The Starboard Side Report

The week ending September 6, 2013

"The continued rise in yields is the 800-pound gorilla waltzing in the room that everyone continues to stare at." Erik Swarts Market Anthropology

The summer doldrums in the market were anything but this year. There are several main themes that have arisen which deserve watching over the remainder of the 2013. 1) Severe weakness in emerging markets. This broad based turmoil has hit stocks, bonds and currencies in the developing world. 2) Continued rise in US bond yields (leading to much lower bond prices and a decrease in global liquidity). 3) Potential for another military conflict in the Middle East and corresponding oil price volatility that goes with it. 4) Continued outperformance of the *developed* world stock markets in the US, Europe and Japan. 5) A potential bottoming for gold and silver after a two-year bear market.

1) Emerging Market Weakness

If we look at the global financial markets as an interconnected group of dominoes, emerging markets have certainly been the first pieces to fall. It has been a brutal summer for many of the former highflyers of the emerging markets as we see below.

Indonesia down 36% since May peak

Turkey down 36% since May peak

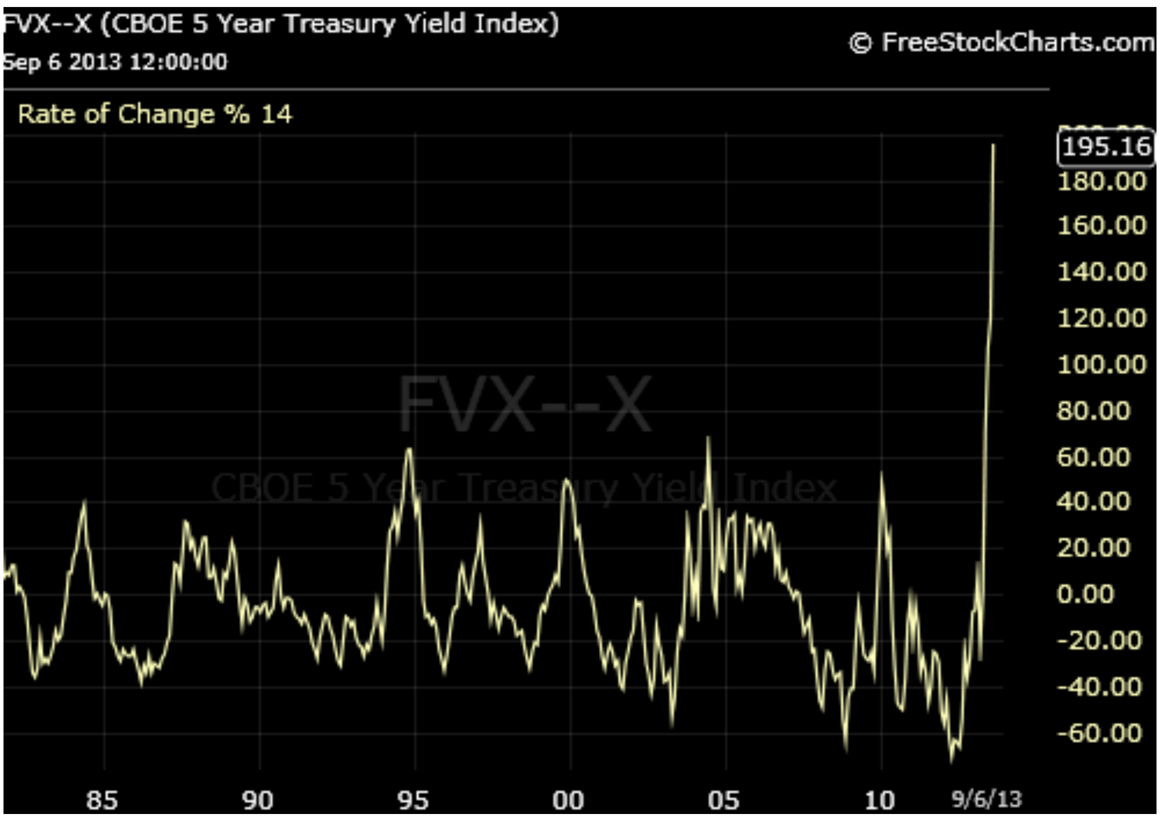
Thailand Down 30% since May

Emerging Market Government Bonds down 23% since March

Those that are ignoring the message being given by this extreme weakness in emerging markets are doing so at their own peril. Especially, since the growing middle classes of these economies are looked upon by many US companies as the main growth engine of the global economy.

