The Starboard Side Report

The week ending November 22, 2013

There are only so many ways we can say that the US stock market is overvalued and risky at this juncture, so we will try to focus this week on where we see relatively attractive opportunities over the next few years. As we have mentioned repeatedly, we feel that the most compelling opportunity in the market over the next 2-3 year cycle is that of precious metals mining stocks. That does not mean that they can't head lower in the very near term, but investors with a three-year time horizon should be amply compensated for the risk that they are taking in gold and gold mining shares. We won't go into much more detail on this thesis this week since we have devoted several reports regarding this opportunity over the past six months. Needless to say, we remain staunch supporters of this little pocket of the investment world that has all but been left for dead. What follows then is our breakdown for where we may look to deploy capital as we go forward. Given that many of these assets that we'll be discussing are very extended right now, we expect to move cash once the markets have had a healthy correction (which is long overdue).

Attractive Valuation and Relative Strength Countries

In contrast to the US market, there are several global markets that do not have the same valuation constraints as the US. Below is a breakdown of the Cyclically Adjusted Price-Earnings Ratio (CAPE) of the major stock markets in the world. For a detailed look at the US market's CAPE ratio please refer to last week's report.

Global CAPE- Cyclically Adjusted Price-Earnings Ratios

Undervalued		Fairly Valued		Overvalued	
Greece	3.48	Belgium	11.69	Sweden	16.25
Ireland	6.45	Singapore	11.92	Thailand	16.47
Argentina	6.54	Netherlands	12.54	HongKong	16.61
Russia	6.94	Poland	12.62	India	17.04
Italy	7.78	UK	13.16	Chile	17.78
Austria	8.92	China	13.36	Canada	18.06
Hungary	9.52	France	13.46	Switzerland	18.61
Spain	9.52	Turkey	13.69	Mexico	18.83
Brazil	10.93	Taiwan	14.61	SouthAfrica	19.04
		Germany	14.83	Japan	19.77
		SouthKorea	15.21	Malaysia	20.22
		Australia	15.27	Indonesia	20.39
				USA	**23.58**

Source: Barron's (all data as of Oct. 1)

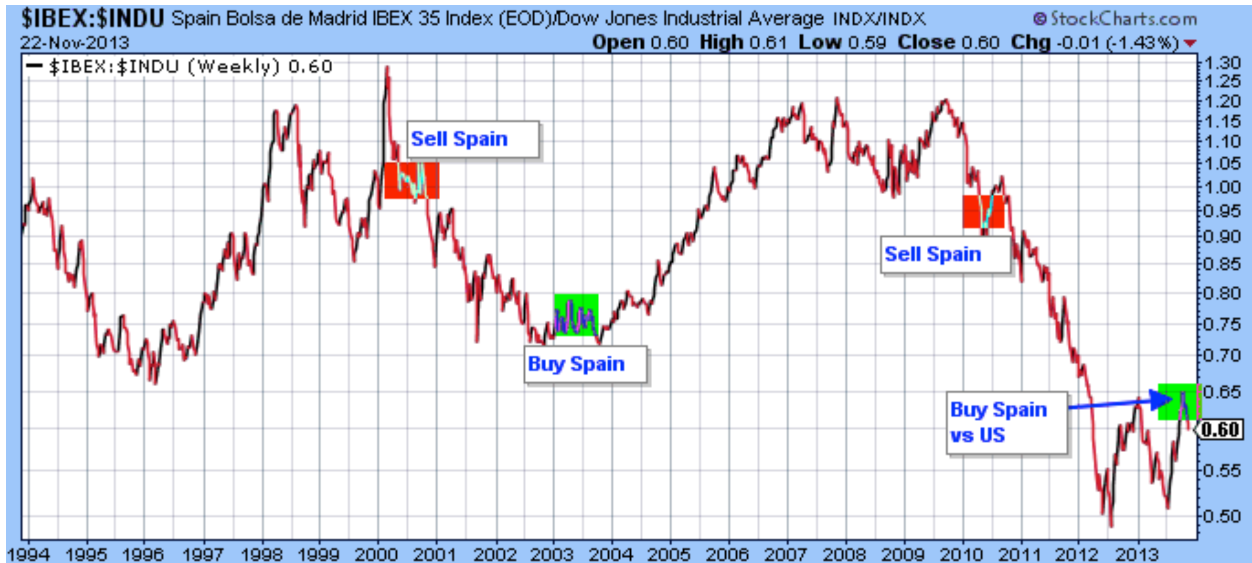
Please note: the CAPE is not a short-term trading indicator, but rather a measurement of long-term valuation.

