The Starboard Side Report

The week ending November 8, 2013

Last week we stressed the challenging nature of the capital markets this year in that all of the return is being driven by one of the riskiest asset classes (equities). Portfolio diversifiers like bonds (foreign and domestic), real estate, emerging market stocks, commodities and precious metals are all negative for the year. The really dangerous disconnect is that this reach for risk is occurring right at the moment that history tells us that stocks are at their most vulnerable for a major decline. Similar valuation set-ups have left US stock investors nursing losses of between 40% and 70% once the cycle turns negative. Of all the major US stock indices, the Nasdaq Composite appears one of the most vulnerable to a big decline.

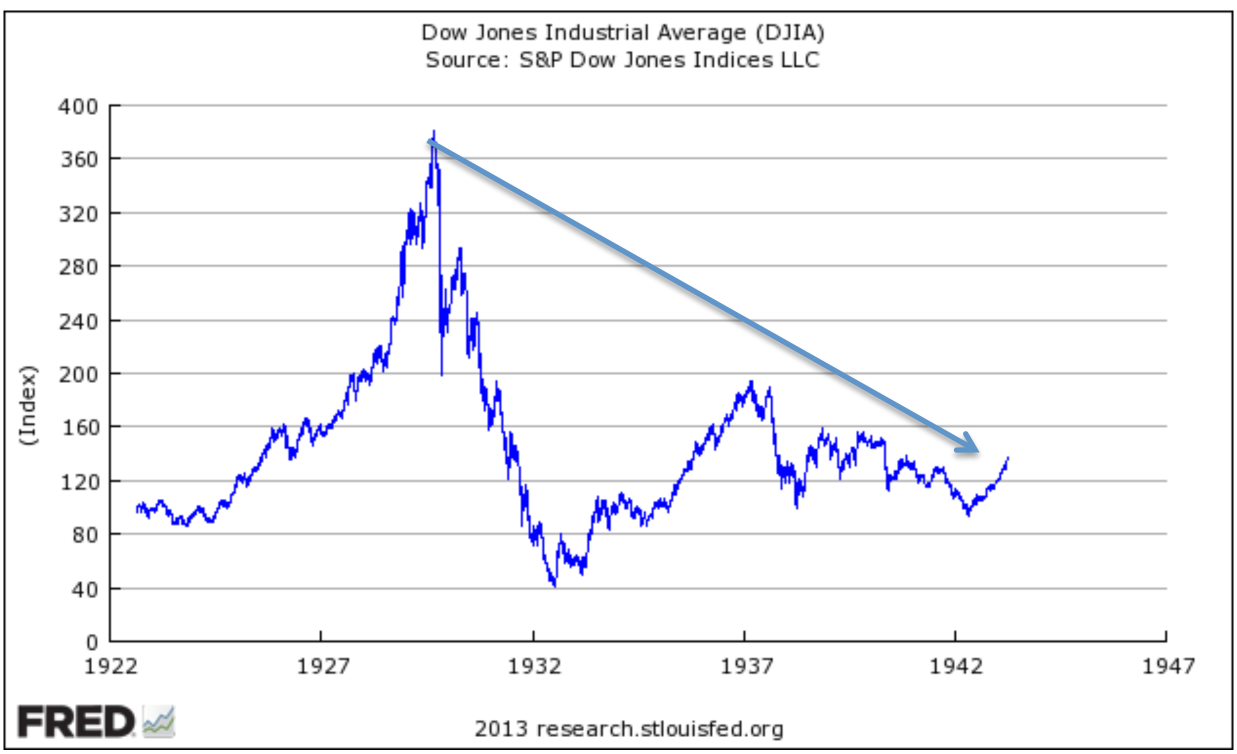
While we can talk about overvaluation metrics until we're blue in the face, sometimes it takes a visual to see how stretched things really are. Here is a chart of the Nasdaq Composite Index that captures the epic 2000 bubble top and the bumpy road since that March 2000 peak. Thanks to the Fed's endless liquidity dump, the stage is now set for the third Wile E. Coyote style market drop in the past thirteen years.

