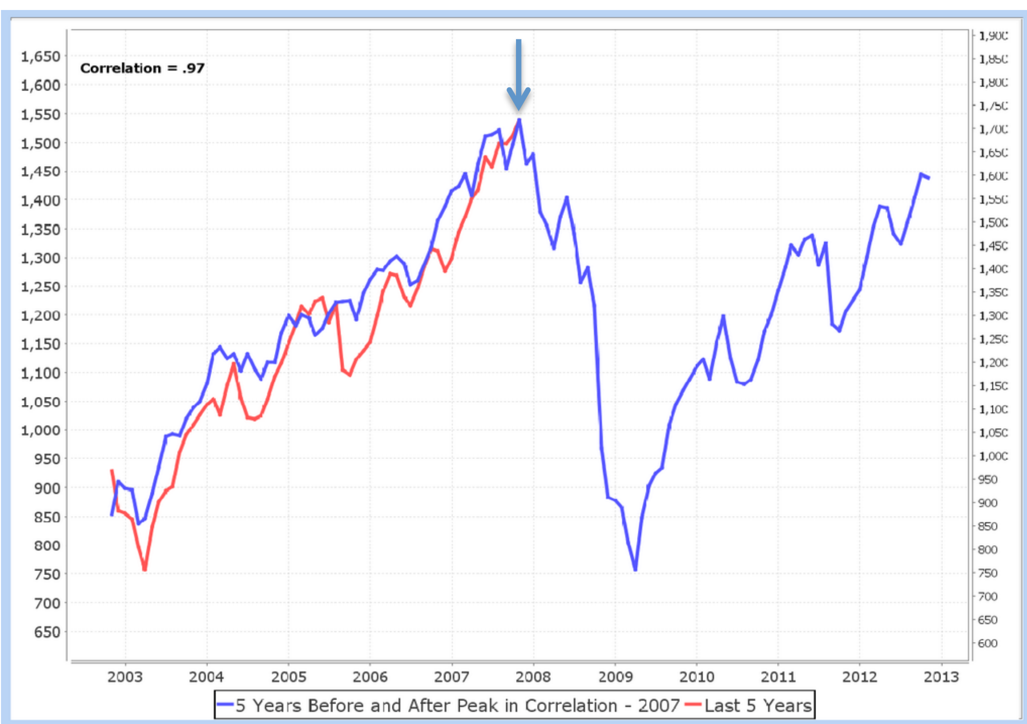
The Starboard Side Report

The week ending November 15, 2013

Many investors inevitably make a lot of bad decisions at major inflection points. Of course, these mistakes are only known through the benefit of hindsight. The perverse nature of investing is such that after an asset has had an extraordinary run, it is often the very worst possible time to be fully invested. This is especially true when markets are expensive from a valuation perspective. On the flip side, the times of greatest despair often present the best long-term buying opportunities. This is consistent with markets ultimately being driven by the statistical concept of mean reversion and the age-old emotional concepts of fear and greed. With this in mind, we wanted to share an interesting study done this week by Bill Hester of Hussman Funds. Hester took 113 years of data and ran a correlation study in order to find which historical 5-year periods had the highest correlation with the last 5 years. The results are pretty ominous and speak to the fact that investing after periods of strong returns is often met with an inevitable mean reversion. Again, this is especially true in markets that are fundamentally overvalued (as they are at present). The number one match in Hester's study, with a correlation coefficient of 0.97 (1.0 is the highest possible correlation), was the five-year period that ended in October 2007. The chart below shows how that episode ended for investors.

