The Starboard Side Report

The week ending May 31, 2013

The resiliency of the US market is pretty impressive, but the wall is starting to break brick by brick. Last week we showed a chart of 10-year Treasury bond yields that were on the verge of breaking out. Well, it didn't take long as the line in the sand at 2.10% was taken out on Monday. This triple top breakout targets a move to 3.30% on the 10-year bond per the chart below.

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

10 Year Treasury Note Yield ($TNX) INDX
31-May-2013, 15:00 ET, daily, O: 20.92, H: 22.11, L: 20.84, C: 21.64, Chg: +0.40 (1.88%)
P&F Pattern Triple Top Breakout on 28-May-2013
Traditional, 3 box reversal chart
Prelim. Bullish Price Obj. (Rev.): 33.5

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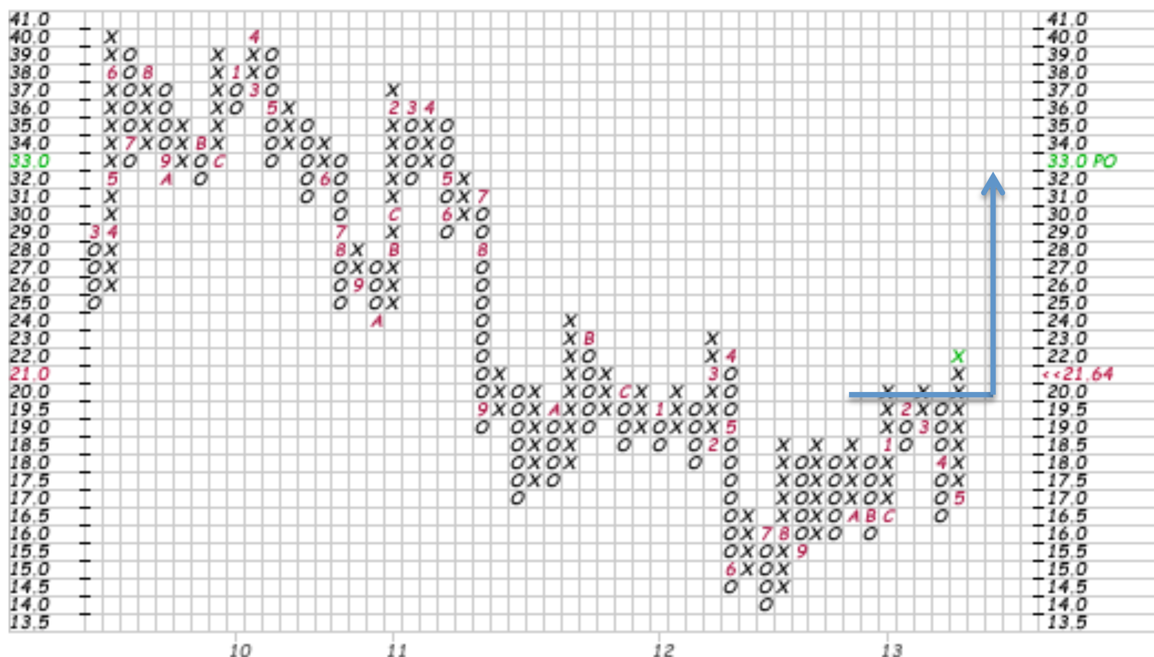


Rates breaking out to the upside are starting to take their toll on interest sensitive equity sectors such as real estate investment trusts and utilities. Below are the charts that illustrate the sharp corrections taking place in these "safer" sectors that income investors rely. These are very crowded trades because Federal Reserve interest rate policy has forced many income seeking retirees to "reach for yield" in more volatile dividend paying equity securities.

iShares US Real Estate Index Fund (Year-to-Date)

S&P SPDR Utilities Fund (Year-to-Date)

Just as junk bonds have led the bond market rally over the past six months, more speculative equities have been leading the US markets higher. This can be observed by the fact that an index of the 50 largest stocks in the US market has been unable to breakout above the 2007 market peak (see chart below). So, while the small and mid cap segments of the market are almost 20% above their 2007 peaks, the top quality companies as measured by this Russell Top 50 Index have not yet confirmed that breakout. We believe that this provides evidence that we are in the late stages of a speculative blow-off rally that could roll over at any time now.

