The Starboard Side Report

The week ending September 27, 2013

One of the side effects of constant monetary stimulus is that the smaller *more speculative* issues in the market tend to benefit more from the liquidity injections than blue chip stocks. This can be observed by looking at a chart of the S&P 100 since 2000. As the chart below makes clear, this index of the 100 largest and most liquid stocks in the US market is still 11% below the level they were in March of 2000 and barely above their October 2007 cycle peak.

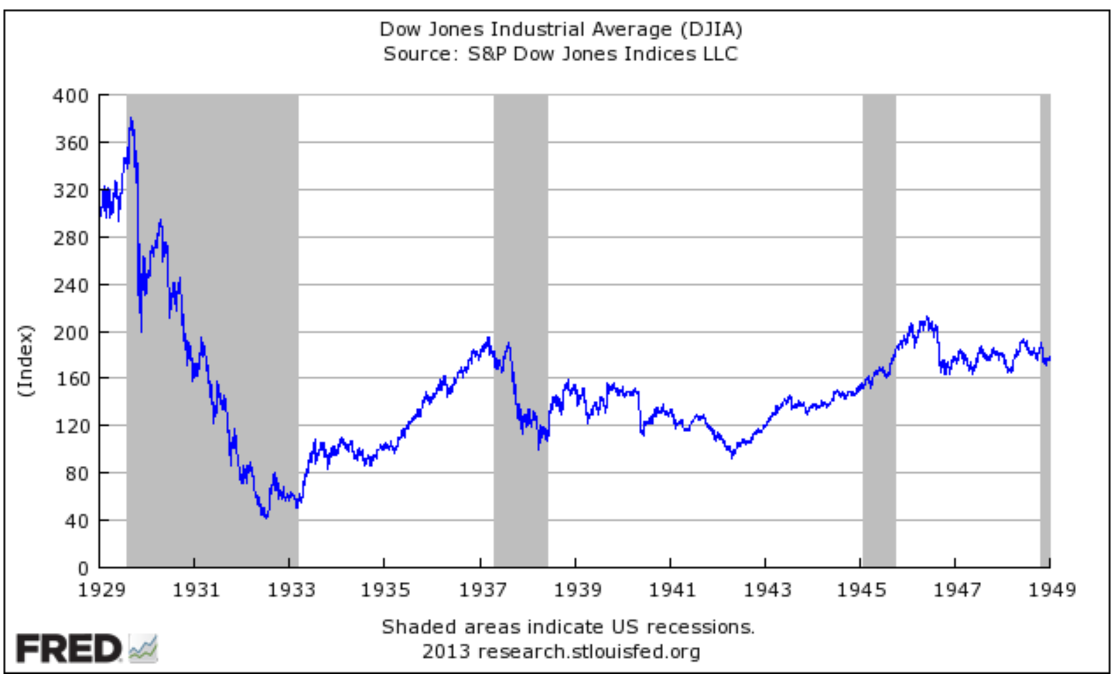
Secular Bear Market

S&P 100 Index (2000 – Present)

The Russell 2000 Index of small stocks is where the risk taking action has been. Liquidity has driven up the value of the Russell 2000 Index much higher then the underlying fundamentals should theoretically support. This disconnect makes the downside of the small stocks much greater than their larger blue chip cousins. The latest GMO asset class study puts the seven-year projected returns of small caps at negative 4% annually! This is one of the steepest overvaluations in history. Federal Reserve quantitative easing has pulled forward returns for investors and left slim pickings for those seeking value in US markets. If forced to choose, we would certainly prefer to own the S&P 100 blue chips versus the small cap segment of the market. However, four and one half years and 160% into a fragile economic expansion is not the time to be loading up on risk assets. We will patiently wait for a material correction before shopping aggressively in US blue chip stocks. Our assessment is that the S&P 100 blue chip index would be vulnerable to declines between 30% and 40% once the next downturn arrives versus a 50% to 60% type correction in the smaller stock indexes. Contrary to recent conventional wisdom, the Fed has not outlawed cyclical stock market corrections of more than 5%.

