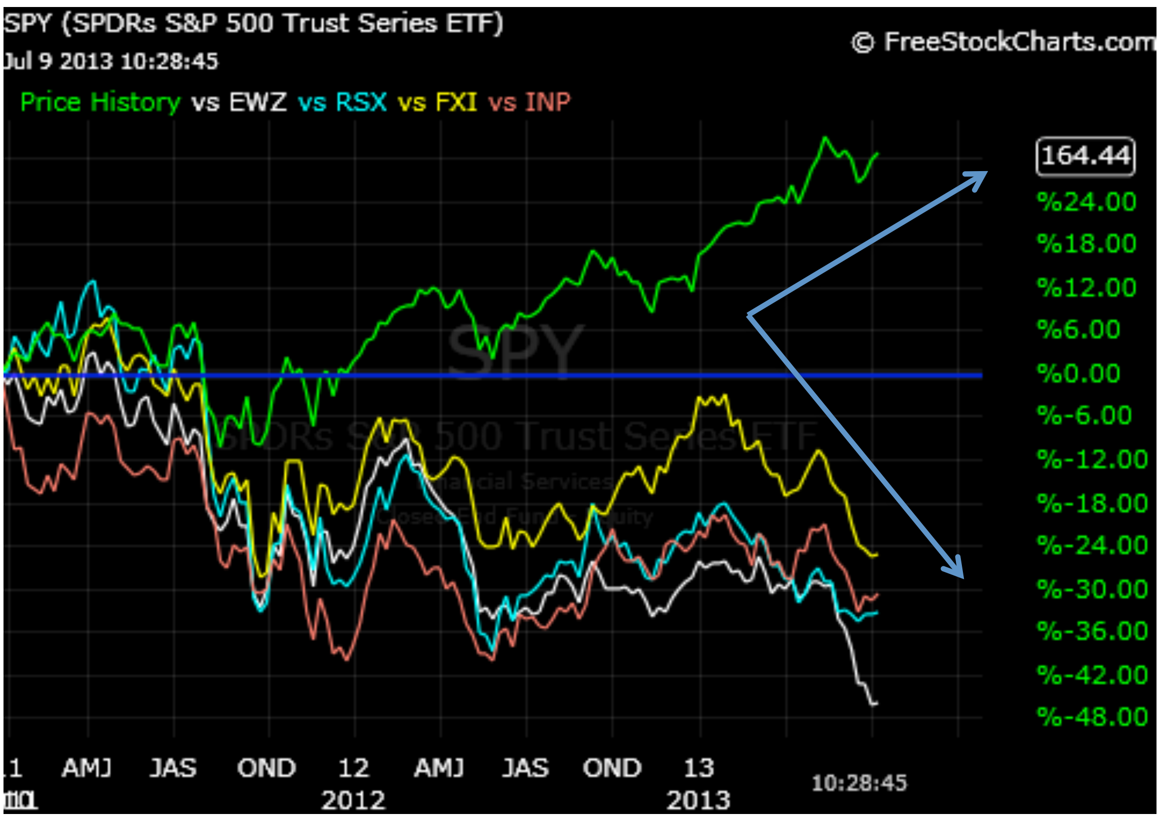
The Starboard Side Report

The week ending July 19, 2013

After riding the wave of emerging market growth out of the 2009 lows, we turned cautious on this area of the world in late 2011 after our indicators pointed to the potential for stock market/economic weakness. Holding an overweight position in US dollar denominated cash versus emerging market stocks has generally been a good decision since that time. However, holding cash instead of US stocks has resulted in a big opportunity cost as the chart below shows.

S&P 500 (SPY) vs. Brazil (EWZ), Russia (RSX), China (FXI), India (INP)

Percent gain loss since 2011



Since the start of 2011, US investors owning the four horseman of the emerging market growth story (Brazil, Russia, India and China) have lost 34% on average. This compares to a 33% gain for the S&P 500 over this 2-½ year span (top green line on chart above). This bloc of countries (known as the BRICs) has now given back *all* of the relative gains that they achieved since bottoming ahead of the US in 2008 and leading the world out of the abyss (see chart below). An upward movement in the chart below means the BRIC stock markets are doing better than the Dow, whereas a downward move in the chart means the BRIC stock markets are doing worse than the Dow.

BRIC Relative Strength vs. Dow Jones Industrial Average (July 2008 – Present)

The question becomes: When will it be safe to take our US dollar cash and put it back in the direction of these faster growing emerging nations? We are of the opinion that it is too soon to answer that important question. The relative strength of these countries versus the US market remains weak and usually improves only improves once the US dollar starts to materially weaken. If it appears as if this phase of dollar strength (that began in 2011) is coming to a close, then we would rather have our dollars outside the US in an appreciating asset rather than in a money market fund earning 0%. However, we just are not there yet.

