The Starboard Side Report

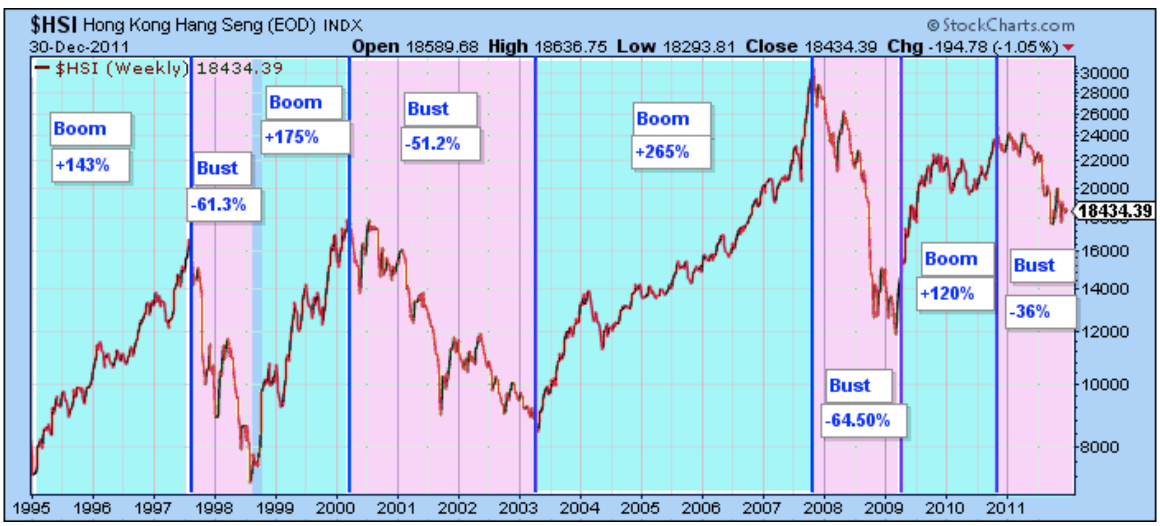
The week ending September 20, 2013

Anyone that tells you that they know exactly how this crazy experiment in financial central planning is going to end is not being very honest. Even the mighty Federal Reserve is flying by the seat of their pants with no real knowledge of the collateral damage that this grand monetary experiment will inflict on the economy and markets. The same exact faulty academic models that led the US economy to the brink of disaster are now being used again to try and get us out of the mess. How the markets still trust 12 unelected ivory tower economists to get it right this time is beyond us. All we can do, as stewards of capital, is assess the probability of various outcomes and carefully construct a portfolio based on that. As we have mentioned before, the two most likely end games to this twilight zone we have entered are another deflationary financial crisis or a spectacular inflation episode. As the inability of the Federal Reserve to reign in stimulus this week showed, self-sustaining growth is not a reality at this juncture without Federal Reserve life support. Therefore, we place the least amount of odds on an outcome that favors self-sustaining growth. At this stage of the economic cycle, we have a relatively low exposure to the interest sensitive growth sectors that have been leading the market higher for the past two years (US finance, real estate and retail). On one hand, we believe the core of any portfolio has to have cash and downside market hedges to cushion the risk of another financial crisis (if yields keep rising US Treasury Bonds may also fit here soon). On the other hand, precious metals and commodities should be owned to help protect against a disorderly US dollar decline and inflation that could result from the Fed's $3 *trillion* (and counting) balance sheet expansion.

The model that the Federal Reserve has been using to direct the economy since the early 1990's has as its primary objective generating asset price inflation (i.e. financial market bubbles). This has turned the once proud US economy into one that's beholden to the boom-bust dynamic of the financial sector. Eric Jansen of iTulip refers to this relatively new driver of highly cyclical US growth as the FIRE (**F**inance, **I**nsurance and **R**eal **E**state) economy. Even with the technology bust and housing bust, the FIRE economy has done extraordinarily well over the past two decades because the Federal Reserve keeps going to a more radical version of the easy money playbook after each successive blow-up. That is how it works when an industry becomes the largest special interest in Washington. Make no mistake; Federal Reserve policy is being orchestrated with the FIRE economy in mind in the hopes that their riches might spill over to the rest of the economy. Five years later, we are still waiting. Until the financial sector is forced to permanently restructure and return to its rightful place as a utility for the rest of the productive economy, then this chronic boom-bust cycle will continue.

Hong Kong's stock market is a good model for what it looks like to have a boom-bust FIRE driven economy. During the seventeen years between 1995 and 2012 the Hong Kong Hang Seng Index had three boom and bust cycles that averaged 175% on the upside and 53% on the downside. The bigger the boom the bigger the bust phase. This is the hallmark of an asset bubble economy driven for the benefit of the financial sector. We believe this is the new America that has been created through the Federal Reserve and the power of the FIRE economy lobby. Until our economic policy ceases to be run for the benefit of the financial elite and not the rest of the productive economy, this boom-bust pattern will continue. We had a chance to restart in 2008, but the powers that be were successful at restarting the same flawed system that brought the economy to the brink after Lehman Brothers collapsed. It was truly a good crisis wasted. And now we await the next one that is brewing beneath the surface.