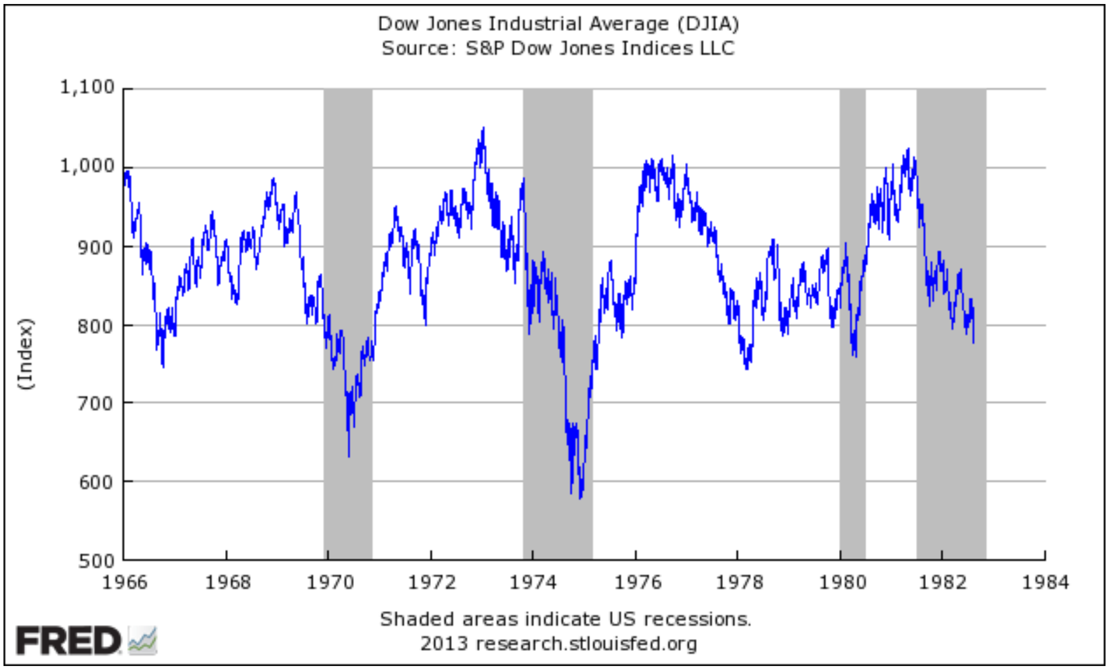
There have been a lot of pundits coming out and declaring that stocks in the US are in a new secular bull market. Funny, they weren't very vocal about this in the depths of despair in 2009. Last week we showed charts that tried to refute this notion from a valuation perspective. This week we are focusing on the time perspective. The first point to be made is that if one thinks we have begun a new secular bull market, its starting date is March of 2009, not 2013. That means the greatest bull market in history (that took valuations to two times what we had ever experienced) only took a little under nine years to fully revert to the mean (2000-2009). That would be seven less years than the 1966-1982 bear market and twelve years less than the 1929 – 1949 bear market. So the argument for us still being in a secular bear market is not just a function of valuation/price as we showed last week, but also a function of time.

Secular Bear Market- Dow Jones Industrial Average (1929 -1949)



The 1929 – 1949 secular bear market was 20 years long and consisted of four recessions (grey shaded bars on chart). These recessions are an integral part of purging the system of the excesses of the prior bull market. At the end of the 20-year period the Dow was still 56% below its 1929 peak. We have only had two recessions since the 2000 top in the market and the Federal Reserve is preventing the system from removing many of the excesses of the prior bull market through its constant subsidization of the financial sector. Until this overcapacity in money and banking is removed, fundamental economic conditions will not allow the sustainable growth needed for a new bull market. Most strategists on Wall Street are either blind or too conflicted to realize this fact.