US Dollar Index Fund since Start of US Financial Crisis (July 2008)

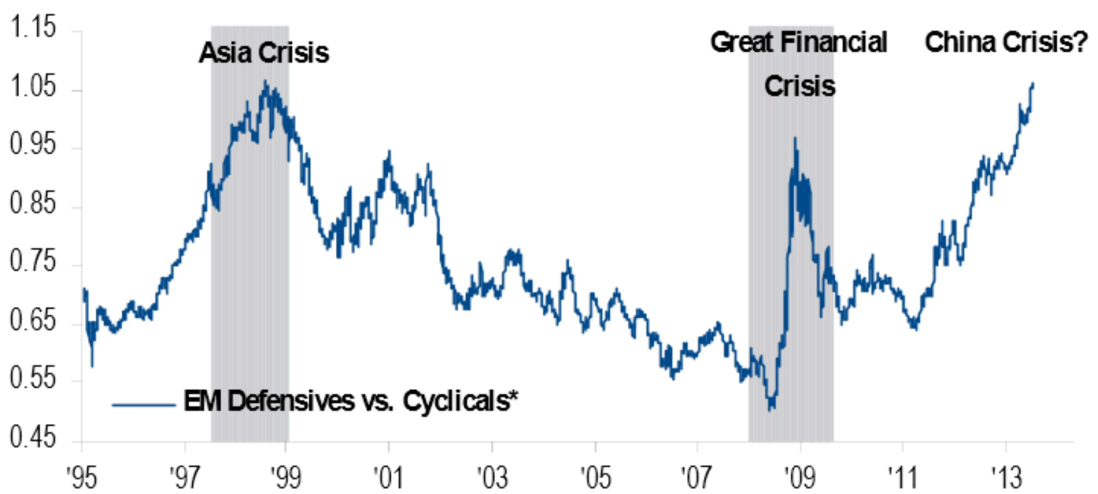
The dollar uptrend that kicked-off in the summer of 2011 (green arrow line) is still intact and this uptrend is one of the main reasons that emerging markets have been in a funk since 2011. However, if we look back to the start of the US financial crisis in 2008, it still appears as if the recent dollar strength is a *countertrend rally* in a broader downtrend. The blue down trend line that is drawn from the early 2009 peak is the key. If the dollar should breakout above that blue line, then it probably means a new bull market for the dollar and a deepening financial crisis in China. If the dollar does an about face and starts to decline again, then emerging market should start to outperform US stocks. The bottom line is that we are at a key inflection point. As with the BRIC relative strength chart above, the broader emerging market index has also given back all of its relative gains versus the US since the 2008 bottom. We have highlighted this "line in the sand" below. This inflection point is occurring with the relative relationship at an oversold level that has marked good buying opportunities in emerging markets over the past two decades (green circles in bottom pane of chart).

Emerging Market Index Relative Strength vs. S&P 500 (July 1996 – Present)

Should emerging markets break below this important line in conjunction with a continuation of the dollar rally, then the markets are signaling big problems ahead for the global economy. Since these emerging countries have been the main drivers of global growth over the past decade, we really need to see the emerging markets stabilize here if the global economy is to regain its footing. We do not believe the debt-laden economies of Europe, Japan or the US are ready or able to take up the slack. A full-blown liquidity crisis in the emerging markets portends bad things ahead for the US market as well. One other metric that is pointing towards the more severe outcome of an emerging market financial crisis is the relative performance breakdown the sectors within emerging market indexes. When cyclical stocks outperform, it usually means growth is strong, but when defensive stocks significantly outperform (as they have done since

2011) it has tended to signal an impending crisis. As we see below, "defensive stocks" in the emerging world are telegraphing a crisis in our midst (the third such one since 1997). That is certainly not a risk that is priced into US stocks trading at all-time highs. Just as the Asian Financial Crisis and Great US Financial Crisis eventually took down every stock market in the world, so too would a China/emerging market crisis.

