The Starboard Side Report

The week ending October 4, 2013

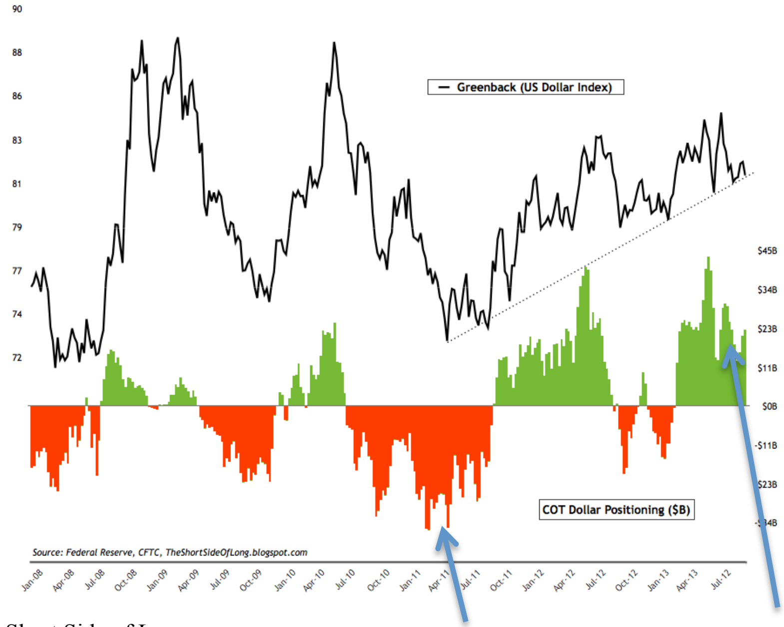
Last week we discussed some of the key technical similarities between the last debt-ceiling showdown in 2011 and the current episode. This week we wanted to touch on one of the *major* differences. In the summer of 2011, the US dollar was in the process of making a major bottom after a nasty 18-month decline.

US Dollar going into 2011 Debt Ceiling Showdown

This washed-out position meant that the dollar was not as vulnerable to the resulting shock from a US debt downgrade. The next charts show that we now have the polar opposite situation. The US dollar is one of the most popular currencies among speculators after a two-year uptrend; it is very vulnerable to weakness should the debt-ceiling showdown drag on or even if it is resolved with a higher ceiling. It may very well turnout to be a lose-lose proposition given the set-up.

US Dollar going into 2013 Debt Ceiling Showdown

US Dollar and COT Speculator Positioning Chart (2008 – Present)



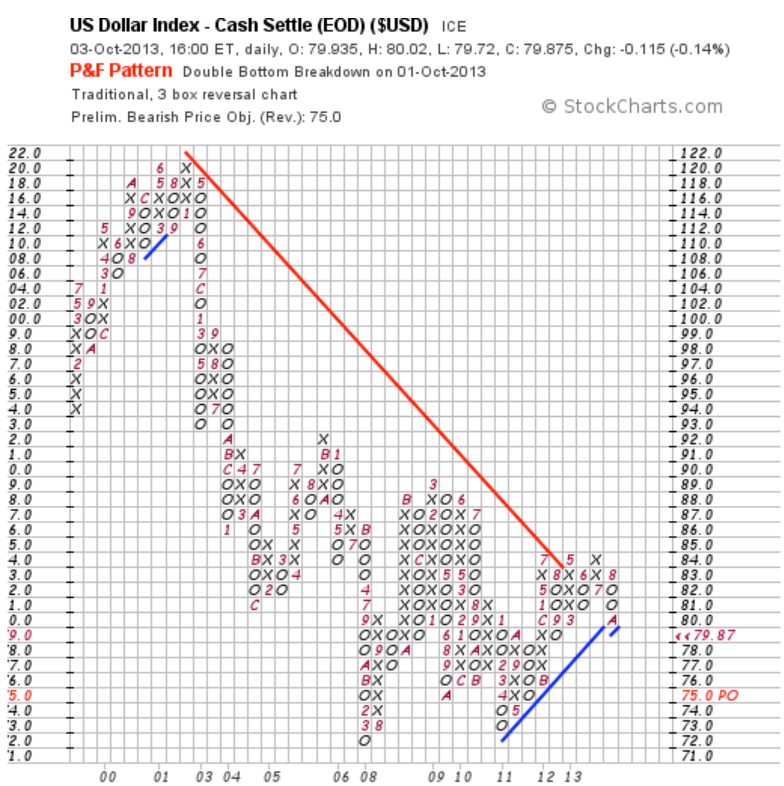
Source: Short Side of Long

US dollar was heavily shorted and ripe for a rebound in 2011.

Much more "crowded" trade now than in 2011. This leaves the dollar more vulnerable to a debt-ceiling shock.