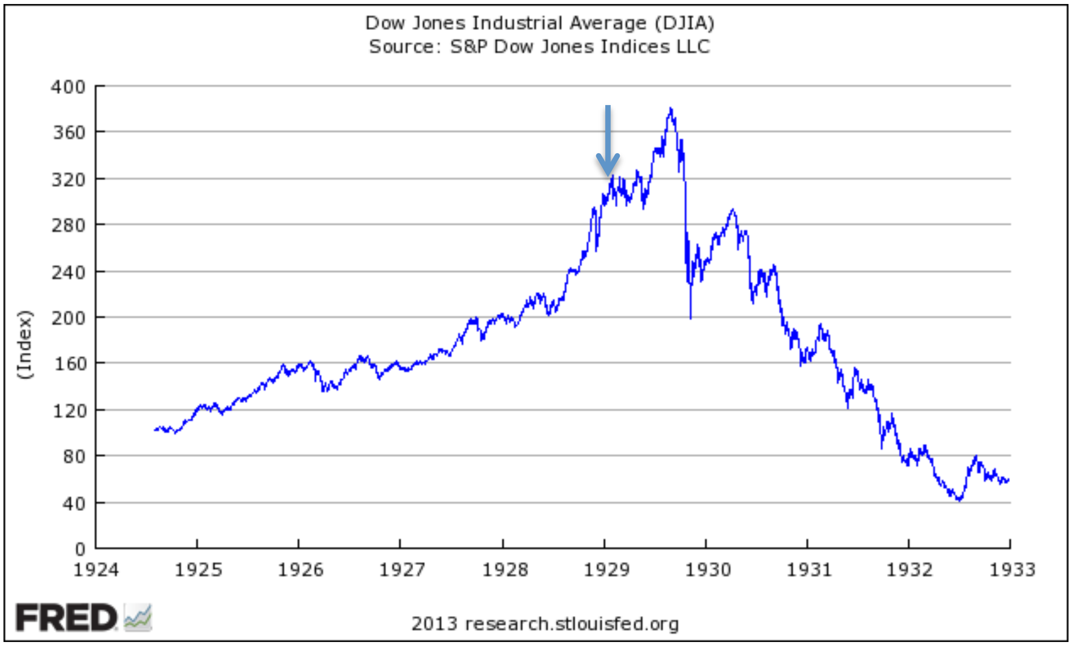
S&P 500 Before and after 2007 Top Compared to Last Five Years



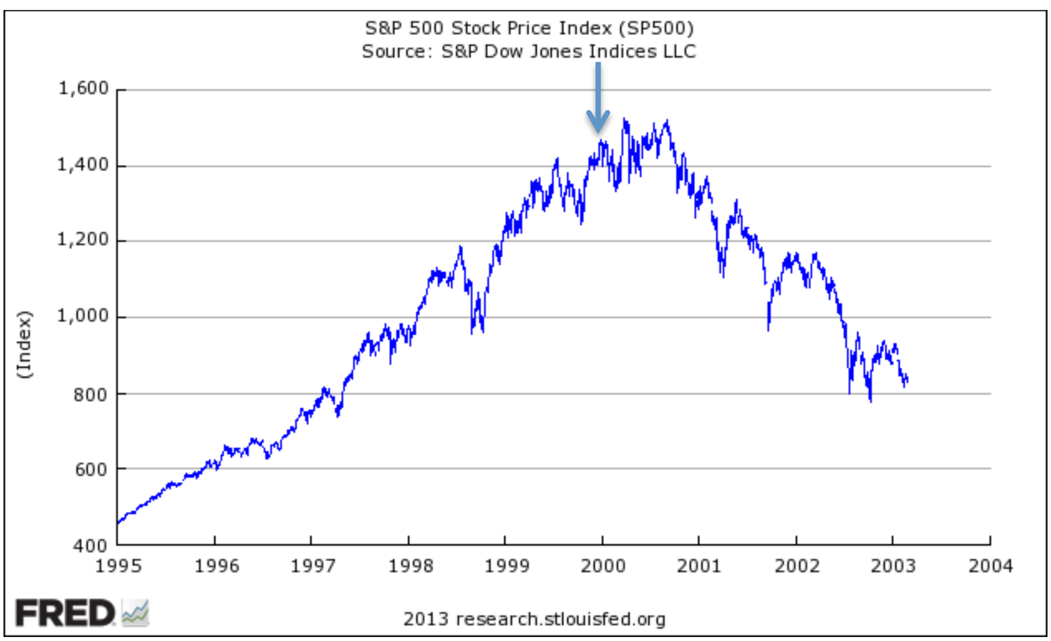
Source: Bill Hester, Senior Financial Analyst Hussman Funds