The first thing to notice all the way at the bottom right corner of the table is the good ole USA. The numbers support the US not only being at one of the most expensive levels in its history, but also overpriced relative to the rest of the world. In the undervalued column you'll notice a mix of beaten down periphery Eurozone countries along with Russia and Brazil/Argentina from Latin America. Greece, Ireland, Spain and Italy clearly have their share of problems, but their valuations are *much* more reflective of the challenges they face. The US economy was a train wreck in 1982, but its 20-year bull market was born at that moment because of cheap valuations (a CAPE of 7 was observed at the lows in 1982). Most secular bull markets in history are born from dirt-cheap valuations when news is usually very bleak. Now, this does not mean we should run out and put all of your assets into the Russian or Spanish stock markets. However, we believe it may make sense to start allocating a portion of capital towards these extremely cheap valuation countries when the opportunity presents itself. Let's take Spain as an example. Other than being very overbought and due for a correction, Spain's IBEX 35 Index is at the same level it was 15 years ago. A 50% rally since June of 2012 has broken this index out of its downtrend and just produced a relative strength buy versus the Dow Jones Industrial Average for the first time since 2003.

Spain IBEX 35 Index (1994 –Present)

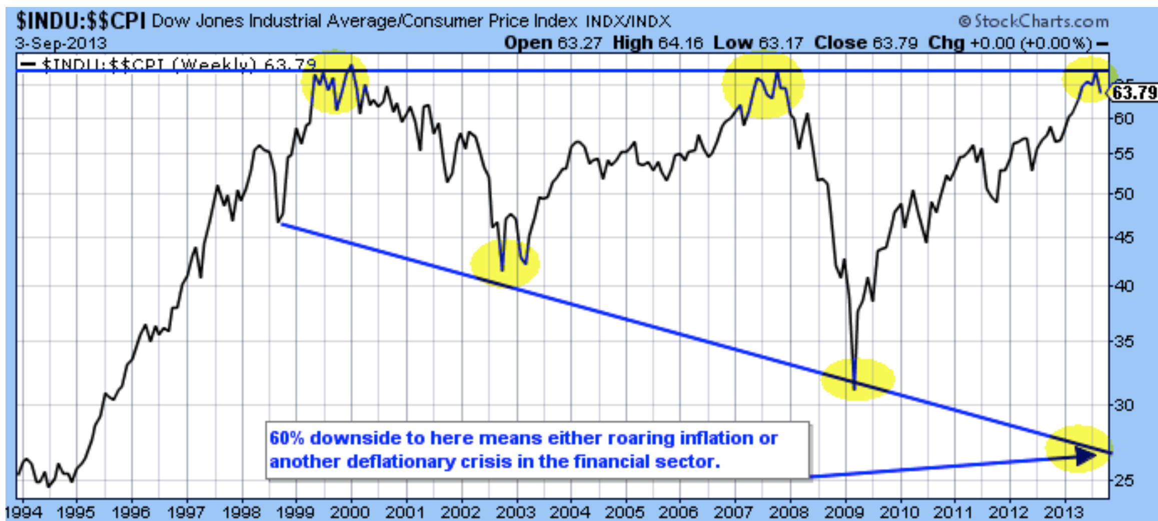
On the next chart below we show a relative strength chart of Spain versus the US to see when relative strength analysis signaled outperformance or underperformance by the IBEX versus the Dow. As you can see, our buy-sell signal has been pretty accurate over the years. The move needed to trigger the buy or sell is usually so big that it takes a few months to digest the move. This gives us time to act on the buy signal given at the end of last month.

Spain IBEX 35 Index vs. Dow Jones Industrial Average (1994 –Present)



Spain is an example of a situation that has both attractive *absolute* valuation (low CAPE) and *relative* valuation versus the US. Canadian small cap stocks could be an example of an asset that has attractive *relative* value versus stocks in the US. Here are a few charts that illustrate our point. First, we show the Dow Jones Industrial Average adjusted for inflation. The top line connecting the yellow dots shows that the Dow has managed to claw its way back to its 2000 and 2007 inflation adjusted high. Said another way, the Dow has returned 0% over the past 13 years on a real basis. Even more troubling is that the bottom line of connected yellow dots shows a 60% downside risk to the secular bear market trend line.