Chart 6: EM defensives significantly outperforming cyclicals



Source: BofA Merrill Lynch Global Investment Strategy, DataStream, MSCI
* Cyclicals = materials, energy, industrials, financials, tech & cons disc
Defensives = healthcare, staples, utilities & telcos

Given all the risk factors swirling about in the global economy, we thought it a good idea to discuss the role of cash in a portfolio. Cash is often overlooked as an asset class, but it can have periods of strong relative outperformance versus a fully invested position in stocks. Cash is an especially valuable asset class when the stock market is in a long-term bear market as it has been since 2000. The following charts are relative strength charts that show when it has been better to be holding large cash positions versus when it's been more profitable to be fully invested in stocks. Cash is the better asset class when the chart is advancing higher, but stocks are the better asset and when the chart is declining. There is a great opportunity cost to being overweighed cash when the line in the chart is crashing lower (i.e. stocks are outperforming).

The rising trend line in the first chart shows that being in cash has been relatively better than emerging market stocks over the past two years. This confirms what we discussed above; namely, that the slowing global economy has had a much more severe impact on emerging markets than US stocks (so far).

US Cash versus Emerging Market Stock Index (May 2011 – Present)

Next let's look at the Dow Jones Industrial Average versus cash to see what we can determine- i.e. where we've come from and where we might be going in the future.

The first chart below is the Dow over the same time frame as the emerging markets chart above. As you can see, since the chart is declining, the Dow has clearly been a better place to be than cash over the past two years.

US Cash versus Dow Jones Industrial Average (May 2011 – Present)

Again this has been a missed opportunity cost by being in cash versus the Dow. Now let's look at the full bear market cycle for US stocks that began in 2000 to determine if now is a good or a bad time to be investing cash into US stocks.

US Cash versus Dow Jones Industrial Average (1998 – Present)

FEAR

GREED

The chart above is a bit busy, but it illustrates something extremely important. Despite, the opportunities that we have missed by holding lots of cash over the past two years, the chart tells us that we should get another chance at even better prices than two years ago to put our cash back into Dow stocks. The bottom arrows on the chart are the part of the cycle where you wanted to be sitting on lots of cash (when everyone is greedy). Right now, having a lot of cash in a portfolio looks foolish, just as it did in early 2000 and mid-2007. Yet, taking cash and putting it into stocks at those points was a *disastrous* strategic decision. Unless, the bear market in stocks that began in 2007 is over (which we strongly believe it is not), then, in hindsight, this moment in time will be looked upon as another disastrous occasion to be putting cash into the US stock market. The emotions of fear and greed that drive investing are such that most humans are hard wired to put cash to work near the bottom arrows after cash has lost huge amounts of ground to the stock market. Lost opportunity and the feeling of missing out consistently makes investors shovel cash into stocks at their riskiest point (when greed is the highest). On the flip side, when everyone is fearful, and cash has vastly outperformed stocks (top arrows), is exactly when everyone decides they want to be in cash. Yet, this is precisely the time to be deploying cash in stocks and not hording it. Warren Buffet summed this up well, "be greedy when others are fearful and fearful when others are greedy." We are very fearful right now.

Two final notes on the gold sector this week. First, we wanted to show a chart of cash versus gold so everyone can see the difference between an asset that is in a long-term bear market (US stocks) and an asset that is in a long-term bull market (gold). Recall the last chart of cash versus the Dow above how there were very clear oscillating relative performance cycles between cash and stocks with cash ultimately going to higher highs during each up cycle. This illustrates that just sitting in cash from the start of the bear market to its end is usually better than riding the stock roller coaster up and down. A "buy and hold" investment strategy simply does not work in this environment. To really prosper, you have to try and time the peaks and valleys of the market.

Now, let's compare this same line of thinking to a bull market such as the one that gold has been in since 2000. Gold is a good asset to pair with cash in a stock bear market because the main risk to cash is loss of purchasing power from inflation. Other than 2008, and the past two years, gold has vastly outperformed cash and been one of the few places that profited from a "buy and hold" investment strategy since 2000.

