THE SHORT SIDE OF LONG

Global Investment Commentary

Equities | Bonds | Currencies | Precious Metals | Commodities | Economics | Geopolitics

Issue 4, April 30, 2013

- Outside of the US, financial markets are underperforming
- US equity valuations are improving but not yet a major buy
- Secular equity bear market still remains in play
- Current cyclical bull market is the fourth best ever
- Looking at the message of S&P's long term valuation indicators
- Sentiment on commodities has become increasingly negative...
- ... while sentiment on US equities and the US Dollar extremely bullish
- Australian Dollar finds itself at a major technical inflection point

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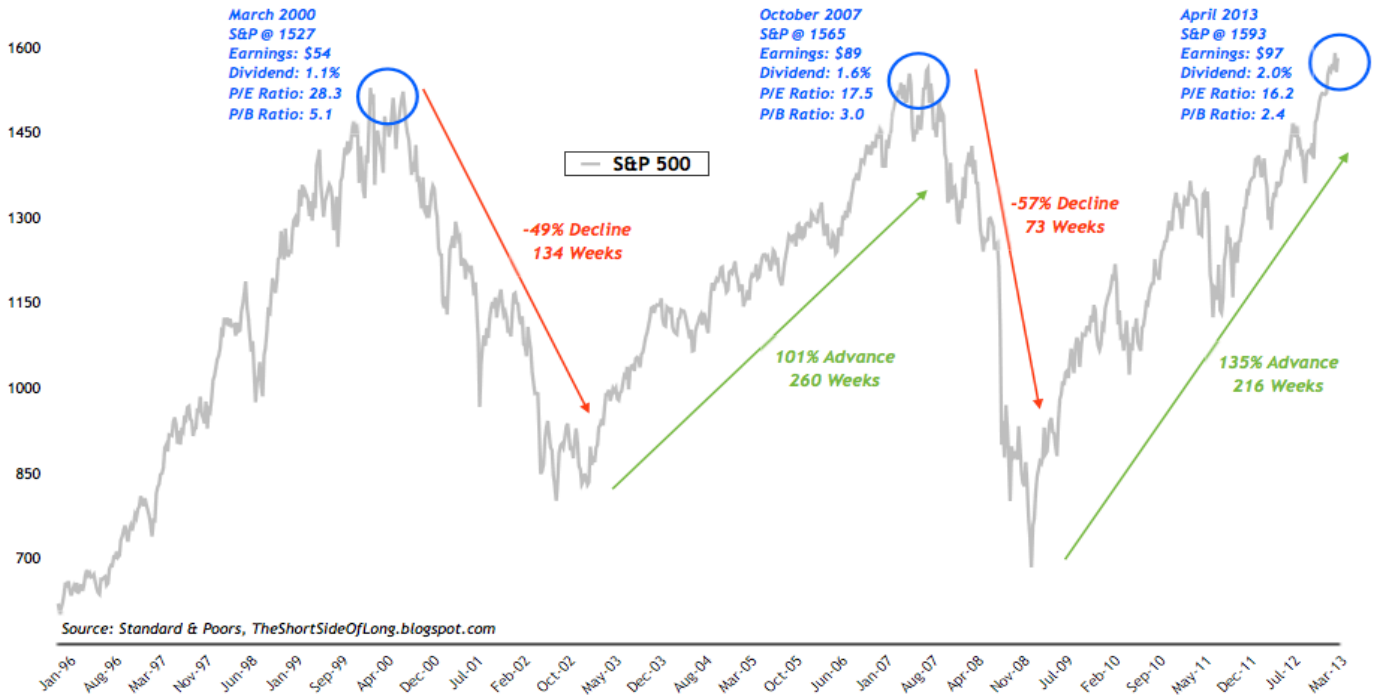
I tend to watch popular business channels late at night (morning in the US) as I write these reports. If I didn't invest the time and effort into doing my own research (and formulating my own opinion), I would easily get the impression that global conditions are relatively fine. In my opinion, this arises from the fact that the majority of the media focuses on only two asset classes: US equities and US bonds. With both assets gifting investors tremendous returns since the early half of 2010, one can understand why they remain a favorite investment strategy.

However, to be quite honest, the global markets aren't all rainbows and lollypops as the media would have us believe. To a keen market observer, the overall mood outside of the US is rather precarious. If we consider that a) EU equities have under-performed since the 2009 lows; b) emerging market equities have struggled since late 2010 and in the case of the BRICs, stocks are no higher than their 2011 peaks; c) frontier markets are in a bear market and at least 20% below their 2010 peak; d) commodity prices remain in a two year downtrend; e) precious metals have undergone a crash recently; and f) bond markets are at historically low yields - we clearly notice that US equities seem to be the only major game left in town.

There is no doubt that a rather prolonged period (twelve years) of sideways price action, combined with expending earnings, is slowly but surely restoring value to a once extremely expensive equity market (refer to Chart 1).

Chart 1: Value is slowly being restored to US equities, however we are not yet at a "major" buying opportunity



Source: Short Side of Long

In a recent research note, the Ned Davis team analyzed the fundamental difference of the S&P 500 at three similar price points over the last twelve years. In March 2000, the S&P 500 traded at 1527 with a total cumulative company revenue of $5.8 trillion, earnings per share at $54, dividends per share at $17 and yields at 1.1% relative to the 10 year note at 6.2%. The price to book ratio stood at an extremely overvalued level of 5.1, while the P/E ratio was at 28.3. Due to such high overvaluations, the S&P 500 plunged 49% over 134 weeks.

To contrast, in October 2007, the S&P 500 traded at an ever so slightly higher price of 1565 with a total cumulative company revenue of $9.2 trillion, earnings per share at $89, dividends per share at $27 and yields at 1.6% relative to the 10 year note at 4.6%. The price to book ratio stood at an overvalued level of 3, while the P/E ratio was at 17.5. While slightly cheaper, the market was still too expensive. What followed was one of the worst bear markets in history as the S&P 500 plunged 57% over 73 weeks.

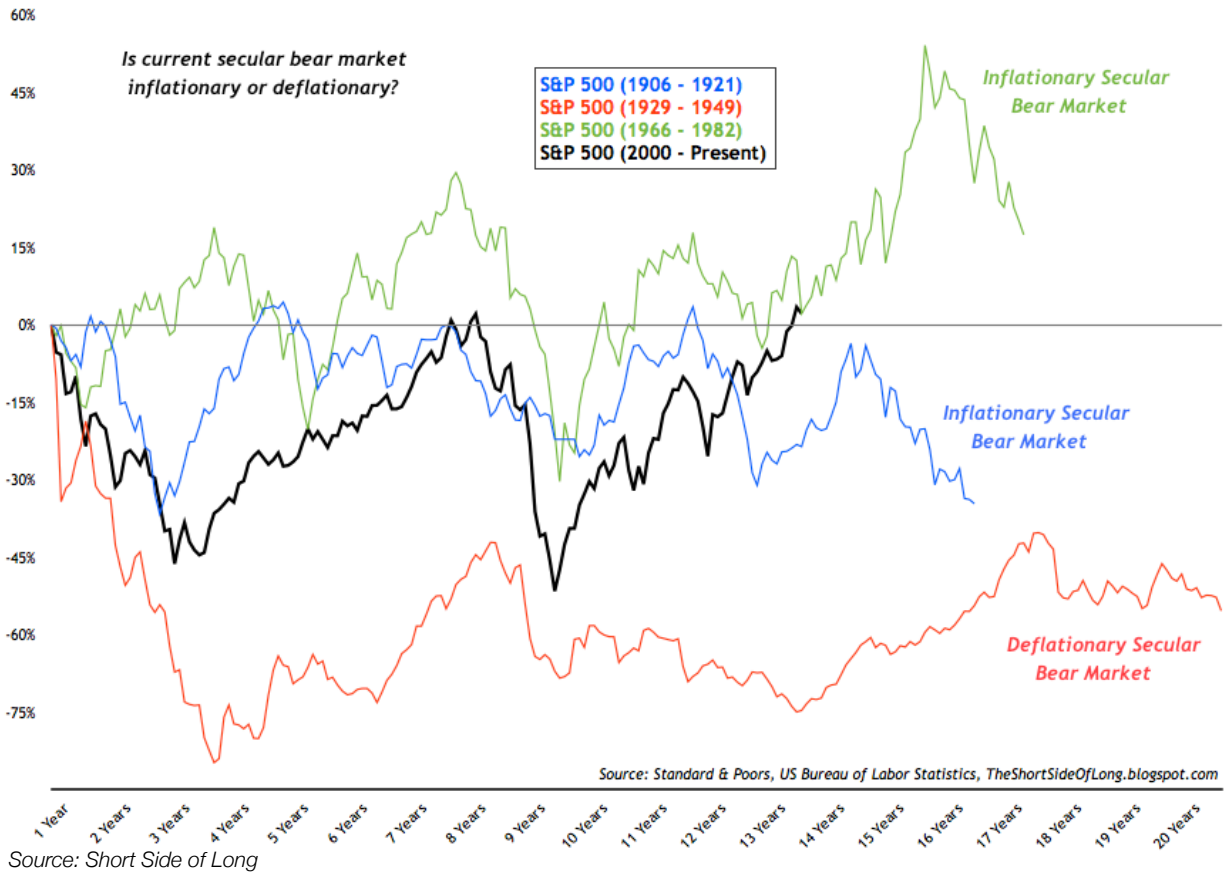
Once again, the index has managed to recover towards similar price levels. Currently, in April 2013, the S&P 500 trades at 1580 with a total cumulative company revenue of $10.3 trillion, earnings per share at $96, dividends per share at $32 and yields at 2% relative to the 10 year note at 1.8%. The price to book ratio currently stands at a level of 2.3, while the P/E ratio is at 16.2. While it is definitely true that the market has become considerably more attractive relative to the valuations in March 2000, the trillion dollar question everyone wants to know the answer to, is whether or not the market remains a buy at the current levels?

In a 2008 letter to shareholders, Warren Buffet famously said that *"long ago, Ben Graham taught me that 'Price is what you pay; value is what you get.' Whether we're talking about socks or stocks, I like buying quality merchandise when it is marked down."*

Whereas the majority of strategists view equities as a great buy (even today), I continue to believe that in the quarters ahead, quality stocks will once again be marked down, creating an exciting opportunity. Moreover, depending on the sell off and the magnitude of the coming bear market (oh yes, it will come eventually), this could be one of those lifetime buying opportunities. Let me explain this viewpoint by updating readers on the valuation of the US stock market. In true Short Side Of Long fashion, it's going to be a chart-fest.

When observing the price trends of US equities, most investors overlook an interesting and very crucial historical development. The stock market seems to behave within the context of extended secular bull and bear market periods. These trends are driven by time, valuation and

Chart 2: Over the last century US equities have undergone periods of long sideways price action



Source: Short Side of Long

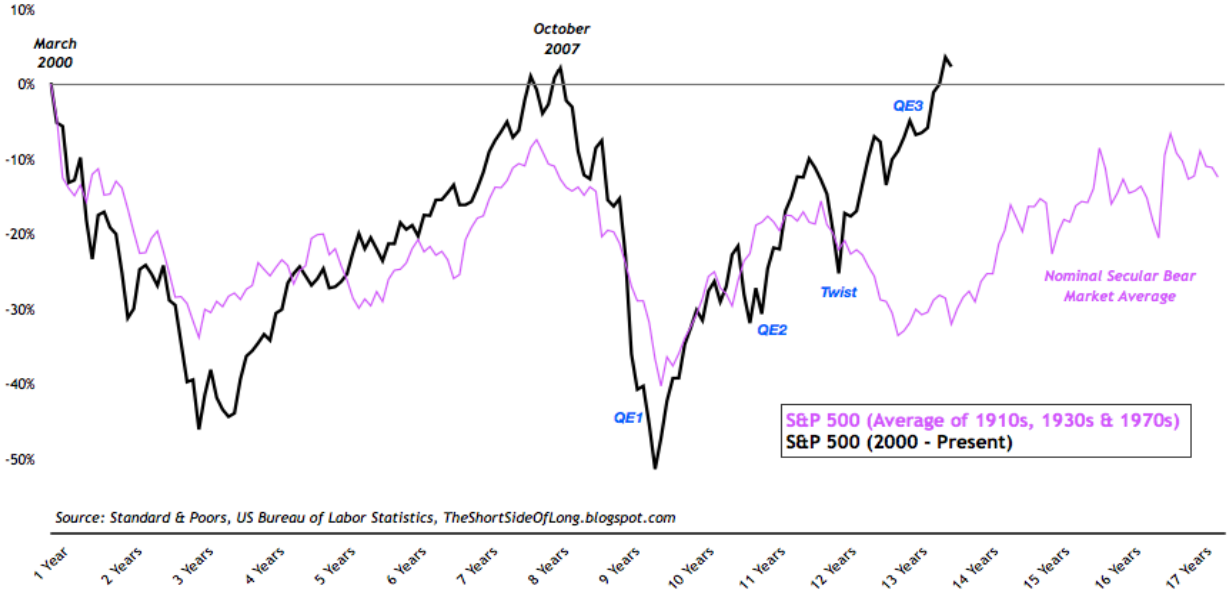
price. Over the last century there have been three great secular bear markets (refer to Chart 2). These are usually symbolized with long sideways trading ranges, where the common denominators tend to be frequent recessions, contracting valuations and general investor pessimism. While dates tend to vary slightly depending on individualized analysis, I personally chart these secular bear periods from 1906 to 1921 (blue), 1929 to 1949 (red) and 1966 to 1982 (green). The current secular bear market started in 2000 and is highlighted in black.

Let us look at the time aspect first. On average, secular bear markets last 17 years (refer to Chart 2 & Chart 3) and currently, we are in the 13th year of this secular trend. Fascinatingly, we can see that the current secular bear market, which started in March 2000, followed the average of the previous three secular bears almost perfectly until October 2011 (refer to Chart 3). However, various monetary policy programs initiated by the Federal Reserve have driven stock prices almost vertically higher in recent times, breaking away from the statistical model.

One could make a case that the stock market is currently imitating the sideways period of the late 1970s to perfection. Therefore, bulls state that the situation calls for a stock market rally of another 30 to 40 percent towards record highs (green line), prior to a correction (once again refer to Chart 2). While this is certainly a possibility, I do not view it as the probable scenario and continue to hold my bearish stance.

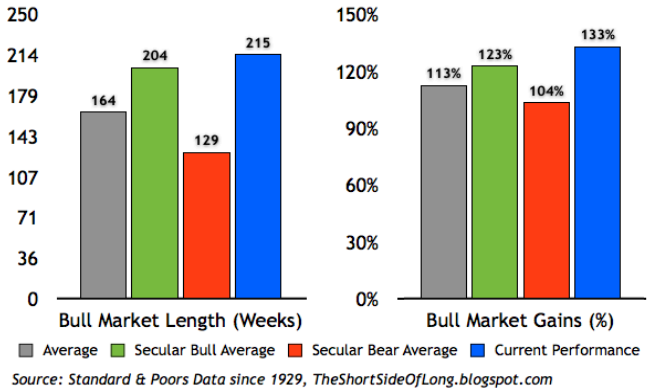
Investors should remember that in the late 1970s, inflation was extremely high (double digits) and the stock rally returns were in fact negative in real terms. Presently, the Bureau of Labour Statistics (BLS) reports inflation to be around 2%, so might be premature to think stocks will surprise to the upside like in the 70s, as inflation is low. Additionally, according to my own statistical study since 1929, there have been 18 cyclical bull markets which on average tend to last 164 weeks and achieve gains of 113%. Usually what follows is a bear market decline of 35% on average. With that in mind, the current cyclical bull market, which started in March 2009, is now 216 weeks old and

Chart 3: Secular Bear Model shows a high possibility of a 17 year sideways trend



Source: Short Side of Long

Chart 4: Current rally is well past the average returns and actually fourth best bull market ever!



Source: Short Side of Long

Sixteen Real Dow Recoveries and the Percent Gain/Loss
Days = Business Days

Recovery Starts	500 Days ~2 Years	1000 Days ~4 years	1028 Days	2000 Days ~8 years	3000 Days ~12 Years	4000 Days ~16 Years	5000 Days ~20 Years
Jul 1932	139.4%	288.4%	287.3%	189.4%	179.8%	148.2%	239.7%
Aug 1921	51.8%	122.0%	127.1%	499.8%	114.9%	238.9%	137.5%
Aug 1982	40.3%	103.7%	116.8%	182.8%	214.3%	608.5%	614.0%
Mar 2009	81.8%	102.9%	105.3%				
Apr 1942	33.7%	94.7%	95.2%	56.8%	105.7%	166.8%	301.4%
Aug 1896	82.5%	63.7%	61.4%	41.1%	96.8%	102.3%	106.7%
Nov 1907	68.5%	46.0%	52.9%	52.3%	-11.3%	-5.7%	101.0%
Oct 2002	32.7%	43.7%	50.1%	22.3%			
Jun 1949	44.2%	45.1%	48.9%	165.6%	245.7%	338.4%	260.1%
Jun 1962	50.3%	56.8%	47.8%	2.9%	-8.0%	-27.0%	-52.6%
Oct 1987	47.1%	45.4%	46.4%	106.3%	322.5%	229.7%	325.2%
Nov 1903	92.0%	20.2%	27.6%	62.4%	73.1%	-5.2%	10.6%
Dec 1974	46.7%	7.2%	7.5%	-3.6%	47.1%	69.4%	136.6%
May 1970	38.5%	7.0%	2.4%	-19.9%	-45.8%	0.0%	28.1%
Dec 1914	56.0%	-7.0%	-7.0%	10.3%	69.0%	89.0%	46.7%
Mar 1938	52.3%	-10.7%	-15.0%	58.6%	26.2%	63.3%	124.5%
Average	**59.8%**	**64.3%**	**65.9%**	**95.1%**	**102.1%**	**144.0%**	**170.0%**

Highlights for less than 0% and more than 100%

Source: dShort

has returned more than 130% (refer to Chart 4).

