The Starboard Side Report

The week ending October 18, 2013

We have said many times that this grand monetary experiment by the US Federal Reserve will eventually end in one of two fashions. Either another financial crisis like 2008 where the excessive bad debts in the system are finally allowed to default (deflation) or there will be a spectacular inflationary episode where the debts are inflated away (inflation). These are really the only two ways out of the mess left behind by the epic real estate bubble. The second option is the most appealing to a political class relentlessly determined to stay in office, so it is the one being pursued with the most vigor. The problem over the past two years for the powers that be is that there has been a very pronounced global slowdown that has sucked many inflationary pressures out of the global economy. Therefore, despite printing trillion of dollars, inflation (especially commodity inflation) has really been a non-issue. This has created a sweet spot for risk assets like stocks and corporate bonds (especially in those countries printing the most money like US, Japan and the UK) and allowed the US dollar to rally on the global stage. With traditional assets like stocks and bonds doing so well, concern about inflation on the part of financial market participants is at extremely low levels. This lack of current concern about the destructive effects of inflation can be easily characterized as complacency. This is the polar opposite situation that we had in 2011. As we mentioned in our October 4th report, the major difference between the 2011 debt ceiling showdown and the current battle was the position of the US dollar. At that time we said the following: *In the summer of 2011, the US dollar was in the process of making a major bottom after a nasty 18-month decline. 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.* We found it interesting that the day after the stalemate was resolved, the dollar tanked. At best, the dollar is due for a mean reversion trade to the downside or, at worst, a disorderly decline due to the can-kicking going on in D.C.

In the next few charts, we will try to point out the implications should the US dollar's two year countertrend rally be reaching the end of the road. The first key point we want to illustrate is that the direction of the US dollar is a big determinant on how US citizens want to invest their capital. The first chart below is divided into two panes. The US dollar index is in the top pane and the MSCI Emerging Market Index is in the bottom pane.

As you can see, when the dollar falls, emerging market stocks tend to rally strongly as they did between 2002 and 2008. On the flipside, when the US dollar rallies (yellow shaded areas) the emerging market stock index declines as liquidity is withdrawn. The dollar uptrend that began in 2011 is one of the main reasons that the emerging market trade has been a disaster for US investors since 2011.

US Dollar Index (top pane) and Emerging Market Stocks (bottom pane) [2001 – Present]

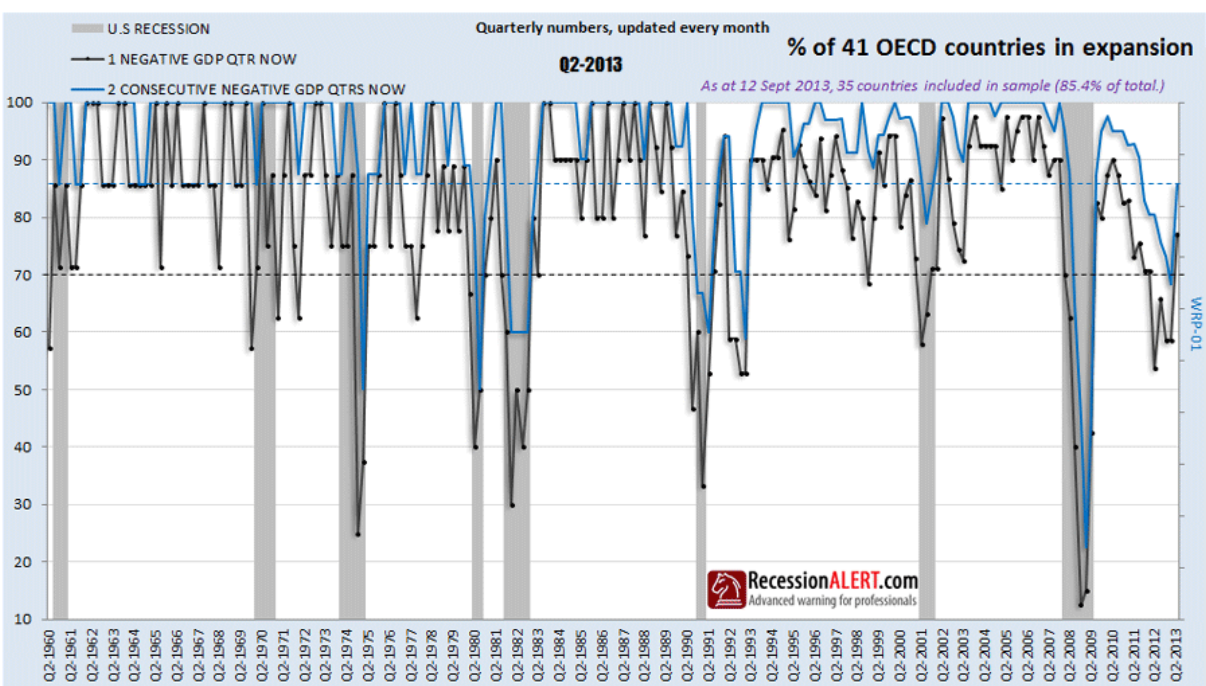
In 2011, when we saw signs that the US dollar was about to enter into a rally period, we took emerging markets from about 20% of our assets to 0% (where they remain). As the next chart below shows, emerging markets have had a dreadful period of underperformance versus the US since 2011, so avoiding emerging markets has been a good strategy. Since May of 2011, the MSCI Emerging Markets Index is 14% lower while the S&P 500 is 27% higher; a forty one percentage point performance gap!! Said another way, emerging market stocks have lost 41% relative to the S&P 500 over the past thirty months. Whenever we see this type of performance discrepancy, we look for signs of a bottom or key inflection points in the relative relationship. Those same signs that told us that it was time to get out of emerging markets in 2011 are now starting to point to the winds of change blowing in favor of emerging markets once again.

