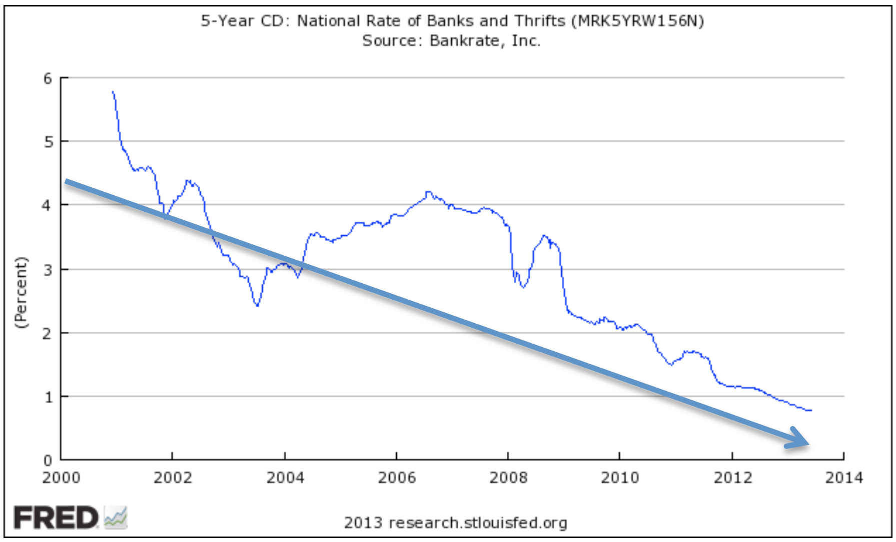
The Starboard Side Report

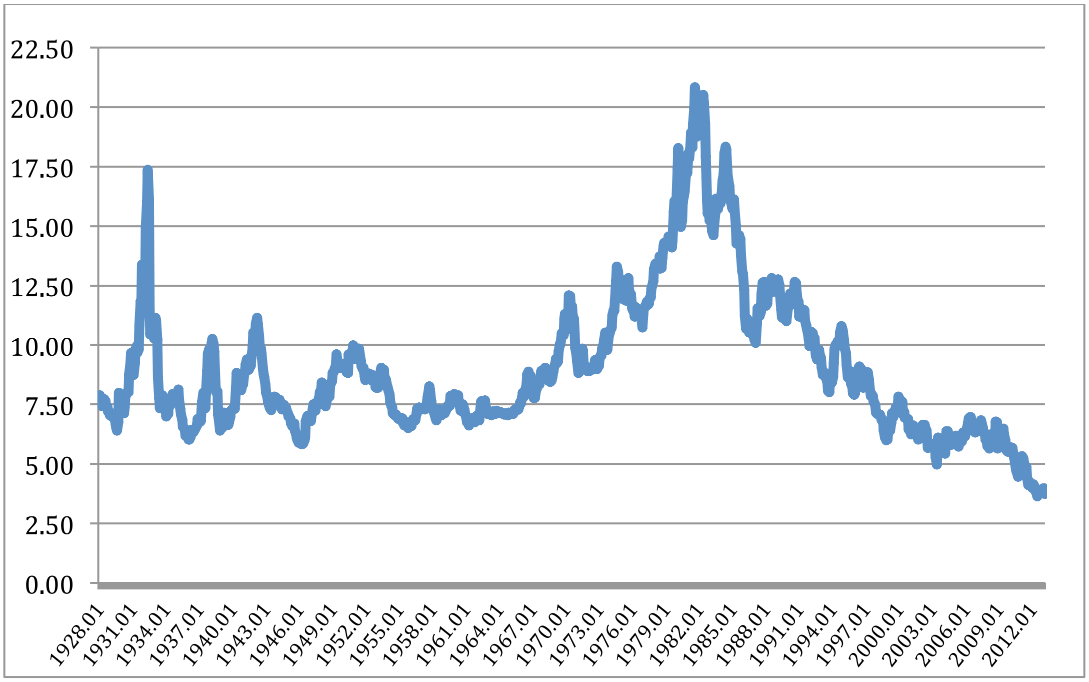
The week ending June 14, 2013

One of the key characteristics of the past four years, since the end of the financial crisis, has been the zero interest rate policy (ZIRP) of the Federal Reserve and its effect on prudent savers. Back in 2007 before the financial crisis even started, a very conservative investor could expect to receive 4% risk-free with a 5-year CD. As we show below, that same CD is paltry 0.77%.



Why does this matter? Well, for one thing ZIRP greatly reduces the amount of *risk free* income available for retirees. In 2000, a million nest egg would earn you $60,000 per year in interest. In 2007, that was down to $40,000. Now, thanks to the Federal Reserve, the interest earned in this scenario is just $7,700 per year or 87% less than just thirteen years ago. This means seniors that want to live off of their retirement savings have to start working longer or taking more risk. As we have found out in the past three weeks, reaching for yield comes with consequences. Reaching for yield via risker instruments is all well and good when the market is moving higher. However, once the momentum shifts, a year's worth of income can be wiped out in a matter of days. In a world in which both stocks and bonds are significantly overvalued, there are few places for income seeking investors to hide. The chart we showed a few weeks ago is very relevant to this discussion. It shows the combined yield of the S&P 500 Stock Index and the 10-year Treasury bond yield. In 85 years of market history, the combined yield of both these major asset classes has never been lower.

