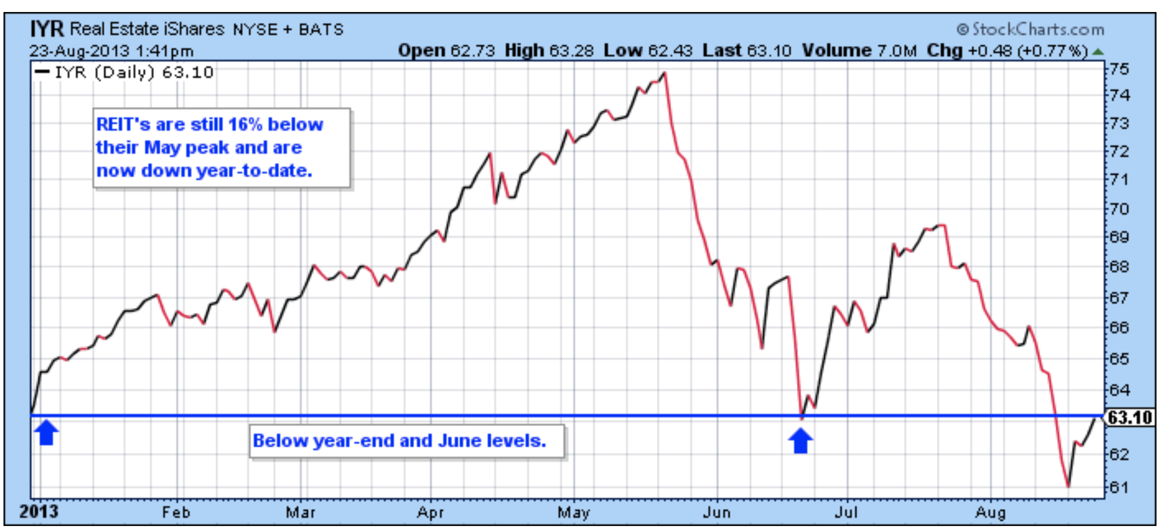
The Starboard Side Report

The week ending August 23, 2013

At this point, almost 4 ½ years into a US economic recovery, it is all about the credit cycle. The 2003 -2007 expansion ended when sub-prime mortgage credit started to dry up. In a highly leveraged finance-based economy like the US, the credit cycle and the economic cycle have become one and the same. In the good ole days, the economy weakened and credit followed. Today, we have the opposite in that first comes the top of the credit cycle and then the rest of the finance based economy follows. We believe the credit markets are showing signs of extreme exhaustion that are consistent with a cycle top. Just like in 2007, this will have major implications for the US equity markets due to the extreme overvaluation that exists. Let's check in on some of the most interest sensitive areas of the market to see what (if anything) they are showing. With the S&P 500 still trading at less than 3% from an all-time high, we would expect to see credit sensitive assets near or above their highs as well. Yet, as we how below, that is just not the case.

First up is real estate, the one sector that has really kept the US economy afloat over the past two years. Real Estate Investment Trusts (REIT's), Mortgage Real Estate Investment Trusts and home construction stocks are some of the main ways to play real estate. As the first chart below shows, REIT's as a group are 16% below their May peak and down on the year.

US Real Estate iShares Fund (Year-to-Date 2013)

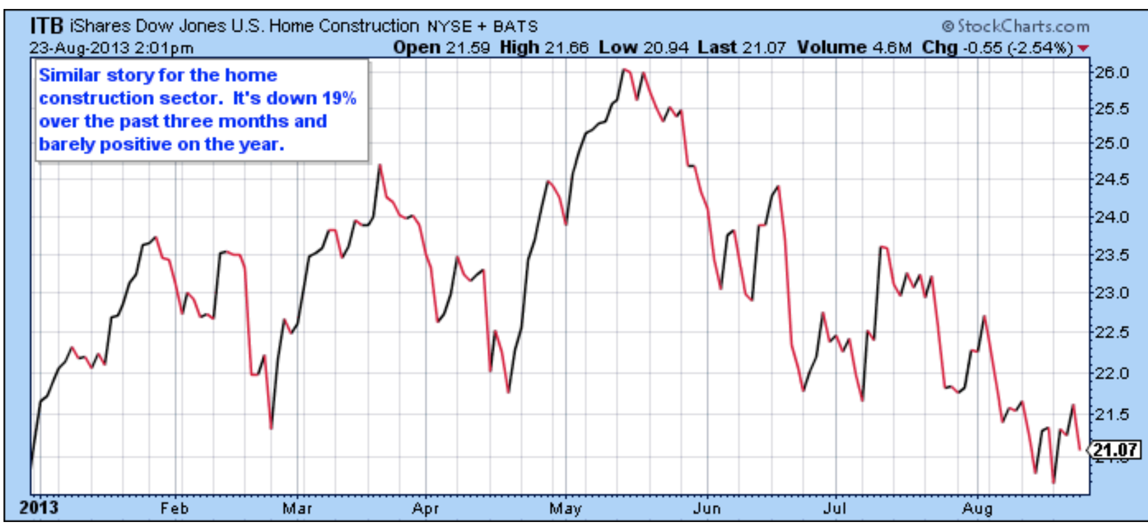


Below we see that Mortgage REIT's are feeling the same pain as their traditional REIT cousins with a 21% decline since the May peak.

iShares Mortgage REIT Fund (Year-to-Date 2013)

It is a similar story for the home construction sector. It is now down 19% over the past three months and barely positive on the year.