Emerging Markets Relative Strength versus the S&P 500 (2001 – Present)

If in fact the US dollar is making a major top, then it could be the catalyst to pass the liquidity baton from the US back to emerging markets. Notice how powerful emerging market relative strength was between 2001 and 2008 as the Greenspan Fed weakened the dollar much as Bernanke is trying to do now.

The fundamental underpinnings of the emerging market decline over the past two years has been a pretty brutal global slowdown caused by inflation pressures in China and the European debt crisis. Both of those headwinds have subsided and it appears as if global growth is starting to rebound as per the chart below.

% of 41 Major Global Economies in Expansion (1960 – 2013)



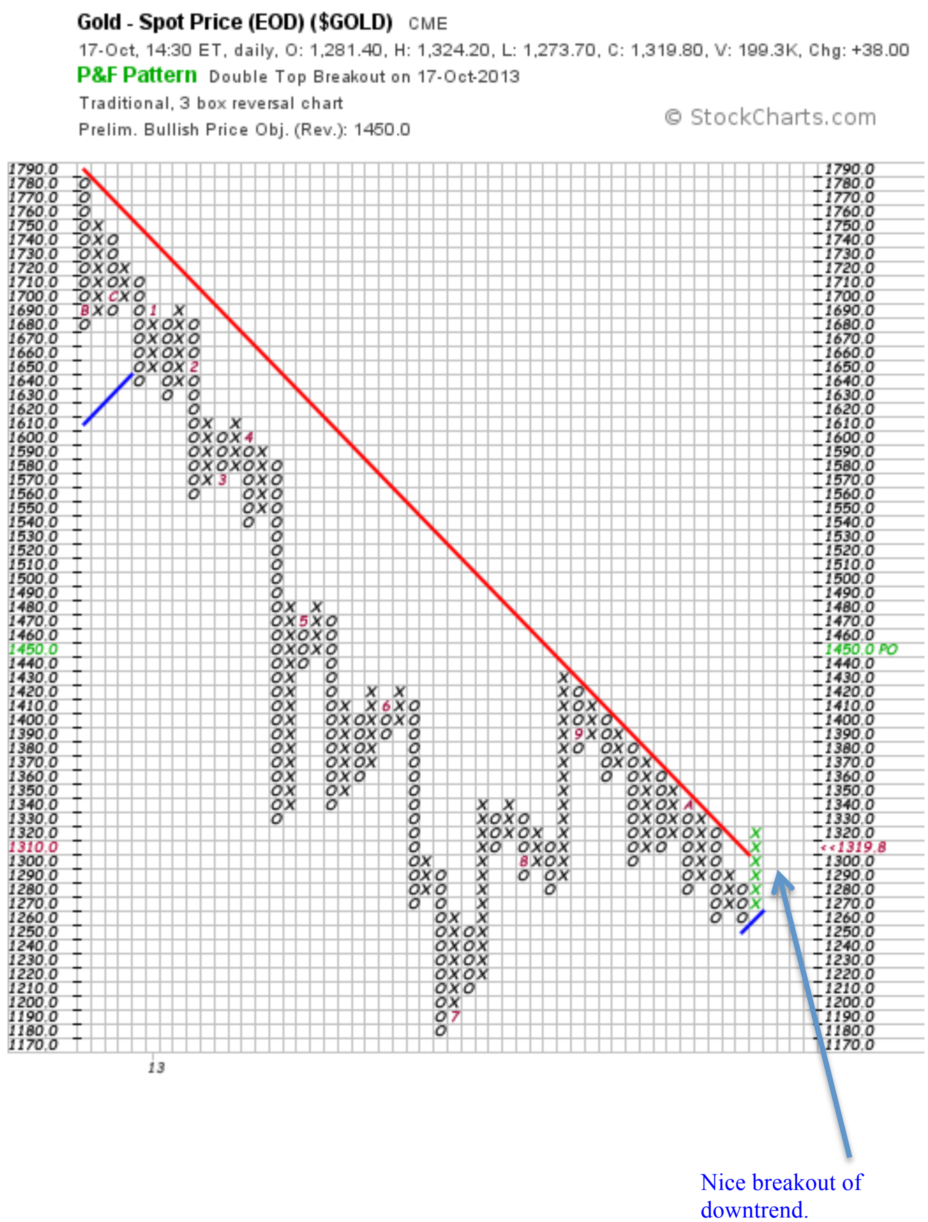
The essential take away from this busy chart above is that the slowdown that hit in 2011 was one of the worst for the global economy since 1960. Almost 40% of the global economy was mired in recession over the better part of the last two years. The fact that the US stock market was able to skate through this global economic contraction relatively unscathed is mainly due to the mean reversion bounce in the US housing market in addition to the S&P 500's relatively high weighing of less cyclical consumer defensive stocks. The good news for global stock markets is the worst of the contraction appears to be over with fewer and fewer countries in economic contraction mode. This is being reflected in the hardest hit areas of Europe (as we pointed out last week) and the emerging world.

One area of the emerging world that has been hit particularly hard has been the small company segment. In the chart below, you can see that small cap stocks in China have lost 50% of their value versus small cap stocks in the US since 2010. More importantly, they appear to have made a bottom this summer right at the support line drawn from the 2008 low.

Guggenheim China Small Cap Fund Relative Strength Versus Russell 2000 Small Cap Fund

