The Starboard Side Report

The week ending November 1, 2013

By numerous measures (many of which we have discussed in past versions of this report) the US stock market is among the most overvalued in the world (not to mention in its own 130 year history). Yet, despite this severe overvaluation, the S&P 500 is blowing the socks off of a properly diversified portfolio. The following table sums this up nicely.

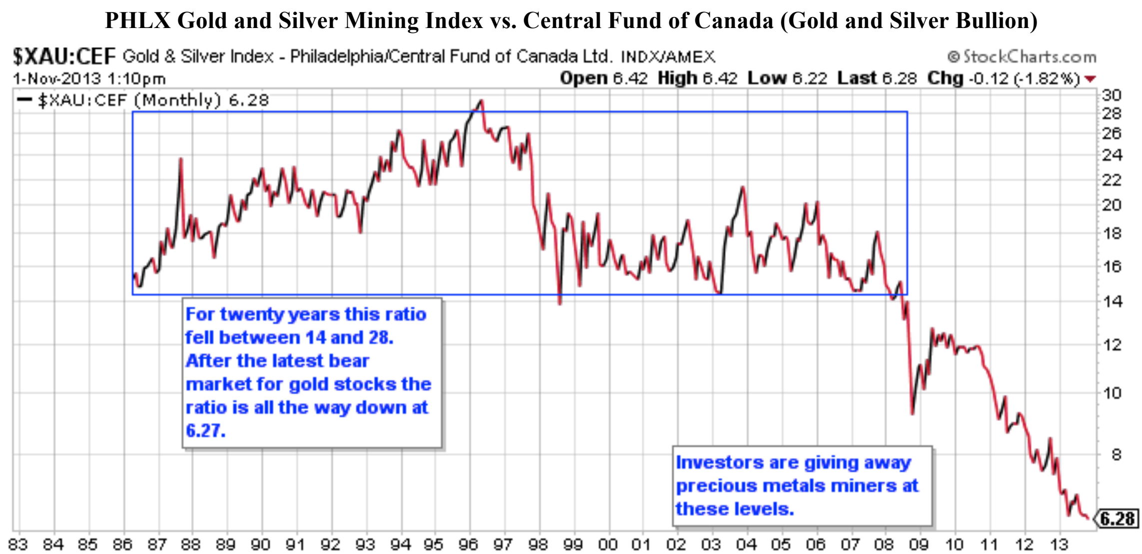
Symbol	Description	% Change YTD
SPY	SPDR S&P 500 ETF Trust	23.44
ICF	iShares Realty ETF	1.41
IRX	Cash/Money Market	0.04
JNK	SPDR Barclays Capital High Yield Bond	-0.2
MBB	iShares Barclays MBS Fixed-Rate Bond ETF	-1.43
EEM	iShares MSCI Emerging Markets ETF	-4.26
LQD	iShares iBoxx $ Investment Grade Corp. Bond ETF	-4.79
GCC	GreenHaven Continuous Commodity Index	-9.23
EMB	iShares JP Morgan USD Emerging Markets Bond ETF	-9.32
TLT	iShares Barclays 20+ Year Treasury Bond ETF	-11.17
GLD	SPDR Gold Trust	-21.16