Rydex Russell Top 50 ETF (2005 – Present)

It has been an incredible 13-year run for small and mid cap stocks versus their large cap brethren. It is our belief that we are in the final stages of this trend that has gone on longer than most could ever imagine. That is the nature of bubbles; they go further than most think possible. According to the latest GMO 7-year Asset Class Forecast, Small Cap stocks in the US are now priced to return *negative* 2.6% per year for the next seven years! This is an *extreme* overvaluation that points to the end of the line for the amazing bull market run in smaller stocks. Since 2000, the 100 largest and most liquid stocks in the US market have been in a downtrend versus the small stocks as illustrated in the declining slope of the relative strength chart below. We think that this trade is just about out of gas and that the largest most liquid companies will increasingly start to take over market leadership and outperform small stocks in the years ahead. Those blue chip US companies are the stocks we want to buy more of after the market has had a major shakeout.

S&P 100 Mega Cap Index vs. Russell 2000 Small Cap Index (1994 – Present)

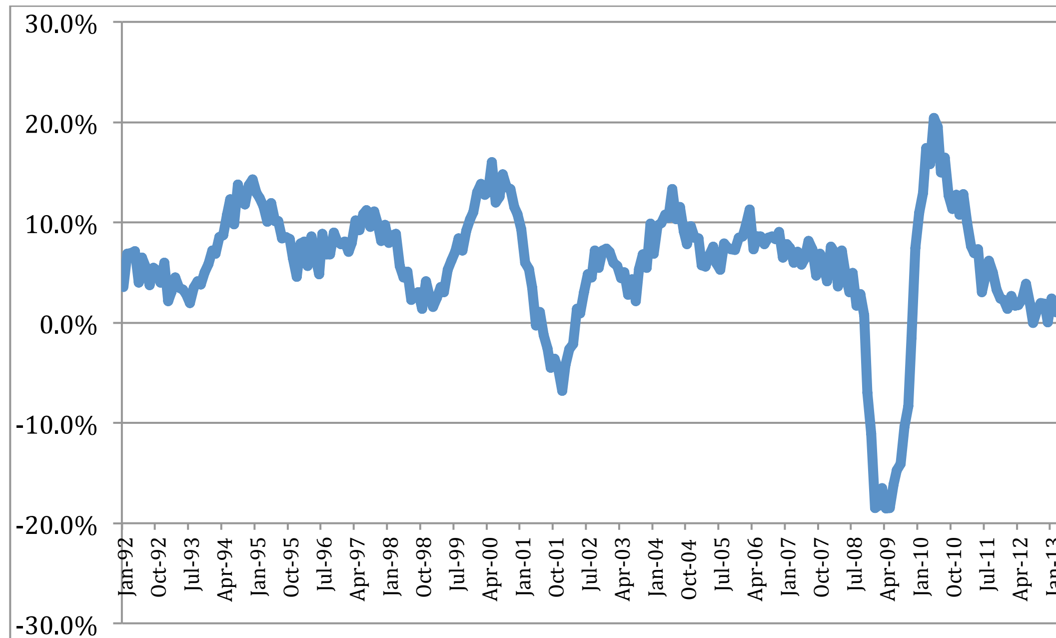
The global picture is starting look toppy after having had a strong move off of last July's bottom. We mentioned the problems in Japan last week, but now it appears as if the Japanese problems are starting to spill out to the rest of the *developed* foreign markets (emerging markets have actually been topping since January and are down 6% year-to-date).

MSCI EAFE Index Fund (Developed Foreign Markets)

MSCI Emerging Markets Index

One look at the chart below of year-over-year growth in world trade tells us all we need to know as to why these global stock indexes are still so far below their 2007 highs. World trade has been bumping along at a 0% to 2% annual growth clip for the past year and a half. This continues to point towards global recession in the not too distant future if it does not start to pick-up.