The Federal Reserve has come out and appeared to postpone "tapering" of quantitative easing due to their fear of upsetting the apple cart. It seems as if there will always be an excuse for why is not the right time to stop the money from flowing. The decision not to taper policy at this time was a direct benefit to emerging markets (a back door bailout) that could really start to see the wall of money shift from the more overvalued US dollar assets to the downtrodden rest of the world. It seems to us that it is a good time to start to accumulate emerging market assets again in the event that the inflation "endgame" starts winning out and the dollar starts another down cycle. Again, this is not a throw all your money into emerging markets strategy because they are the most volatile of the inflation protection assets. Rather, it is simply adding sale priced insurance against one of the two probable outcomes we mentioned at the outset. A two and one half year bear market in inflation insurance assets has provided US investors with a window to add some of these inflation hedges on the cheap.

Gold is sometimes viewed as the ultimate inflation insurance due to its dual use as financial system disaster insurance. Thursday was a big day in that gold had its second biggest upside price gain of the year. The fact that it occurred the day after Washington was backslapping itself for kicking the can down the road for three months is telling in our mind. As we see in the chart below, the spike higher on Thursday was important because it allowed gold to break through the red downtrend line that goes back to December of last year.



In conclusion, recent equity gains in the market have made most investors very complacent about an inflationary outcome from Federal Reserve policy. Gold, commodities and emerging market stocks are selling at a deep discount as a result. We think investors would be wise to build some inflation protection while the dollar is vulnerable and inflation hedges are being ignored.