Boom & Bust- Hong Kong Hang Seng Index (1995 – 2012)



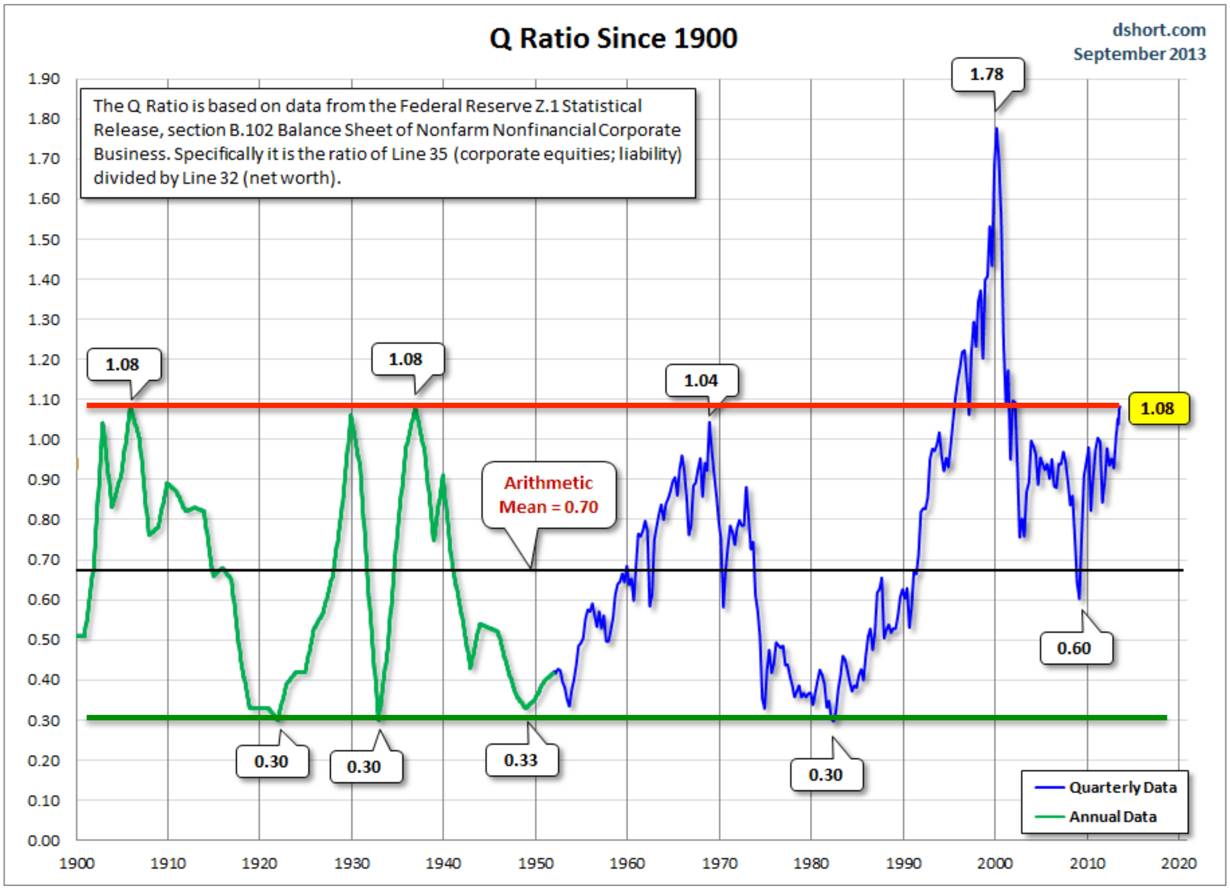
Boom & Bust- S&P 500 Index (1995 – Present)

The Federal Reserve's surprise decision not to taper stimulus should not really have come as a surprise given that they are essentially trapped in a box. Fundamentals continue to disconnect from stock prices as the market rallies on stimulus instead of economic fundamentals. Since the Federal Reserve surprised the markets with QE3 last September, S&P 500 earnings growth has been flat. At the same time the market has gained over 20%. This means that multiple expansion (i.e. paying more for the same amount of earnings) has been the main factor driving the US stock market higher. In a circular twist of fate, any taper of quantitative easing will cause interest rates to rise, which will choke off the fragile interest sensitive FIRE sector recovery and the corresponding stock market rally. So, stocks appear to be rallying on Fed stimulus that is not making the economy or earnings materially better from a long-term perspective, but the stimulus can't be turned off for fear that the markets will tank. It seems as if the flow of easy money must be kept at peak levels or the whole house of cards will come tumbling down. The brutal sell-off in emerging markets, real estate and bonds in June, at the mere suggestion of cutting back, showed this to be true.