One tight correlation alone would not be anything to jump up and down about, but the second and third results from Hester's study were the five years ending in January 1929 and January 2000, each with a correlation coefficient of 0.94. Here are the charts of those periods with the arrow indicating an approximation of where today's market would be within those five-year cycles:

Before and after 1929 Top (with you are here arrow)



Before and After 2000 Top (with you are here arrow)



Projecting a continuation of the most correlated scenario onto today's S&P 500 position, the current market has 0% upside and 58% downside over the next two years. In the 1929 corollary, the current market would have 18% upside over the next eight months and ***90% downside*** over the next three years. In the 2000 comparison, the market would see only 5% upside over two months and 50% downside over the next three years. While certainly not a perfect crystal ball, this exercise does point out potential risks and provides legitimate cause for concern. Just because the market is rallying to new highs every other day, does not mean that the all clear has been given. In fact, history tells us just the opposite; a very nasty storm is probably lurking somewhere right around the bend. Chasing returns at this part of the cycle is an extremely dangerous game of musical chairs.

Price movement correlation is not the only thing that these periods have in common with today's market. At the end of all of these five-year periods, the other shared characteristic is extreme overvaluation according to traditional fundamental measures. As the arrows on the chart below illustrate, the most correlated five-year periods in the Hester study (1929, 2000 and 2007) all had CAPE ratios above 25 (the current CAPE is shown above the red line at 25.25).

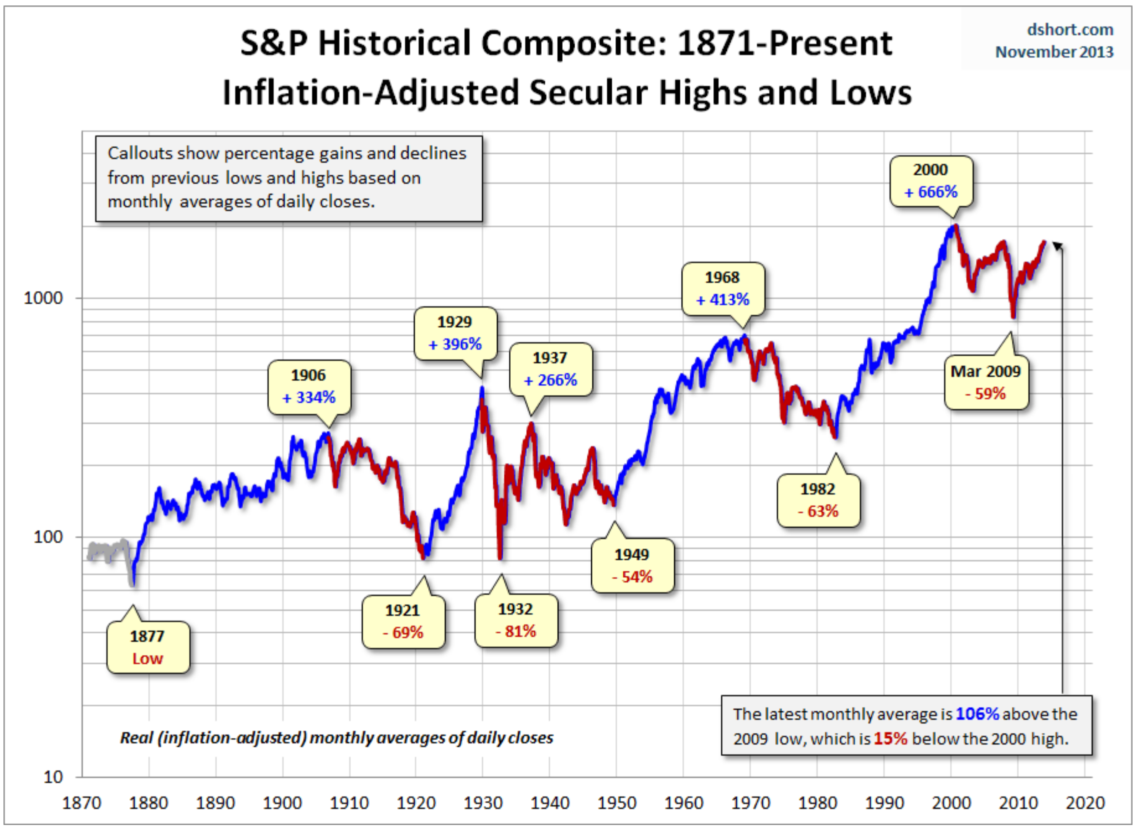
US Market Cyclically Adjusted P/E (CAPE) Ratio (1880 – Present)