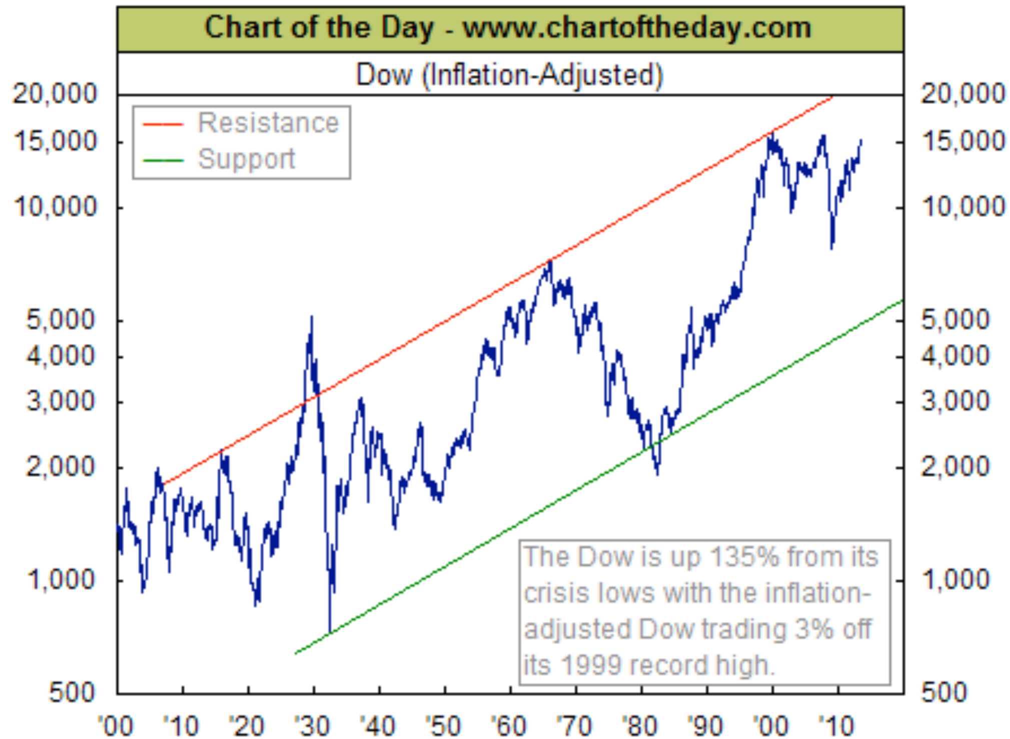
CPB World Trade Monitor since 1992 (annual growth)



One of the problems with Japan debasing its currency in a stagnant world trade growth environment is that the policy becomes a zero sum game in which there has to be a loser for every sales deal the cheaper yen wins them in the global market. As a result, the Yen devaluation is hitting the other emerging market exporters hard. For instance, the Japanese stock market is up 30% this year (even after the recent 15% correction), whereas the South Korean market has lost ground on the year.

Below is one final chart that shows the downside risk remaining in this US stock bear market that began in 2000. We classify it as a bear market because the Dow Jones Industrial Average has gone 13 years without being able to hit a new inflation adjusted high following a correction. The green support line that marked the bottom of the 1930's and 1970's bear markets is some 10,000 points lower for the Dow Jones Industrial Average. Since this is an inflation-adjusted price, the Dow can get down to the green support line in one of three ways: 1) its price can fall some 65% with zero inflation; 2) its price can stay here while inflation rages at a double-digit clip for several years; 3) a combination of Dow price declines and elevated inflation will get the job done. It is not easy to predict, nor will the full mean reversion process be easy. All we can do is prepare our portfolios for either outcome. We remain overweight cash and hedges to cushion the deflationary shocks and overweight gold and silver to combat the inflationary risks. Obviously, this has made for a rough go of it the past year as we sit out the big US rally, but we are banking on the time tested concept of mean reversion to bail us out in the end.

Inflation Adjusted Dow Jones Industrial Average (1900 to Present)



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