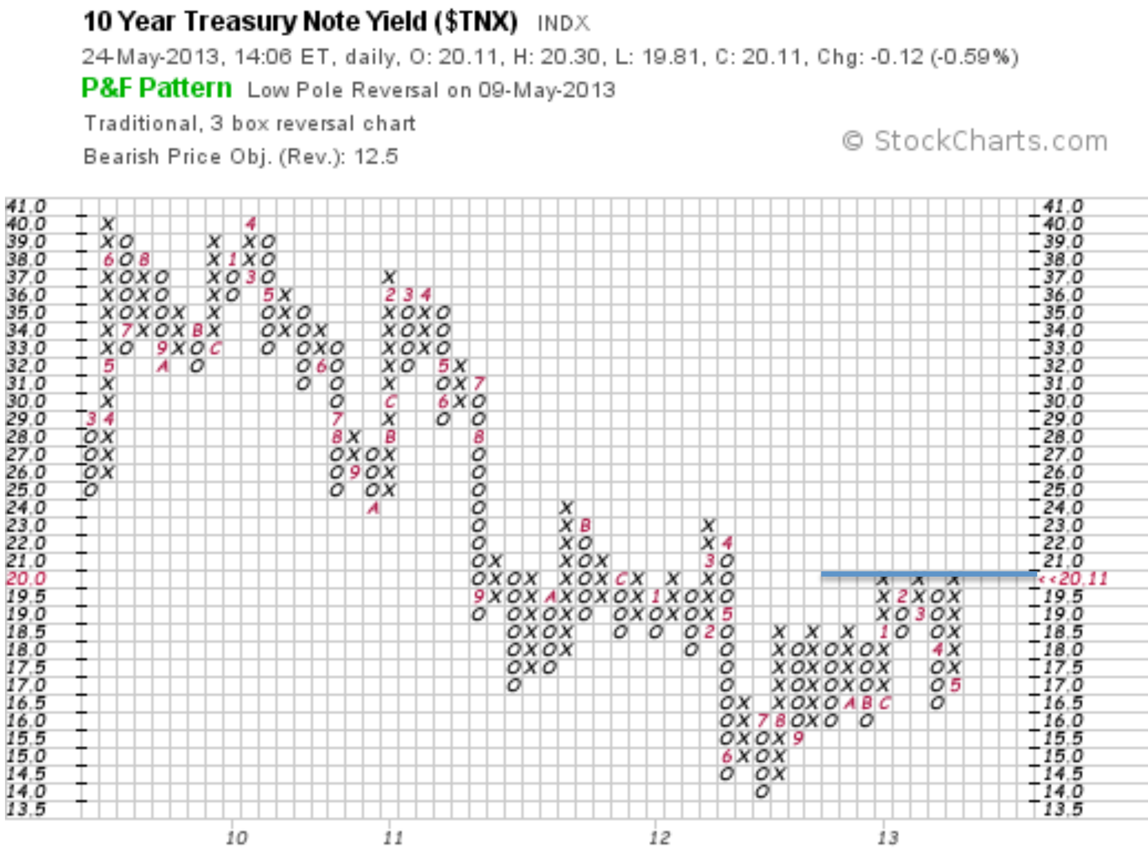


The Japanese stock market has been going gangbusters until the recent air pocket. It will be interesting to see how it reacts in the weeks ahead if bond yields continue to rise. Our guess is that we have entered a high volatility topping phase for Japan. Those that think that this won't spill over to the rest of the global financial market do not understand the interconnectedness of today's casino like markets.

Japan makes the US look like a frugal farmer, but the US debt markets are not without their own issues. We have discussed the corporate bond market, but the US government bond market has been in a 30-year bull market and has built up an enormous amount of excesses over that time. We are at a very important inflection point with yields on US 10-year Treasury bonds. The

Federal Reserve has essentially been holding a giant beach ball under water with its suppression of interest rates in the US. This has the potential to get out of hand in a hurry if yields start to break out to the upside.