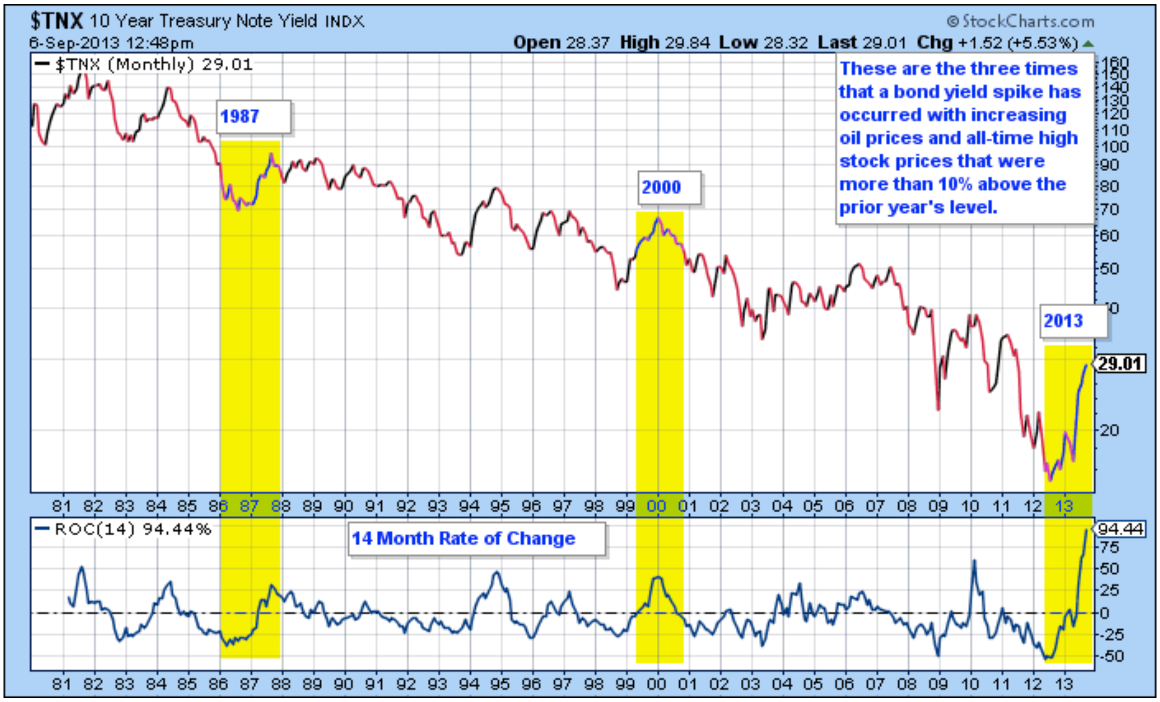
2) US Bond Market Yield Spike

Here is the 14-month rate of change percentage for the 5-year US Treasury Bond Yield Index going back to the start of the US Treasury Bond bull market in 1982. As you can clearly see, the almost 200% increase in yields over the past 14 months is like nothing the financial system has ever had to deal with before. Most of this spike has occurred in just the past three months.



Furthermore, the percentage increase in the US 10-year bond yield (that yield most tied to the mortgage rate) is also exhibiting the biggest year-over-year change in the past thirty years. Those that dismiss this move higher as coming from a “low base” are ignoring the gorilla in the room, as the quote above mentions. In a modern highly leveraged finance-based economy, it is the velocity of the move and not the absolute price that matters. We simply do not know what hidden consequences may yet result from this violent rate increase.

US 10-year Treasury Note Yield Index (1980 – Present)



Over the past thirty-two years, August of 1987 and January 2000 were the only other times that 10-year US Treasury bond yields have risen by 30% over a 14-month period in conjunction with rising oil prices and the S&P 500 up double digits year-over-year and within 3% of its all time high. Frothy stock markets, rising oil prices and disorderly bond markets have the potential to be a deadly cocktail for investors as the respective charts below of 1987 and 2000 illustrate.

S&P 500 Index (1987)

The first pane in the chart above is the S&P 500 and the bottom is the yield on the US 10-year Treasury. The market was still 3% from its 52 week high in early October 1987, even as rates climbed from 7% in March to above 10% in October. The crash wiped out almost two years worth of gains in a matter of days. The next chart of the S&P 500 below shows a similar story as stocks kept heading higher in late 1999 despite a rising interest rate and oil price environment.

S&P 500 Index (1999 -2002)

It may not be this week or this month, but sometime in the next few months, the liquidity that is being removed by the bond market and emerging market meltdowns will be felt by those investors that are thinking US stocks are immune. It would easy to get sensationalistic and claim a stock market crash is imminent, but that is not what we are trying to do here. We are simply trying to show the conditions are ripe for a possible nasty outcome. The history lesson we take from 1987 and 2000 is that it is unwise for stock investors to ignore a disorderly rise in interest rates (especially when oil prices are rising too).