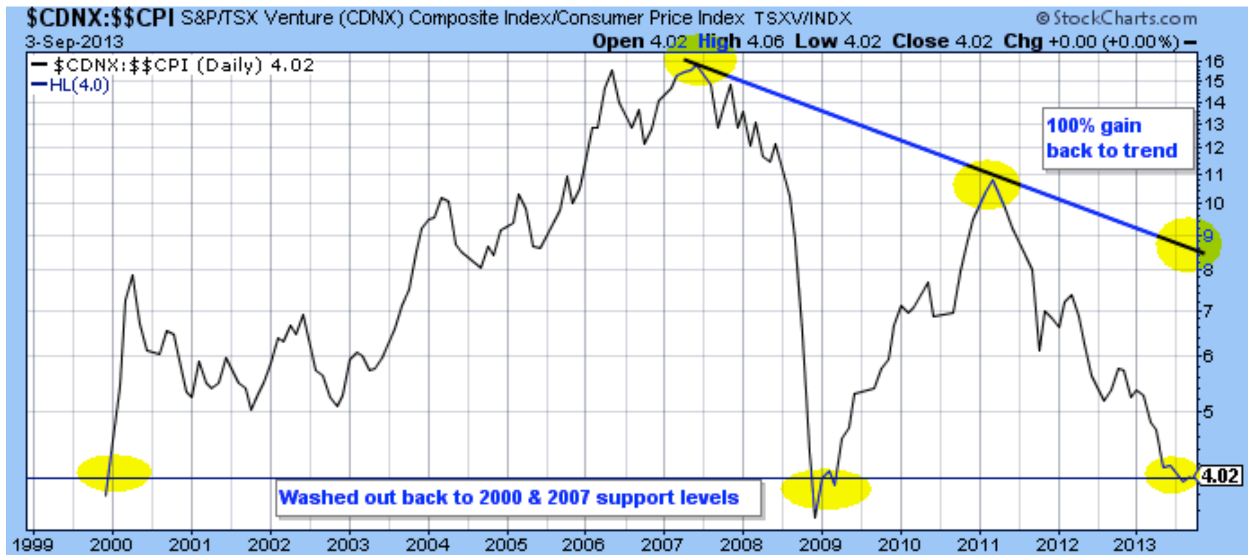
Dow Jones Industrial Average Adjusted for Inflation (1994 – Present)



Now that we have illustrated risky, let's look at a situation with a bit more risk wrung out of it. Please pay particular attention to the polar opposite situation that exists in the Small Cap

Canadian stocks known as the Toronto Venture Exchange. This index consists of a much greater amount of natural resource stocks, so it is not surprising to see it so downtrodden. The inflation adjusted price of this index has been wiped all the way back to its 2000 and 2007 **lows**. This presents a much better *relative* risk reward set-up than we are seeing in the US market.

Toronto Venture Composite Index Adjusted for Inflation (1999 – Present)



From the CAPE table on page one, Russia was in the column of undervalued countries with a CAPE ratio of below 10 (6.94) to be exact. We can drill down to the company level in that market to see how ridiculously cheap some of their companies are versus their US counterparts. Below is Exxon versus Lukoil, the number one and two largest publicly traded oil companies in the world respectively. We get that there is political risk in Russia, but at a valuation discount range between 50% and 75% (and a 70% higher dividend yield) it is hard to ignore the more cheaply valued foreign option.

Exxon Mobil Valuation versus Lukoil (Russia)

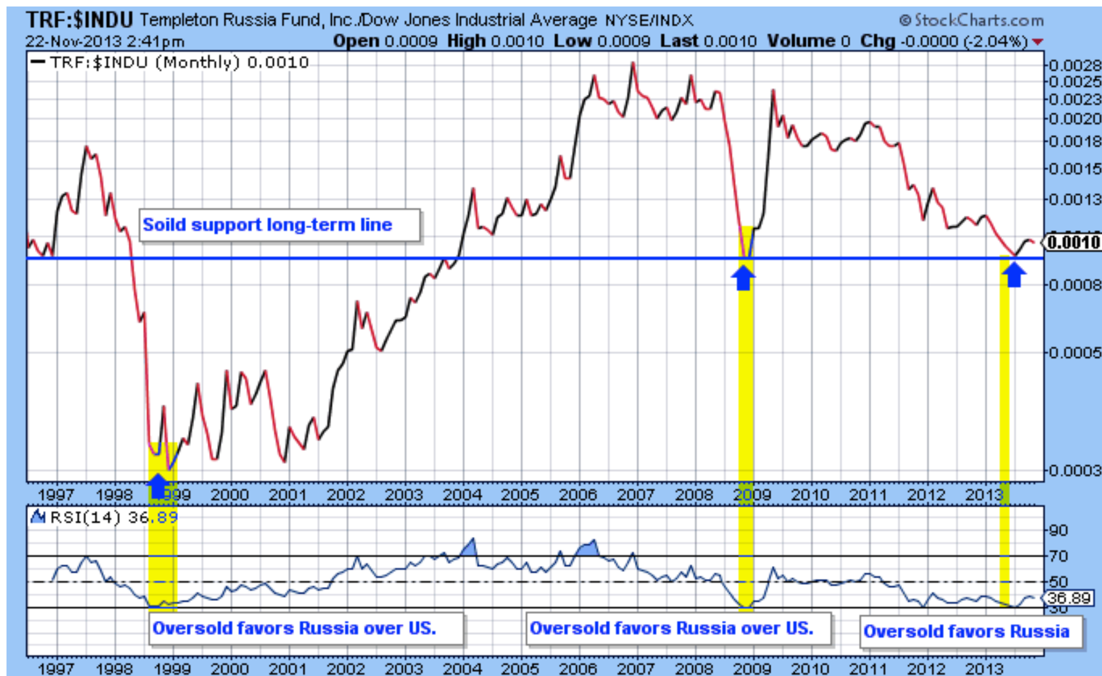
	Exxon	Lukoil	Discount
Mkt Cap	414	48	-88.4%
PE Ratio	12.4	4.4	-64.5%
CAPE	13.59	6.9	-49.2%
Dividend Yield	2.6	4.4	69.2%
P/Book Value	2.44	0.62	-74.6%
P/Revenues	1.04	0.34	-67.3%

