The Starboard Side Report

The week ending December 20, 2013

The psychologically difficult part about investing is that the greatest buying opportunities in history have generally occurred when surrounding circumstances appear the bleakest. Think back to early 2009 and you will remember that everywhere you turned the financial world was imploding and the US stock market was predicted to go to zero. On the flip side, the worst buying opportunities are usually when things appear their best and the media convinces us it's nothing but blue skies ahead for markets. We can recall like yesterday the cocky assuredness of technology stock bulls circa 1999 as well as the housing/banking stock cheerleaders in 2007. In just five short years the majority of US investors have gone full circle from wanting out of the market at all costs (when the risk levels were much lower) to wanting in at all cost (when risk levels have seldom been higher). One of our key roles as financial fiduciaries is to point out the key inflection points that could lead to either chaos or opportunity. Timing the commencement of chaotic declines is difficult because the euphoria at the end of a bull cycle always seems to last longer than one anticipates. After all, fear of missing out is a powerful fuel for markets. We were warning about the housing bubble for two years before it hit the mainstream psyche. Here we are once again at the frothy point of the cycle with the warnings of prudent investors falling on deaf ears or being outright mocked. On the flip side, the great opportunity being presented by this year's gold sell-off is being tuned out because it is difficult to imagine that anyone could make money in an asset that has essentially gone down for two straight years (sound familiar). Just like US stocks in early 2003 and early 2009, gold is loathed, feared and being discarded from portfolios with reckless abandon. For both the US stock market and the gold sector, we believe that we are at a major inflection point that will be looked back on in three years as another "oh yeah" moment when everyone in hindsight will be saying; "darn, I should have seen that coming

First, we want to illustrate how what has been transpiring with gold since late June of this year is consistent the same exact bottoming process that occurred in the S&P 500 in 2003 and 2009. Both instances are looked back on as extraordinary buying opportunities, yet the volatility associated with these bottoms made most investors flee in panic.

The first chart is of the seven-month bottoming process for the S&P 500 in 2002-2003. This was a mentally draining time for those calling a bottom during this period. Yet, patient discipline was eventually rewarded as stocks were driven sharply higher during the last nine months of 2003. This was the start of a four-year cyclical bull market. Abandoning stocks was the easy way out and felt good for a few weeks/months, but it was an awful long-term strategy. Once again peak despair proved to be the right time to buy. On the chart we highlight what's known as the momentum bottom and then the final low of the bottoming process. As the second pane in the chart shows, momentum bottomed in late July 2002 and trended up during the volatile bottoming process that concluded seven months later in early March of 2003. That is the type of divergence that a technical analyst looks for in order to help gauge a true bottom from a continuation of the bear market in question.

