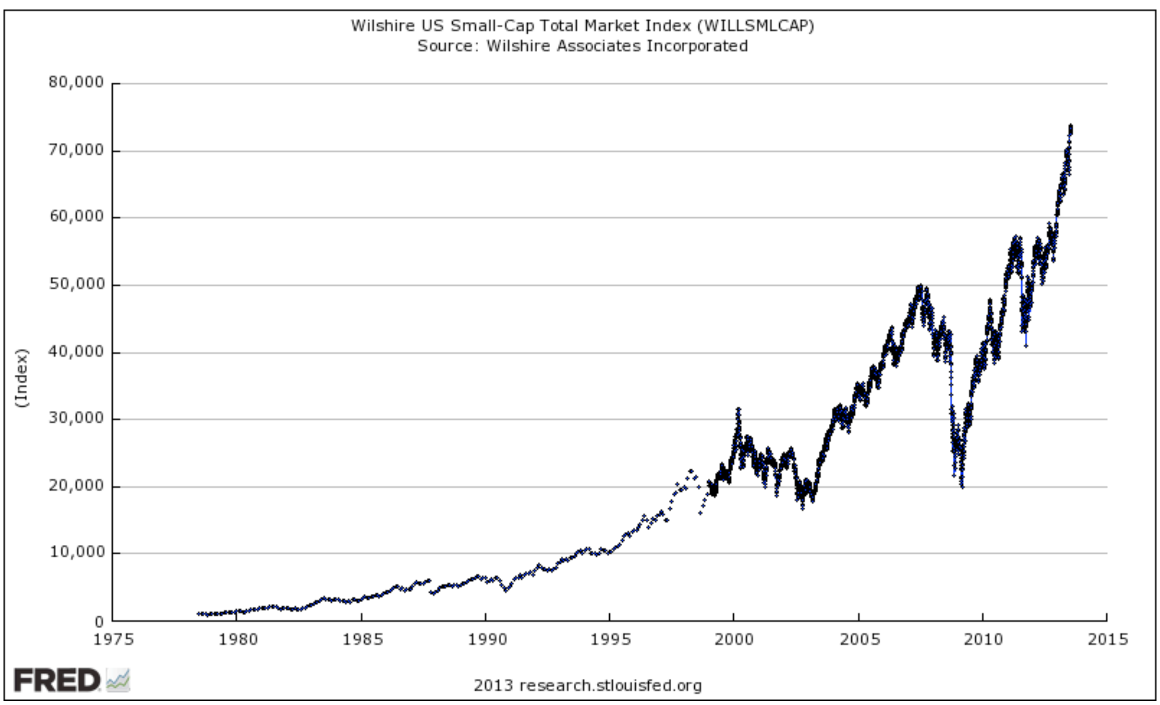
The Starboard Side Report

The week ending August 2, 2013

As anyone that followed the Nasdaq Composite in the final two years of its bull market found out, markets can remain extremely irrational in the final burst of euphoria that occurs at the end of a long-term bull market. While we have made the argument that US stocks have been in a bear market since 2000, there might be an exception to that rule when we study the specialized asset class known as small capitalization stocks. Small caps, as these are referred to in industry jargon, have simply had a stunning run over the past 35 years. So much so, that one can make the argument that they are in the final stages of a bubble almost as big as the one that hit technology stocks in 2000. While the large cap segment of the market (as defined by the S&P 500, Nasdaq 100, and Dow Jones Industrial Average) is either below or barely above its 2000 highs, the same cannot be said for the small caps. In this report, we will focus on two of the most well-known small cap indexes; the Wilshire US Small-Cap Total Market Index and the Russell 2000 Small Cap Index. What we will try to show is the enormous amounts of risk that currently exist in this highly volatile area of the market and where it may be headed over the next few years, once the music finally stops.

Wilshire US Small-Cap Total Market Index (1978 – Present)



Nasdaq Composite Index (1971 – March 2000)

The charts above, of the current Wilshire US Small Cap Total Return Index and the Nasdaq Composite Index until its peak in 2000, are pictures of an investment mania. It may be a bit misleading to say this is an exact apples to apples comparison because the Nasdaq Composite is a price only index whereas the Wilshire Small Cap is a total return index (i.e. includes dividends reinvested). Yet, given that the Nasdaq companies rarely paid dividends, the total return comparisons would probably be similar. In any regards, here are how the numbers stack-up. The Nasdaq Composite Index was created in 1971, exactly 29 years before the bubble peak in early 2000. During those 29 years the Nasdaq Composite Index advanced by 5032%. In its final move higher into the bubble top, the Nasdaq gained 278% in the eighteen months following a major market meltdown in 1998. The Wilshire US Small Cap Total Market Index was created in June 1978, or just over 35 years ago. In the span of those thirty-five years, this index has returned 7280%. This greater than seventy-fold advance eclipsed the fifty-fold price return provided by the Nasdaq Composite (granted over a period of six more years and dividends included). Interestingly enough, the final surge in the Wilshire Small Cap since the bottom of the market wipe out in 2009 has been 270% over the last four years and five months. It appears as if the 2008 financial crisis just postponed the ultimate bubble top by a few years for small caps. In aggregate though, we feel that the excesses of small caps are on par with that of the technology stocks in 2000 and that the unwind of the small cap bubble will be equally painful. Respected short seller Jim Chanos was quoted as saying at a recent investment conference that there are currently *more* companies in the US stock market trading at over 3x's book value then there were at the top of the technology bubble in March of 2000. The equity bubble in 2000 was narrower in that it was mainly the largest stocks in the US and the technology sector that got caught up in it. The current bubble is much more broad in that it includes large amounts of the small and mid size companies that make up the meat of the market.