Dow Jones US Home Construction Index (Year-to-Date 2013)



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All of this weakness in interest rate sensitive assets is being driven by the 100% increase in 10-year Treasury yields over the past year. *This is the largest year-over-year increase in at least the past 35 years.* We believe that such a large move (even though it's coming from a low base) greatly increases the chance of a financial accident over the next several months. Such is the systemic risk inherent in a highly leveraged finance based economy.

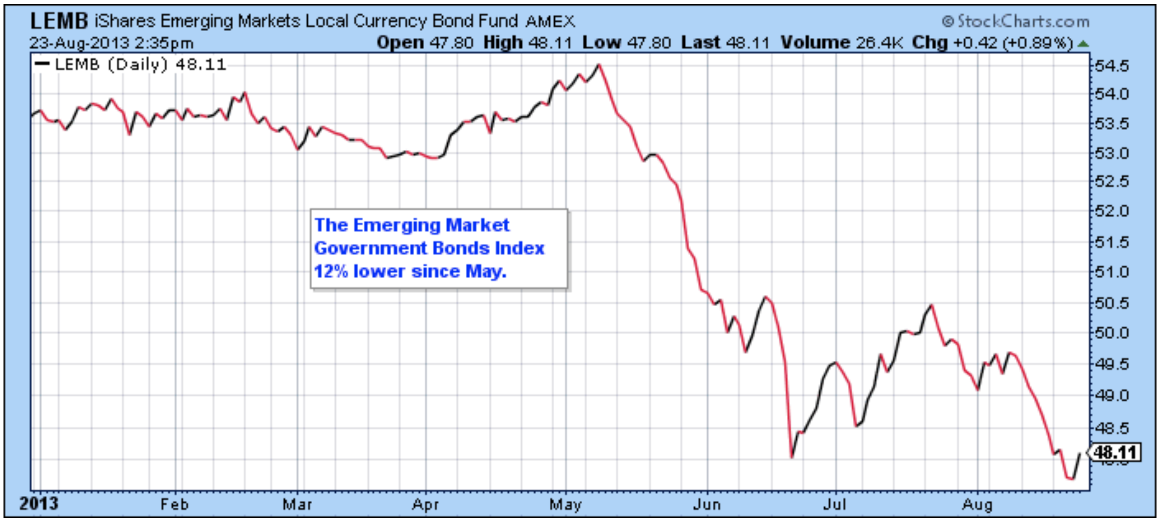
10 Year US Treasury Yield Index (May 2012 – Present)

Rising Treasury bond yields are causing a decline in normally “safe haven” corporate bond funds.

iShares Investment Grade Corporate Bond Index (Year-to-Date 2013)

Finally, that giant sucking sound you hear is the rise in US Treasury yields creating a vicious feedback loop in emerging market credit instruments. Bond yields are rising in the emerging world in sympathy with US yields; causing emerging market bond prices to fall rapidly. It has been a very challenging year for anyone that has a diversified portfolio. Investors have had to take the extremely risky undiversified position of being 100% invested in US stocks to be having a good year. Foreign stocks/bonds, real estate, commodities and US domestic bonds are all doing poorly year-to-date.

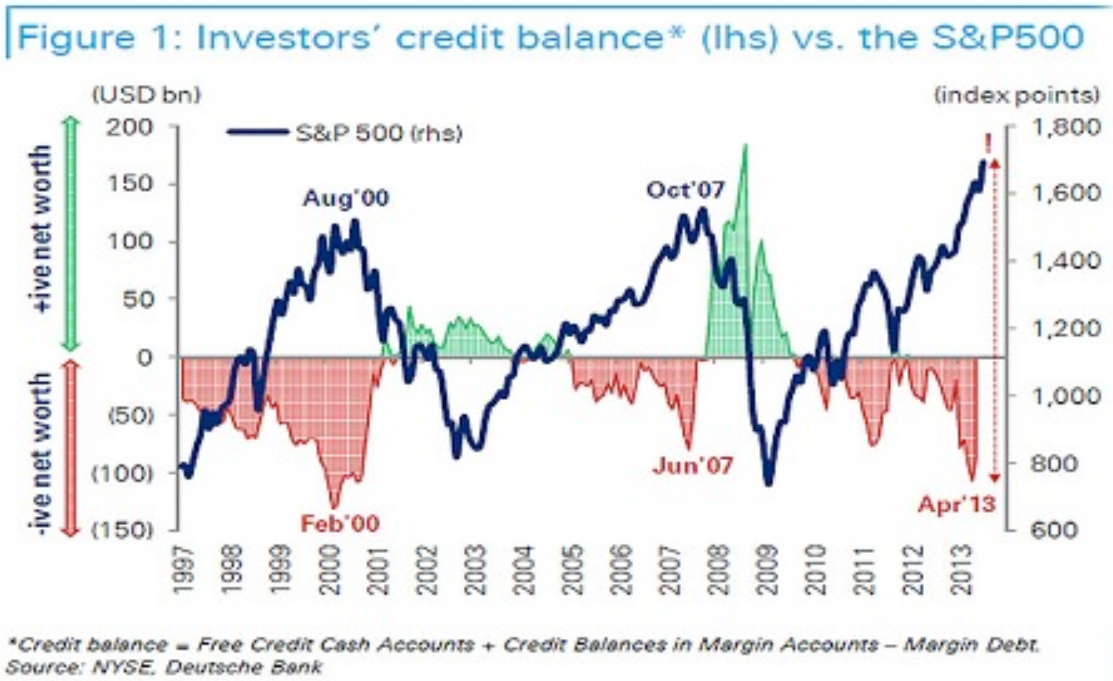
iShares Emerging Market Local Currency Bond Fund (2013 Year-to-Date)