While this already puts the current rally into overstretched territory, Doug Short's research indicates that the current bull market is actually the fourth best ever (refer to table two in Chart 4), only beaten by the heroic recoveries of 1932, 1921 and 1982. I am not sure why Wall Street strategists interpret current conditions as bullish? While they constantly put buy recommendations forward, contrary to majority, I do not like buying anything that is even remotely close to the "best ever".

As we reflect on Chart 3, which puts forward an average historical model of secular bear markets, we can analyze the performance of stock prices dating back to the nineteen century and study the periods where performance was flat or negative over a 17 year period. These periods of long term mediocre gains should be one of the key components to divulging a generational buy signal (refer to Chart 5).

Assuming that the secular bear continues to behave within the similar historical context, the chart below shows that the ongoing under-performance of stocks has not yet reached extraordinary value, like we saw in the late 1910s, late 1940s and early 1980s (all great market bottoms). While the major panic of 2008 was an exceptional buying opportunity in nominal terms, as I believe that the S&P will not again trade below the 666 printed on 06th of March 2009, investors who are holding stocks could be in for a few more years of sideways consolidation and negative surprises.

So while the price might not completely collapse in nominal terms, the S&P 500 will most likely continue to underperform in real terms, until the end of the decade. Moving away from the price and time analysis of the current secular bear market, unquestionably one should also use valuations to gauge expected future returns.

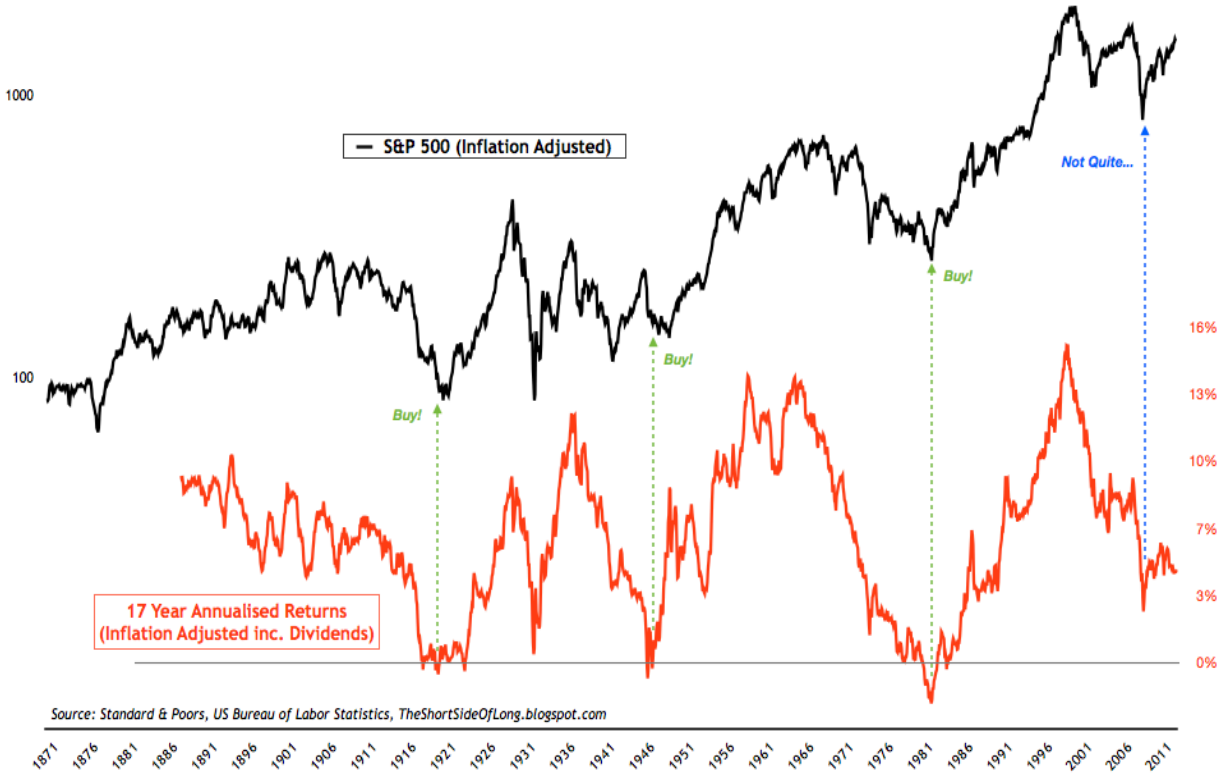
One of the only reliable ways to determinate the fundamental valuation of the stock market is to utilize Robert Shiller's Cyclically Adjusted Price Earnings Ratio, also known as CAPE10. Those not familiar with the CAPE10 concept should find the following explanation by Doug Short (source: dshort.com) very convenient and beneficial:

"Legendary economist and value investor Benjamin Graham noticed the same bizarre P/E behavior during the Roaring Twenties and subsequent market crash. Graham collaborated with David Dodd to devise a more accurate way to calculate the market's value, which they discussed in their 1934 classic book, Security Analysis.

They attributed the illogical P/E ratios to temporary and sometimes extreme fluctuations in the business cycle. Their solution was to divide the price by a multi-year average of earnings and suggested 5, 7 or 10-years.

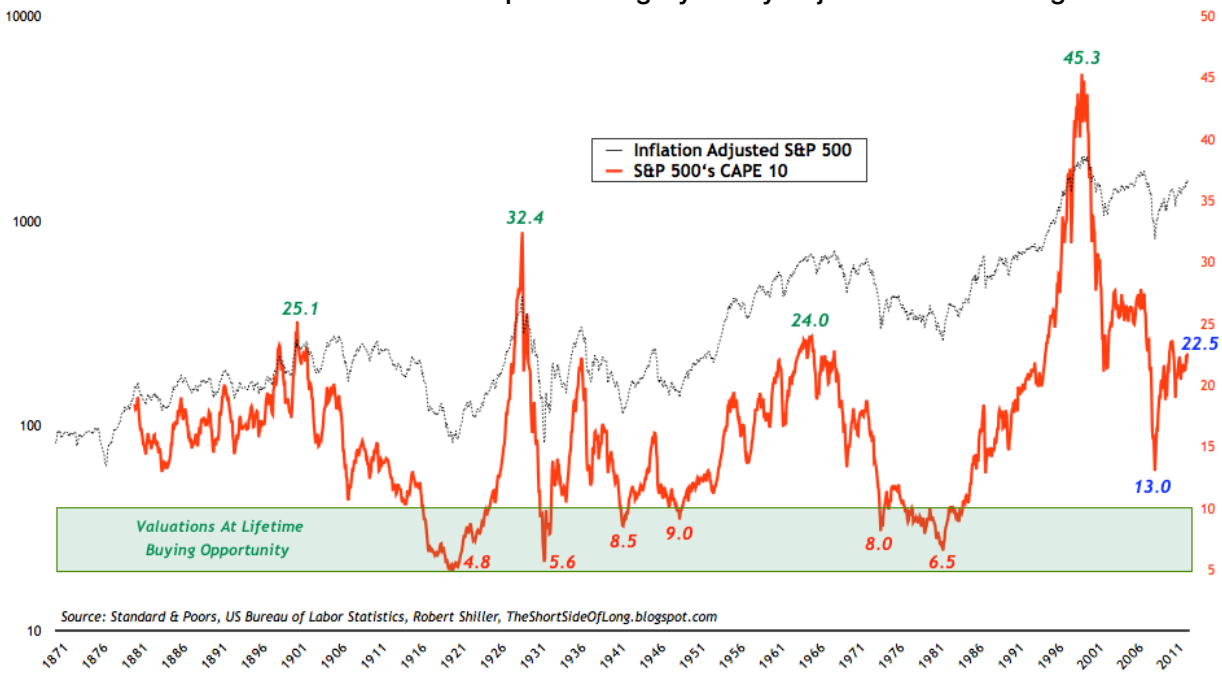
In recent years, Yale professor Robert Shiller,

Chart 5: During secular bears equities fall into negative return over a 17 year annualized period



Source: Short Side of Long

Chart 6: The historical valuation of US equities using Cyclically Adjusted Price Earnings method



Source: Short Side of Long

the author of Irrational Exuberance, has reintroduced the concept to a wider audience of investors and has selected the 10-year average of "real" (inflation-adjusted) earnings as the denominator. Shiller refers to this ratio as the Cyclically Adjusted Price Earnings Ratio, abbreviated as CAPE, or the more precise P/E10, which is my preferred abbreviation."

By closely observing Chart 6, investors should notice that all major bottoms and great generational buying opportunities occurred when the CAPE10 reached a single digit ratio. Dirt cheap valuations occurred in 1921 with 4.8 times, 1932 with 5.6 times, 1942 with 8.5 times, 1949 with 9 times, 1974 with 8 times and 1982 with 6.5 times CAPE 10 ratio. Interestingly, investors should also observe that since the early 1980s, long term valuations, using Robert Shiller's methodology, have not reached single digits. In other words, **US equities have not traded at drastically cheap, lifetime buying valuations for three decades.**

Since the March 2009 bottom never reached single digit CAPE10, I continue to hold a view that the trough will most likely not be a major one in inflation adjusted, real price terms. Moreover, since the current CAPE10 is above 22, it is highly likely that further sideways price action and more downside disappointments will materialize before equities become truly cheap.

Therefore, it is all together possible that the astronomical overvaluations we saw during the Tech Mania of the late 1990s, as CAPE10 reached a new historical record of 45 times, could prolong this secular bear market. It is going to take more time to subdue current overvaluations. Even though trading ranges commonly run for about 17 years, we could go through a longer twenty year span like in the 1930s and 1940s.

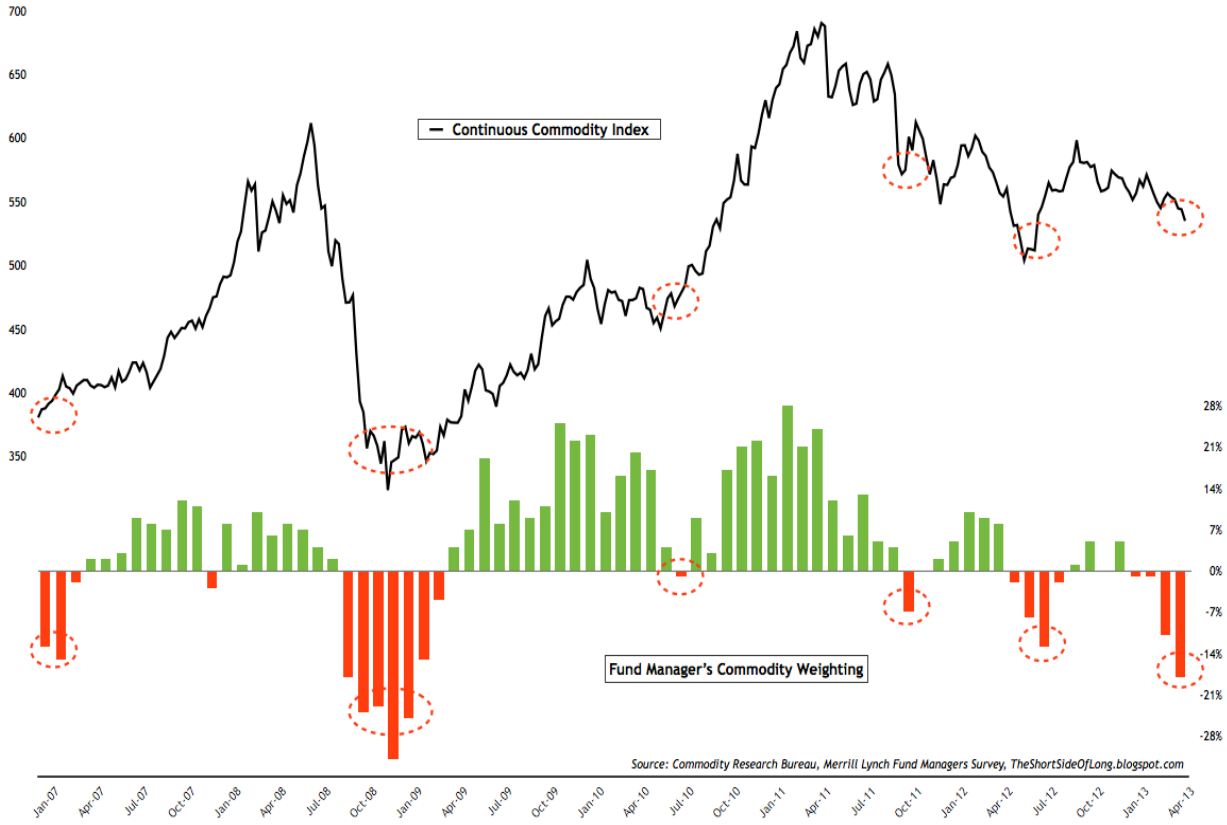
For wise long term investors, periods when CAPE10 reaches single digits and 17 year annualized equity returns reach flat or even negative levels, are unquestionably rare and incredibly significant opportunities. Consider the fact that opportunities such as these have occurred in only three periods over the last 120 years. These were between 1918 and 1923; 1946 and 1949; and finally between 1978 and 1984. Buying equities during any of those periods and holding for at least a decade has resulted in colossal life changing fortunes being made.

The reason I write this newsletter is because I sincerely wish all of my readers the best possible returns in financial markets, while avoiding catastrophic pitfalls (we have all made them at least once in our trading career).

As a result of the secular bear market analysis thoroughly explained in this newsletter, I continue to believe that the "Great Rotation" reasoning to purchase equities at the current levels will prove premature.

While equities are definitely becoming cheaper relative to the remarkable overvaluations of the late 1990s, a lifetime buying opportunity and a true bottom which long term investors can participate in, is not here just yet. I believe that one more major correction will do the job. Shifting gears to near term investment considerations, I would first like to

Chart 7: Global fund managers are now extremely underexposed to commodities



Source: Short Side of Long

summarize my views from the previous newsletter. In Issue 1 of the Short Side of Long, written on March 18th, I stated that the *"current investment conditions continue to be a tug of war between the super-easy monetary policies of global central banks and slowing economic activity. In most investor's minds, there is no shadow of doubt that under the current central bank policies, equities are a 'must buy' and it is this type of certainty that has me worried. Therefore, on a relative basis and as a contrarian investor I tend to find Treasuries somewhat more attractive."*

Treasuries bottomed by mid March and have enjoyed a decent rally. While prices could very well resume their climb from the current levels towards new highs, I would advise against chasing at these lofty values. Do not misunderstand me, if equities once again enter a bear market, there is definitely a possibility that super bears and deflationist's predictions of extremely low yields (10 Year Note at 1%) could turn out correct. However, as a long term investor, I would prefer to buy value rather than chase momentum. My personal preference of value remains with commodities.

Naturally, the majority of global equities, currencies and commodities corrected as bonds rallied. Commodities, in particular, came under heavy selling pressure. Underexposure, investor negativity and universal expectations of even lower prices are all usually a sign that a bottom within the sector is fast approaching. AgriMoney blog writes:

"A fund manager survey highlighted the extent to which commodities have fallen out of fashion by revealing an 'unambiguous capitulation' in the sector, sending exposure to the asset class to a four-year low.