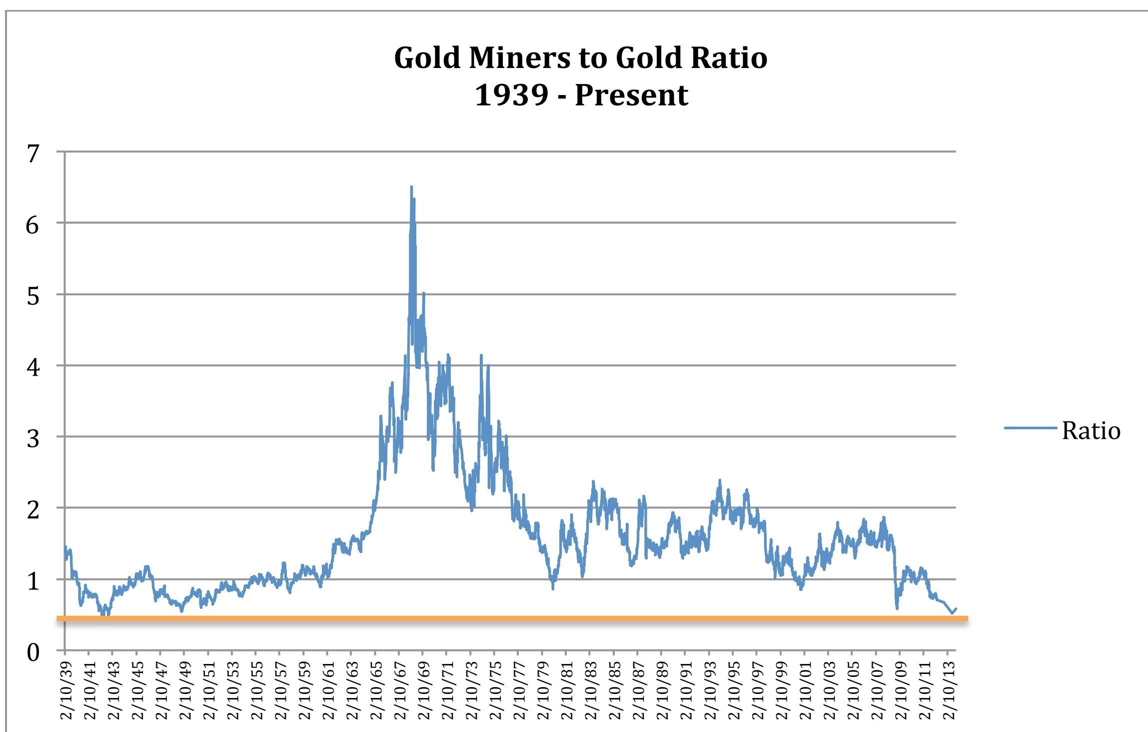
Foreign and domestic bonds, cash, commodities, real estate, emerging market stocks and precious metals are all key diversifiers that help offset the risk and volatility inherent in a US equity portfolio. Amazingly, the average of the ten non-S&P 500 funds representing this diversifying group in the table above are down 6.0% on average this year versus a gain of 23.4% for the main US stock index! If you wanted to get return this year, you would have had to take an extraordinary amount of equity risk in order to do so. This is usually what we see late in a market cycle and it is how the majority of late comers wind up nursing big losses once the momentum reverses down. In our opinion, those that are piling into US stocks at the moment, and fleeing a prudent diversified strategy, are making a classic mistake. Five years ago was the time to seek out risk. It is distressing that those investors that were paralyzed by fear in 2009 are now jumping on board the equity train five years after it left the station. They are blind to the fact that the higher the market climbs the more painful the crash will be. We can say this with some confidence because the last 400 points in the S&P 500 have occurred with very little improvement in earnings per share. This means it is *momentum and liquidity* that have driven the price into the stratosphere, not fundamentals. The US Federal Reserve has essentially turned US stocks into commodities; units to be traded solely on supply and demand. Once the liquidity spigot is turned off, stocks will crash lower in line with the fundamentals. The counter intuitive and tricky aspect to investing in the stock market is that the periods that seem the best (when

everyone wants to own stocks) are actually the riskiest periods to be involved. On the flip side, the time to seek out risk is usually when volatility is at its highest and things seem to be at their worst. At major market bottoms, investors incorrectly confuse volatility with risk.

We believe this concept, of confusing volatility with risk, is what market participants are doing in the precious metals mining stocks at present. Despite the fact that the sector has been making a volatile *bottom* since June, these stocks are still loathed by investors. Nothing shows that distain more clearly than a simple ratio comparing the Philadelphia Gold & Silver Mining Index (XAU) with the cost of the metals that they produce. Investors are simply throwing away gold and silver miners in an indiscriminant manner. This can be observed in the following two charts.