Source: Multpl.com

All of this certainly does not guarantee that we won't continue to head to even higher levels in the weeks/months ahead. Perhaps we have entered into some sort of new investing paradigm never seen in our history. However, not heeding the warnings of history leaves most investors doomed to repeat it. **Based on the history of five-year price ramps that end with excessive valuations, the markets are statistically set-up for a *major* setback in the months ahead.**

The main reason that we remain positive on the long-term prospects of an alternative asset like gold is for the simple fact that it's in a secular bull market. Historians of the financial markets define long wave trends as either being a secular bull or secular bear market. The word *secular* is derived from the Latin word *saeculum* and loosely translates into "lasting for a long time." In this case, a long time usually means between 15 and 20 years for each of these secular bull and bear cycles. It is very important for investors to recognize which type of market they are in. The chart below from Doug Short illustrates these sweeping bull and bear periods in the S&P 500 going all the way back to 1871. The secular bull periods are in blue and the secular bear markets are in red. It is not uncommon for stocks to be in a secular bear while gold is in a secular bull.

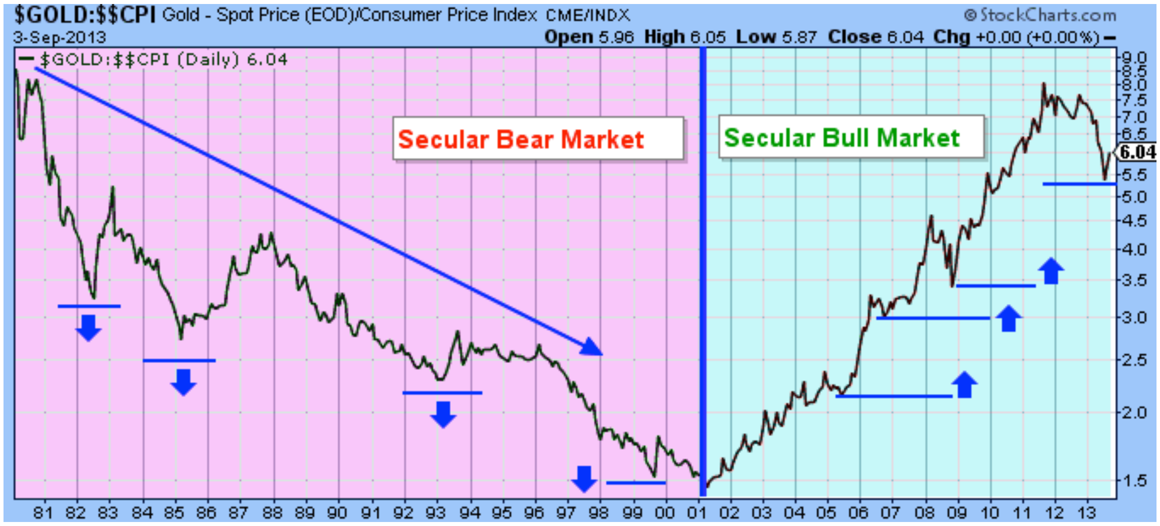
Inflation Adjusted Secular Bull and Secular Bear Cycles since 1871