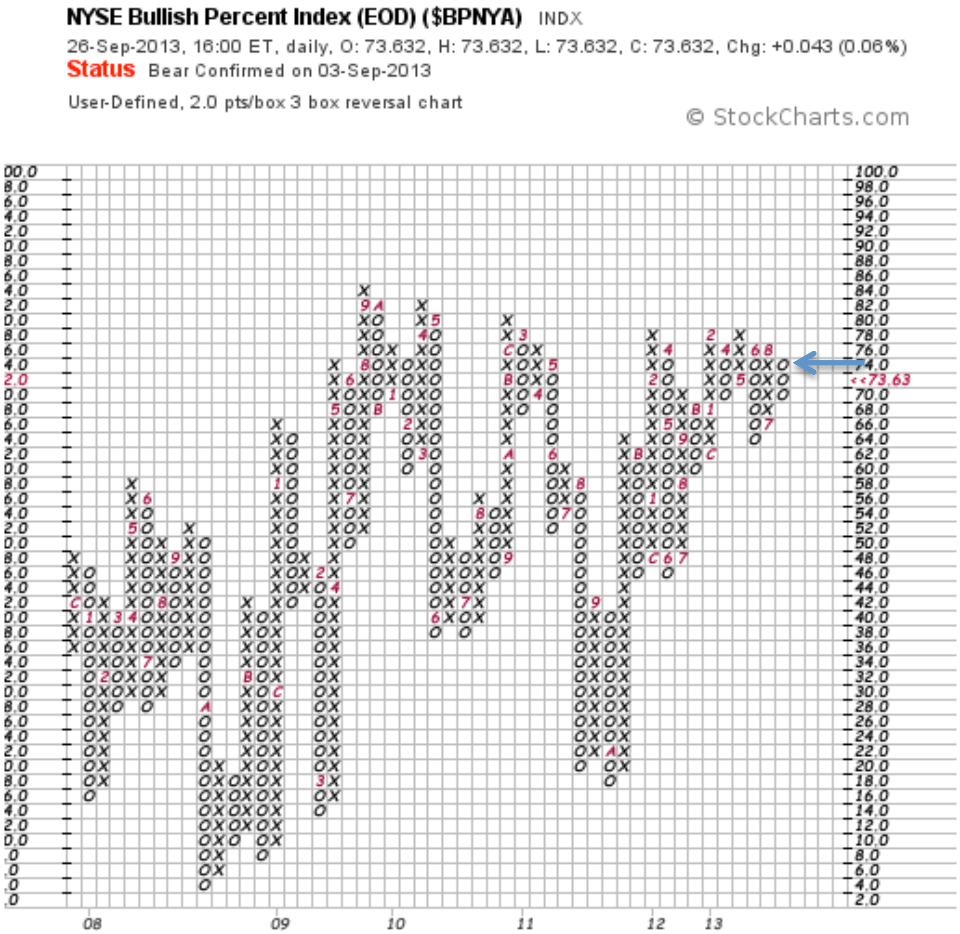
Secular Bear Market- Dow Jones Industrial Average (1966 -1982)



The 1966 – 1982 secular bear market was 16 years long and also consisted of four recessions (grey shaded bars on chart above). Again, these recessions are an integral part of purging the system of the excesses of the prior bull market. At the end of the 16-year period, the Dow was still 23% below its 1966 peak.

The reason that we showed the S&P 100 Index on the first page is that the most heavily owned segment of the market is the best chart to help illustrate that stocks are still stuck in a secular bear market (defined by epic trading ranges that span multiple decades). We expect more severe downside volatility, an additional recession or two and much more attractive valuations before we can close the chapter on this secular bear that began thirteen years ago this month. Again, please see last week's report for what we mean by attractive valuations (i.e. mean reversion).