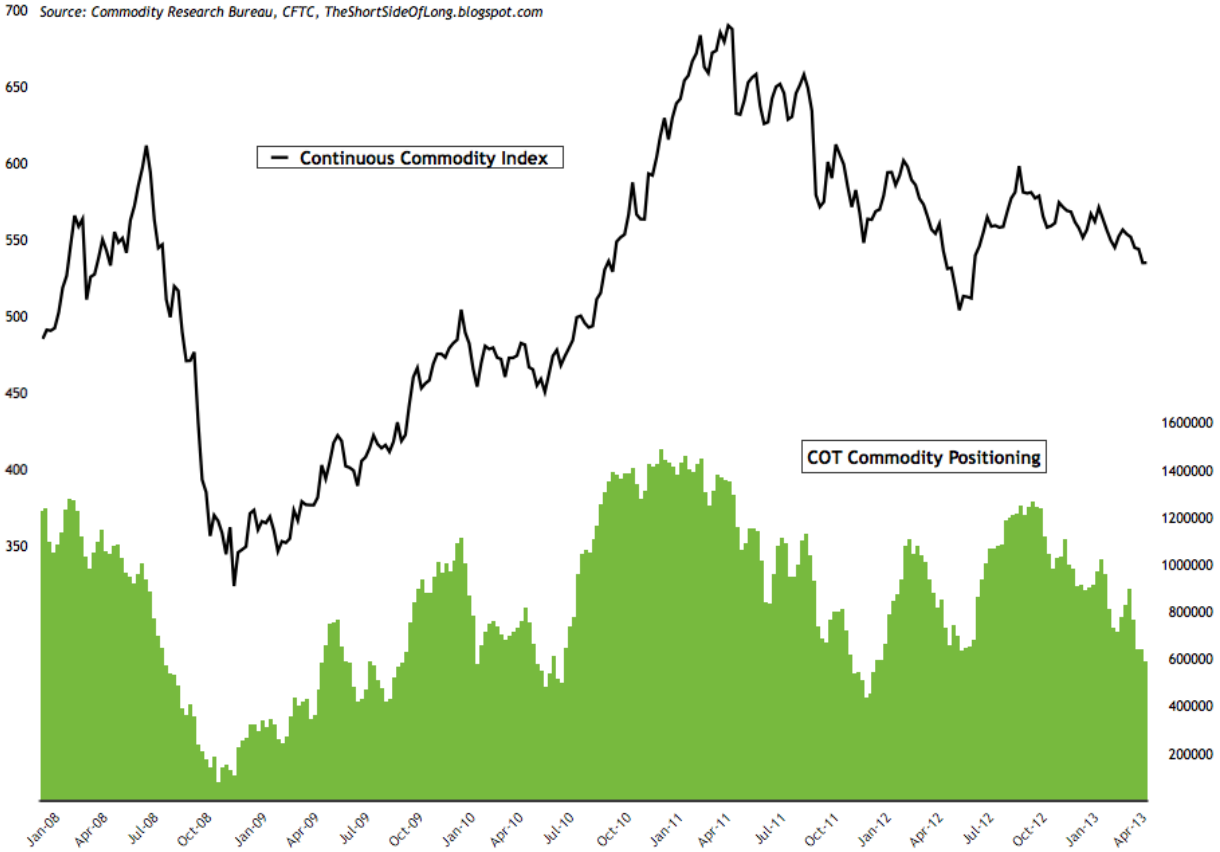
The proportion of investment managers underweight on commodities outnumbered those overweight by 18 points, the highest level since January 2009, a BofA Merrill Lynch survey showed." (refer to Chart 7)

Confirming this outlook is the recent CFTC Commitment of Traders report. Hedge funds and other speculators have reduced their net long positions to 589,787 contracts from 1,268,258 in October 2012 - a 54% decrease (refer to Chart 8).

Commodities that have become significantly out of favor according to SentimenTrader's Public Opinion are Gasoline, Heating Oil (high correlation with Brent Crude), Copper, Gold, Silver, Platinum, Cattle, Lean Hogs, Coffee, Sugar and Wheat (refer to Chart 9). As a matter of fact, it is remarkably difficult to find a commodity which has favorable news accompanying it.

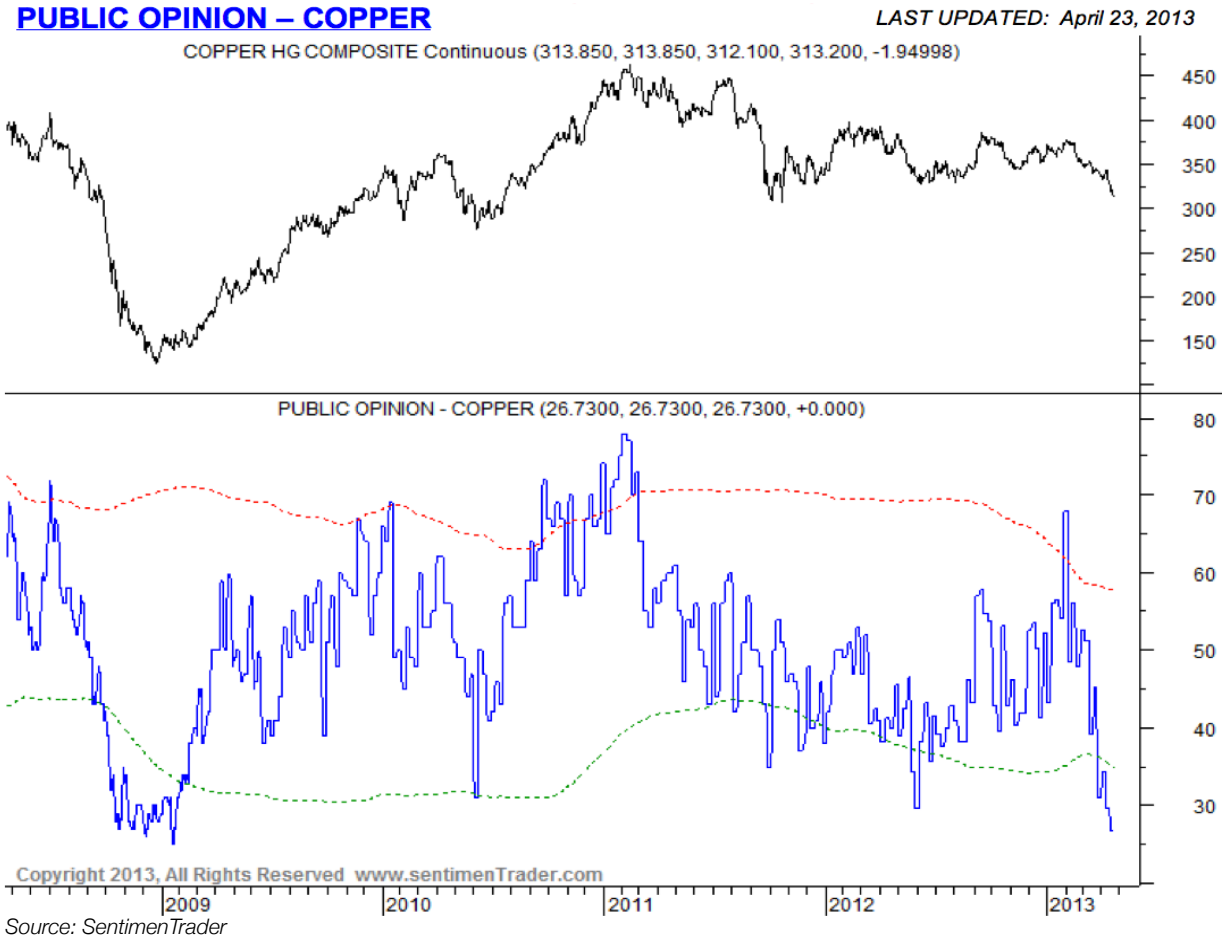
In recent newsletter issues I made a reference towards extremely high US Dollar sentiment. In particular, Issue 2 made a reference that *"Dollar sentiment has reached excessively bullish levels.*

Chart 8: Hedge funds and other speculators hold lowest commodity exposure in 14 months



Source: Short Side of Long

Chart 9: Investors have become extremely negative on industrial commodities like Copper



Source: SentimenTrader

While further appreciation is not impossible, in my opinion it is very unlikely."

Chart 10 perfectly explains why I still believe this to be the case from a contrarian point of view. Therefore, from a short term perspective, when we take into account extremely low commodity sentiment (glance at Chart 7, 8 and 9 again), investors should not be surprised to see rising commodity prices and a falling US Dollar in the coming months. If the inflation trade was to take hold, there is also a possibility of rising bond yields, hence why I mentioned that chasing Treasuries at the current levels isn't a wise value play.

At this point, certain readers will question my bearish stance on equities yet again (no I do not hold prejudice towards US equities), stating that they hold a positive correlation with commodities and negative correlation with the greenback. In other words, if the US Dollar falls, commodities as well as US equities could benefit.

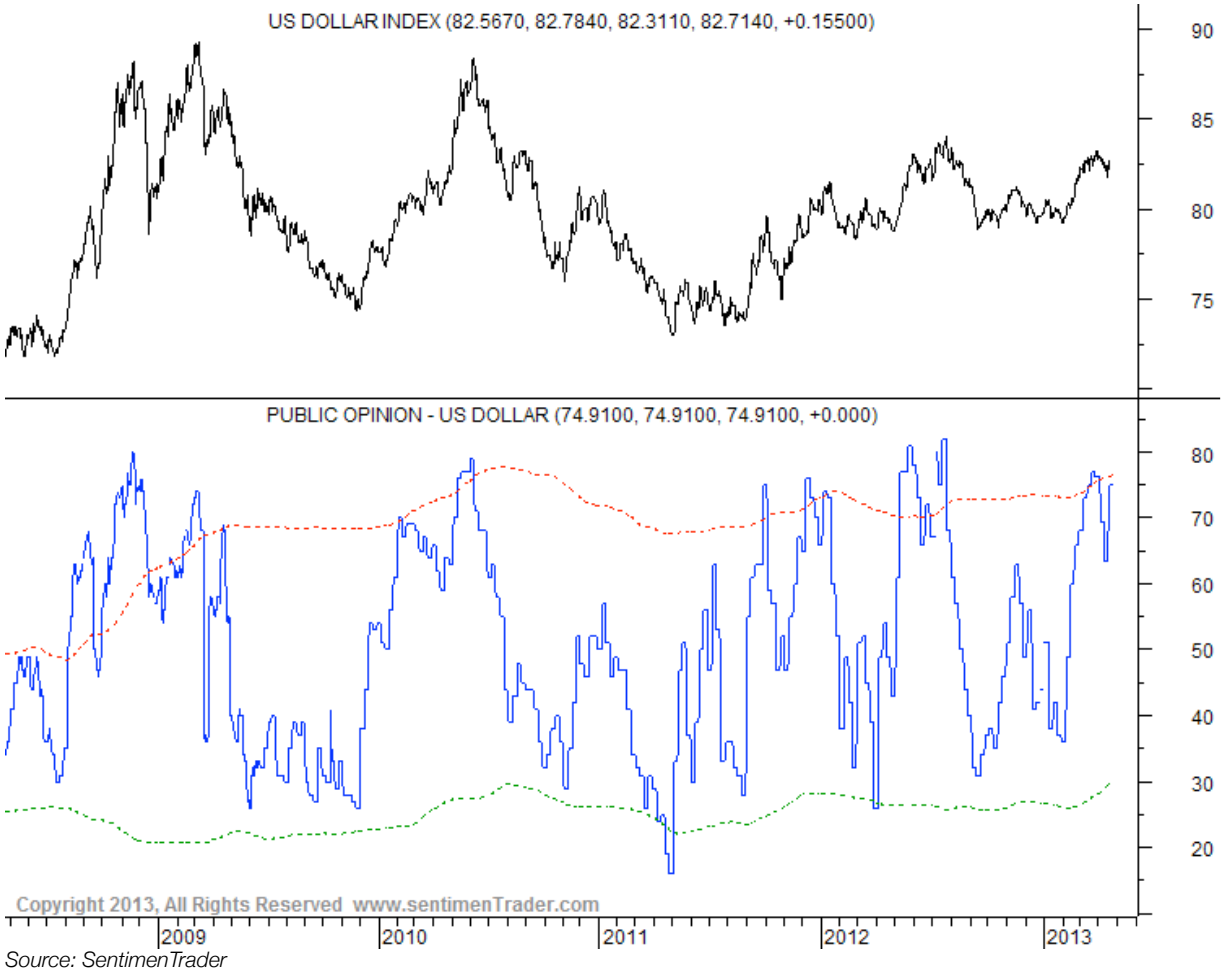
While this is true majority of the time, I would like my readers to remember the period between late 2006 and early 2007, as it holds close resemblance to the current economic and financial conditions. The business cycle was nearing the end of the expansion and the slowdown due to the subprime issues was becoming more pronounced in the US. By early 2007, sentiment was extremely depressed on all commodities from energy to precious metals and agriculture, while US equities enjoyed a spectacular rally. However, as the subprime situation worsened, Ben Bernanke decided to cut interest rates in August 2007 from 5.25% towards 3.0% by January 2008. This sparked a parabolic run up in commodities, while US equities declined by 20% over the same period.

Similar conditions exist today, especially if the economy begins deteriorating. As already explained in previous newsletters, the sentiment on US equities remains extremely bullish, with margin leverage at exceptionally high levels (refer to Chart 11 & 12). Since US equities have outperformed just about every other asset class to date; including EU & GEM stocks, commodities and bonds; a period of underperformance could take place in the not so distant future.

To end the letter, I would like to wish all of my readers in the Northern Hemisphere improving weather conditions and the warmth that only spring and (eventually) summer can bring. Enjoy!

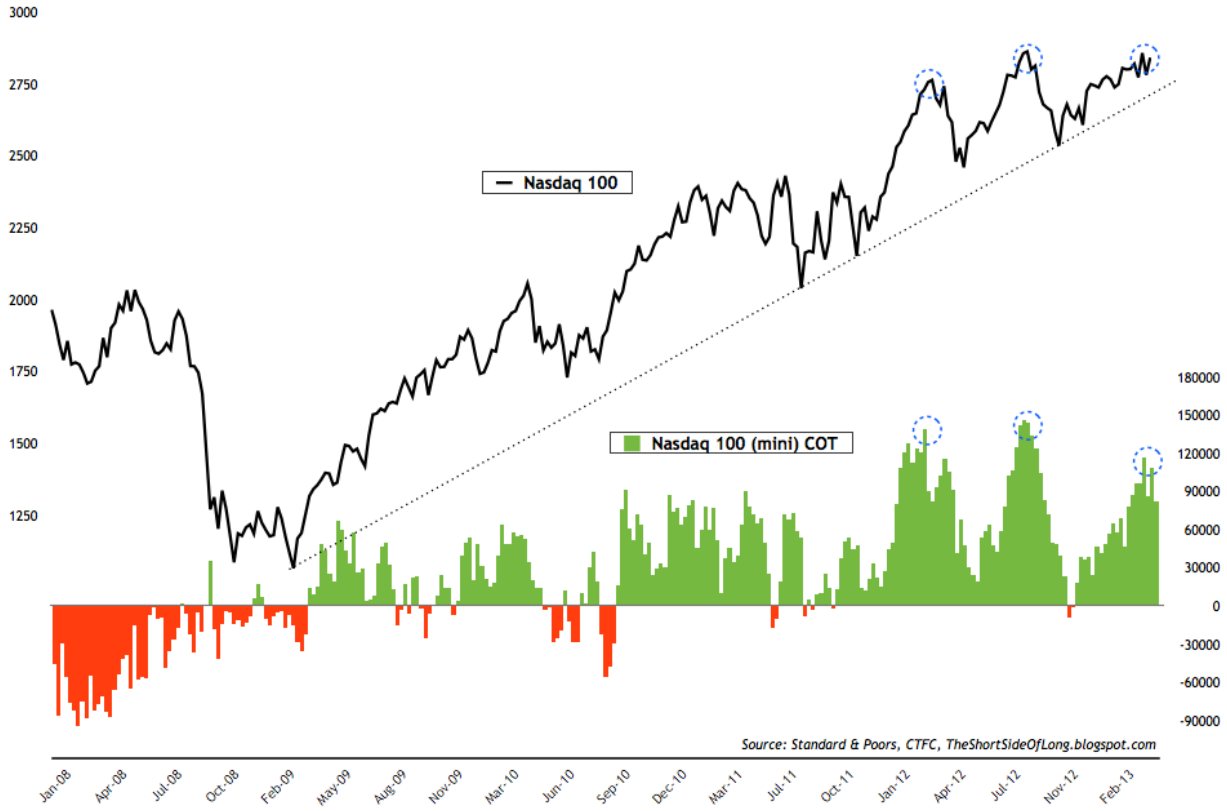
Warmest of Regards ~ Tiho

Chart 10: Extremely bullish Dollar sentiment could be a commodity rally catalyst



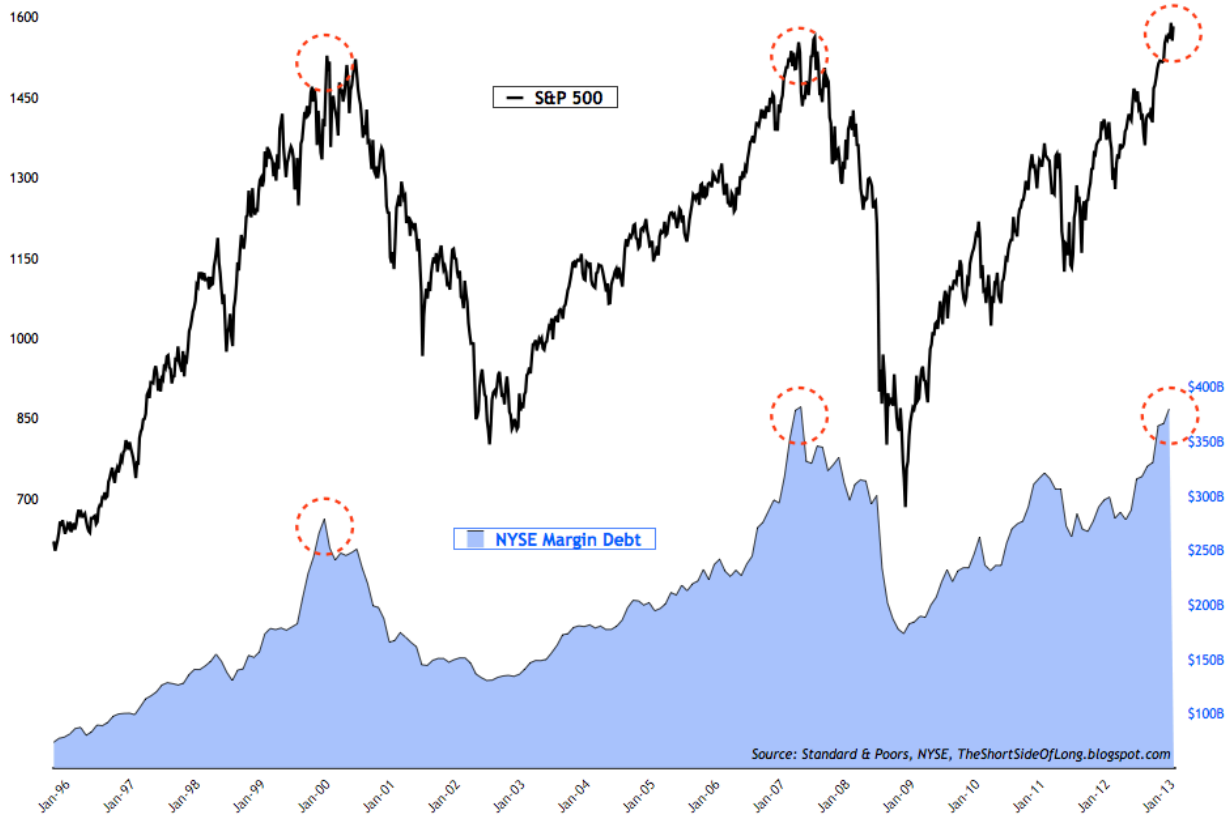
Source: SentimenTrader

Chart 11: Hedge funds, whose timing is rather poor, hold large bullish bets on technology stocks