The credit cycle also factors into the stock market in the form of margin debt. Margin debt is simply someone borrowing against the value of their brokerage account in order to invest more than they could otherwise afford on his or her own. It is a highly speculative way to manage money and it is correlated to the overall credit and market cycle. Margin debt is usually highest right at market tops when the news is the best and lowest at market bottoms after everyone has been flushed out of their positions. Therefore, high levels of margin debt are seen as a red flag by savvy investors because of how quickly forced stock sales by overleveraged investors can set off panics. Below we see that total margin debt is starting to rollover (credit starting to contract) from the same level that marked the 2007 market top.

Total NYSE Margin Debt (1990 – Present)

This next chart shows an overlay of the S&P 500 (blue line) versus the total credit balance of investors. A red (negative) credit balance means lots of speculation and borrowing to juice stocks. A green (positive) credit balance means lots of conservative cold hard cash. Notice how the red troughs line up to major tops in the S&P 500 in 2000 and 2007.

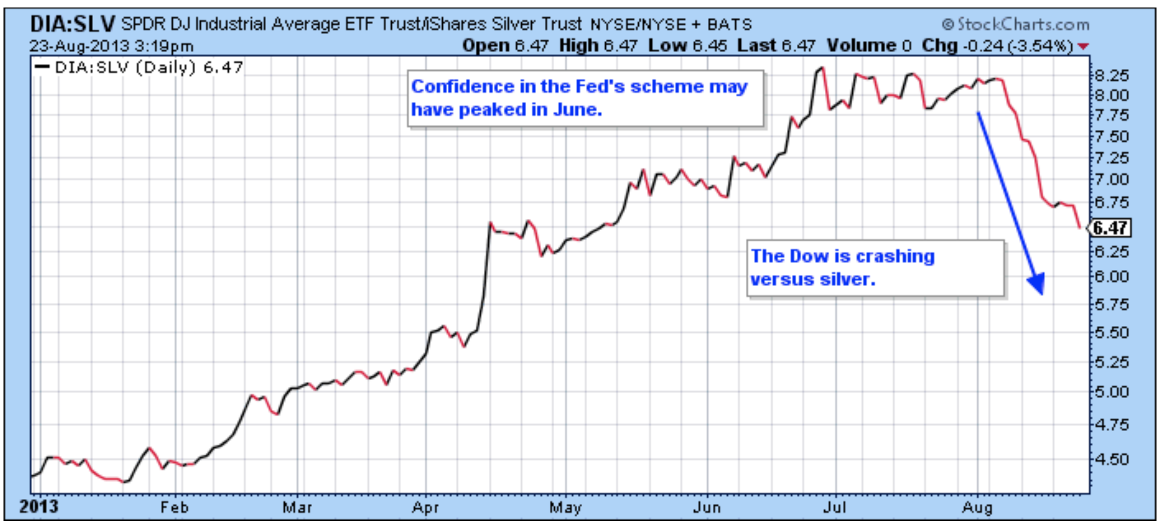


Despite the S&P 500 resting at only 2% below its all-time high, the charts above show that it is not all sunshine and rose out there. The cracks have been showing in the global markets and commodities for a while, but are now starting to pop up in the credit markets and interest sensitive assets. We believe stock investors in the US are living in la-la land in the hope that the Federal Reserve will make everything ok. We take the opposite view of the crowd and believe that this unwavering faith in a misguided institution is a bubble in and of itself. Until the main strategy of economic growth in the US is no longer trying to prop-up asset prices, the markets remain highly susceptible to the boom-bust cycle that we have been living in since 2000. We want to try and be aggressive buyers at the trough of the bust phase rather than the peak of the boom cycle.

Two final charts this week that illustrate that the market may be starting to lose confidence in the Federal Reserve's latest schemes. Since late June, the Dow Jones Industrial Average is 14% lower when priced in gold and 21% lower versus silver. This is a big shift that points to an end of the precious metals bear market that began in 2011. We will continue to delve into this improving precious metals relative strength picture in upcoming reports.

Dow Priced in Gold (2013 Year-to-Date)

Dow Priced in Silver (2013 Year-to-Date)



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