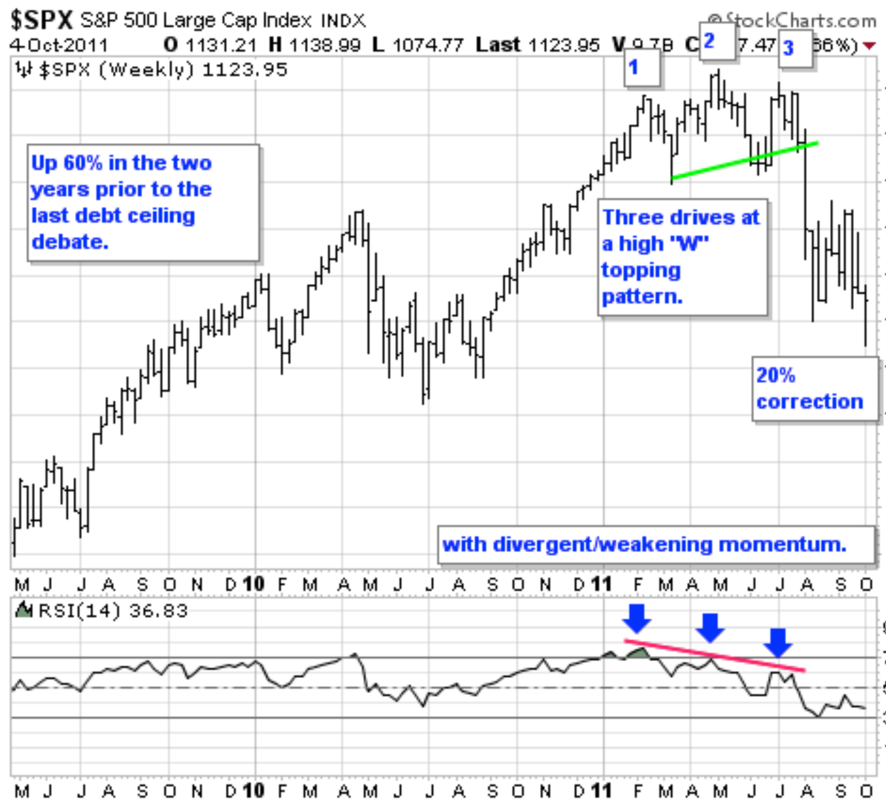
The obvious question is when do we get that next cyclical downturn within this secular bear market. Given that the last two downturns kicked-off in the September/October window, we are very cautious at this juncture. The debt ceiling debate is simply a catalyst to get an overdue down cycle started. Stock market historian and technical analyst Jeffrey Cooper likes to say, "the news tends to break with the cycles." That could definitely be the case here. The market is technically vulnerable in a similar way to just before the first debt ceiling debate in 2011. The NYSE Bullish Percent is still in a column of O's on its chart. This means that supply has the upper hand over demand at the moment in the market.



The next two charts below show the almost eerily similar chart pattern in the S&P 500 Index heading into this round 2 of the debt ceiling debate. Notice how both markets were up 60% over two years as they made a third "drive to a new high". In 2011, the third attempt stalled out in the middle of July, one month before the August deadline and a 20% market correction. This year's pattern appears to have just stalled out after its third attempt at a new high since May. This is also occurring exactly one month before the debt-ceiling deadline. It remains to be seen if history repeats, but it makes good sense to wait to see how it all plays out before determining if a traditional year-end rally is in the cards.

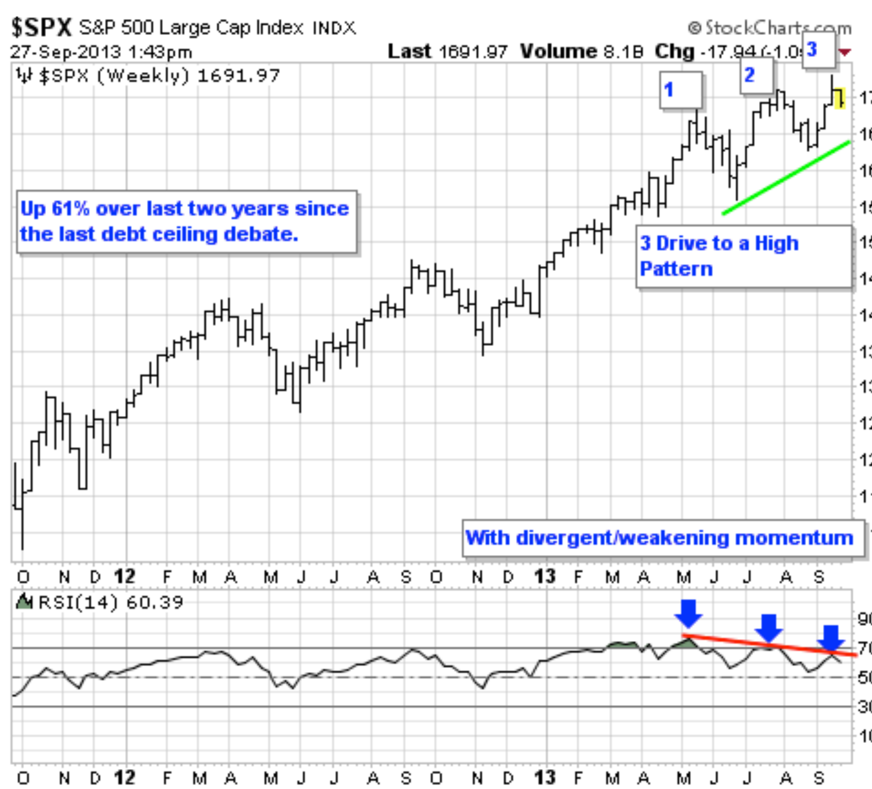
Debt Ceiling Round 1

S&P 500 (May 2009 – September 2011)