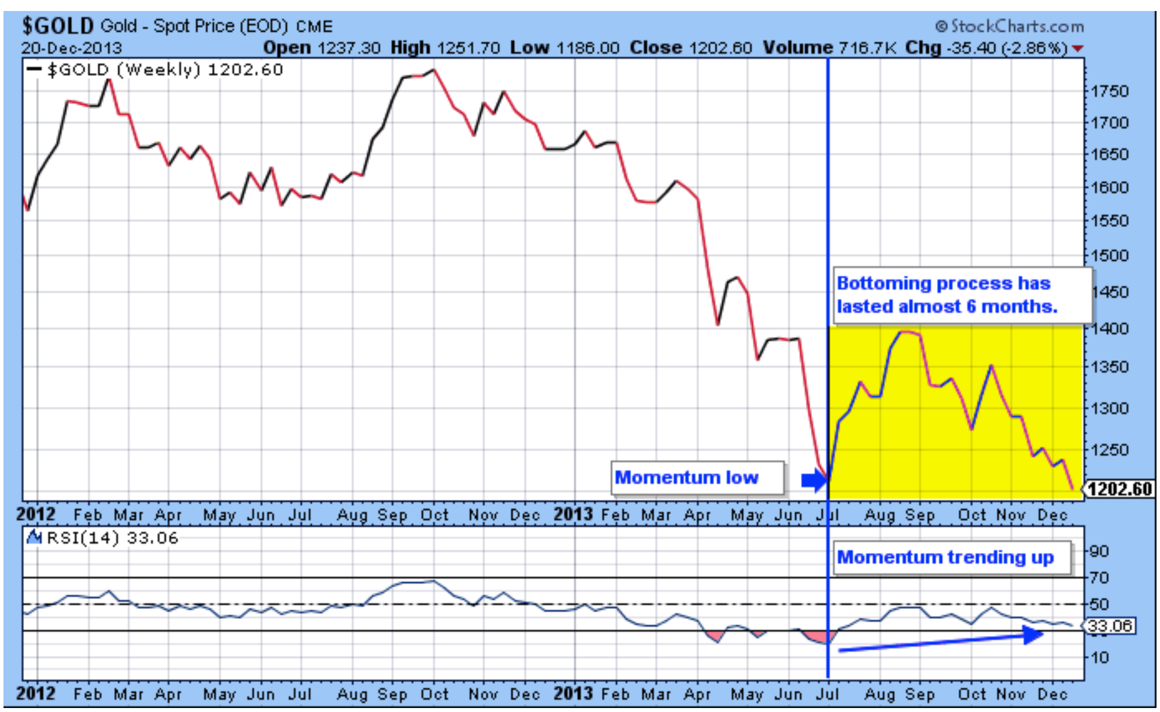
S&P 500 with Seven Month Bottoming Process in 2002 - 2003

The 2008-2009 bottom was a bit different than the 2003 affair in that the time from momentum low to final low was five months, not seven. Additionally, the market actually went on to a modestly lower price low before all was said and done. However, even as that new price low was occurring in late February 2009, notice that this momentum gauge did not make a new low and was still sloping upward. This was decent price action even though many were shaken out of the market by the volatility.

S&P 500 with Five Month Bottoming Process in 2008 - 2009

Next, we present the gold price chart over the past two years. Please notice how the past six months resembles those recent great buying opportunity bottoms in the S&P 500. Importantly, gold's momentum is still solidly above the June price low even though the gold price is now back down to those levels. Although, we would like to see the "double-bottom" hold, the price of gold can continue to decline for a few days/weeks without calling into doubt our bottoming thesis (as long as momentum does not confirm the new low by making a new low itself).

Gold's Current Bear Market with Potential Six Months Bottoming Process



When one looks back at all the bull markets ***since 1896*** *and averages them out they find the average bull to last* ***39 months****. With this current bull market in month number 57 we get the feeling we are looking at an 85 year old man who wants to buy life insurance. The actuarial table says we should not write the policy. Sorry.* Bruce M. Kamich, CMT via The Stock Traders Almanac

We thought the above quote is a good segue into our next segment on major market tops. The next two charts show the last three times that the S&P 500 has had a similar 55-60 month price return pattern that resembles the past 57 month cycle. It is a veritable whose who of terrible times to invest in the US market. First up is the market leading to the legendary 1987 stock market crash. This bull market lasted exactly 60 months before at 40% decline came along and wiped out almost two years worth of gains in less than two months! The fact that this decline occurred during what is now known in hindsight to be a secular bull market was of little solace to those punished by its fury.

S&P 500 Index- 60-month bull market ends with a bang in the form of the 1987 crash

S&P 500 Index

62-month bull from 1995 – 2000, 55-month bull from 2003 – 2007, current 57-month bull

In the chart directly above we highlight the other two powerful 60-month bull market cycles following 1987 along with the current 57-month run. The first episode ended during the first quarter of 2000 after a 62-month run that started in 1995. The subsequent bear market resulted in a loss of 50% for the S&P 500 over the next two years. This decline saw the market give back five years worth of gains. The middle cyclical bull market pictured on the chart is the 55-month affair that ended in 2007. The S&P 500 then lost 58% over the next year and a half and gave back twelve years worth of gains! The thing that all of these monumental tops have in common is that they were longer than average in duration (average 59 months), the fear of missing out became most intense near the top, the subsequent bear market was brutal and Wall Street was oblivious to each one. Finally, notice how similar the current run is in both price intensity and duration. March is the five-year (60 month) anniversary of this bull market. It is clearly getting long in the tooth and risk levels are rising with every passing month.

