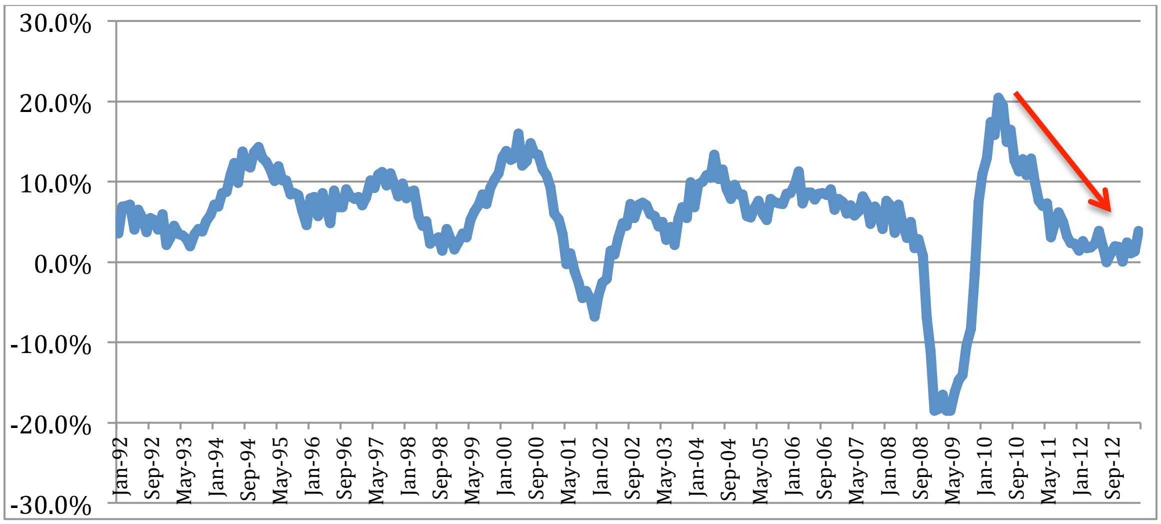
The Starboard Side Report

The week ending July 12, 2013

As we illustrated in our last report, it has been a challenging 30 months for global investment managers that are not solely focused on the US stock market. The global stock market weakness started when world trade screeched to a standstill in 2011. As the chart below shows, trade has been bumping along the bottom ever since and remains near recessionary levels. Rising stock prices in the face of weakening fundamentals is a dangerous cocktail for US investors.

CPB World Trade Monitor Year-Over-Year Growth in World Trade (Jan 1991 – April 2013)



Source: CPB Netherlands Bureau for Economic Policy Analysis

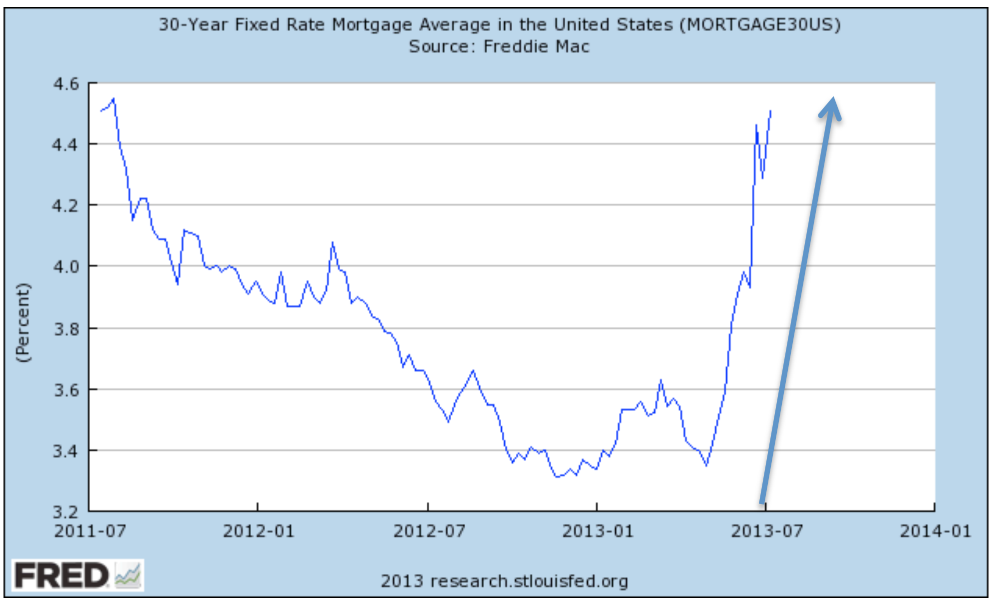
The US has bucked the global trend of declining stock prices due its ongoing effort to manipulate the price of money (interest rates) via quantitative easing. This has breathed life back into the left for dead real estate market and jump-started economic activity related to housing and finance. This is the much desired "wealth effect" that the Federal Reserve is trying to accomplish. However, we would argue that all this manipulation has done is further distort asset markets and misallocate capital. It blows our mind that the Federal Reserve is still being allowed to use this asset inflation playbook after these same policies led to two epic financial collapses (stocks in 2000 and real estate in 2008). The question then becomes, what type of foundation has this housing revival been built upon? Is it sustainable and will it spread to the other 90% of the economy? To help find the answer to this question all one has to do is look at the interest sensitive sectors of the economy since interest rates started to spike in May. Just the simple *suggestion* that quantitative easing may start to be tapered sent the markets into a hissy fit. Those that have benefited so much from artificially low interest rates are addicted to free money and don't want the good times to end. Welcome to the circus that is our casino economy where twelve unelected academics control our countries' destiny with their overanalyzed words and deeds. The irony is that, ultimately, government intervention will create the very volatility that they are trying so desperately to suppress. While we can analyze stock charts and asset fundamentals, one thing we can not do is read the mind of the US Central Bank Chairman and how his centrally planned markets are going to react to his every word. As such, we remain conservatively postured as fundamentals of the global economy deteriorate in order to try and protect against the two worst possible big picture outcomes. Aside from rapid growth (which is not in the cards according to the world trade chart above), the US will soon be faced with a stark choice of *rapid inflation* or *painful debt write offs*; these are the only two ways out. Investors must be prepared for either outcome if they expect to preserve long-term purchasing power. Our core position in precious metals is for protection against currency debasement/inflation and our large amounts of cash are to protect against a debt liquidation/default spiral.