As you can see, as sure as night follows day, secular bear markets follow secular bull markets. It is the mean reversion process at work. The other thing to notice is that we are currently still in a red line period, which means the S&P 500 is still mired in a secular bear market. The blue line zones have one major thing in common and that is they all continually make new inflation adjusted highs following each cyclical correction; hence a steep upwardly sloped line. The secular bear markets on the other hand are characterized by a sideways to downwardly sloping trend that last on average 18 years.

Now that we have spelled out the difference between a secular bull and bear market, we thought we would look at the recent charts of gold and the S&P 500 to show the secular picture close up.

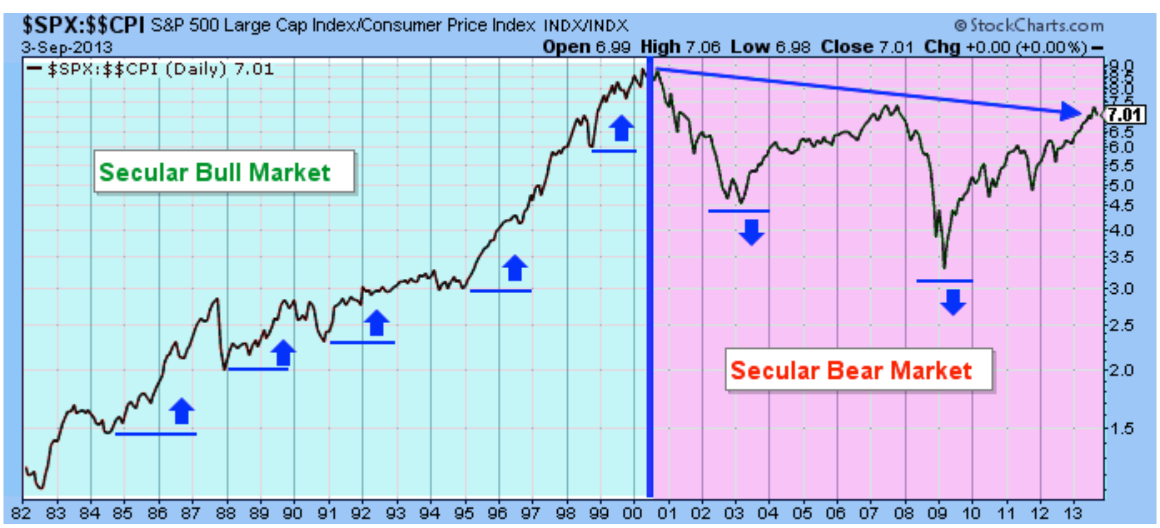
Gold Inflation Adjusted Secular Bull and Secular Bear Cycles since 1980



This above chart of gold is clearly labeled to show its 1980 – 2001 secular bear market in pink and its current secular bull market that began in 2001 in green. Notice how in the secular bull phase that each correction is above the prior correction and each rally has then gone on to achieve a new inflation adjusted high (arrows to help illustrate each correction low being higher than the prior one). The opposite occurred during the 21-year secular bear market that lasted from 1980 to 2001. We cannot stress enough how important it is to recognize the current two-year correction in the price of gold as a ***cyclical bear*** correction within a ***secular bull*** market.