Nasdaq Composite Index Echo Bubble (1994 – Present)

On the bottom pane we have included a RSI momentum index that shows where the momentum level was at both the 2000 and 2007 cycle ending peaks (red arrows). As you can see highlighted in yellow, RSI level is once again back above 75 as it was at those major tops. This is not an automatic crash and burn trigger, but it is a clear red flag warning that the end of the cycle is near. No one knows quite when the bull market cycle end will arrive, but partygoers are certainly dancing around with lampshades on their heads after being over-served at the Federal Reserve's bottomless punchbowl. Make no mistake though; the end will arrive just as it always does. Our best guess is that it could be at *any* time over the next three months. That means tomorrow, yesterday, three months from now or any day in between. One thing is for certain, when this party is over, the hangover will be ugly and there will be major losses in the down cycle. On the chart, we have noted the declines that have followed similar set-ups. A 78% fall in the 2000 - 2002 bear market and a 56% loss during the 2007 – 2008 bear market. The blue trend line that is drawn off of those prior lows is 62% below current levels. Traders chasing the technology stocks that make up the Nasdaq are all hoping to be able to find a seat before the music stops; however, we know that not all will.

The great Nasdaq bubble of 2000 was one of the biggest in the past 100 years. We are now 13 years and 8 months from that March 2000 peak. The only two bubbles that have come close were the 1929 US stock market bubble and the 1990 Japanese stock market bubble. As a comparison, we thought that we would take a look at where those two stood after the 13 year and 8 month mark.

Dow Jones Industrial Average 1922 - 1943



Still 65% below its bubble peak 13 years later

Tokyo Nikkei Average (1980 – 2003)

When you compare these three massive bubbles it is truly remarkable that the Nasdaq is the only one that has been able to claw its way back towards its prior bubble peak in such a short time frame (it's now just 20% below the 2000 peak). Thirteen years following the 1929 peak the Dow was still 65% below its old highs. Furthermore, it took the Dow a full 25 years before it fought back to within 20% of the old high as the Nasdaq has just done. Amazingly, the Nikkei was 77% below its peak after 13 years and is now still 60% below its 1990 peak (over 23 years later)! The dreadful performance after these bubbles burst is one of the reasons we have been so cautious on US technology stocks over the past two years. After the Nasdaq rallied 140% in the two years following the 2009 low, it seemed farfetched to conclude that the Nasdaq would be able to keep climbing. Yet, here we are with the Federal Reserve miraculously able to reignite some of the similar speculative fever that burned so many just thirteen short years ago. It usually takes a whole generation before those *burned by a bubble* are tempted to go back in. Fool me once shame on you, fool me twice shame on me. What do we say to those that are about to get fooled for the third time?

One more visual to the overstretched nature of the US stock market comes from the Russell 2000 Small Cap Index. This is the most overvalued segment of the market and one of the big factors driving the Nasdaq back towards its highs. One could say that large cap stocks created the 2000 bubble top whereas the present incarnation is a small stock frenzy.

Russell 2000 Small Cap Index (1998 – Present)

This chart does a good job of laying out the risk versus reward parameters in the Russell 2000. The top pane is the price of the index itself, whereas the bottom pane is an RSI momentum index like we showed on the Nasdaq chart above. There has been a rather orderly pattern since 1998 that points to this being an extremely high-risk crossroad. The three other times that the red long-term resistance line in the top pane was hit (at the same time that the momentum line has gone above 73), the Russell 2000 has declined on average 48% down to the green long-term support line; a 38% decline in 1998, a 47% decline in 2000 and a 60% decline in 2007. The scary part is that the Russell 2000 has once again hit the long-term resistance line with a RSI above 73 and the green long-term support line is 67% below the current level of the index (as marked by the yellow arrow on the chart).

The mirror image of risk versus reward can be observed in our final chart of the gold mining sector. We mentioned last week that we thought investors were making the classic mistake of confusing volatility with risk in the beaten down gold miners. We also showed how cheap the stocks are when compared to the main commodities that they sell (gold and silver). This week we wanted to show the stark contrast between the Russell 2000 chart and the PHLX Gold and Silver Mining Index. The charts are basically polar opposites of each other. One is bumping up against its long-term resistance line with 67% downside risk to its long-term support line and the other appears to be bottoming along its long-term support line with 235% upside to its long-term resistance line.

PHLX Gold and Silver Sector Index (XAU) 1997- Present

You will notice the gold stocks have been hugging the green long-term support line drawn in the upper pane. This long-term chart does a good job of blocking out the day-to-day volatility and shows a four months bottoming process at the key long-term support line. The other interesting contrast between this chart and the Russell 2000 chart is the RSI momentum of the gold stocks (bottom pane) is washed out near 30. This level has marked two key bottoms since the gold bull market began in 2000. The green arrows at the bottom of the chart indicate this attractive risk-reward set-up.

At the risk of sounding like a broken record, we see the US stock market (especially the Nasdaq Composite and Russell 2000 Indexes) forming a massive top that exhibits horrible risk-reward characteristics. On the flip side, gold mining stocks are presenting a very attractive risk-reward set-up for patient investors; one that has all the hallmarks of a major bottom.