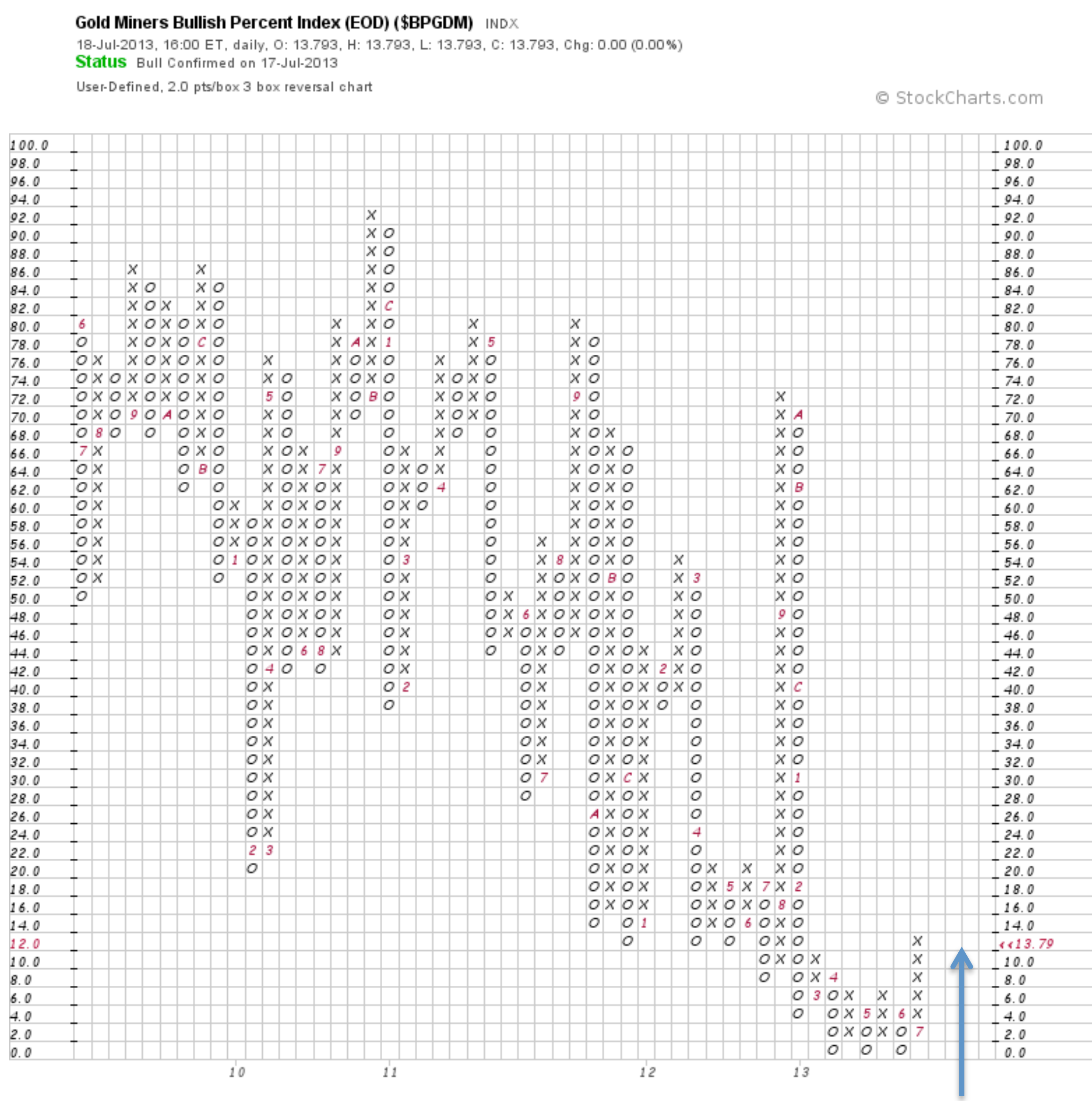
US Cash versus Gold (1997 – Present)

Notice how this chart looks more like a downhill slalom mountain than the roller coaster in the cash versus Dow chart. Even though cash has outperformed gold since late 2011, we see that it is still well below the prior peak in 2008. As importantly, we see cash has started to turn lower versus gold in the past few weeks (yellow highlight right at the downtrend line). This means that gold's corrective decline may be over thereby allowing it to resume its superior long-term relative performance versus cash.

It is a good exercise to measure both bull and bear markets against a risk free position like cash in order to see where real risk lies. The important take away is that opportunity cost of holding cash in a bear market is usually easier to stomach because market declines eventually bail out conservative investors (the later you get in the cycle the more true this is). On the flip side, it is much riskier to hold large cash positions (or try and market time) when doing so keeps you out of an asset in a long-term bull market. History proves that it is simply better to ride out the ups and downs of a bull market asset because being out of the market in the up-phases usually results in not getting the same opportunity again. The bottom line is that the lost opportunity cost of being in cash during a long-term bear market (the Dow) is more easily recovered then in a bull market (gold) when sitting in cash can quickly become a sunk cost if you miss the rallies.

The final word on the gold market this week relates to the mining stocks. The following chart shows that demand is finally coming back into the stocks. The Point & Figure chart of the mining sector just went to a buy signal from below 10. It may not be a straight-line recovery, but this chart points to the majority of the risk being wrung out of the group. This is the first buy signal on the Point & Figure chart since last August from an extremely attractive risk-reward set-up.

AMEX Gold Miners Bullish Percent Index (Past Four Years)



First buy signal in almost a year