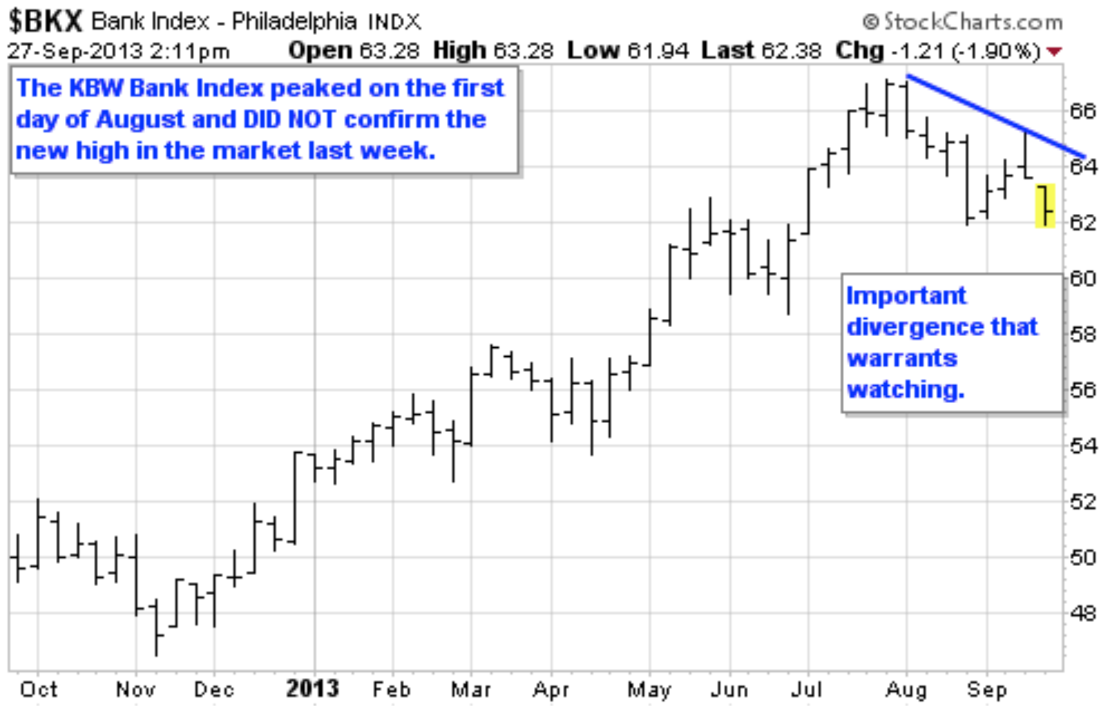
Debt Ceiling Round 2

S&P 500 (October 2011 – Present)



This week we wanted to show how one of the key leading sectors off of the October 2011 bottom is struggling. Below we see that the KBW Bank Index (BKX) peaked on August 1st and did not confirm the market's new high last week. This is an important divergence that warrants watching because it is hard for us to see a year-end rally without the banking sector onboard.