Source: Short Side of Long

Chart 12: Investor leverage, measured by Margin Debt, is as high as during the infamous 2007 top

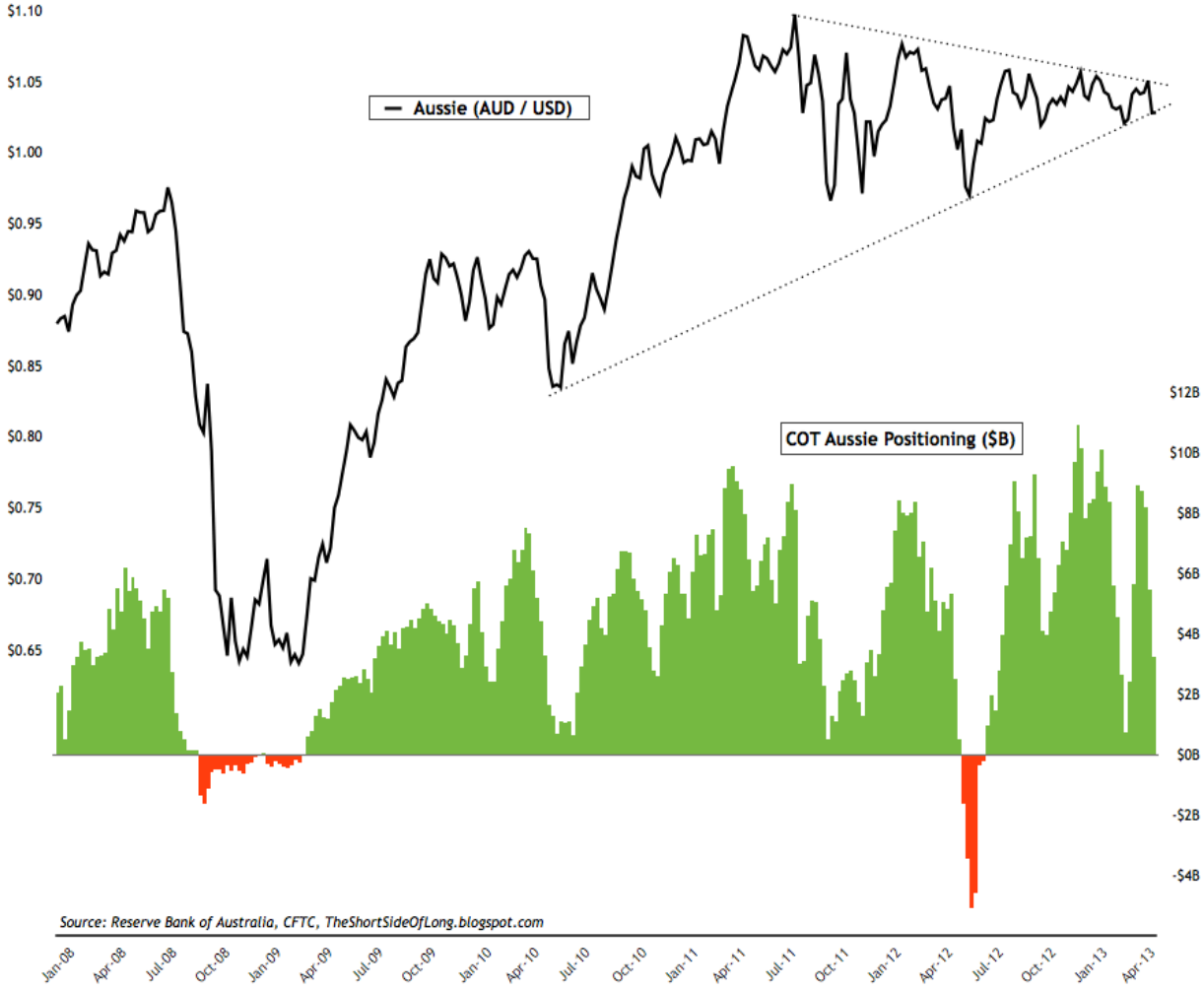


Source: Short Side of Long

The Contrarian Corner

Turning the attention towards upcoming technical market opportunities

Chart 13: The Australian Dollar finds itself at a major technical inflection point



Source: Short Side of Long

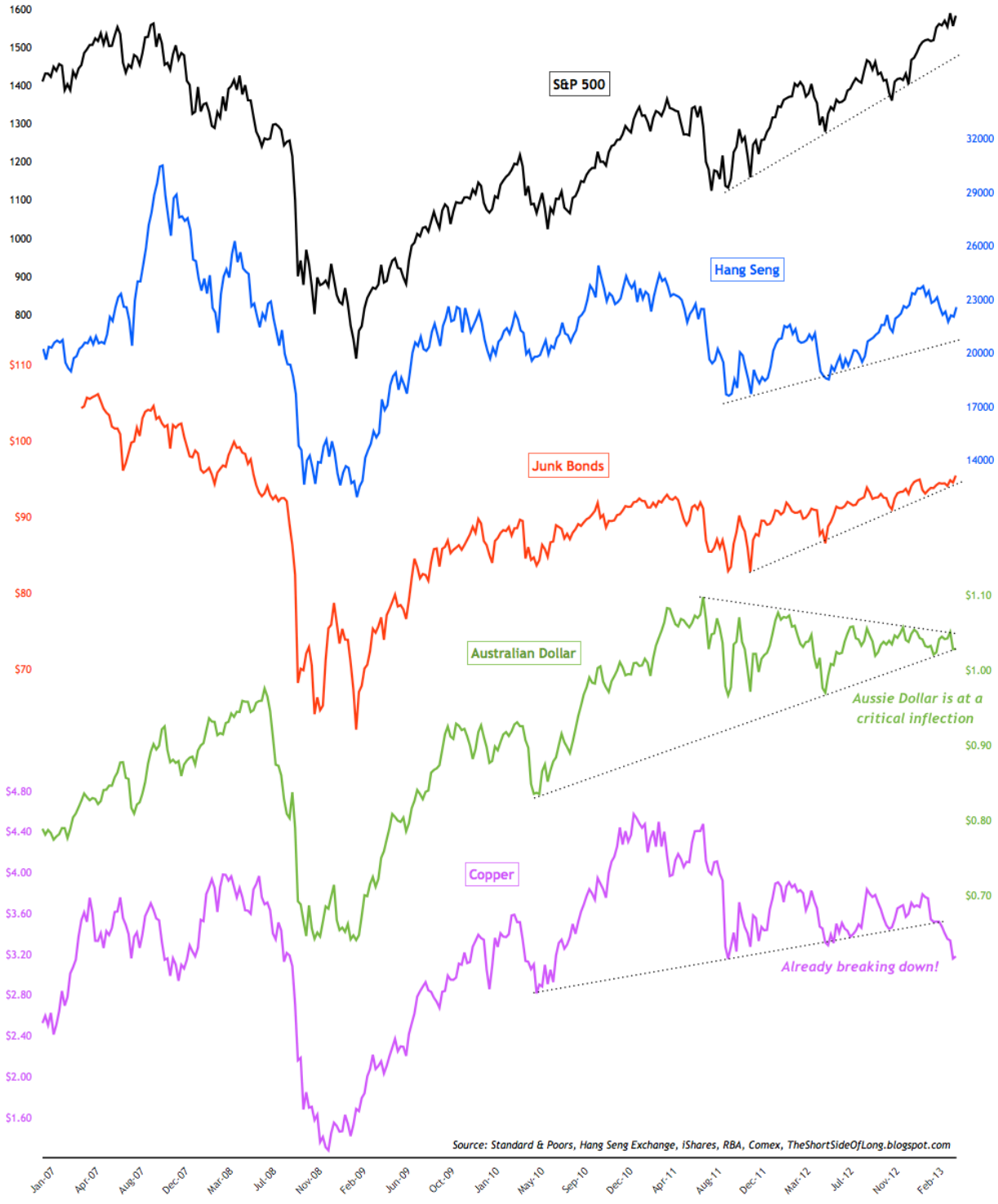
My focus continues to remain on the major currency markets of the world. In the last Contrarian Corner I covered the future prospects of the Canadian Dollar (Loonie). The triangular technical pattern did not break downwards, as the majority of the hedge funds (dumb money) holding large bearish bets experienced a short squeeze. The pattern still remains in play for now and traders should keep a close eye on further developments.

In similar fashion, commodity currency cousin, the Australian Dollar, also finds itself at an inflection point (refer to Chart 13). However, the technical triangle in the Aussie Dollar is so much more compressed, meaning that a decision could be almost imminent. A break in either direction should hold a significant message for the rest of the market and especially so called risk assets (refer to Chart 14).

At certain times, the Australian currency has correlated very closely with global equities and at other times more closely with commodity prices. Certain traders also claim that the Aussie is one of the major proxy plays for Chinese economic activity, with China being Australia's largest trading partner and the Renminbi remaining blocked to forex liquidity. Therefore, one can easily comprehend the ramifications regarding the technical inflection in Chart13 and 14.

Bottom Line: The Australian Dollar, just like many other commodity currencies, has been in a prolonged consolidation pattern. With resistance and support defined almost perfectly, a technical break in either direction should be imminent. Traders willing to play the inflection point could consider this opportunity via ETF CurrencyShares Australian Dollar Trust (NYSE symbol: FXA).

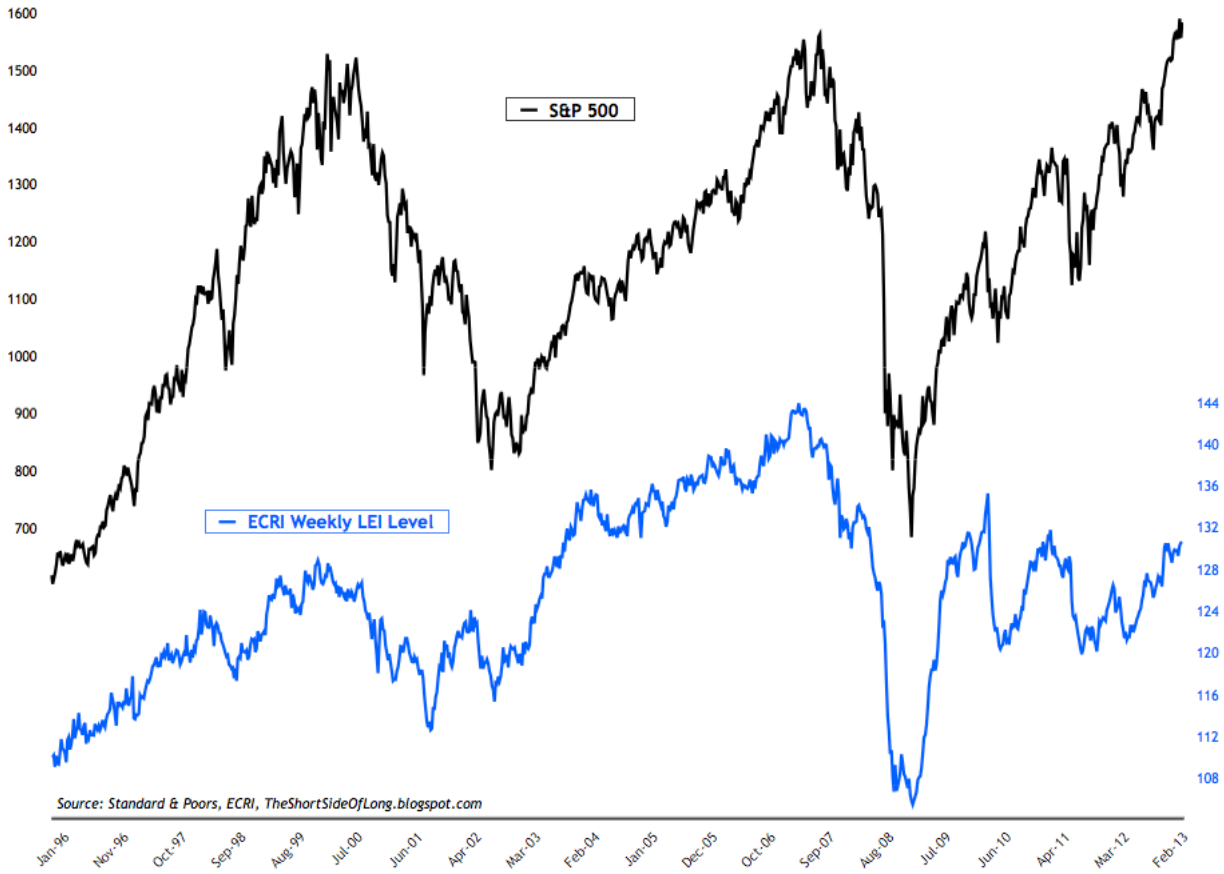
Chart 14: With Copper breaking down, could the Aussie Dollar be next? We will find out soon!