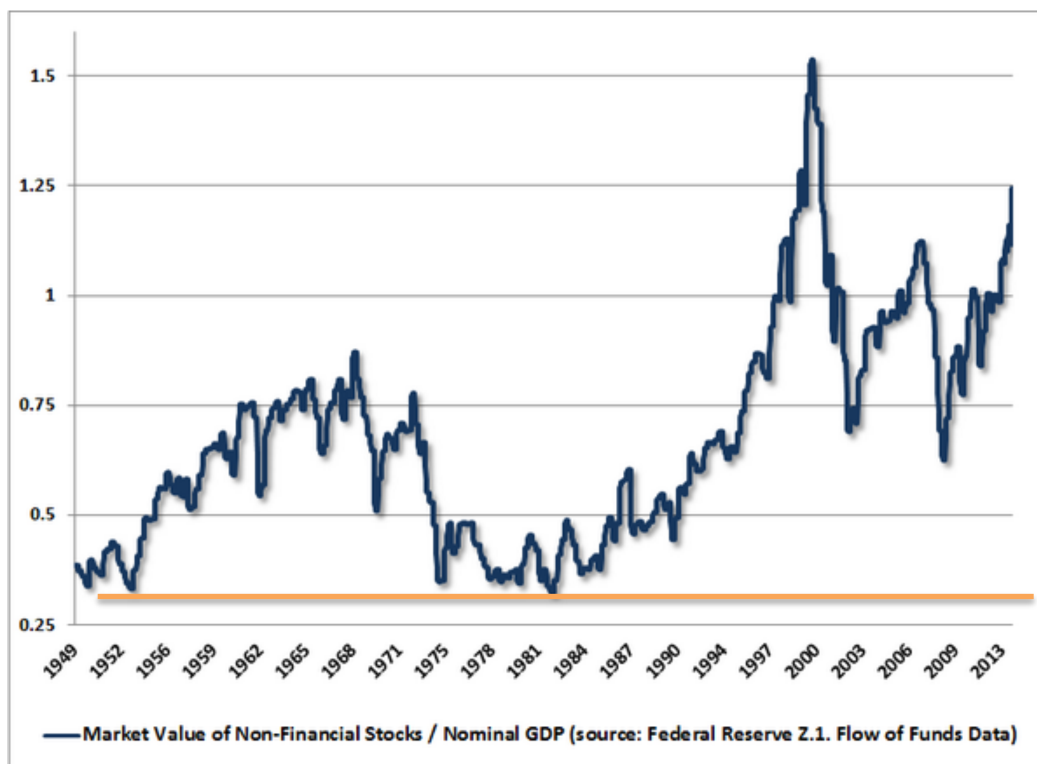
PHLX Gold and Silver Mining Index vs. Central Fund of Canada (Gold and Silver Bullion)





The first chart above shows a thirty-year view of the XAU versus the Central Fund of Canada (a closed-end fund that owns gold and silver bars in near proportional amounts). As you can see, the disconnect is literally off the charts with the ratio 57% below the low-end of the range that held for over two decades (1986 thru 2008). In the second chart, we zoom out even further to look all the way back to 1939 in order to see how the Barron's Gold Mining Index (an index with a longer history) is valued versus gold. As you can see, the ratio is at an all time low. This indicates that gold mining stocks have almost never been this cheap over the past seventy-five years. This is a rudimentary price-to-sales ratio for the gold mining stocks much as the chart we showed last week of the US stock market to GDP ratio was a basic look at a price-to-sales ratio of the US stock market. As a refresher, here is that chart again.

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



Source: John Hussman

Bottom line: The argument can be made that the US market has never been as overpriced as it is at present (other than a few months at the peak of the technology bubble in 2000), whereas gold mining stocks have never been this cheap (other than major bottoms in 1942 and 2008). The volatility inherent in the bottoming of gold mining stocks should not be confused with risk due to the significant value that exists in this sector. In the same vein, the complacent desire for investors to own US stocks at all-time highs (and nosebleed valuation levels) should not be confused with a good opportunity.