KBW Bank Index- 1 year Chart



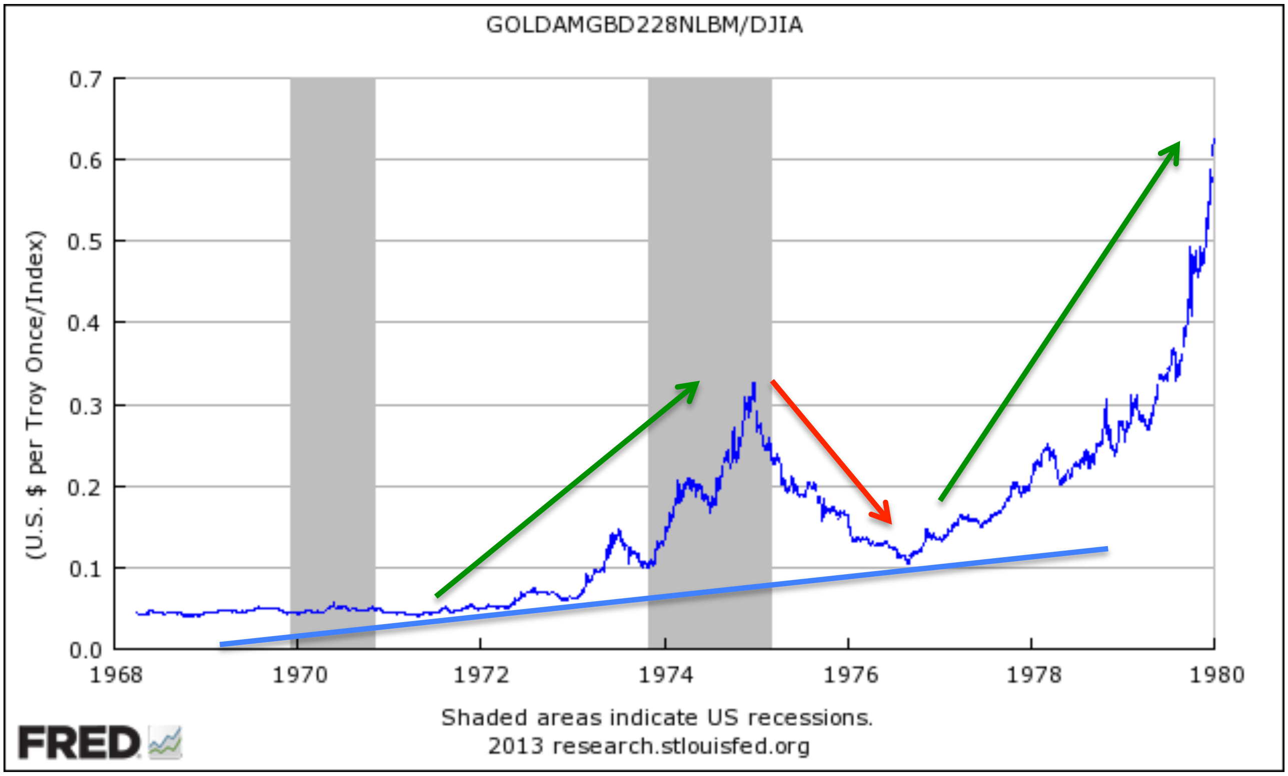
We realize that every passing week that the market stays elevated near its all-time highs it gets harder to defend our conservative position. But in reality, the fact that the market has kept climbing over the past two years on stagnating earnings and subpar economic growth only means the next decline is going to be that much more severe when it finally arrives. According to Doug Ramsey of Leuthold Weeden Capital, "twelve month trailing S&P 500 earnings per share are 89.18, **essentially flat from the fourth quarter of 2011**. Yet, the stock market clearly isn't focused on this issue, with the S&P 500 up 14% in 2012 and 18% YTD in 2013." As we discussed last week, the US market now sits at one of the most extreme overvaluation levels of the past one hundred years largely due to the Federal Reserve injecting liquidity directly into the securities markets. The old saying that the market can stay irrational longer than one can remain solvent has never felt so real. If the debt-ceiling crisis can be averted and we get through the seasonally weak October period unscathed, then we will reassess how much longer the market can stay irrational and then act accordingly. However, with record valuations in conjunction with the three concerns shown above; 1) the similar chart set-up to July 2011, 2) the NYSE Bullish Percent in O's and 3) the big divergence in the banking sector, it makes sense to remain cautious. We sense that the interest rate volatility over the summer is the reason we are starting to see some cracks show up, especially in the interest sensitive sectors of the economy. Given the inherent leverage built into the system, the odds of something "breaking" this October are greater than normal.

We will end with a few final comments on gold this week. It has clearly been a rough year for gold, but the third quarter has seen some stabilization. The below chart shows that gold has actually outperformed the S&P 500 over the past three months. After a two-year bear market, we'll take any positive news we can get. Improving relative strength is clearly good news.