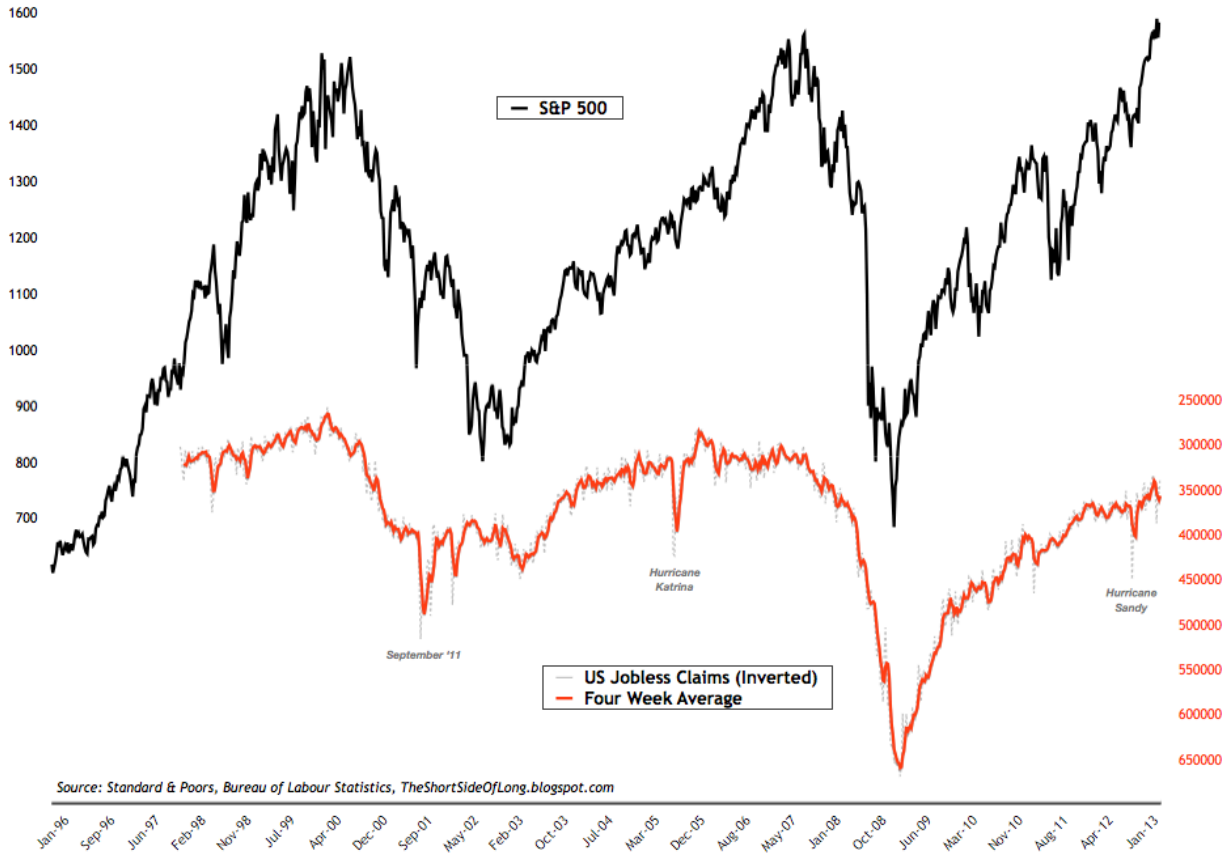


Source: Short Side of Long

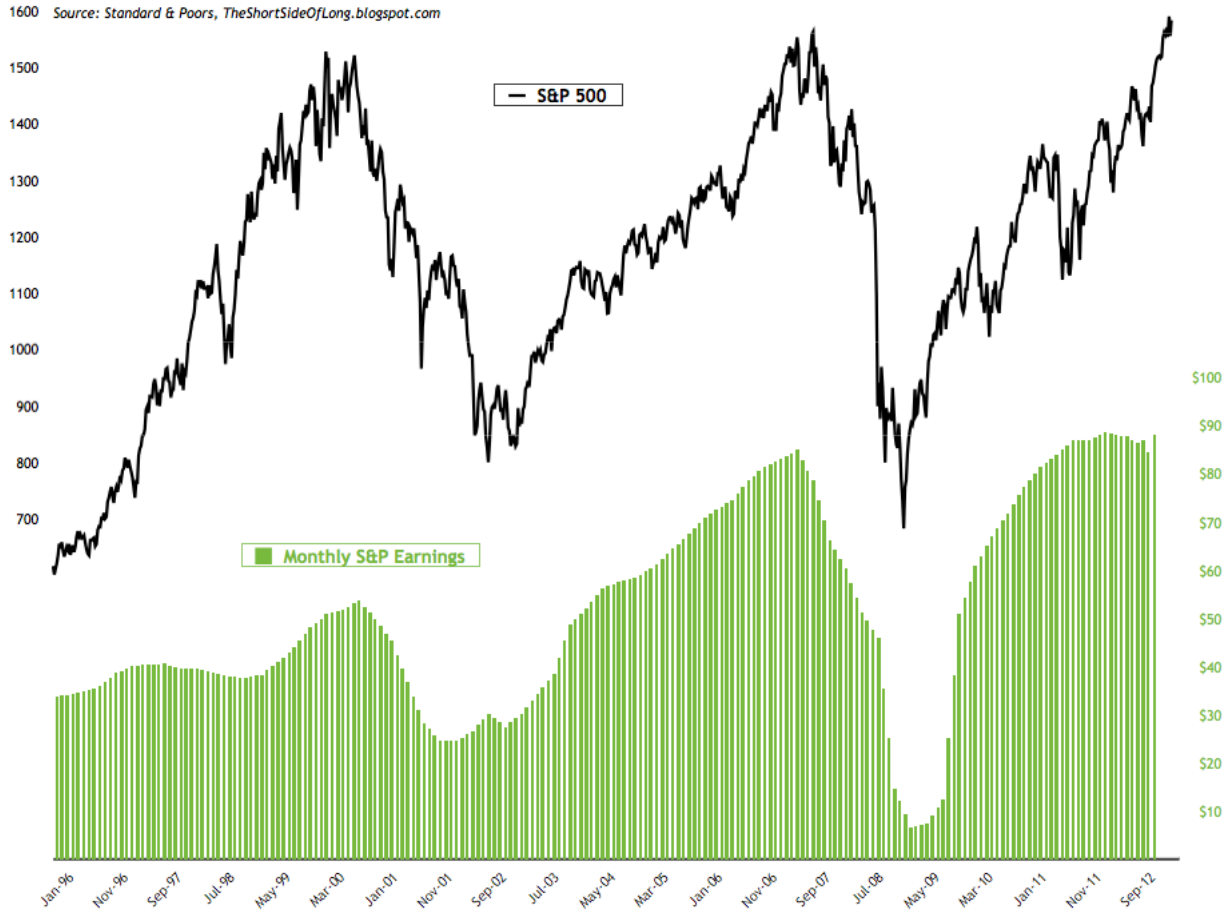
Economic Indicators

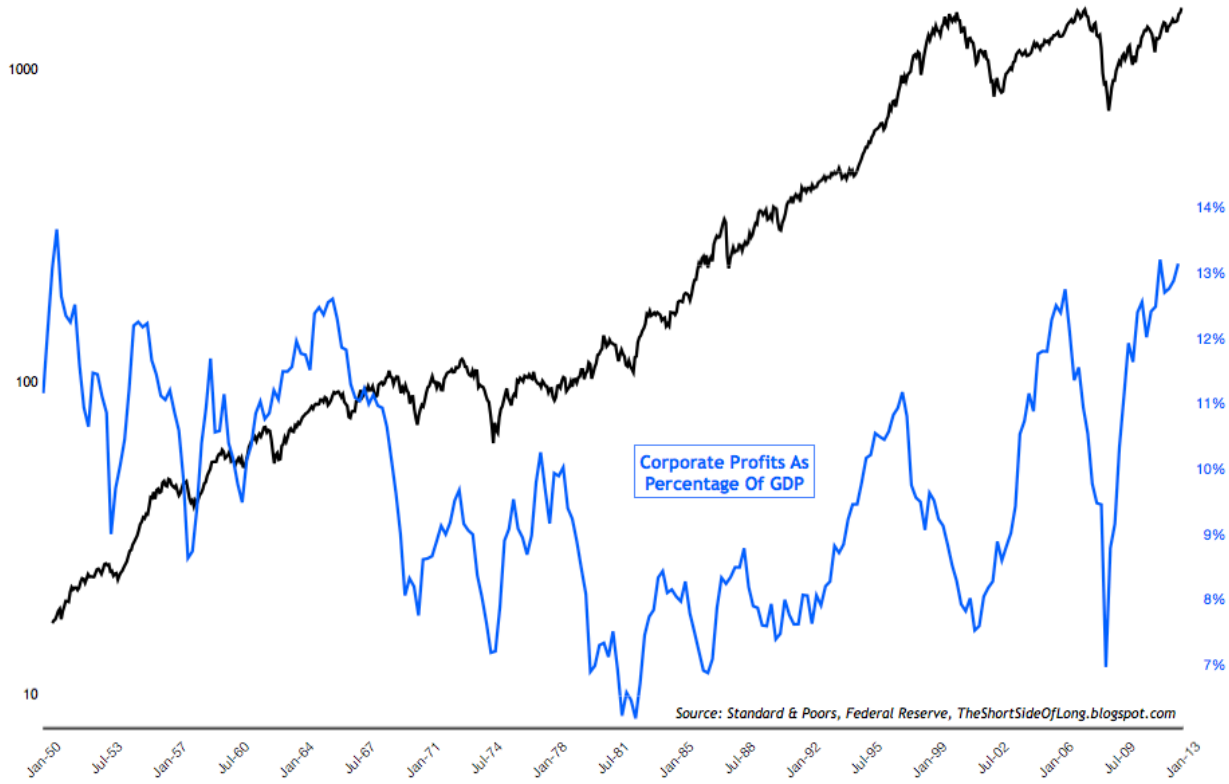
Leading Indicators | Corporate Earnings | Business Sentiment | Consumer Sentiment