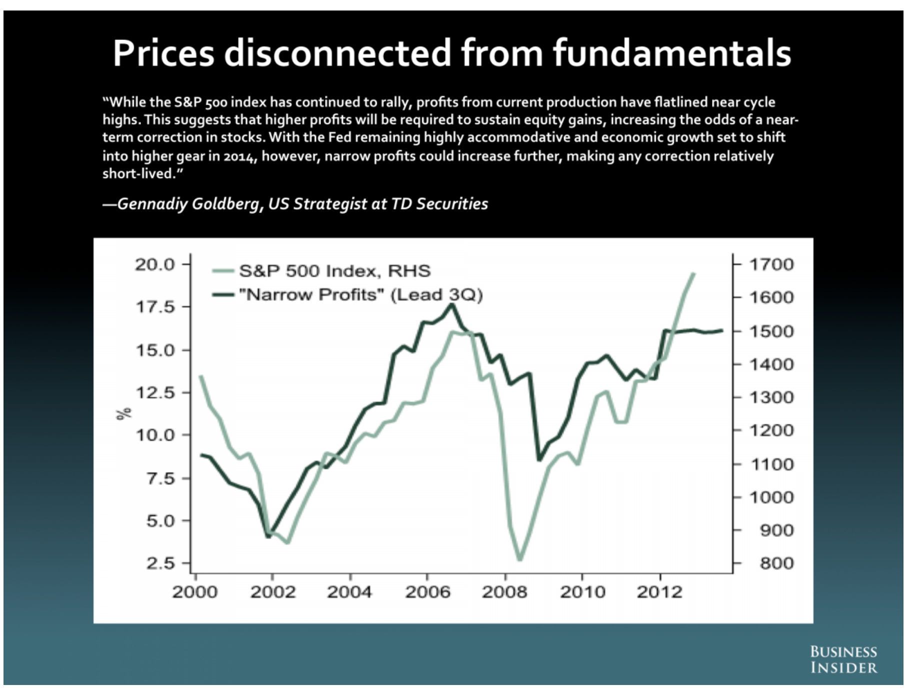
Now let's bring this all back to the present situation. One asset currently looks like the 2003 and 2009 S&P 500 major panic **bottoms** that we showed above (gold) and one market looks like the S&P 500 tops in 1987, 2000 and 2007 (S&P 500). How do you want to be positioned in 2014? We feel strongly that long gold while avoiding the US market is going to be the prudent call over the next 12-24 months.

The final segment of this week's report is a table that we have been monitoring for a few months. The purpose is to drill home that, excluding equities, all major asset classes had negative returns in 2013. This has made a mockery of those prudent investors that have attempted a diversified portfolio investment strategy. More troubling is that it's causing many to abandon a properly diversified portfolio at exactly the wrong time in the investment cycle. The clear theme of 2013 was "risky and undiversified is better" as investors poured into developed world equity markets in Japan, Europe and the US. Cash has been no better and has obviously returned zero percent this year. The Federal Reserve is essentially forcing people into extremely risky undiversified portfolios with little regard for the potential collateral damage. Making investors reach for risk and making stocks the "only game in town" is a recipe for long-term investment disaster. This is especially true because it is price momentum and not earnings growth that has driven the majority of gains this year in the US equity market. The performance in US stocks this year was a once in a lifetime gift that has only pulled forward future equity appreciation potential because the fundamentals have not changed. The Federal Reserve is perpetuating a boom and bust stock market cycle that is fast approaching the 60-month mark that tends to usher in the arrival of the painful bust phase.