3) Threat of War and Rising Oil Prices

Twisted conventional wisdom would have you believe that wars are good for the economy and stock market. However, we do not believe that is that case in a world that is running out of cheap and easily accessible oil reserves. Furthermore, this is especially not the case when the potential conflict is in the middle of one of the remaining cheap and abundant oil resources. It remains to be seen how the Syrian mess will play out, but a worst-case scenario of China and Russia fighting a proxy war versus the US and France could be a disaster for the fragile global economy.

Crude Oil (Past 3 years)

As you can see in the crude oil chart above, this fresh conflict in the Middle East is occurring at a very dangerous time. $110 per barrel is the level that helped trigger big US stock market corrections in 2011 and 2012. Correlation does not necessarily equal causation, but we think it makes sense that an economy bumping along at 1-2% growth cannot handle any more oil shocks. In fact, the oil price economic slowdown genie may already be out of the bottle even before a single bomb is dropped on Syria (oil prices have climbed 26% since April). Throw in the interest rate spike on top of the slowdown in the emerging markets and the pieces of the puzzle are starting to point to the potential for a big stock market shakeout around the bend.

4) Outperformance of the *developed* world stock markets in the US, Europe and Japan.

If you had gone to sleep on Memorial Day and woke up on Labor Day, the S&P 500 trading at the exact same level would lead on to believe it was an uneventful summer. However, as we now know, that was hardly the case.

S&P 500 Summer of 2013

Said another way, all of the S&P 500's 16% year-to-date gains occurred before Memorial Day. The US, select Eurozone countries and Japan are really the only stock markets on the planet that are showing positive performance on a year-to-date basis. However, they too have been struggling to gain ground since May.

Symbol	Desc	%Change YTD Year-to-Date	%Change Since May Top
GIM	Global Bond	-14.41	-15.57
IYR	US Real Estate	-4.70	-16.34
AGG	US Total Bond Market	-5.57	-4.58
GC/	Gold	-18.31	0.03
GCC	Commodity Index	-7.35	-1.18
EEM	Emerging Markets	-11.16	-8.29
EFA	Foreign Developed Markets	6.93	-3.32
SPX	US Stocks	16.05	-0.02
	Average	**-4.82**	**-6.16**

We believe the above table of asset class returns is instructive for three reasons. First, any investor that has constructed a prudent portfolio is likely down this year as the average return row shows. Home bias has many US investors believing that this has been a good year for the markets. In reality, the numbers say it has not; unless you have taken the extremely risky position of being 100% invested in US stocks. The second interesting take away is that of all the assets listed, *only gold is showing a gain since the global market top on May 22nd*. Finally, the performance of the foreign developed markets are clearly ahead of the rest of the pack (other than US stocks) in both timeframes. What this tells us is that markets are pretty much putting their money where powerful central banks appear to have their backs. The US Fed, ECB and Bank of Japan have been aggressively trying to offset huge amounts of leverage with appeasing words and deeds over the past year. Ultimately, the danger of this strategy comes into play when the markets start to lose confidence in the ability of central banking academic theories to save the day in any kind of sustainable manner.

A Potential Bottom for Precious Metals

Gold/Silver and precious metals mining stocks have had a two steps forward one step back type of recovery since making a seemingly major low in late June. This has made the uptrend off of the lows pretty volatile, but an uptrend nonetheless. As we pointed out above, gold is one of the few major assets to post a positive return since the world markets topped in the third week of May. This had led to a very nice uptick in relative strength over the past two months versus the rest of the US market. The precious metals sector has become extremely uncorrelated to the S&P 500 stock index. This is a good thing if one thinks US stocks are due for a fall and a bad thing if one believe US stocks are going to keep rallying. A world in which bonds are very overvalued means that they might not do as good a job of padding downside volatility, as has historically been the case. Gold's uncorrelated posture makes it a valuable portfolio diversification asset in today's highly correlated world.

When just about the whole world was throwing in the towel on gold and silver at the end of the second quarter, we said the following:
"Corrections are a part of investing that all long-term investors have to face at one time or another. Some are definitely steeper than others. The main issue that separates successful long-term investors from the rest is how those corrections and the emotions they elicit are managed throughout the FULL market cycle (measured over the span of many years). The two questions that have to be asked when faced with a long-term decision on a rapidly falling asset class is: 1) is the long-term trend still intact, 2) are the long-term fundamentals underpinning the asset class still strong in support of more upside? In the case of gold and silver, the answer to both is still yes. The fact that every major financial media outlet will be discussing what a terrible quarter gold had is not reason to sell. In fact, as we have shown on this report, it could very well mean that a major turning point is close at hand."