Those investors buying stocks at these record highs, on a weakening economy, are betting that they can get to a chair before everyone else. This game of musical chairs is very dangerous and will end badly for most. The problem with stimulus being left at full bore is that we are at all-time high valuations and prices in the stock market. This has created a situation where the Fed has helped blow the third stock market bubble in just the past fifteen years without letting a full mean reversion process play itself out. A full mean reversion has been the hallmark of every bear market bottom and it has not arrived yet for the US market bear market that began in 2000. As a result of valuations being back to where they were in 2000 and 2007, risk levels have rarely been this high in US market history. Here is a quick look at what a full mean reversion has looked like in the past.

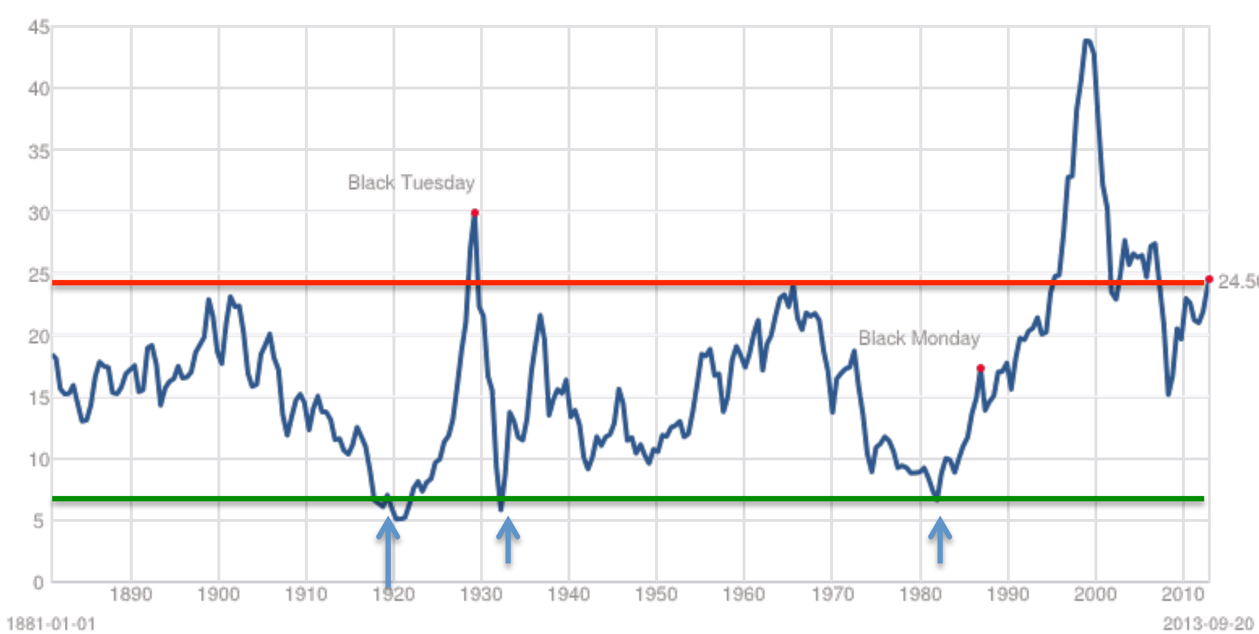
The first metric that shows the US market back at peak valuation levels is the Tobin's Q Ratio. This is essentially a look at the value of the entire US stock market in relation to the aggregate corporate assets of the economy (a sort of price-to-book value for the whole economy). All bull markets in US history (except the technology bubble in the late 1990's) have died out before this Q Ratio has been able to exceed the 1.10 level. The red line in the chart below helps to clearly illustrate this line in the sand. The summer rally in the S&P 500 has taken the Q Ratio back to the red line at 1.08. We are clearly overpriced using this measurement of value. The mean reversion process of the prior bear markets in US history have taken this ratio down below 0.35. We are a long way down to that level which is highlighted by the green horizontal line.

