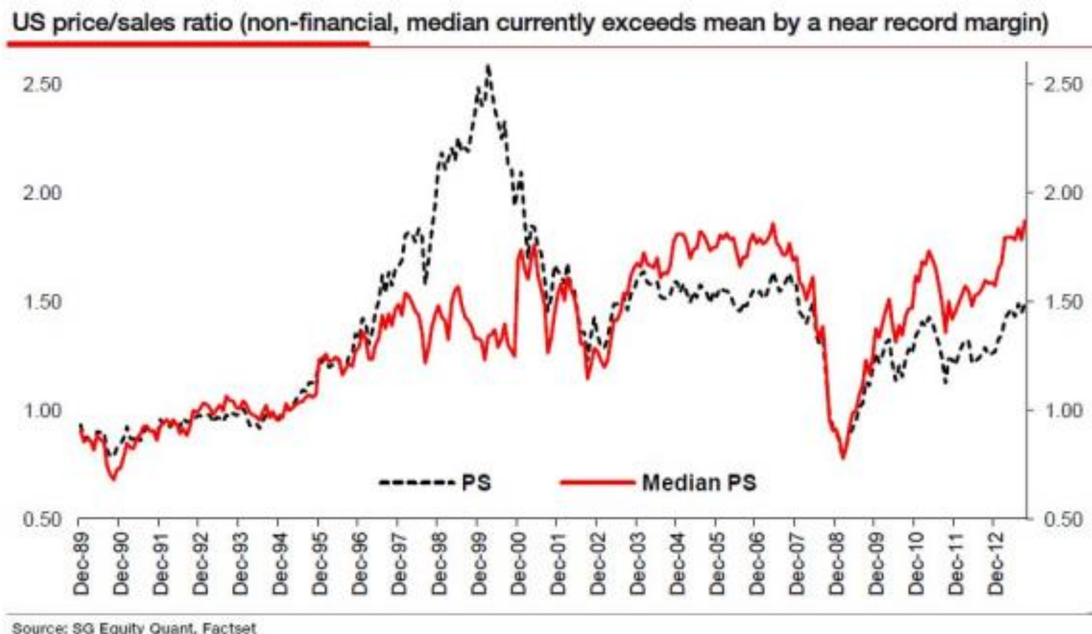
The Starboard Side Report

The week ending October 25, 2013

A company's bottom-line earnings are often the primary fundamental tool used to assess stock market value. However, in a world of zero interest rates and financial engineering, those same earnings can be massaged to produce a certain bottom line number that Wall Street likes. Given the risk of financial shenanigans on bottom line results, it makes sense to also look at top line revenues versus total stock market value in order to get a sense for whether the market is cheap or expensive at any given moment in time. The following chart shows that the median market value to sales ratio of the US market (red line) is currently at a record high. Furthermore, the median exceeds the mean (dotted black line) by a record amount. This indicates that the small and mid capitalization stocks are extremely overpriced. This is the opposite of the 2000 top when the biggest companies were more expensive and the smaller segment of the market showed relative value (mean above median). Since there are many more small and medium issues on the US exchanges, the total number of overvalued issues is much deeper than in 2000 when only a handful of large companies and one sector (technology) led to the step overvaluation.

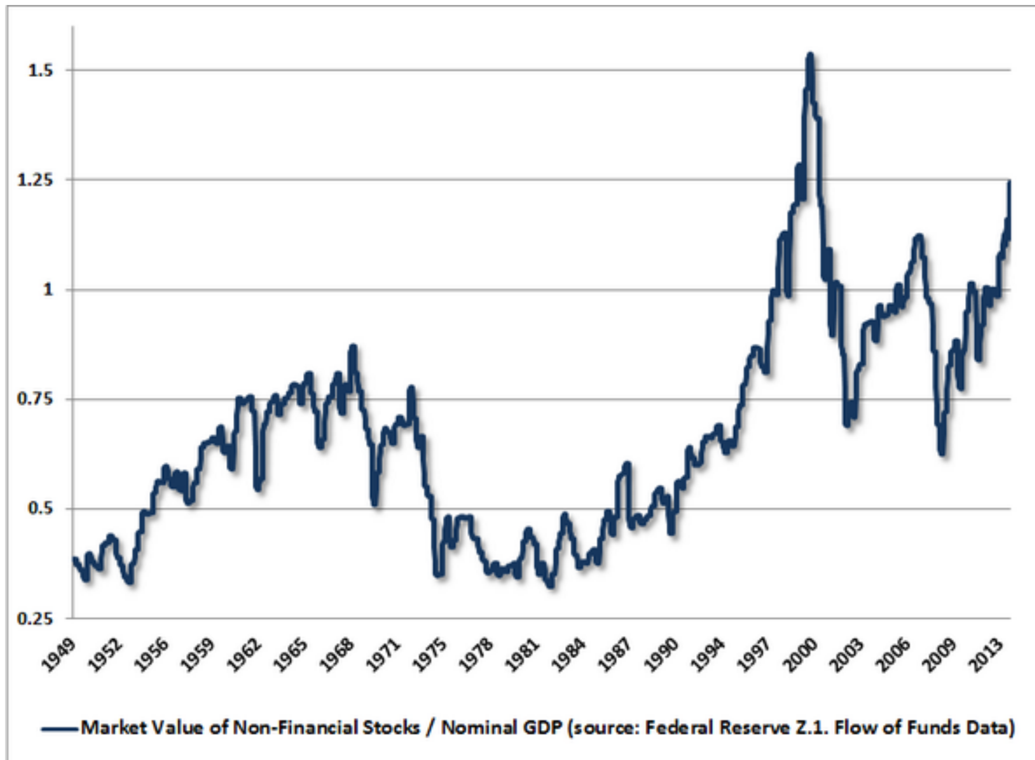
US Market Value/Sales Ratio (1989 – Present)