Asset Class Performance Since Taper Talk First Began in May and Year-to-Date

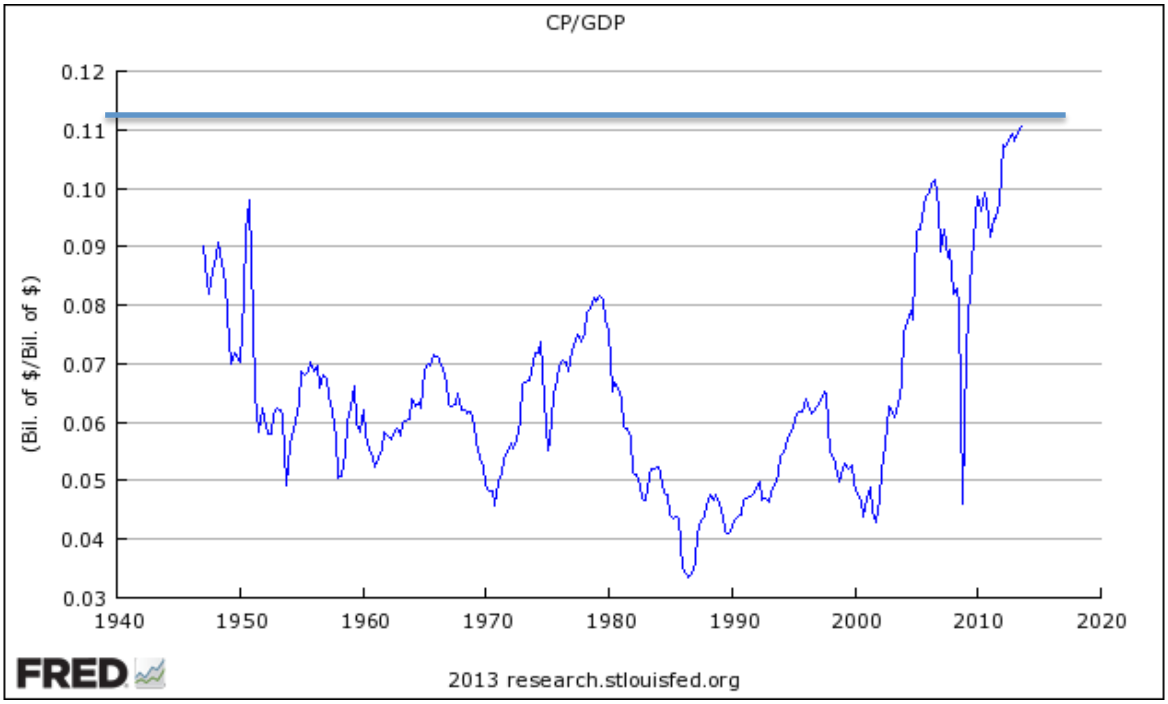
Description	% Change since May 20th "Taper Talk"	% Change YTD Year-to Date
iShares Russell 2000	12.93	32.87
SPDR S&P 500 ETF Trust	8.72	27.44
SPDR Barclays Capital High Yield Bond	-2.48	-0.32
iShares Dow Jones U.S. Real Estate	-16.24	-2.61
iShares iBoxx $ Investment Grade Corp. Bond	-4.67	-5.49
iShares National Municipal Bond	-6.00	-5.87
iShares US Treasury Inflation Protected Bonds	-7.44	-9.36
GreenHaven Continuous Commodity Index	-5.65	-10.79
iShares JP Morgan USD Emerging Markets Bond	-8.95	-11.56
iShares Barclays 20+ Year Treasury Bond	-12.19	-15.27
SPDR Gold Trust	-15.02	-29.13

The next chart below shows the disconnect between this year's S&P 500 price performance and the underlying earnings that normally drive that share price performance. The black line is earnings and its sideways trend clearly shows that multiple expansion (paying more for the same amount of earnings) has driven almost the entire gain in the S&P 500 this year. Those that are banking on more gains next year are hoping that earnings start to dramatically ramp higher over the next few quarters (even though we are entering year five of this business cycle). Strong earnings growth will be an especially hard challenge with profit margins near all time highs. That means investors actually need to see revenue growth and not just more financial engineering in order for the market to head higher.