The recent spike in interest rates is already causing the Federal Reserve to backtrack on a potential stimulus exit in an effort to appease battered markets. Below is a chart of the performance of "safe havens" and popular conservative income vehicles since the Fed suggested they just might have to start taking away the proverbial punch bowl. In a matter of weeks, without the endless promise of stimulus, a range of supposed low volatility assets such as emerging market bonds, long-term US Treasuries, real estate investment trusts, investment grade corporate bonds and gold lost between 10-20%. US stocks (green line) are now apparently the only safe haven investment around as they only briefly fell below the blue breakeven line.

Percent gain loss since May 1, 1013- S&P 500 (SPY), Emerging Market Bonds (EMB), 20+ Year US Treasury Bonds (TLT), REIT's (IYR), Gold (GLD), US Investment Grade Bonds (LQD)

This need for constant around the clock stimulus is opening up a can of worms as it relates to energy price inflation. It seems the Federal Reserve has been backed into a corner and now has to choose between higher mortgage rates or higher energy prices. Given the power of the mortgage/banking lobby it seems they may have decided that higher gas prices are the lesser of two evils. Oil prices are now 32% higher since last July due to tensions in the Middle East. Bernanke's latest promise to keep the stimulus juices flowing is risking an upside run in oil prices, but it may stop the bleeding in the mortgage market. Mortgage rates have gained back two years worth of declines in the last two months due to the simple suggestion that the Fed may start to rollback stimulus!

30-year Fixed Rate Mortgage Past Two Years



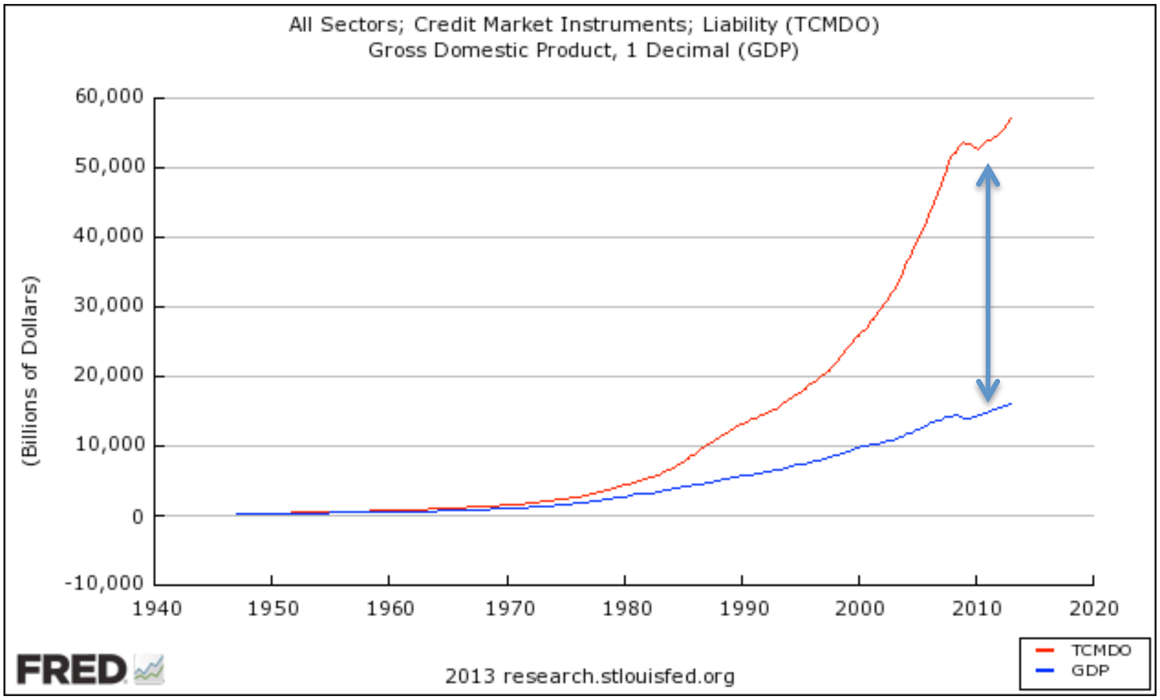
West Texas Intermediate Light Crude Oil- (September 2009 – Present)