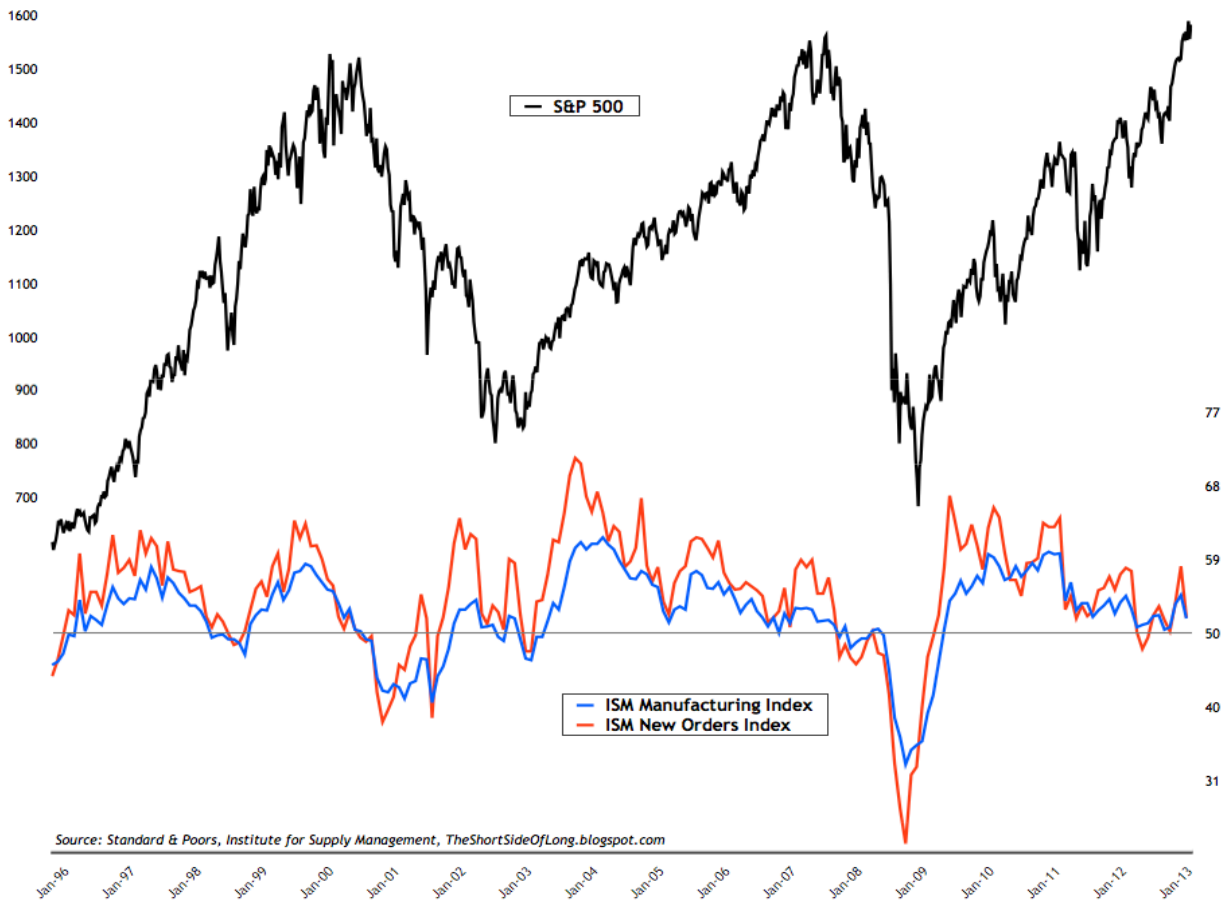


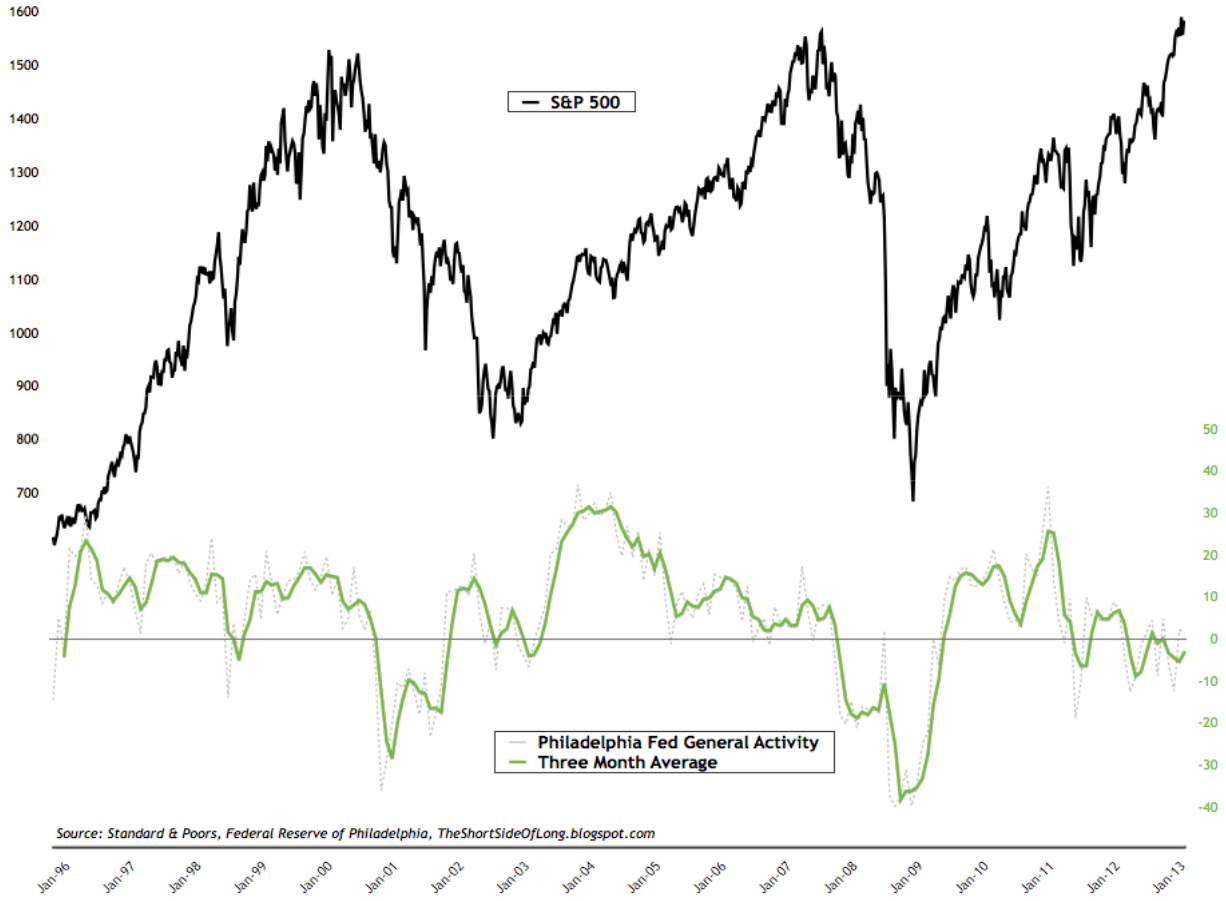
Economic Indicators





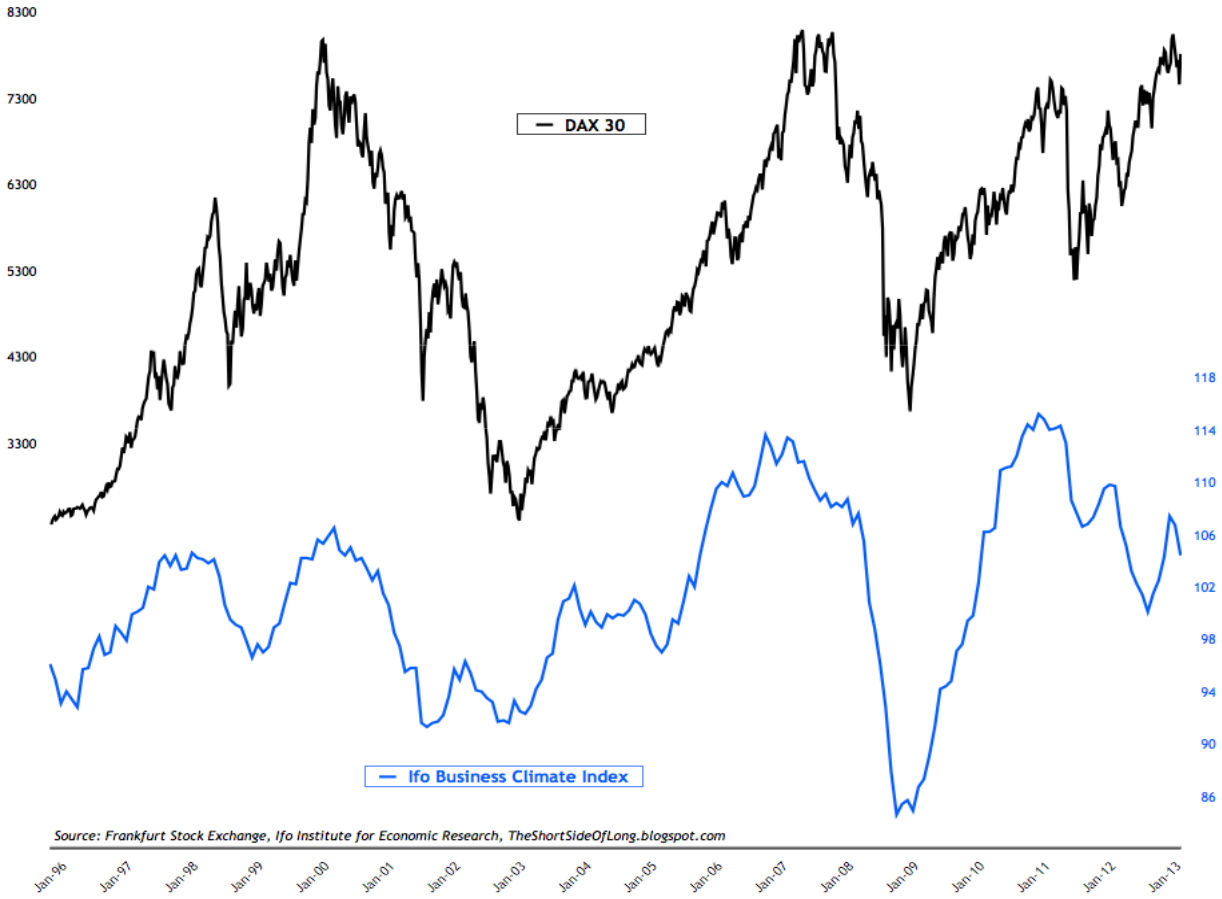
Economic Indicators

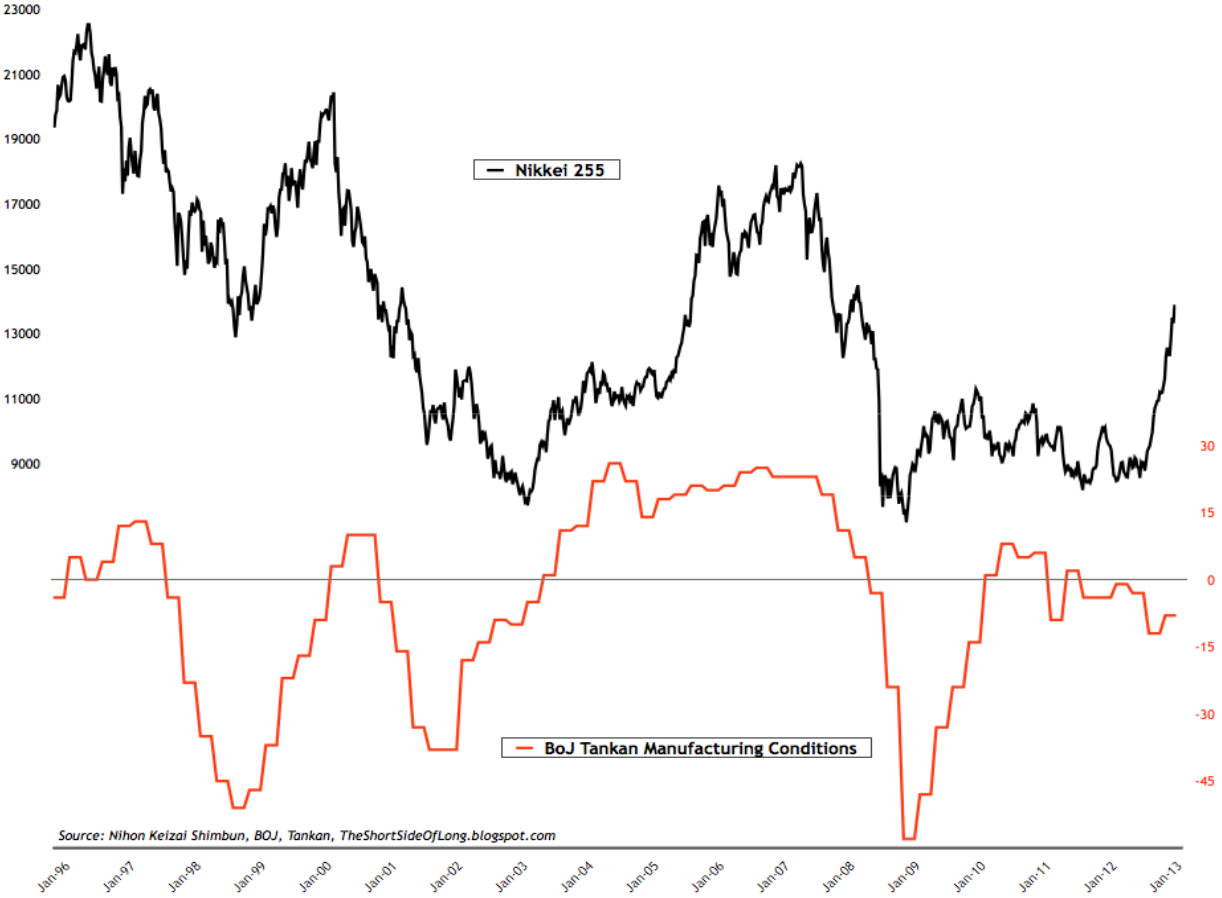




Economic Indicators

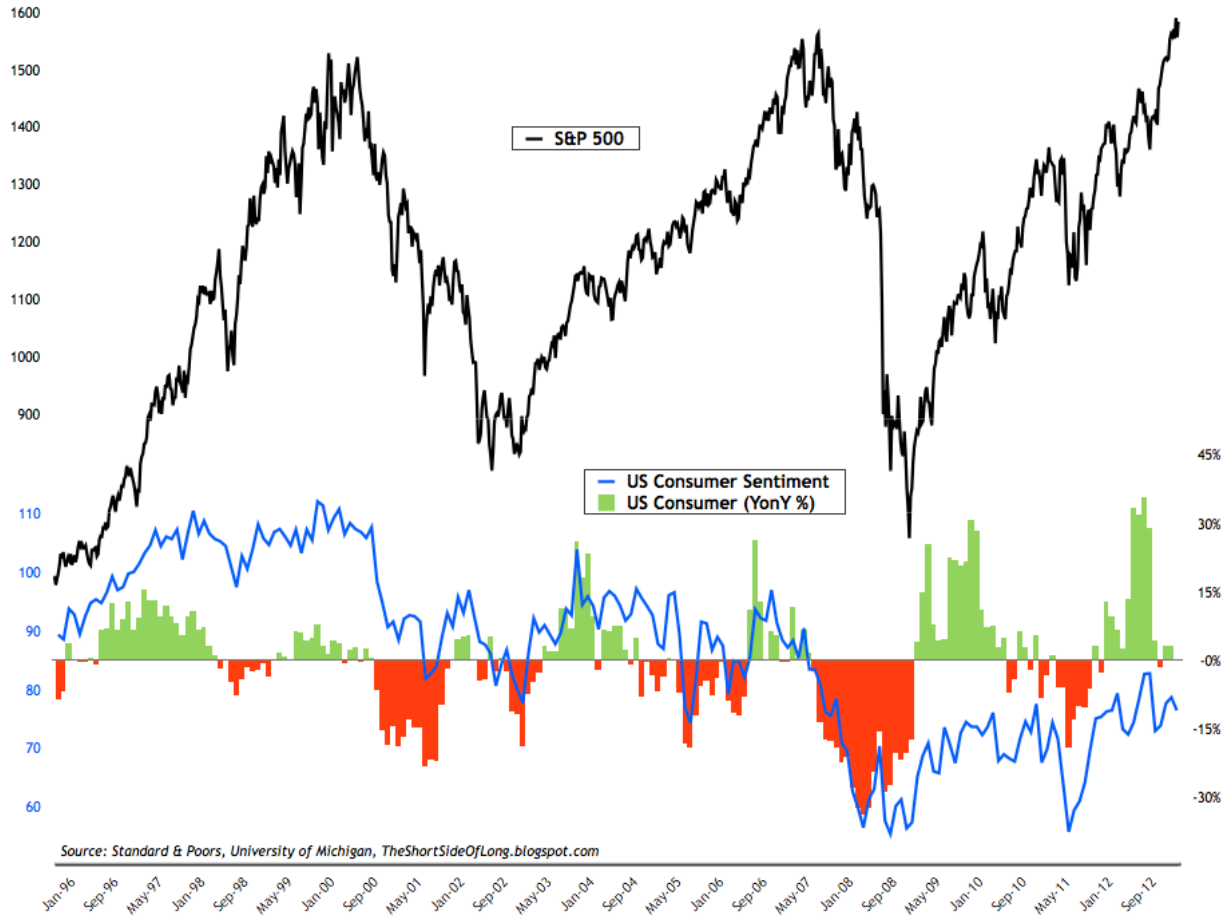
Leading Indicators | Corporate Earnings | **Business Sentiment** | Consumer Sentiment

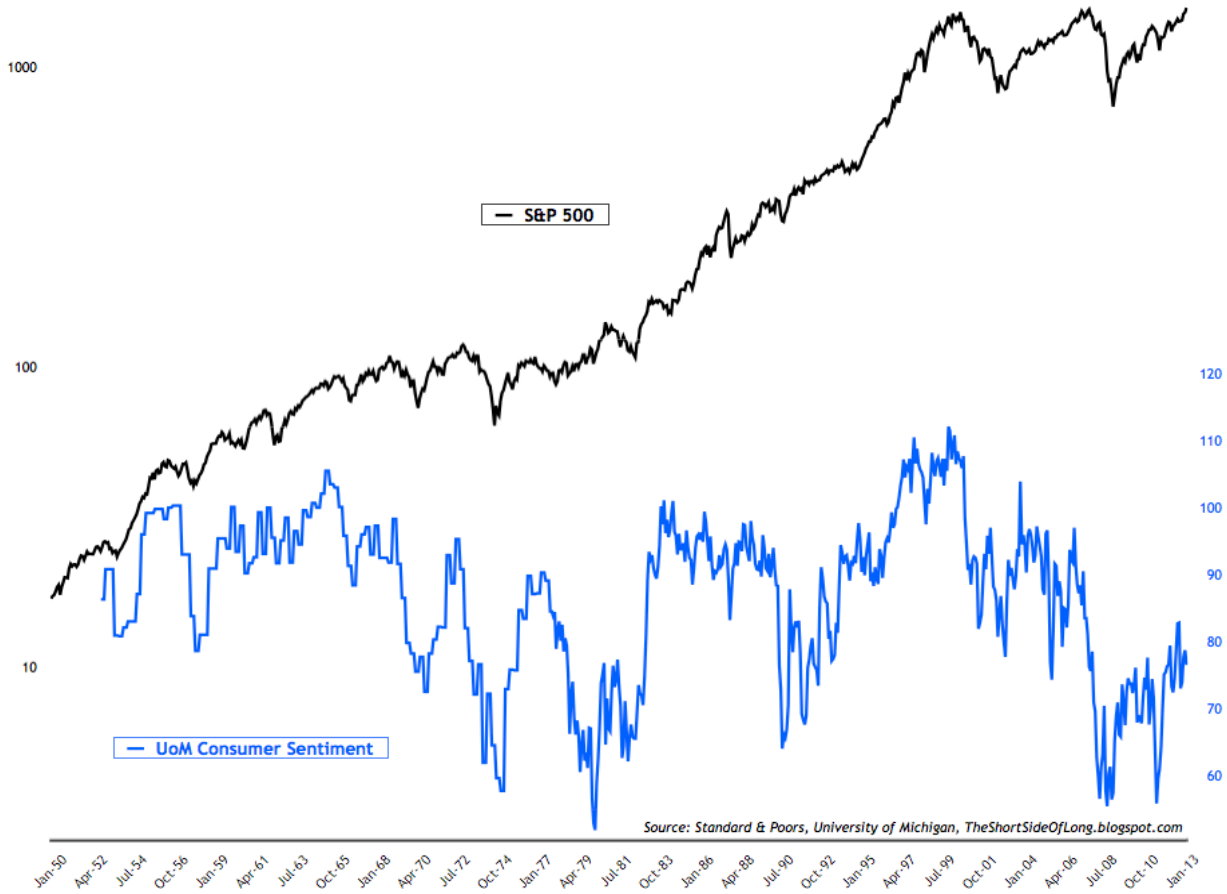




Economic Indicators

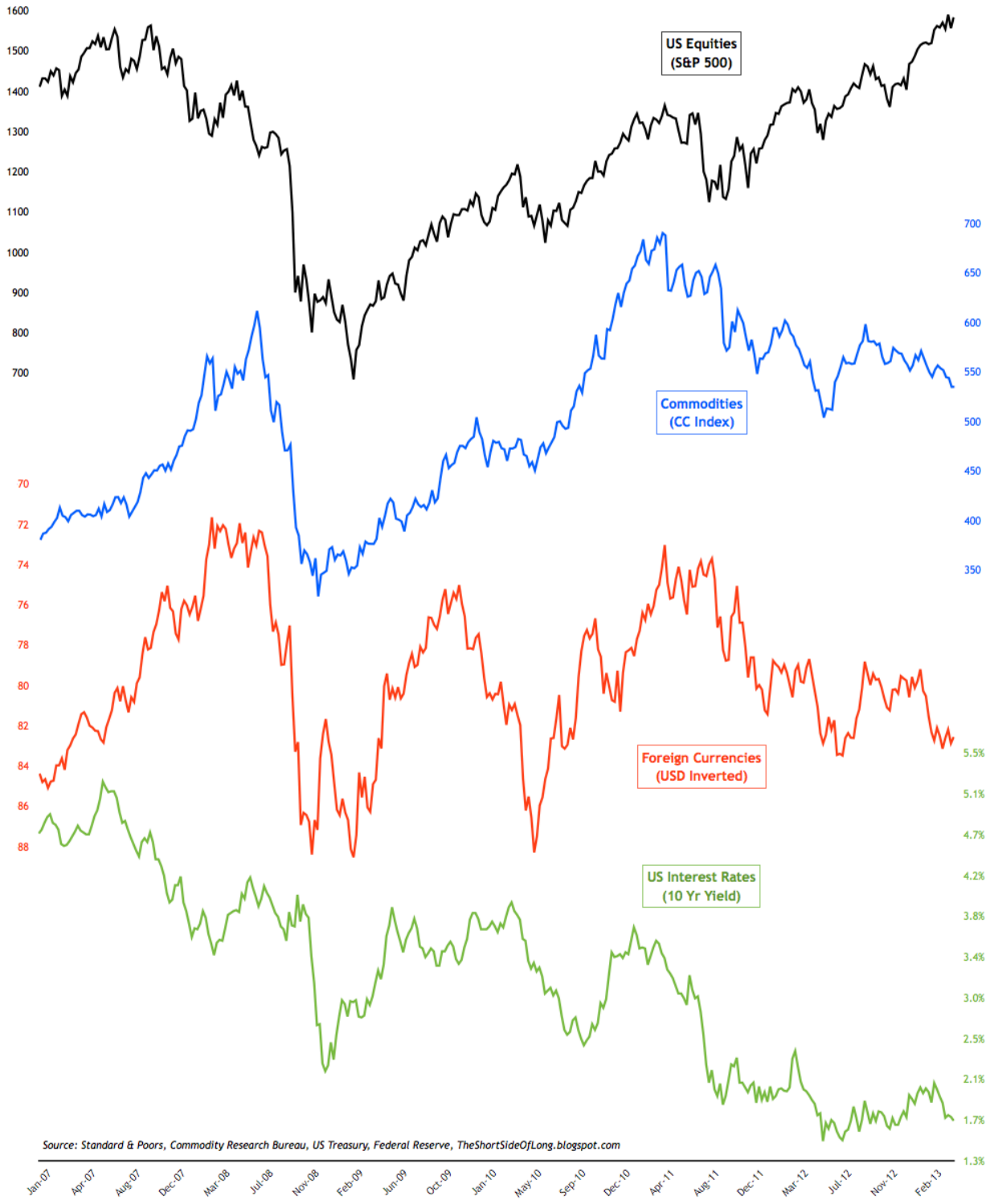
Leading Indicators | Corporate Earnings | Business Sentiment | **Consumer Sentiment**





Macro Indicators

The Performance of Equities, Bonds, Currencies and Commodities



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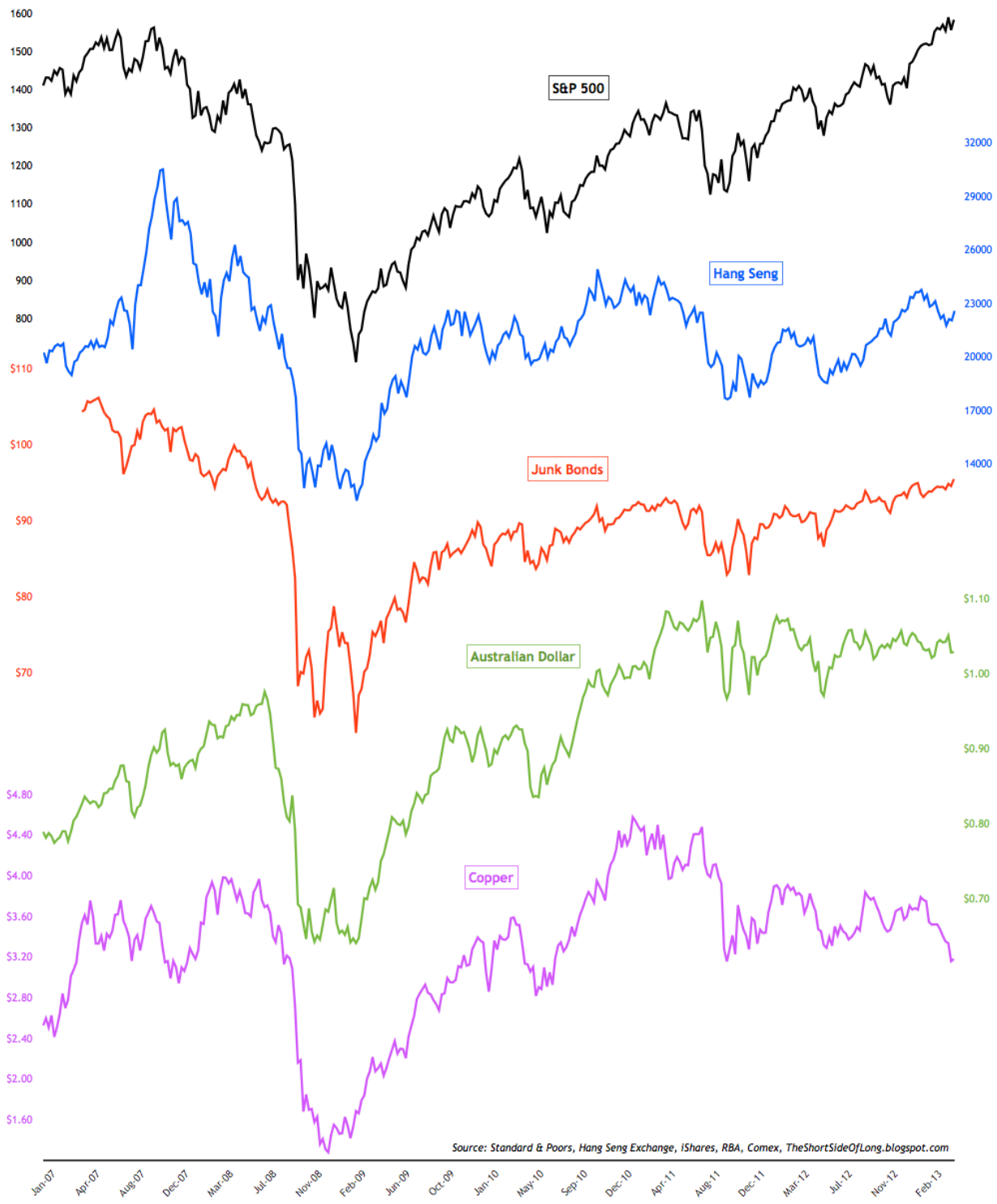