For the fourth time in the past twenty years the relative relationship between the US market and Emerging Markets has reached a very important inflection point (blue line on the chart below). In 1997, a breach of this level (labeled as point 1) marked a key breakdown where the emerging markets accelerated lower as money continued to flow aggressively towards the US market and out of emerging markets. In both 2006 and 2008 (labeled as points 2 and 3 on the chart), this relative level marked the opposite inflection point whereby the emerging markets ended a period of poor relative performance versus the US and then began a two-year period of outperformance. This summer the emerging markets bounced off of that same level (point 4) and appear to be making another relative bottom versus the US markets.

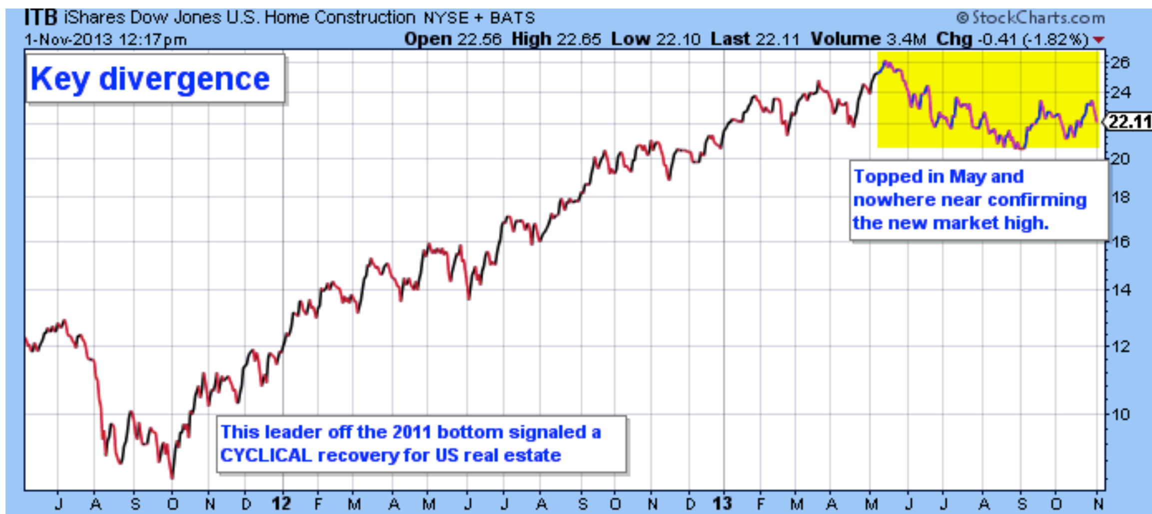
Emerging Markets vs. S&P 500 Index (1996 – Present)

We are beginning to position portfolios as if the emerging market stabilization since July is the start of a meaningful relative reversal and that the emerging markets will start to once again outperform the US. The 1997 scenario of downside acceleration seems less likely to us at this point. While emerging markets have their own issues with debt excesses, their equity markets are generally much more attractively valued than the US market. Said another way, there is a lot more bad news priced into emerging market shares. We will be very disciplined with the approach and pull the plug should we see this relative strength chart reverse and decisively break that key line in the sand we have drawn.

There are a few key issues that we are watching that show that all is not well with the latest move to new highs in the US stock market. Two of the leading sectors off of the bottom in 2011 were home construction and banking. If there was any silver lining and fundamental improvement in the US economy over the past two years it has been in the real estate market. Given this fact, one would very much like to see this key sector confirming the market's new record highs. As

we show next, this just is not the case. Rising interest rates have really stalled momentum in these interest sensitive parts of the economy.

Dow Jones US Home Construction Index (June 2011 – Present)



KBW Bank Index (August 2011 – Present)

The transition period from old leadership sectors to new ones is rarely seamless. If somehow the US market rally were to continue, we'd at least expect a big shakeout period characterized by the rotation out of the old leaders into new leadership areas. These corrective shakeout periods usually cause the major market averages to fall somewhere between 10% and 20% in order to remove the excesses that have built up in the "hot" sectors. We can then watch the charts to see which sectors/countries hold up the best during the correction and those that lead coming off of the final correction bottom to make a determination where the new relative strength will come from.

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