At $106 per barrel, the price of oil is now within 4% of its post financial crisis peak of $110 (see chart above). This built in brake to economic growth has caused equity rallies to stall in each of the last two years. So, more stimulus thrown at the mortgage market may cause the "gasoline tax" to start to bite US consumers again. Again, this seems to be a risk the desperate Federal Reserve is willing to take.

Perhaps the Federal Reserve has seen enough dollar strength (hurts US exporters profits and makes debt burdens more onerous) and they feel that the time to resume dollar debasement has arrived. This dollar debasement strategy (importing inflation) is the least painful way to get rid of the *huge* debts that are facing our country (according to politicians). The dollar lost 2.5% over a 24-hour period after Bernanke spoke on Wednesday. That is a pretty volatile move for a currency. The bond market blow-up of the past two months illustrates how painful the "taking our medicine" approach will be and why the powers that be prefer inflation. Hence, the about face on the stimulus withdrawal this week as the need for more inflation intensifies. A more aggressive dollar debasement policy should gradually start to shift US funds back towards foreign assets and inflationary stores of value such as precious metals/commodities. The four horsemen of the emerging markets, Brazil, Russia, India and China are down 34% on average since the start of 2011. Commodities and precious metals have been equally as weak. If the dollar starts to head down again this relative underperformance gap may start to reverse.

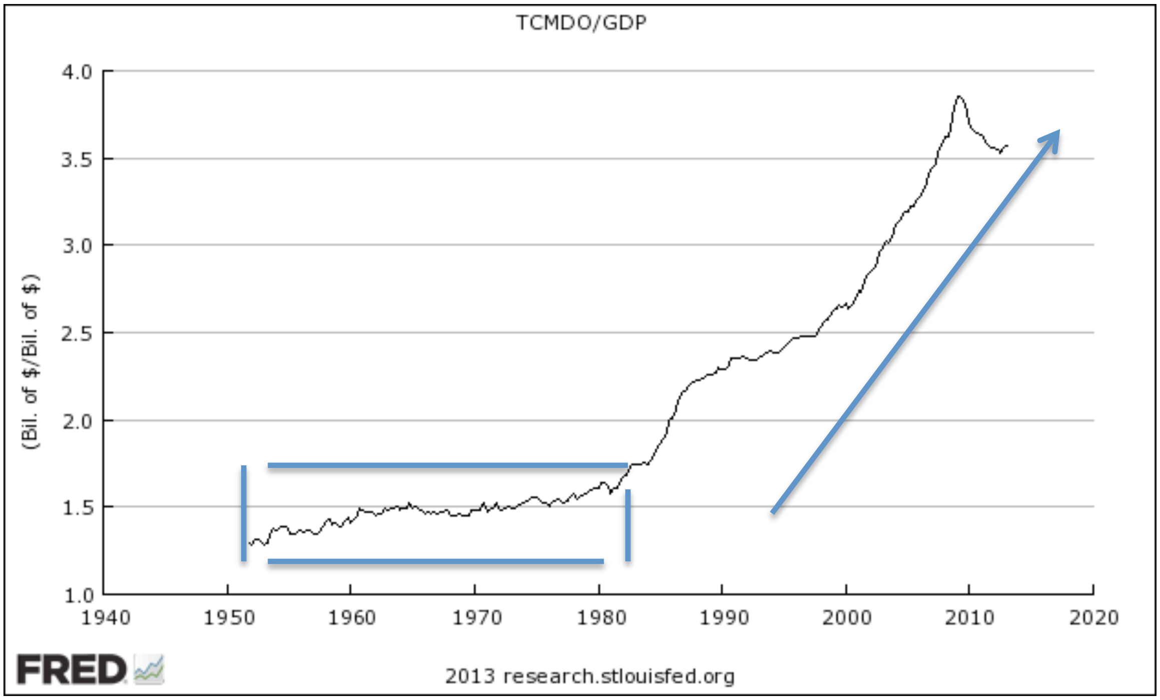
It is important to realize that the problems that caused the 2008 financial crisis have not gone away. There is simply too much unproductive debt in the system to have a lasting economic recovery. The Fed knows this and it is why they are being so aggressive trying to prop-up the markets. Below is a summary of what the US still has to deal with in the coming years in order to get its financial house in order.