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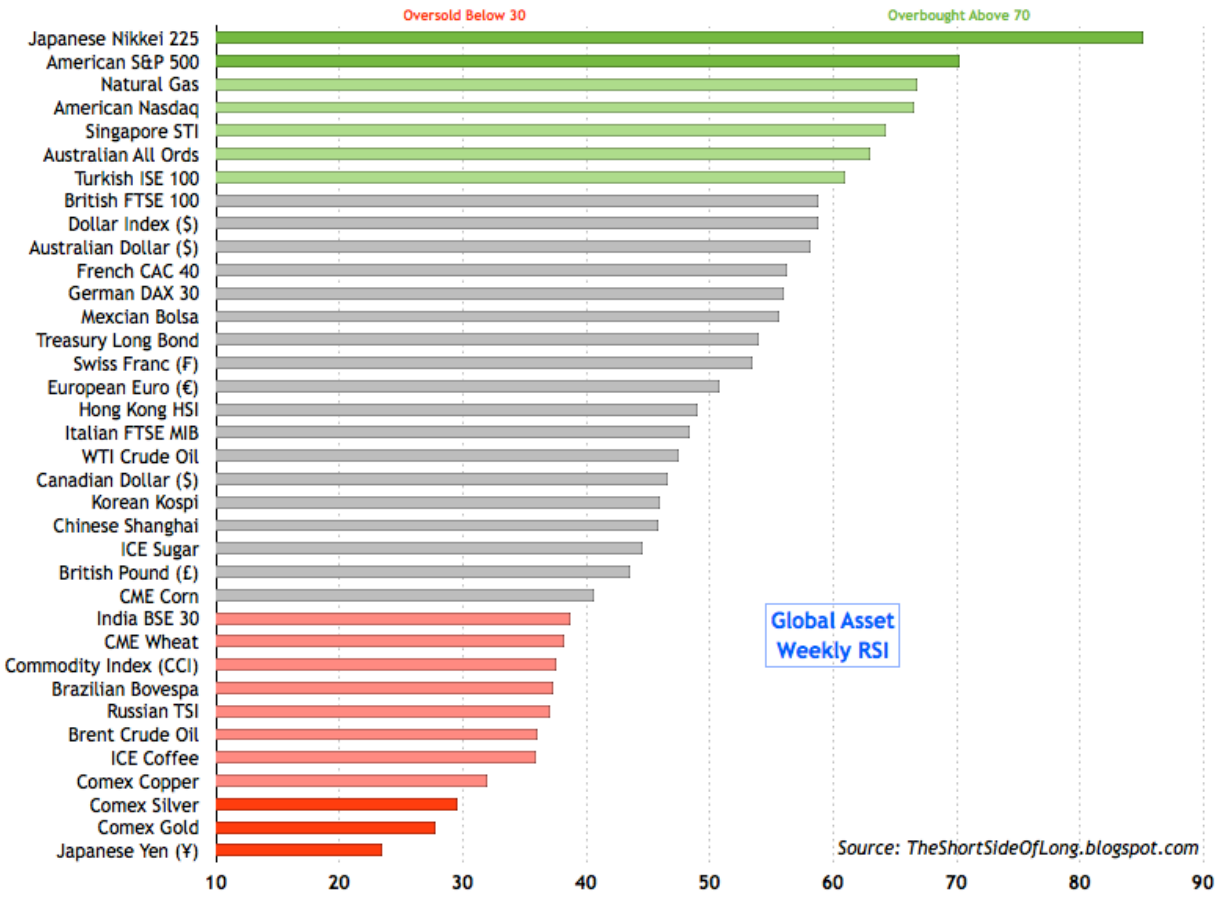
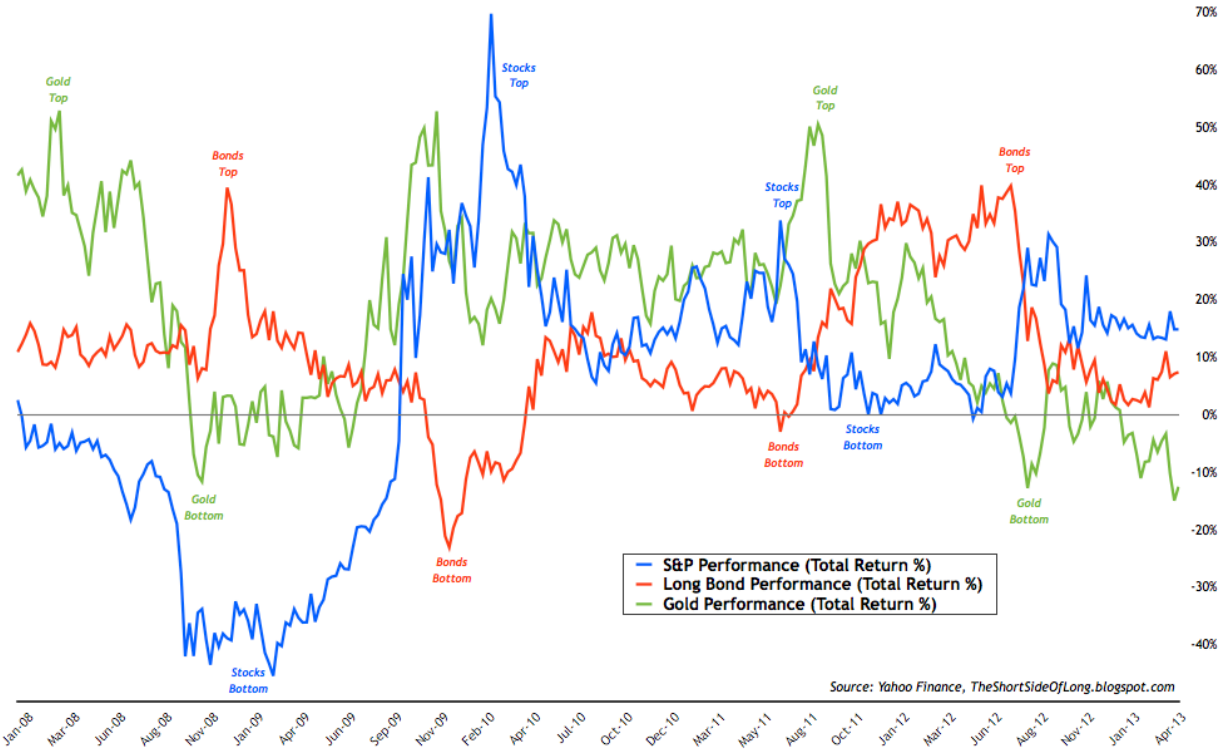
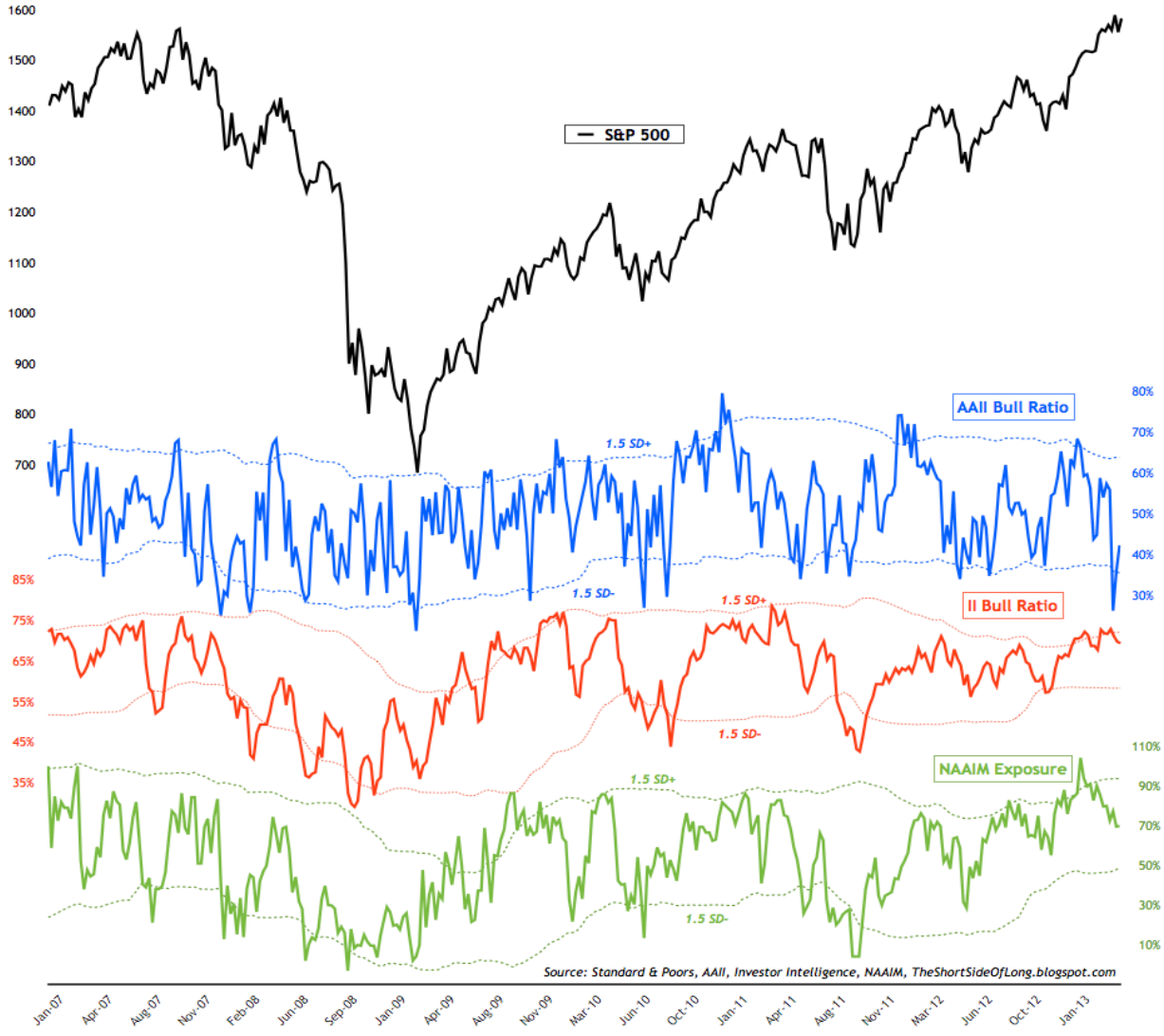
The Performance of Equities, Bonds, Currencies and Commodities

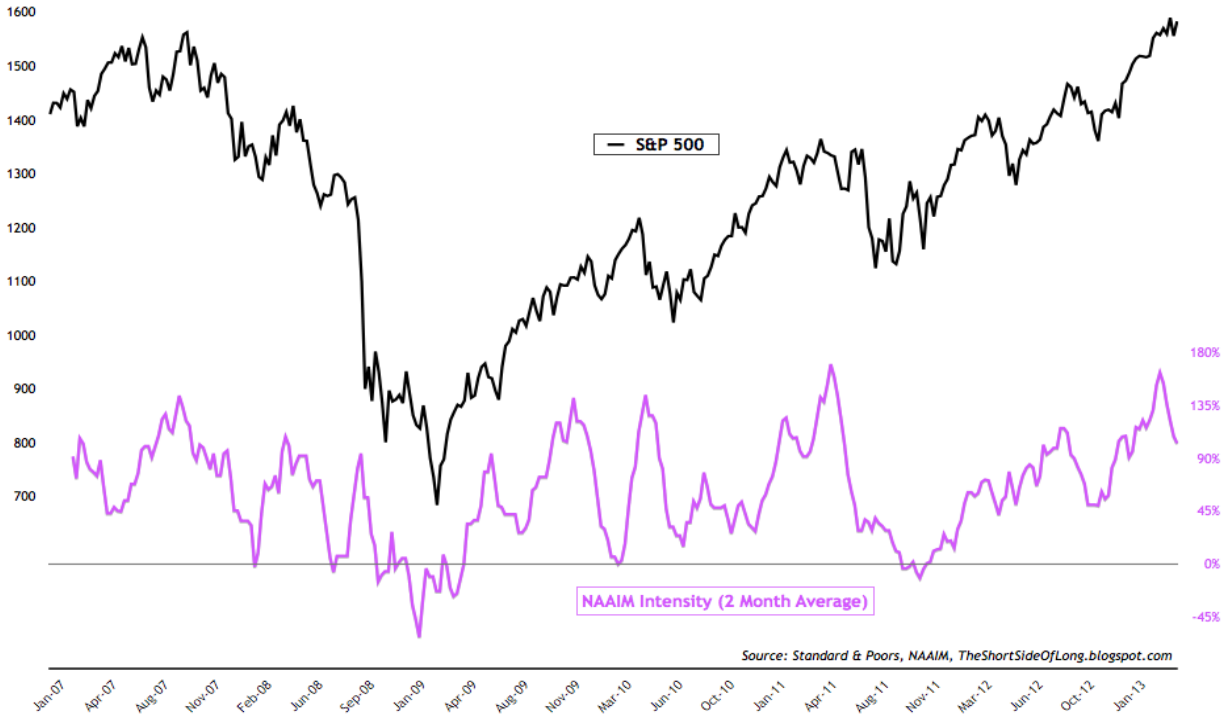




Equity Indicators

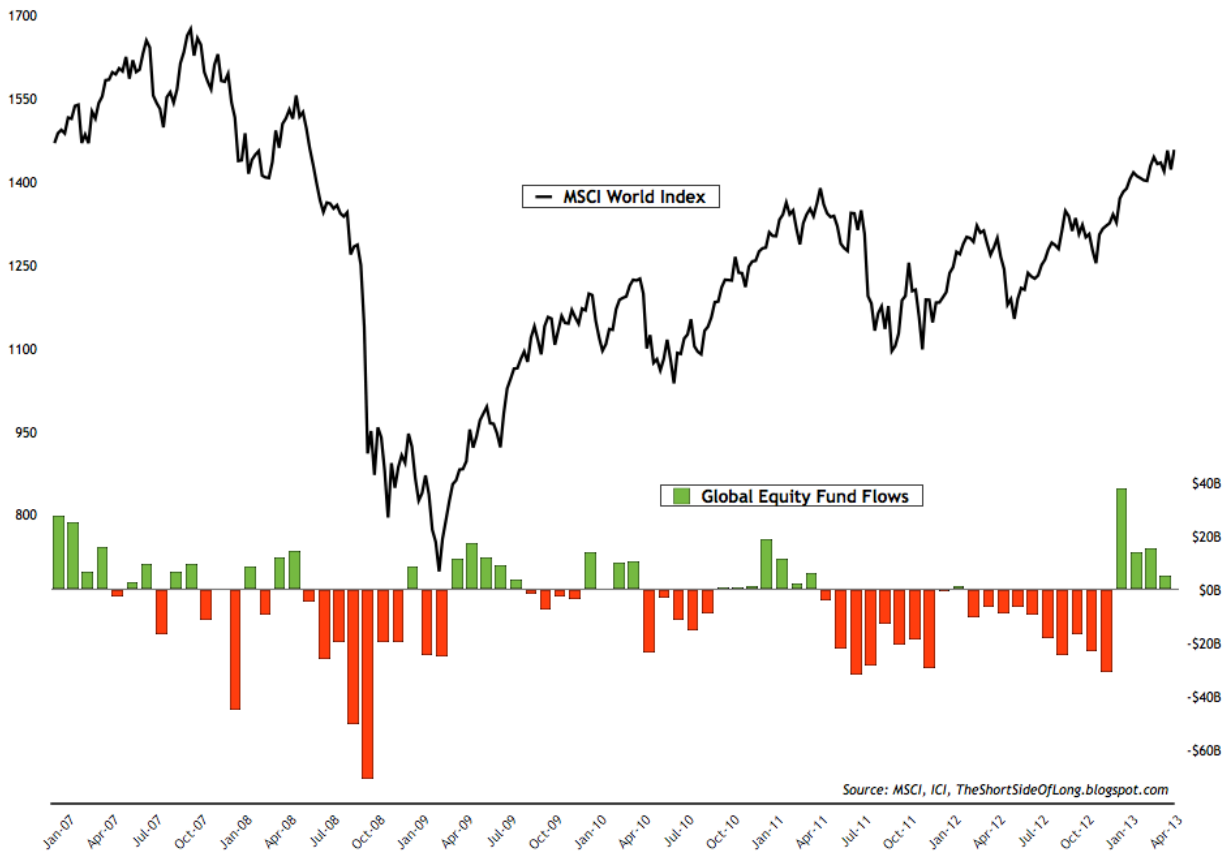
Sentiment Surveys | Fund Flows | Volume & Volatility | Performance & Price | Breadth