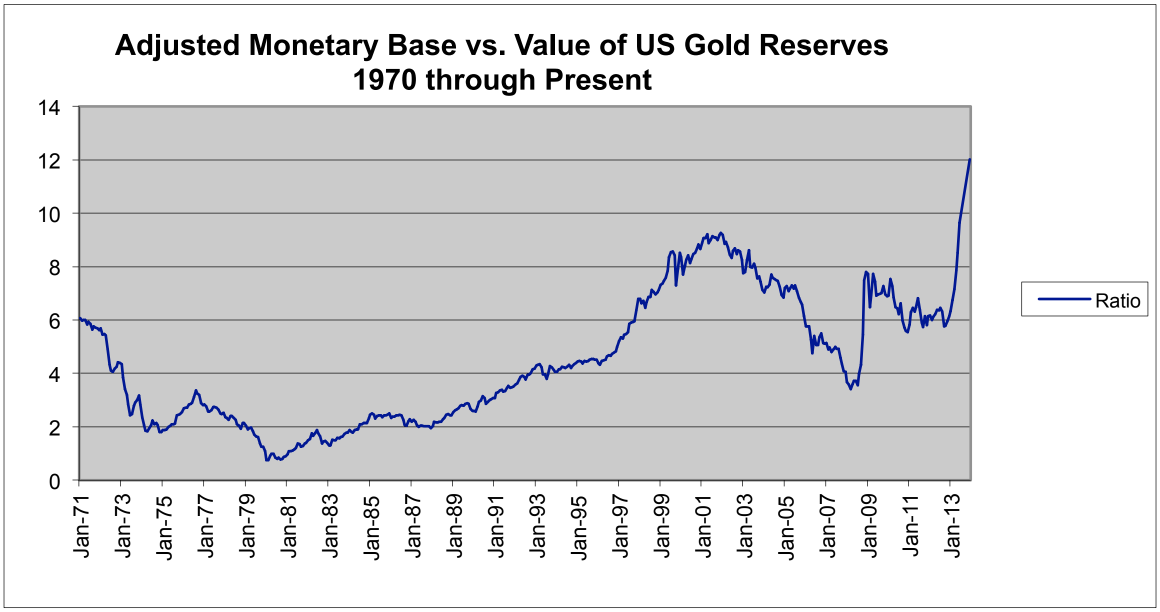


Source: TD Securities via Business Insider

US Corporate Profit Margins as a percent of GDP have never been higher since WWII



So with the S&P 500, we have a very mature momentum driven bull market with wavering fundamentals. Meanwhile, the fundamental underpinnings have rarely been better for gold (the asset we argue is in the process of making a major bottom). The value that the US Treasury holds in gold reserves (which backed the currency up until 1971) has never been more diluted versus the US monetary base. Due to the Federal Reserve's unprecedented multi-trillion dollar money printing operation over the past five years, and the recent correction in gold over the past two, the ratio of the Monetary Base to the Value of US Gold Reserves has climbed above 12 to 1 (see chart below). During the last gold bull market, this ratio bottomed at a 1 to 1 parity in 1980. By the time the Federal Reserve has finally finished its quantitative easing program (an effort that just started this week and is expected to drag out over the next year), the price of gold would need to be at 15,000 per ounce to get back to that same 1 to 1 relationship. That is not a prediction, but an illustration of the massive fundamental disconnect between the financial excesses fostered by the Federal Reserve over the past three decades and the current price of gold.



In conclusion, the purpose of this report was to point out the role that psychology plays in major tops and major bottoms and to juxtapose the current bottoming process in gold with the potential top approaching in the S&P 500 Index. Bottoms are mentally tough processes that often cause the majority to throw in the towel and panic at just the wrong time. Major tops are greed induced momentum festivals that lead most ration investors to throw caution to the wind for the fear of missing out. We believe that a historic top (S&P 500) and a historic bottom (gold) are playing out at the very same time in these two major asset classes. In addition, the woeful underperformance that a diversified portfolio has endured this year versus a pure stock portfolio should start to reverse once stocks start to weaken. It may take time for this to become apparent, but sometime in 2014, a well constructed portfolio that is overweighed gold, heavily underweight the almost 60 month US stock bull market and prudently diversified should make much more sense to the outside world.