US Total Credit Market Debt Outstanding (red line) overlaid against US GDP (blue line) 1950 - Present



The red line on top is the total credit market debt outstanding in the US as it now approaches the $60 *trillion* level. **As you can see, total system debt in the US is now actually higher than when the financial crisis started in 2007.** The blue line at the bottom is total US GDP. Up until the early 1980's these two lines were relatively connected on a gentle slopping upward trajectory. However, over the past 30 years as the financial lobby has taken over Washington, the debt line has gone parabolic. Again, something has to give. Either that redline has to come down closer the blue GDP line (the painful medicine route). Or, the blue line (economic output) has to start rapidly accelerating towards the red line. This can happen in one of two ways. Either through inflation or nominal economic growth; that's pretty much it. Many studies have shown that once debt gets this high, nominal economic growth becomes very difficult to generate (as the world trade chart above illustrates). Therefore, we keep getting back to the fact that there are really only two ways out- painful debt write-offs or inflation. It is clear that we really have not even started to deal with the painful consequences of this giant debt overhang. The only thing that has happened is that a large part of the new leverage has come from the government as opposed to the private sectors. Said another way, the can has been kicked down the road. The government balance sheet has been used to bailout the financial system. But, who will be there to bailout the central banks once the next economic recession hits. To paraphrase a great analogy from Peter Atwater of Financial Insyghts; in 2008, the lifeguards (Federal Reserve and US treasury) jumped in the raging waters to save the drowning swimmers (US banks). The question now becomes; who will save the lifeguards?

Total US Credit Market Debt to GDP Ratio (1950 – Present)



Debt to GDP stayed in a tight range at about 1.5 over the thirty period following WWII.

Then, over the next 30 years, the financial lobby slowly hijacked the US economy. This helped send debt to GDP skyrocketing to unstable levels above 3.5 times.

Our final segment this week deals with the month of July and why the new highs hit this week might not mean stocks are off to the races. There have been three occasions in the past 15 years when the US equity market appeared to be breaking out to new highs in the first half of July only to crash over the rest of the summer. Below are those three examples.

First, we have 1998. This may be the most fitting analogy because it was preceded by a two-year period when the US stock market vastly outperformed the emerging world. There was a big first quarter rally, a volatile May/June correction period and then a "fake-out" rally during the first two weeks of July. That was then followed by a 20% crash in August.

S&P 500 1998 July "Fake-out" not Break-out

The second episode was during 2007. This was similar because it was the fourth year of a major cyclical bull market. This current cyclical bull market is also now in its fourth year after beginning in March of 2009. Once the credit markets topped in May (like this year), the stock market corrected in late May and June of 2007, but this was quickly followed by one final new high in the middle of July (yellow highlight on chart below). It was all down hill from there as this marked the start of a brutal 2-year bear market that would shave 57% off the July 2007 S&P 500 "fake-out" peak.

S&P 500 2007 July "Fake-out" not Break-out

The final episode of July marking a false dawn for the US market was in 2011. That year also followed a similar pattern. There was an early year rally that fizzled out in May. The subsequent six-week correction made it look as it stocks were about to fall off a cliff. Yet, once again, a late June and early July buying stampede came to the rescue and took stocks all the way back to their May peak (yellow highlight). That was it though and stocks plunged 20% in August on the debt ceiling scare.

S&P 500 July 2011 Major Double Top

In conclusion, the US Federal Reserve has their backs to the wall in that if they try to remove stimulus they risk crashing the bond market and sending mortgage rates much higher (as we saw in May and June). Global growth is slowing too rapidly to generate the growth or inflation needed to deal with the massive debt pile in the US. If the Fed continues down the aggressive stimulus road to generate more inflation, we are getting to the point where oil prices are going to start to weigh on growth. In our opinion, they probably view oil prices as the lesser of two evils versus rising mortgage rates. Finally, even though the S&P 500 is back to its May high does not mean that we are out of the woods in terms of market volatility. The three concrete examples provided above are a reason to be wary of false breakouts in July. The bottom line is that we are in the midst of massive crosscurrents that may very well come to a head over the rest of the summer as the Federal Reserve struggles to keep its fragile scheme together.