Gold to S&P 500 Relative Strength Ratio- 3rd Quarter 2013

Present Day Gold to the S&P 100 Relative Strength Ratio- Chapter 1 and Chapter 2

1960's & 70's Gold Bull- Gold to Dow Jones Relative Strength Ratio- Chapters 1,2 & 3



Gold gained 500% versus the Dow from 1964 through 1974 (first green line). After the great recession of 1974, gold lost over 50% when stocks rallied back and gold went into a two-year bear market (red down line). Sound familiar? Those that bailed on the gold bull market and went all in on US stocks after that mid-cycle correction in 1976 were dealt a wicked curve ball over the next three years with gold outperforming the Dow by some 500% (second green line).

The last gold bull market in the 1960's and 1970's was marred by a nasty bear market in 1975 and 1976. Much like the past two years, the gold decline coincided with a big rally in the Dow back to its pre-recession highs. Many were probably proclaiming stocks in a new bull market at that point. But the final chapter was not yet written for either the Dow or gold. Those that were impatient and bailed on gold left extraordinary gains on the table over the next three years as gold surged and the US stock indexes were brought back to the reality of the weak economic fundamentals. The Dow lost 25% over the next few years as economic mismanagement created an inflationary quagmire. We strongly believe that we have only seen the first and second chapter of this current gold bull market. Just as September 1976 was the start of chapter 3 of that prior gold bull, the best chapter of this current gold bull market may now just be beginning.

To bring this all full circle, you can clearly see in the last chart below that the Dow had a topping pattern over the summer of 1976 that was reminiscent of the current topping process. A final spike in the third week of September with a multi-month weakening of internal momentum is the same exact pattern that we are seeing now.   In 1976, the Dow lost 10% into the end of November, had a rally into the end of the year that challenged the old September high and then went down pretty much non-stop for the next fifteen months as inflation and economic reality took hold. All the while, gold bottomed and began the final chapter of its bull market.

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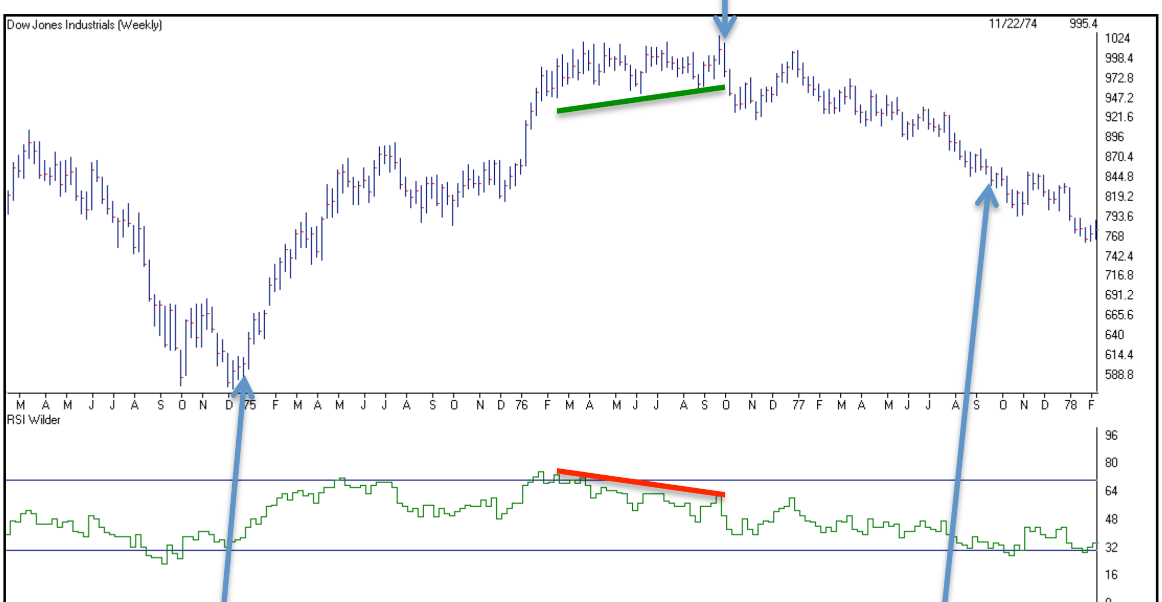
Dow Jones Industrial Average (1974-1977)



In a similar fashion, the Dow gained 70% in two years off of this bottom as gold fell for two years.

Momentum divergence in Sept. 1976.

Dow fell 25% over the next year and a half as gold resumed its bull market.

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