The other more popular small cap benchmark index, other than the Wilshire, is the Russell 2000 Small Cap Index. According to the Wall Street Journal, the Russell 2000 Index is now trading at a nosebleed valuation level of 49 times trailing 12-month earnings! A P/E ratio above 20 is usually considered overvalued, but now we have the Russell P/E pushing 50. That is greater than the S&P 500 when its bull market ended in March of 2000 at historic peak P/E of 44. The chart below shows the Russell 2000 over the past fifteen years. It is very important to understanding where we are and where we could be going. We identify some key takeaways below the chart.

Russell 2000 Small-Cap Index (1998 – Present)

1) The **long-term resistance line** (marked by the top blue arrow) gives an upside target of 1,100 or only 4% above current levels. We have circled this resistance point at the top right corner of the chart and labeled it "Reward of 4%".
2) The **long-term support line** (marked by the bottom blue arrow) is where each of the prior three serious corrections has bottomed. The percentage decline of each correction is shown next to the point that the chart intersects the support line. This support line currently resides some 65% below current levels (labeled "Risk of -65%").
3) The lower pane of the chart is a risk measurement tool called a **Wilder's RSI Index**. Since 1998, a monthly close above 73 has been very negative for small cap stocks. We have identified this with a red line and the caption **"extreme risk zone"**. The white rectangles identify those times the Russell 2000 has closed a month in this overbought

zone. As you can see, this is only the fourth time since 1998 that we have registered a monthly close above 73 on the Wilder's RSI Index. The other monthly RSI closes above 73 were March of 1998, February of 2000 and May of 2007. Each of these tops was followed by an average correction of 48% (as marked with the percentages shown along the long-term support line in the chart).

It is not only the small cap asset class that is severely extended on its chart, but also the medium size companies known as mid caps. The chart below is of the S&P Mid Cap 400 Index. Its risk-reward set-up is equally as bad as the Russell 2000 chart shown above. The long-term resistance line is only 2-3% higher from here and the long-term support line is 65% lower.

S&P Mid-Cap 400 Index (1993 – Present)

Based on this analysis, here is what we believe may happen. The small and mid cap stocks might have one final flurry higher in the magnitude of 2-5% over the first half of August. That will set up a parabolic top that flames out from its own inertia rather than any specific catalyst. Once that final top is in, the small cap asset class would begin a very long and volatile journey to fair value somewhere along the lower support line that lays some 65% below present levels.

While small cap stocks are the most overvalued in the market at present, it does not mean their large cap cousins are much more attractively priced. We still see 35-50% downside for the larger segment of the market in the next bear cycle. One of the catalysts that may end this market rally that began in 2009 is the recent dueling increase in interest rates and energy prices.

We keep a running study in our research database that has the year-over-year change in interest rates (10-year Treasury yield) and oil prices going back thirty years. Nothing can change economic momentum quite as quickly as a big move higher or lower in these critical economic price gauges. Most months the move is pretty benign and nothing to really worry about. However, there are a few select months where oil prices and interest rates show big year-over-year increases. History teaches us that those are the ones that you want to pay attention to, especially if they are both heading higher at the same time and the Dow Jones Industrial Average closes the month at a 52-week high. In this regard, July was a very historic month. Over thirty years of history (or 360 months), there have only been twelve other months in which the combined percentage increase in interest rates and oil prices exceeded 90% year-over-year. If we narrow that down to only those combo 90% increases that occurred in the same month as a closing 52-week high in the Dow, it takes our sample size down to just three: July 1987, December 1999 and the month just past, July 2013. Here is what the Dow did over the years following the first two readings. The month of the interest rate and oil price spikes over 90% are highlighted in pink.

Dow Jones Industrial Average (June 1987 – 1990)

Dow Jones Industrial Average (November 1999 – November 2002)

One 40% crash in the subsequent three months and one 35% decline over the next three years. Not a guarantee that it will repeat, but we feel it's a pretty convincing reason to remain very cautious. The history of the market teaches us not to mess with spikes in interest rates or spikes in oil prices. When they occur together it screams, run for the hills! Being risk adverse during late stage bull market melt-ups is NEVER fun. But, from a long-term investment standpoint it is the prudent course of action, especially with interest rates and oil prices rising.

We wanted to end this week with another look at why we like the risk-reward set-up of gold stocks versus the US small and mid cap charts shown above. This chart below is the polar opposite of what we see in the Russell 2000 and S&P Mid Cap 400 Indexes. Namely, we have gold stocks forming a reversal right at their long-term support line after a 65% correction.

AMEX Gold Bugs Index 1998 – Present)

Despite all of the recent volatility that has accompanied the gold miners over the past two months, this is actually a rather orderly chart. No one in the markets has a crystal ball, but this is what we envision the Russell 2000 chart looking like two years into the future. Gold stocks have already had their bear market and are making a bottom at long-term support, whereas the highly overvalued small and mid cap segments of the US market are right at long-term resistance after a long euphoric rally. The Wilder's RSI Index in the bottom pane has reversed from a historic "low risk zone." The "X" on the chart marks the spots of the other two similar set-ups in December 2000 and December 2008; both great entry points for precious metal investors.