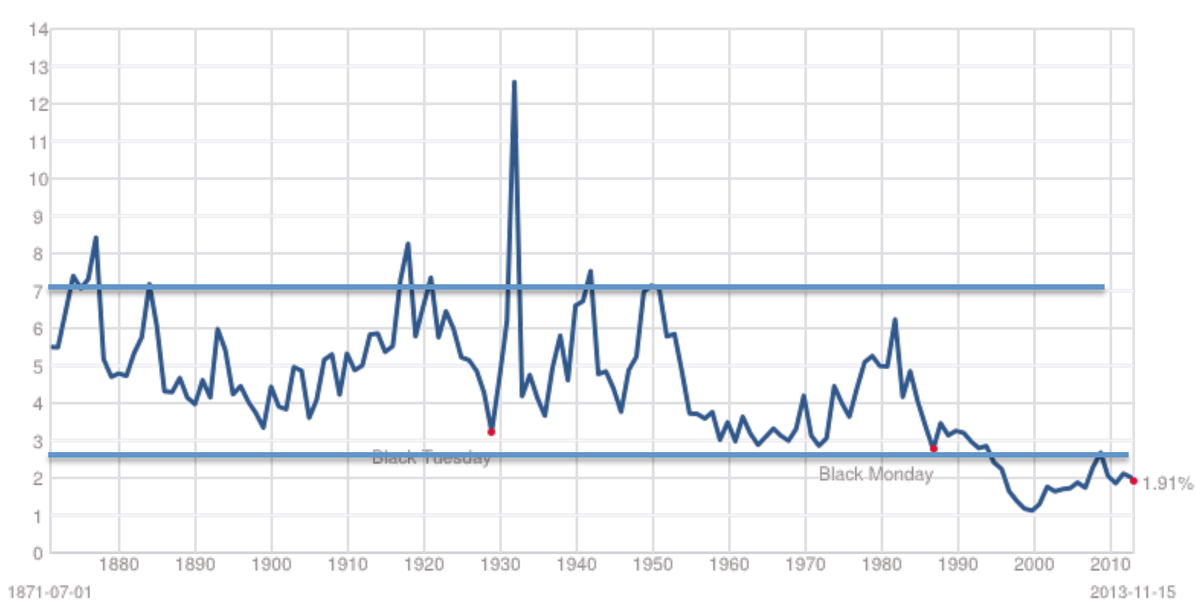
On the other hand, the S&P 500 secular cycles are clearly the mirror image of the secular gold story. This is equally important to comprehend because it means that the S&P 500's rally is just another ***cyclical bull*** market rally with in a ***secular bear*** market. Once this *cyclical* rally ends the secular bear will reassert its long wave downward trend towards more washed out valuations.

S&P 500 Inflation Adjusted Secular Bull and Secular Bear Cycles since 1982



One of the questions we often get is why can't this rally that began in 2009 be the start of a new secular bull market for the S&P 500? The answer comes in terms of both time and price. On a time basis, if this is the start of a new secular bull market for US stocks, then its starting date was March of 2009. That means the secular bear market would have ended in just nine years despite it following the greatest bull market in US history. Again, 18 years was the average span of the prior three mean reverting secular bear markets. It does not make sense that a bull market that was twice as overvalued as any before it would be over in only half the average duration. The second and more important component of a secular bear market is that they do not give birth to new secular bull markets until valuations fully revert to the mean (please see the CAPE chart on page 3 for a visual aide). The past three bear markets did not reach a valuation low until the CAPE ratio fell below 7! For comparison, the current market is one of the most expensive with investors paying 25.25 times ten-year earnings. That means the typical bear market bottom valuation is 75% below current S&P 500 valuation levels! In 2009, this ratio only got down to 14, so we did not come close to the type of mean reversion needed to set the stage for a new secular bull market. Even if the 2009 low happened to be the start of a secular bull market, it is just about over anyway because valuations are now stretched all the way back to the level at which prior secular bull markets have ended. As we have shown in prior reports, it isn't just the CAPE that says stocks are overvalued. Most of the evidence points to this being a cyclical stock market rally within a secular bear market (which means once the up cycle ends, the market will eventually go down to even lower inflation adjusted price lows than were seen in 2008). For instance, the dividend yield of the market is now back down below 2% at 1.91%.