Source: Soc Gen Equity Research

One other broad way to look at how stocks are valued versus their revenues is to look at a chart of total US market value divided by nominal GDP (total output of the US economy). This is said to be one of Warren Buffet's favorite measures of US stocks market value.

US Market Value of Non-Financial Stocks to Nominal GDP (1949- Present)



Source: John Hussman

As you can see on the chart, the US stock market value (excluding financial stocks) is currently more expensive than 2007 and rapidly catching up to the massive 2000 bubble top. The prior two long-term bear markets that ended in 1950 and 1982 had a market value to nominal GDP of 0.30 when they bottomed versus 1.25 at present. That attractively priced prior bear market bottom value level of .30 is some 75% below current levels! For an economy barely growing at 3% before inflation, it will take many years for stocks to "grow into" their current valuation. Investors are clearly stealing returns from the future right now. Either way you slice it, both the top and bottom lines of the corporate income statement show an extremely overvalued US stock market that in no way points towards the start of a new bull market.

Relative performance analysis is a key aspect of our decision making process. The problem that we have run into over the past two years is that the areas of the market with the strongest long-term relative performance have had the weakest short-term relative performance. Gold, commodities and emerging markets have been the best overall performers since the US stock bubble first peaked in 2000. Yet, since the middle of 2011, a cyclical global slowdown in the emerging world, in conjunction with a cyclical recovery in the US real estate market, made the strong weak and the weak strong. We have spelled this out in the graphic below. The first column shows the performance of various assets from September 2000 up until today (long-term relative strength) and then those same assets since May of 2011 (short-term relative strength).

The Strong Shall Be Weak and the Weak Strong

Symbol	Description	% Chg since Sept 2000	% Chg since May 2011
GLD	Gold	375.0	-14.75
SLV	Silver	325.0	-53.55
GDX	Gold & Silver Mining Index	196.1	-57.99
XME	Broad Metals and Mining Index	169.6	-47.57
XLE	S&P Energy Sector	165.9	6.96
VWO	Global Emerging Market Stocks	137.9	-17.23
GCC	Commodity Index	72.6	-27.03
DIA	Dow Jones Industrial Average	38.3	21.07
EFA	Global Developed Market Stocks	23.0	5.03
SPY	S&P 500	15.5	28.49
UUP	US Dollar	-26.2	1.81
XLF	S&P Financial Sector	-27.0	26.8
XLK	S&P Technology Sector	-41.0	24.64

The first thing you will notice is that the seven strongest performers since 2000 have all been weak since May of 2011 (far right column), with an average decline of 32.15%. Yet, despite this two-year setback, this group of seven strong long-term performers is still up 206% on average since September 2000. On the flip side, the six weakest performers since 2000 (shown in the bottom half of the table) are 18% higher since May of 2011, yet 2.96% lower on average since 2000! The benefit of the doubt still rests with the strong long-term relative performance assets despite having been in a downtrend over the past two years. If any chart encapsulates this long-term versus short-term performance dynamic, it's the relative strength performance chart of gold and silver versus the S&P Financial Sector.

Central Gold and Silver Fund versus S&P Financial Sector (1999 – Present)

The gold and silver in this picture is the Central Fund of Canada, which owns both gold and silver bullion. The contrast between long-term strength and short-term underperformance is stark. Furthermore, we appear to have reached a key inflection point. Gold and silver are trying to make a relative strength bottom at a washed out momentum level (green box in bottom pane) and right above the long-term uptrend line.