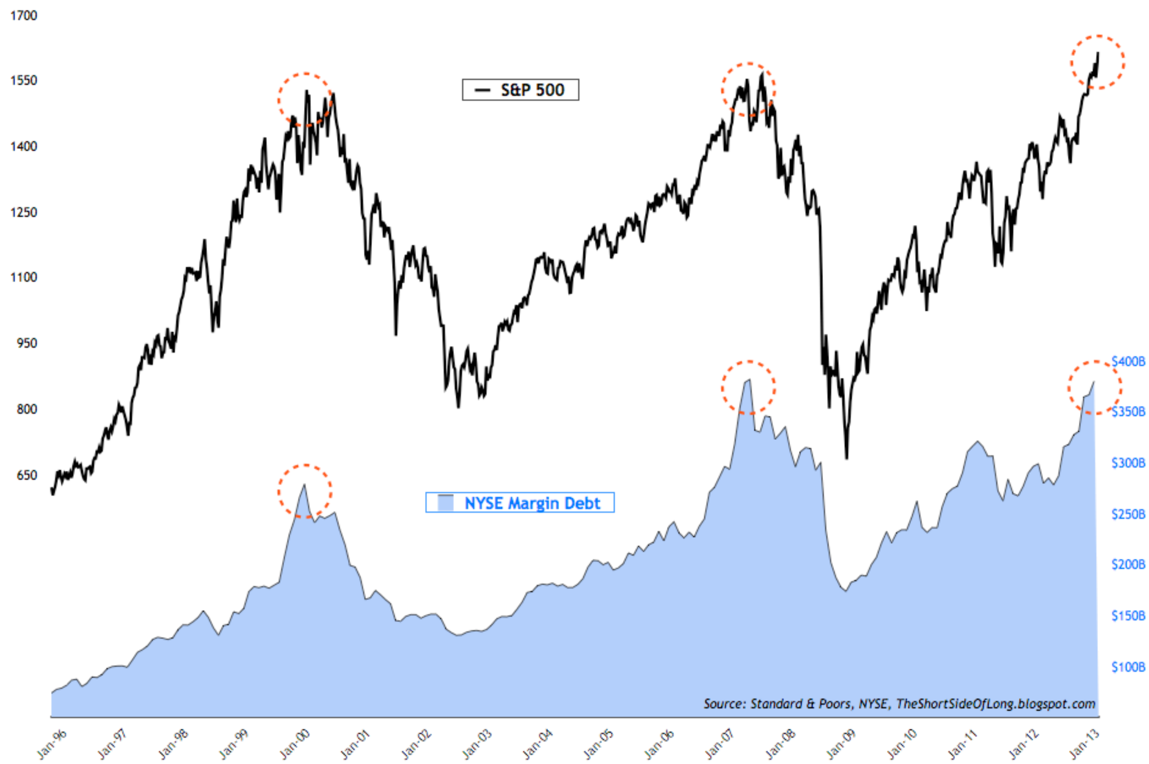
US 10-Year Treasury Note Yield Index (March 2009 – Present)



We have drawn the line in the sand on the treasury yield chart above. A move above 2.10% in the weeks ahead would be a triple top breakout on the chart that has the potential of triggering a massive yield spike in the US bond market. This would affect securities of all shapes and sizes that are priced off of the 10-year benchmark rate (from corporate bonds all the way down to high yielding blue-chip stocks). While not as massive a problem as the Japanese situation in terms of shear leverage as a percent of GDP, at least Japan's stock market is still over 60% below the level it hit in 1990! That means a lot more of their debt issues are "baked into the cake." Turmoil in the highly leveraged US credit markets, *with stocks at all time highs*, is a recipe for disaster (as we saw in 2007 with the subprime mortgage problems).

Our final chart this week illustrates how leverage creeps into the stock market at the top of a stock bull cycle. Margin debt (borrowing money to buy stocks) is back near its all time high just as stocks are breaking out above their all time highs. The blue chart at the bottom is the New York Stock Exchange Margin Debt and the black line on top is the S&P 500. Investors appear to be making the same mistake of leveraging up at the top of the cycle in order to try and capture the momentum train. Leverage cuts both ways, so once these trends reverse, it tends to amplify downside volatility until the excess is purged from the system. Anyone buying stocks at these levels is surely banking on the four most dangerous words in the investing lexicon- *"this time is different."*

NYSE Margin Debt Compared to S&P 500 Index (1996 – Present)



Source: Short Side of Long

We will leave you with one of our favorite Warren Buffet quotes that we like to repeat near the top of the market cycle; "only when the tide goes out do you discover who's been swimming naked." There is no doubt that upside momentum remains extremely strong and the bulls will not go down without a fight. However, over the course of the next few months, we think the market will start to find out exactly who are this cycle's naked swimmers.