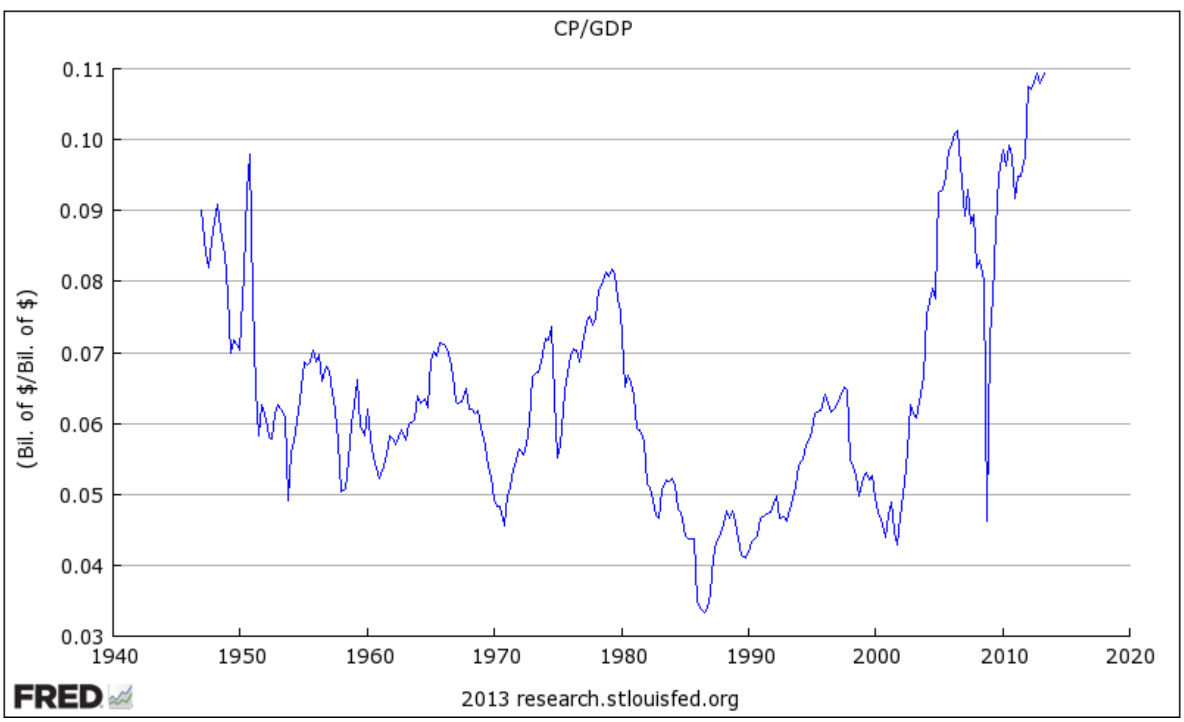
S&P 500 Dividend Yield (1870 – Present)



Dividends have historically been an extremely important component of stock market total returns. A recent study by BlackRock stated that 90% of U.S. equity total return over the past 100 years has been delivered by dividends and dividend growth. At an average dividend yield of just 1.91%, U.S. investors are being woefully undercompensated for the market risk they are taking. The chart above shows that prior to 1990's stock bubble, the S&P 500 consistently yielded between 3% and 7% (shown by channel we have drawn on the chart).