Sources: McDep, Fast Graphs, Yahoo

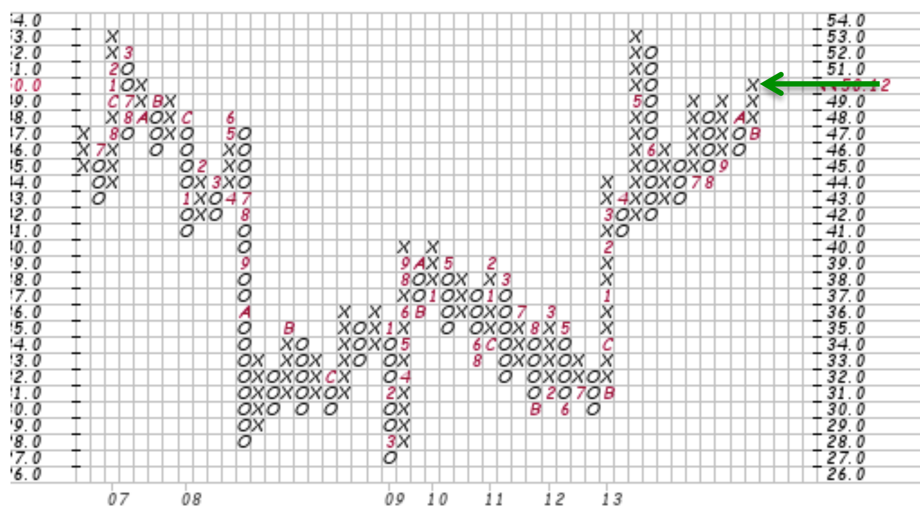
Next is a key relative strength chart of the Templeton Russia Fund versus the Dow Jones Average. As you can see, we are at a level that has marked key periods of Russian stock market outperformance over a number of years. According to the CAPE table above on page one, the

entire Russian market is selling at a 72% discount to the US market. This may present a compelling long-term opportunity for patient investors.

Templeton Russia Fund vs. Dow Jones Industrial Average (1996 – Present)



The final country that we will look at is actually in the overvalued CAPE category in the table on page one. However, it might actually be an exception to the valuation rule in that this market is 60% below where it traded 23 years ago and has underperformed the S&P 500 by 450% since that time! The first chart shows the up close picture of a widely held Japan Equity Fund breaking out this week.



More important is the big picture that shows a 23-year period of underperformance that is on the verge of breaking out. This next chart, courtesy of Chris Kimble, does a good job of highlighting the key inflection point and how one of the longest most grinding bear markets in history may be on the verge of turning into a secular bull market. Given its relatively expensive valuation versus the rest of the world, this is more of a relative strength/momentum call at this stage rather than a compelling value. However, 23 years of pent up selling pressure could unleash some interesting opportunities despite Japan's crushing debt burden. Japanese politicians and central bankers have certainly telegraphed that they are going to try everything in their power to inflate away that debt. First things first though, the 23 year downtrend line must first be broken.

Nikkei 225 Index (1987 – Present)

Source: Kimble Charting Solutions

There is so much momentum in the US stock market right now that investors are turning a blind eye to some major disconnects in valuation and relative strength globally. As famed value investor Benjamin Graham eloquently stated many years ago; "in the short run, the market is a voting machine, but in the long run it is a weighting machine." This means price momentum carries the short-term, but that value always wins out in the end. The technology bubble in 1999 was a prime example of this. We would not be shocked if the US market had a final parabolic "blow-off" into the year-end. However, next year could very well be the time that investors start to rotate into other unloved areas of the market that have better risk-reward and value profiles.

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