The long term Point & Figure chart of the US dollar since 1999 further illustrates the key inflection point that exits at the present moment. A move to 79 in the US Dollar Index would break the two-year uptrend and reassert the primary downtrend that began in 2001.

US Dollar Index (1999 – Present)



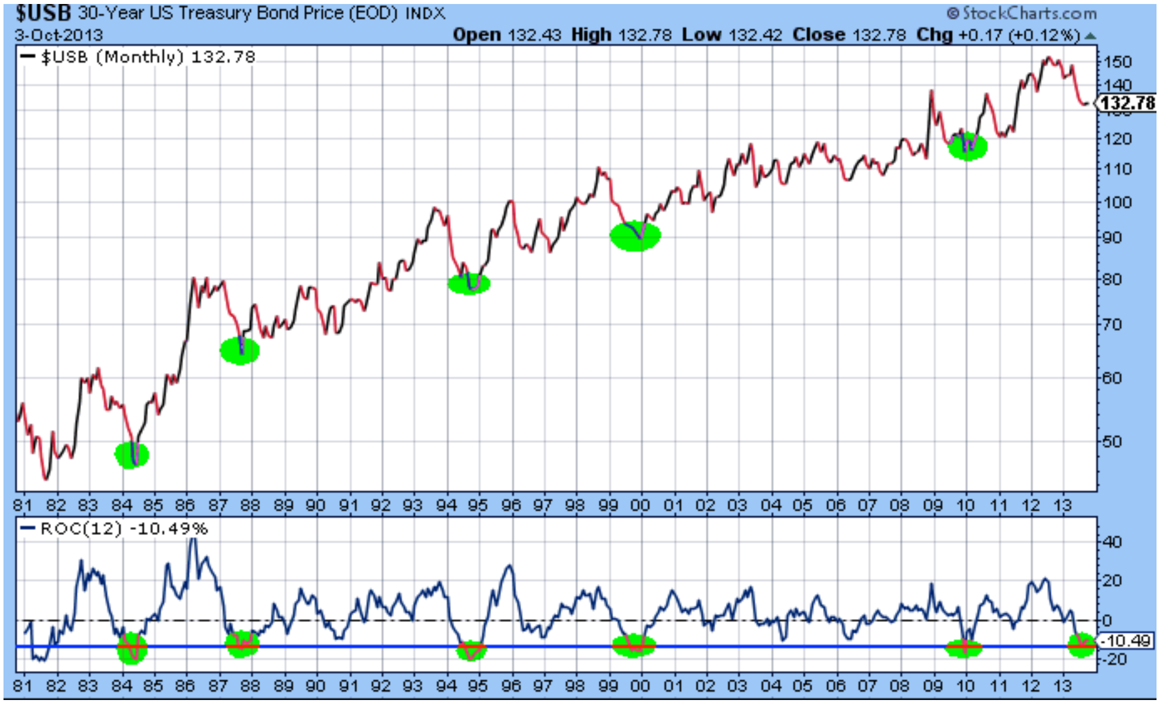
While the US dollar is one possible causality from the government shutdown/debt ceiling drama, the other is the forward momentum in the US economy. We have maintained that the two endgames of the Federal Reserve's reckless monetary policy are either another debt deflation financial crisis or a prolonged period of very uncomfortable inflationary pressure. The key to portfolio management is to have both risks covered because it is impossible to know exactly how the tug of war between these two opposite forces will play out. A breakdown in the US dollar would contribute to the inflation outcome, but this is not a given considering the deep structural issues of the Japanese Yen and European Euro (the dollar's two chief competitors). If the US economy were to meaningfully slow down in the months ahead, then the odds of a debt deflation scenario would increase. Cash and US Treasury bonds would be the best assets to protect against this deflationary outcome. Japan is the best example of a country stuck in a long-term debt deflation trap. Ever since their debt bubble popped in 1990, any meaningful rise in yields has automatically choked off any hope at economic recovery. In this negative feedback loop, it has paid to allocate money to the bond market after each period of rising rates. This has helped to preserve capital in the recessionary periods caused by this perpetual cycle. Rates on Japan 10-year government bonds have gone from 8% in 1990 to 0.65% at present. At 2.7%, the US 10-year bond is still a long way from 0.65%.

Japan Government Bond- 10-year Yield (1990 – Present)

Source: Trading Economics

Bond prices move inversely to bond yields, so a rise in yields means lower bond prices and vice versa. Given the brutal price sell-off (and corresponding yield spike) in the US Treasury market over the past year, it makes sense to add some deflation insurance at prices that are well below last years cost (yields well above last years levels). The magnitude of this bond market sell-off can be seen below. Over the past 30 years, any time the price of the US long-bond declined this much over the past year, it marked a prudent time to add some exposure to falling interest rates. The green highlights on the bottom pane are the big year-over-year declines in price similar to the one we have just experienced and the green highlights on the upper price chart show the tendency of these to mark major bottoms.