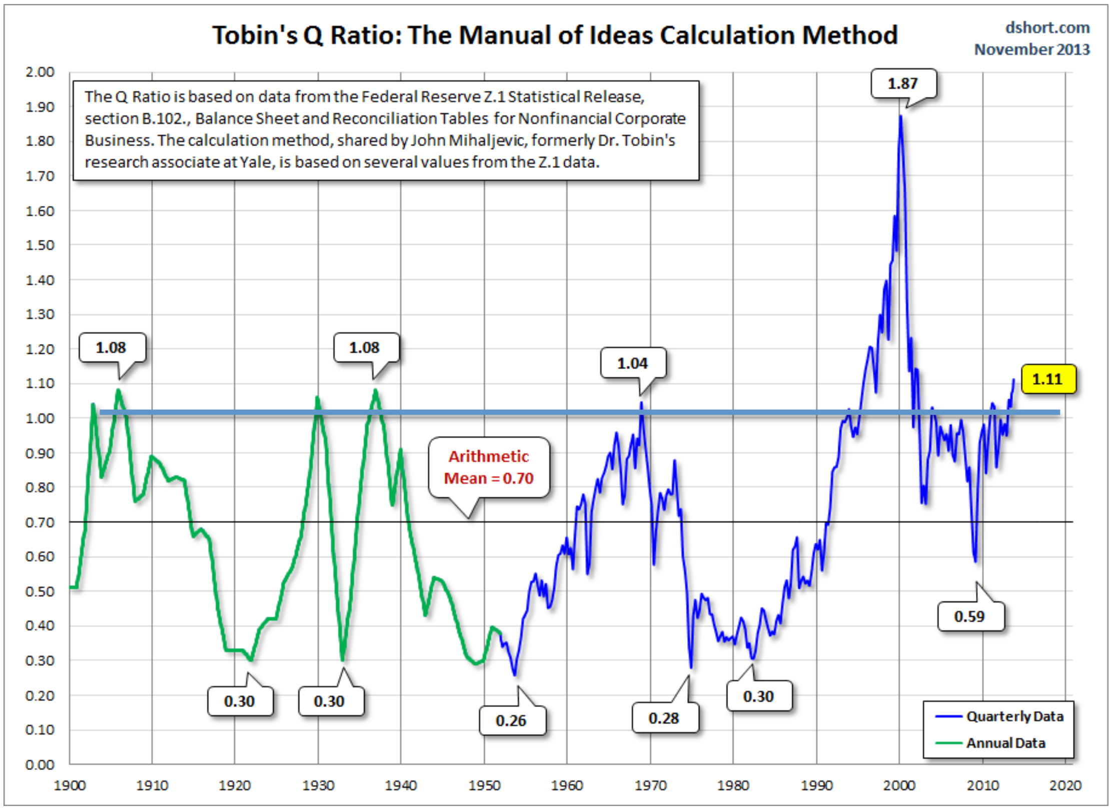
One other metric that speaks to the expensive nature of the US market is the elevated level of profit margins. At 11% of GDP, US corporate profits are at a record. This is important because it means an expensive market is all the more expensive when you consider that an *unsustainably high* percentage of corporate revenues are flowing through to the earnings line (which makes up the denominator of the price-to earnings ratio). Assuming a 10% profit margin, a $100 stock with $5 p/share in earnings has a P/E ratio of 20. However, at the historic average margin of 6%, that same $100 stock's earnings per share now falls 40% to $3 p/share. This now results in a P/E ratio of 33, as the stock becomes 65% more expensive without any increase in the share price. This is a very rudimentary example of how unsustainably high profit margins make the market appear cheaper than it really is.

US Corporate Profits After Tax as a Percent of GDP (1945 – Present)



Finally, the Tobin's Q Ratio below shows that the market, with the exception of the 2000 bubble top, has never valued US corporate balance sheet assets higher than it's doing right now. This is just another metric disproving the crazy assertion that US stocks have entered a new secular bull market.

Tobin's Q Ratio (1900 – Present)



In conclusion, we think history is shouting from the rooftops for investors to be very cautious with capital at this juncture of the market cycle. It is the nature of secular bear markets to try and suck in as many as possible at the cycle tops via seductive headlines and vision of endless stock market profits. While we can't rule out a few more months of speculative feeding frenzy, those gains will most likely be *fleeting and lost* once the cycle turns down. Finally, the reason we like gold is that it still fits the definition of an asset that is in a secular bull market. The two-year *cyclical* correction is making a bottom that is still well above the 2008 lows. Once momentum returns to gold it should be able to exceed its 2011 inflation adjusted high and ultimately preserve wealth better than US stocks, which still have some severe secular bear market mean reverting ahead of them.