S&P 500 Dividend Yield + US 10-year Treasury Bond Yield (1928 – Present)

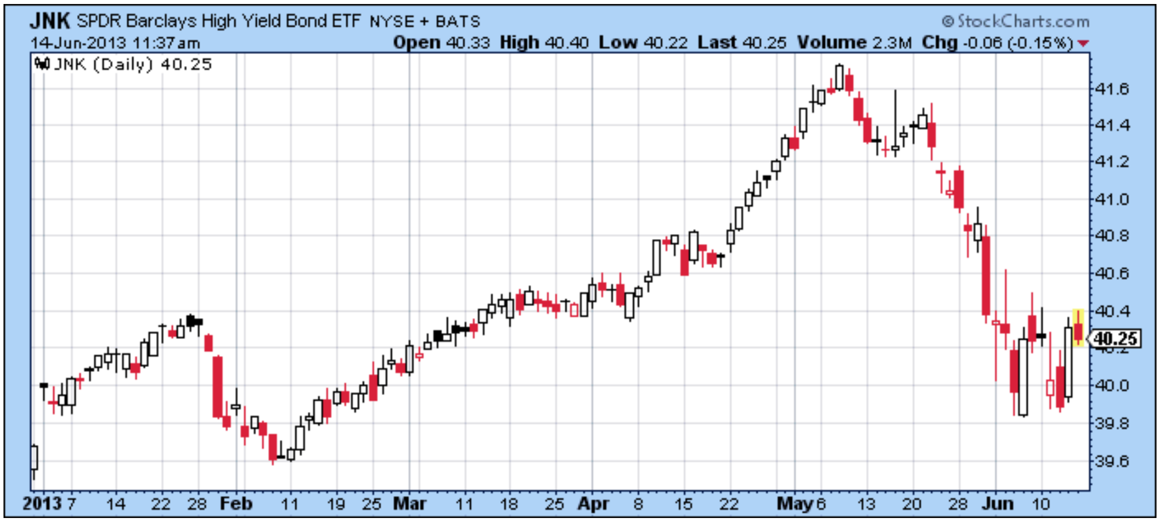


Source: Robert Shiller Yale.edu

Again, this means that prudent risk-adverse retirement investors have never had such a challenging environment to navigate in order to keep ahead of inflation and grow assets. Furthermore, they have never had to reach as far out on the risk spectrum in order to generate portfolio income. So here we sit, about to crash head-on into the largest retiree wave this country has every seen at the same time that income provided by the two key retirement asset classes has never been lower.

Let's see what has happened over the past month in the "safer" area of the markets where investors have been reaching for "risky" yield. Year-to-date is the timeframe of the first nine charts below.

Junk Bonds down sharply since early May



Emerging Market Bonds down sharply since early May (now down 7% on the year)

Largest Bond Fund in the World PIMCO Total Return Fund Wiped out all of 2013 gains

Real Estate Investment Trusts down 13% over past three weeks

Utilities are trying to stabilize, but have lost 10% since May 1st

Usually low volatility Inflation Protected Bonds (TIPS) down 7% since early May

US Investment Grade Bonds are now lower on the year after a 5% plunge since May 1

Muni Bonds also getting hit by the fear of rising rates

Emerging Market “low volatility” funds didn’t live up to their name over the past month

If this is how the market reacts when the Federal Reserve simply *suggests* they may start to reign in money printing operations, imagine the carnage when they actually start doing it. The Fed's ultra low rate policies have created another financial monster in equal size to the mortgage bubble. This one appears to be in all of those income-like asset classes that have been mispriced (i.e. artificially inflated) due to ZIRP. Bubbles can go on longer than most imagine, so this may just be a shakeout before one final surge higher in this Fed induced yield bubble. Yet, safe risk-free income it surely is not. We think at this juncture of the cycle, cash and gold are the two most underappreciated asset classes. Cash has no yield right now, but its only risk is inflation risk. Hedging that inflation risk away with gold and silver seems to be the most prudent strategy in this anything but prudent yield-chasing environment.

Here are several more charts for those that think *all* has been rosy this year and that *all* is healthy with the global economy.

The Japanese stock market is now down over 20% from its highs in just three weeks and shows no signs of slowing its free-fall.

Emerging markets are now down 11% for the year (this is not a good thing for the US)

Emerging markets are crashing on a relative basis versus the US

Emerging markets have only been this oversold versus the US on two other occasions in the past twenty years; 1997/1998 and 2008 (highlighted in yellow on the chart above). While it may seem as if the US is a safe haven from the global economic slowdown that started in 2011, the end game will not be pretty even for the US market. When you combine the declines we are seeing in the "safe" low volatility asset classes with the breakdown in the emerging markets, then it is a real worrying sign. It's as if the suspension cables that are holding up the bridge (the US market) are popping one at a time and it is just a matter of time before the whole bridge comes crashing down. Meanwhile, there are still investors driving on our proverbial bridge as if there isn't a care in the world. The financial system in the US has become the tail that wags the dog, so it may seem that the economy is cruising along in a fairly tranquil state. However, if a financial accident occurs somewhere in the global risk chain, that tranquil state will turn very volatile in a heartbeat. We saw that with the Asian crisis in 1998 when Long-term Capital Management blew-up and during the US Housing crisis in 2008 when Lehman went under. Here is what the most speculative part of the US market (small cap stocks) did during these two periods of emerging market stress.

The Russell 2000 held-up for a while as Asia crumbled, but eventually fell 40% in 1998.

In late 2008 and early 2009, the Russell 2000 lost just under 50% in less than 6 months

While the US stock market has been a port in a developing global economic storm, the interconnectedness of the global financial system means that eventually the storm will arrive on our shores. When it does we don't want any part of it. By the looks of many of the charts that we have shown this week, the clouds are certainly starting to gather.