Let's check in on the charts that we had included on that 6-28-13 report to see how the **long-term** picture is shaping up.

Gold Price in US Dollars (1990 – Present)

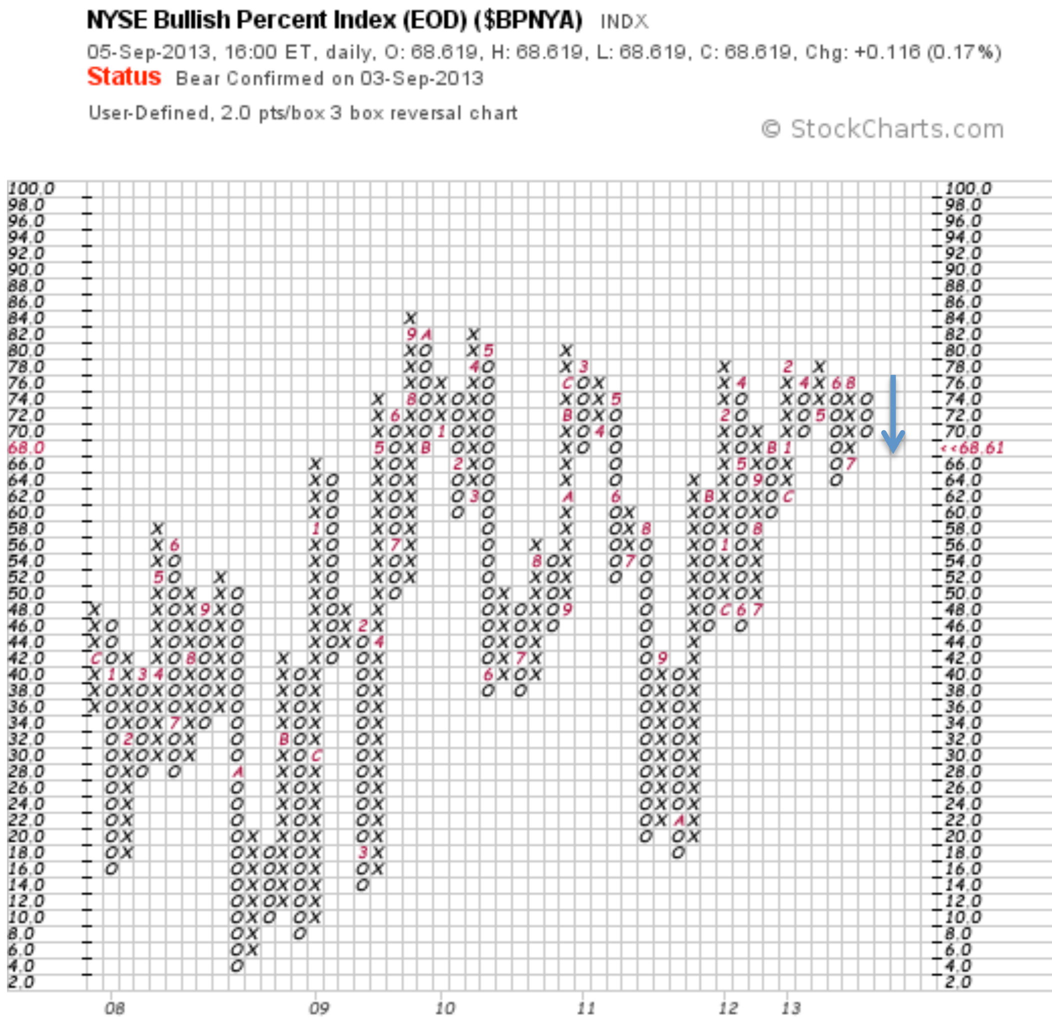
Silver Price in US Dollars (1990 – Present)

Silver Price in US Dollars (1993 – Present)

Much like 2008 for gold and 2004 & 2008 for silver, these precious metals charts appear to be in the early stages of resuming their long-term uptrends after the disastrous second quarter flushed out a good many speculators and investors alike.

In conclusion, the summer wind came blowin' in and left behind numerous risky crosscurrents that must be carefully navigated. We remain patient to see how this will play out over the next few months. We remain especially concerned that the fragile set-up of rising bond yields, falling emerging market stock prices and rising oil prices is occurring as we head into the seasonally weak September and October timeframe. Clearly we are not the only ones worried about the crosscurrents as the NYSE Bullish Percent just reversed down into O's from above the 70%

level. This means supply has taken control of the market from demand and that investors are bringing the defensive team out onto the field.



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