Tobin's Q Ratio (1.08)- US Balance Sheet Shows Market Overvalued



Source: dshort.com

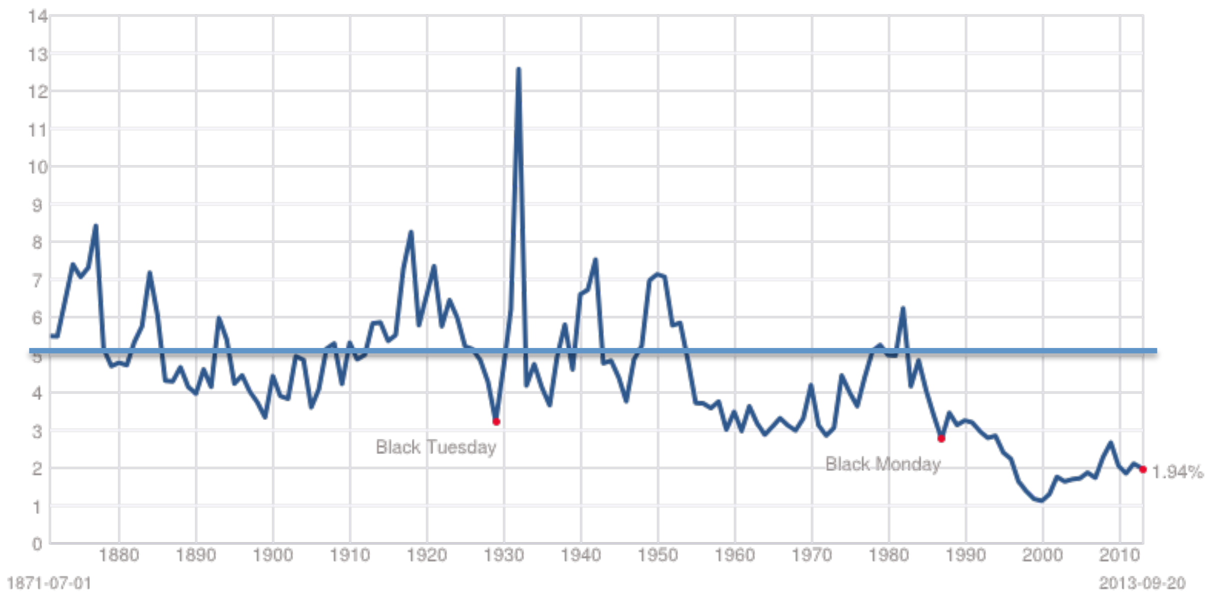
Cyclical Adjusted P/E (24.50)- Income Statement Analysis Shows Market Overvalued



Source: Multpl.com

The chart above shows that an income statement analysis of the companies in the S&P 500 also points to a highly overvalued market that has not yet fully mean reverted. The cyclically adjusted P/E ratio is a 10-year average of S&P 500 earnings that helps to smooth out the volatility of the profit cycle. The stock market currently trades at 24.5 times cyclically adjusted profits. This is in line with prior *bull* market peaks as shown by the red line. The arrows along the green line show that a full mean reversion has not historically come into play until this number is below 7!

S&P 500 Dividend Yield (1.94%) - Yield Analysis Shows Market Overvalued



Source: Multpl.com

We have drawn a line through the 5% level on the above S&P 500 dividend yield chart. This seems to have been a level associated with good stocks market value in the past. The dividend yield at the end of the 1970's bear market was just north of 6%. Of all the valuation analysis tools we have, this may have the best chance of "being different" this time due to the role corporate buybacks play in the current environment. However, we still do not think 1.94% represents any kind of great value for stocks even when factoring in buybacks, especially when the 10-year Treasury is yielding 2.75%.

Total US Stock Market Value to US GDP Ratio (1950 – Present)

Source: VectorGrader

The Total US Market Value to US GDP Ratio of 1.15 tells a similar story of overvaluation. This metric is now back to the levels that marked the top in 2007 as illustrated by the arrows on the chart. The other key takeaway from this analysis is that the bear market of the 1970's did not end until market value to GDP ratio mean reverted all the way down to 0.3.

Taken in isolation, any one of these metrics has its detractors and skeptics that point to non-relevancy and this time being different. However, when taken together, it lends significant credence to our assertion that the Federal Reserve has succeeded in blowing the third major stock market bubble in the last fifteen years. Unfortunately, this one will likely end in the same ugly fashion as the other two. The time to be an aggressive long-term buyer of stocks is when the crowd is afraid and the mean reversion process has been completed. In our estimation, we have rarely been further from that moment. In a boom-bust economy, the most successful long-term investors become those that remain disciplined at the top, even if it means missing out on late cycle gains. The goal is to have as much liquidity as possible to put to work when the bust inevitably puts numerous quality assets on the deep discount rack.

All of this analysis does not mean the market will roll over and decline 50% tomorrow, but it does mean that once the top finally arrives, there will be plenty of downside risk ahead. The Fed has practically guaranteed that with more of the same from their worn out boom-bust playbook. One of our largest positions remains the precious metals sector because it has tended to do well in downside mean reversions. This would especially be true this time if the catalyst for the mean reversion were a loss of Federal Reserve credibility. The Fed is trapped in a box with no orderly way out and mainstream Wall Street investors may finally start to figure that out after this week's surprising Fed decision.