30-Year US Treasury Bond Price (1980 – Present)

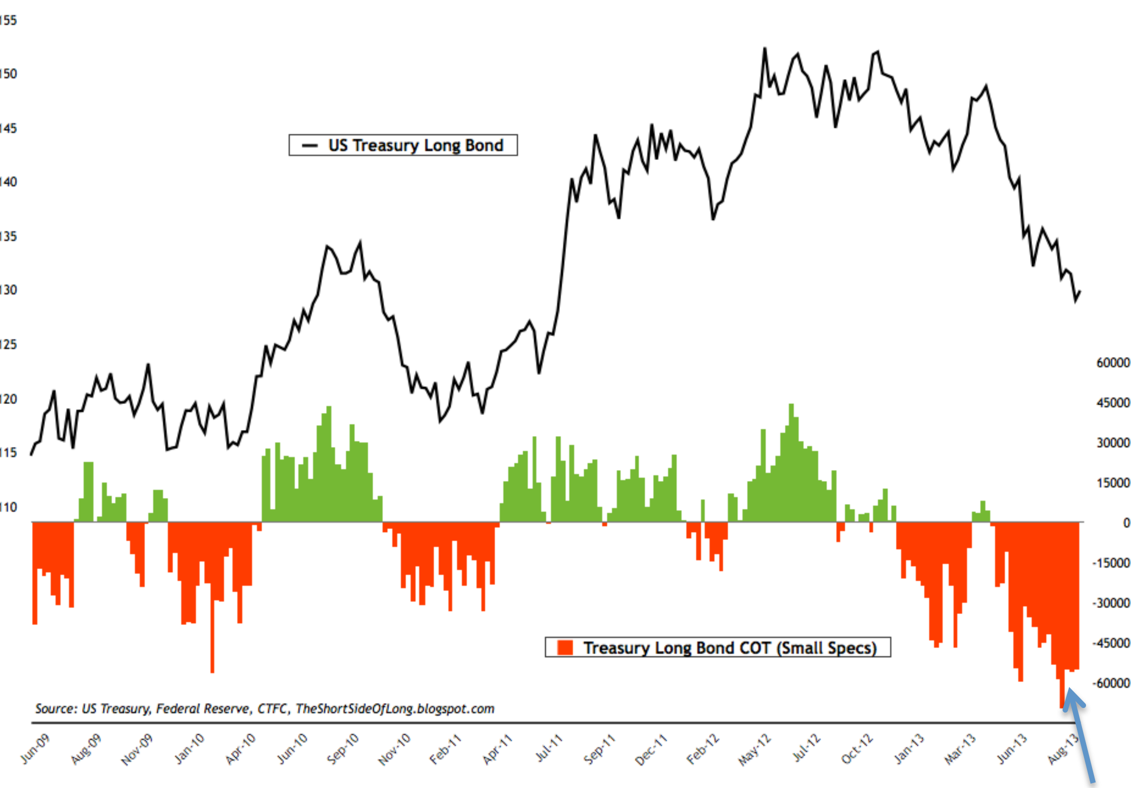


The next chart captures the inverse relationship between price and yield. The red highlights on the bottom pane are the big year-over-year yield spikes similar to the one we have just experienced and the red highlights on the upper yield chart show the tendency of these yield spikes to mark major peaks in yields.

30-Year US Treasury Bond Yield (1980 – Present)

One other reason that Treasury Bonds are interesting at this moment in time is that they are universally hated by investors and therefore present a contrarian buying opportunity. A recent Bank of America Merrill Lynch poll showed a net 68 percent of investors are *underweight* bonds, the lowest since April 2006. The following chart shows that short-term speculators are unanimously betting against bonds right now. That leaves a lot of room for investment demand to chase the price higher once demand returns.

US Treasury Long Bond Price (top line) and COT Speculator Positioning Chart (2009 – Present)



Massive short position in US government bonds is a contrarian signal that supports our turnaround thesis.

The bottom-line is that deflation/recession insurance is on sale and we feel it is a prudent diversification to gradually put *some* cash in this direction in the event we have a recession and a return to asset deflation/lower yields. After all, this economic expansion has now entered its fifth year and there are still many signs that the US economy could be caught in a Japan style debt/liquidity trap. Historically, this means we are in the late innings and due for another economic contraction. The yield and capital price appreciation potential of treasury bonds, up and above cash, makes this an attractive "deflationary playbook" alternative to 0% money market funds.