The same dynamic can also be observed when the commodity index is compared to the S&P Financial sector. It shows long-term relative outperformance versus the financial sector since 2000 despite a two-year cyclical corrective phase.

CRB Commodity Index versus S&P Financial Sector (1999 – Present)

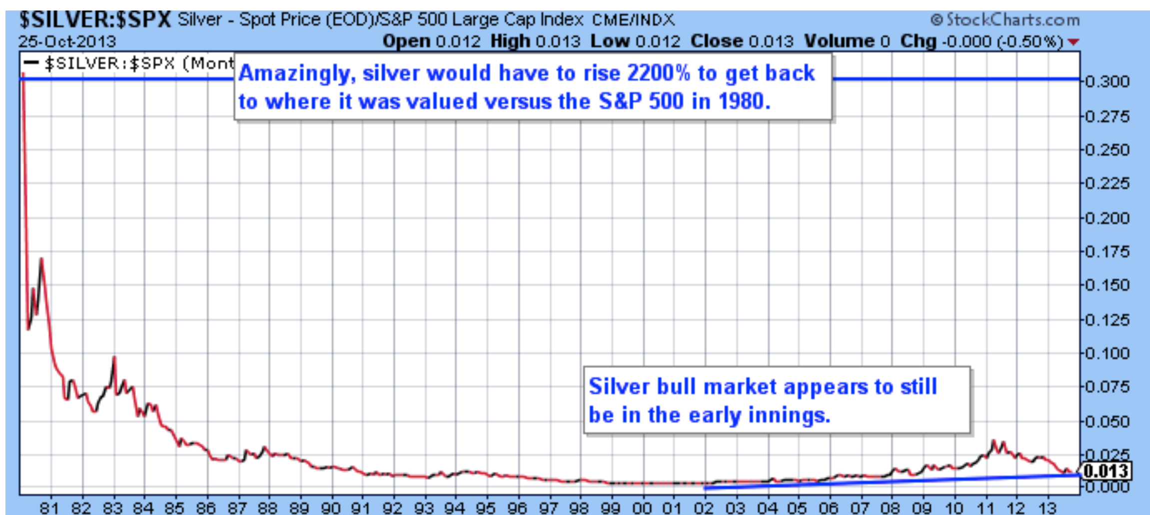
Despite what the financial media would have you believe over the past year, it has been gold, silver, commodities and emerging market stocks that have grown capital the best since 2000; not technology and banking stocks We expect the bottom that has been forming in gold (and some commodities) since June to hold in the weeks ahead as the market comes to grips with the fact that the Federal Reserve is trapped and will be unable to stop their money printing for fear of sending the fragile global financial system back into the abyss. Perpetual money printing should start to reawaken interest in the depressed precious metals and commodities sectors given their historic roll as a store of value during times of monetary excesses. Until these charts start to break the long-term uptrend lines that go back to 2000, then we remain convinced that gold and commodities still have more room to run in their bull market and that the financial sector in the

US still has lots of downside risk. The last two charts show how undervalued gold and commodities are versus the S&P 500 from a *very* long-term perspective.

Gold versus S&P 500 (1980 – Present)

Gold currently trades at a ratio of 0.77 times the value of the S&P 500. In 1980, at the peak of the last gold bull market it traded at 6 times the value of the S&P 500! This is a barometer of value between hard assets and financial assets that points clearly in favor of hard assets.

Silver versus S&P 500 (1980 – Present)



Silver currently trades at a ratio of 0.013 times the value of the S&P 500. In 1980, at the peak of the last gold bull market it traded at 0.30 times the value of the S&P 500. Silver would have to rise 2200% from $22 to $500 in order to have a similar relative relationship. It is probably a stretch to say silver will get back to the relative relationship, but this chart points to silver still being a good value despite the recent 65% decline over the past two years. The bull market

uptrend line from the 2000 bottom is still intact, so we believe the pullback is a temporary one not a permanent loss of capital or the start of a long-term bear market for silver.

CRB Commodity Index versus S&P 500 (1980 – Present)

Finally, commodities would need to rise 350% to get back to where they were in 1985. Therefore, the long-term bull market in commodities also appears to have a lot of life left despite recent declines on both an absolute and relative basis.

To bring it all together, the first segment of this report was used to help show the overvalued nature of the US stock market when compared to the revenues of the underlying companies. The second part was to show that there is good relative value to be found in those assets that have far and away been the best performers over the past thirteen years despite their correction over the past two years. In a world of non-stop quantitative easing it all becomes a relative game. We feel that the pendulum has shifted too far in the favor of US stocks and is due to start heading back towards those assets (like gold, silver and commodities) that are actually in a *big picture* structural bull market.

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