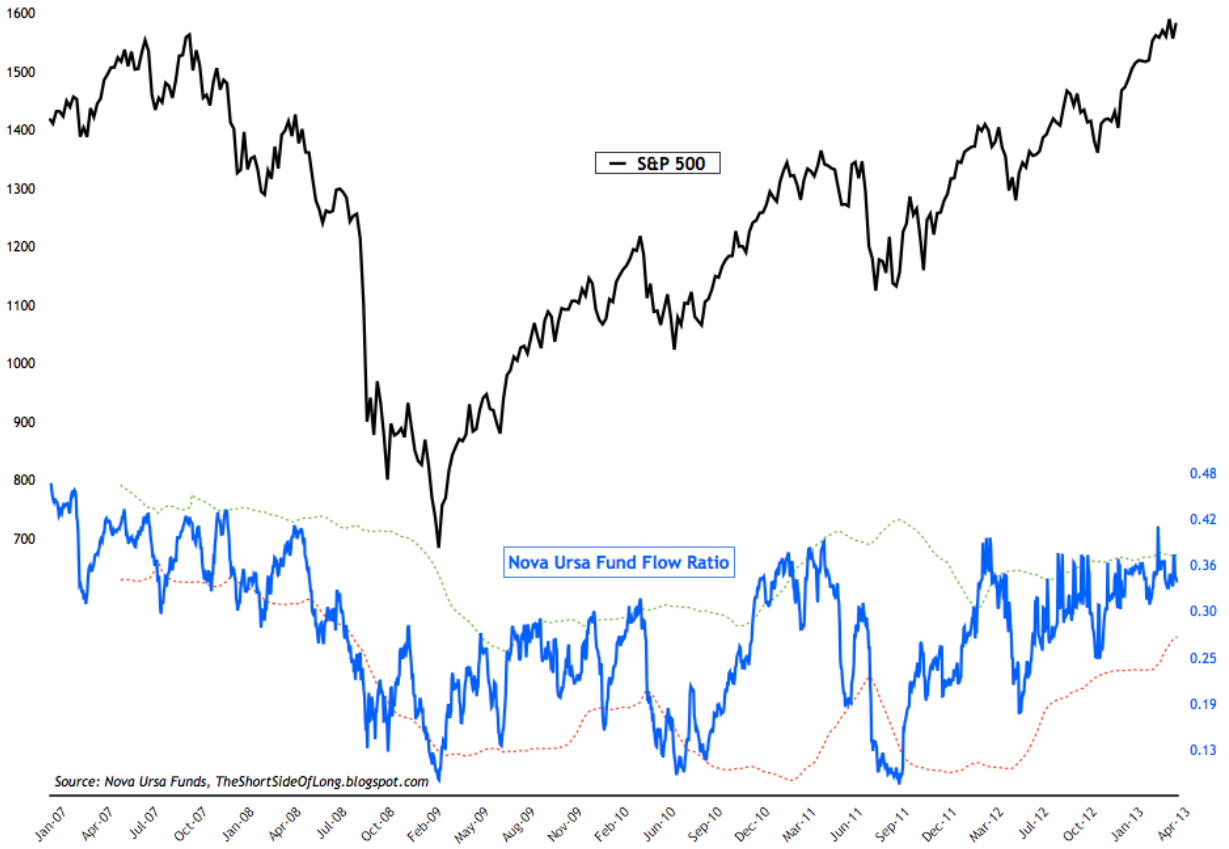




Equity Indicators

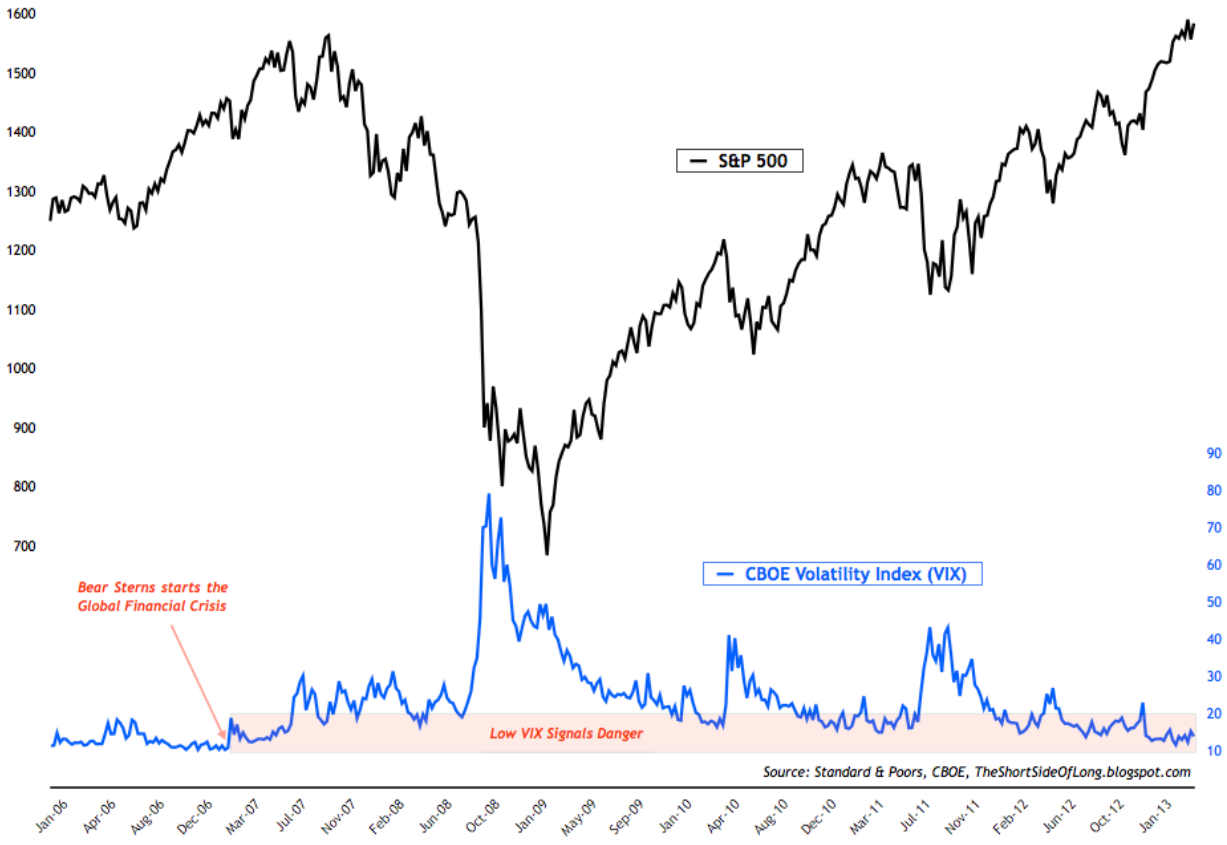
Sentiment Surveys | **Fund Flows** | Volume & Volatility | Performance & Price | Breadth

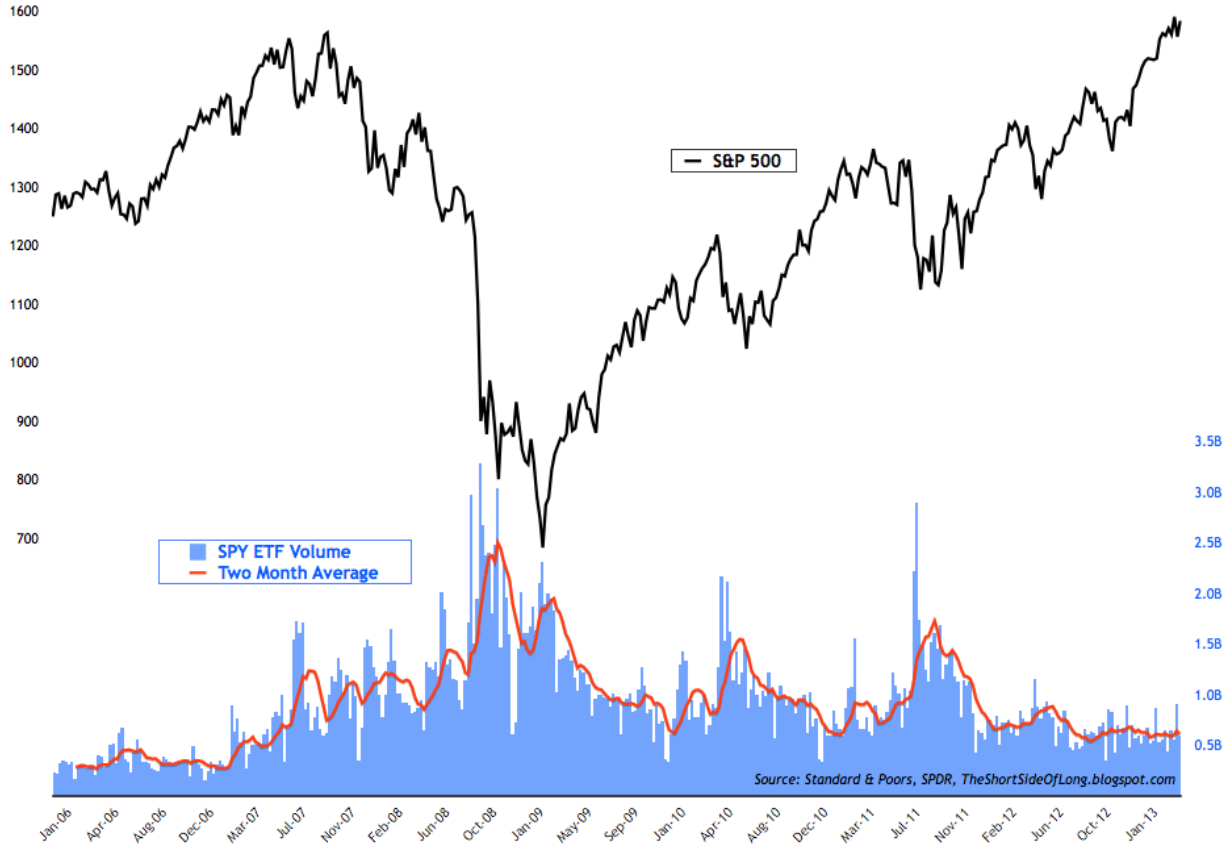




Equity Indicators

Sentiment Surveys | Fund Flows | **Volume & Volatility** | Performance & Price | Breadth





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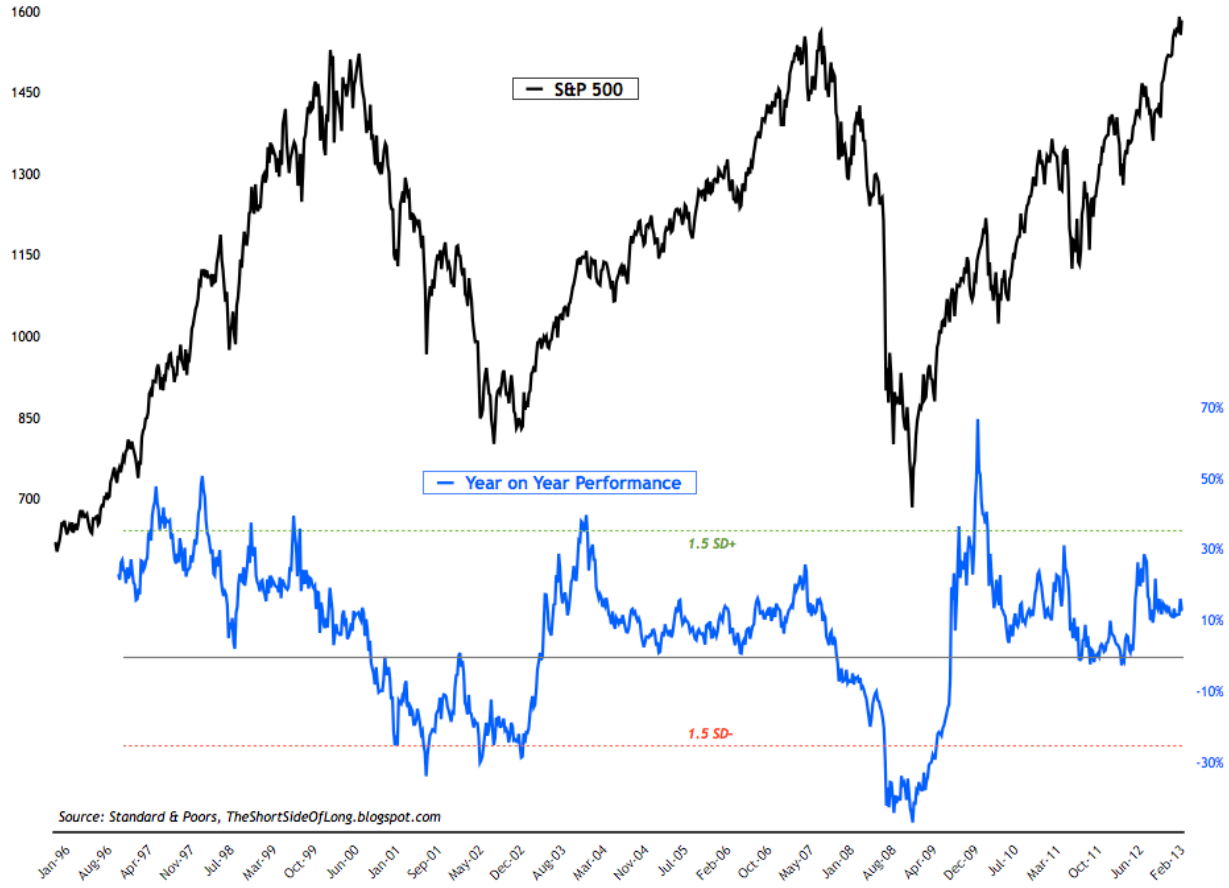
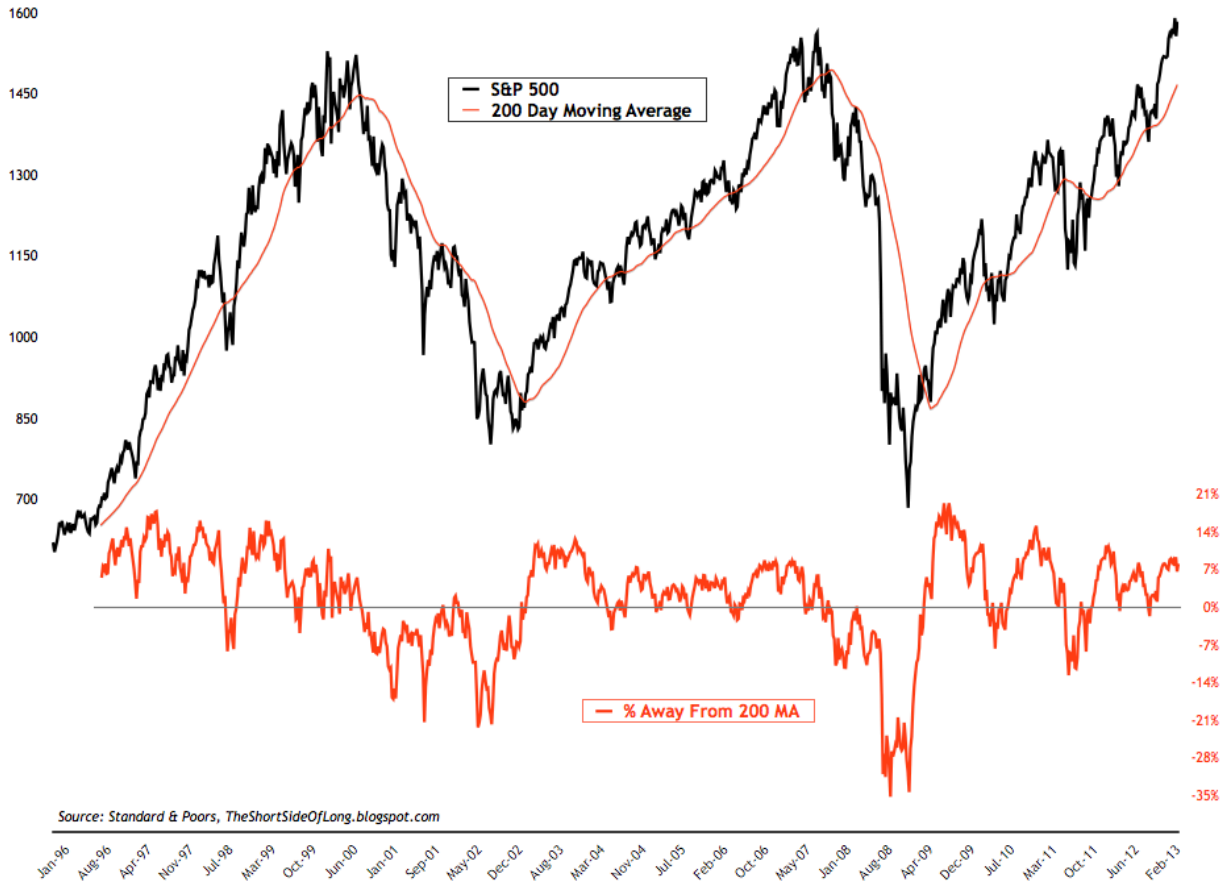
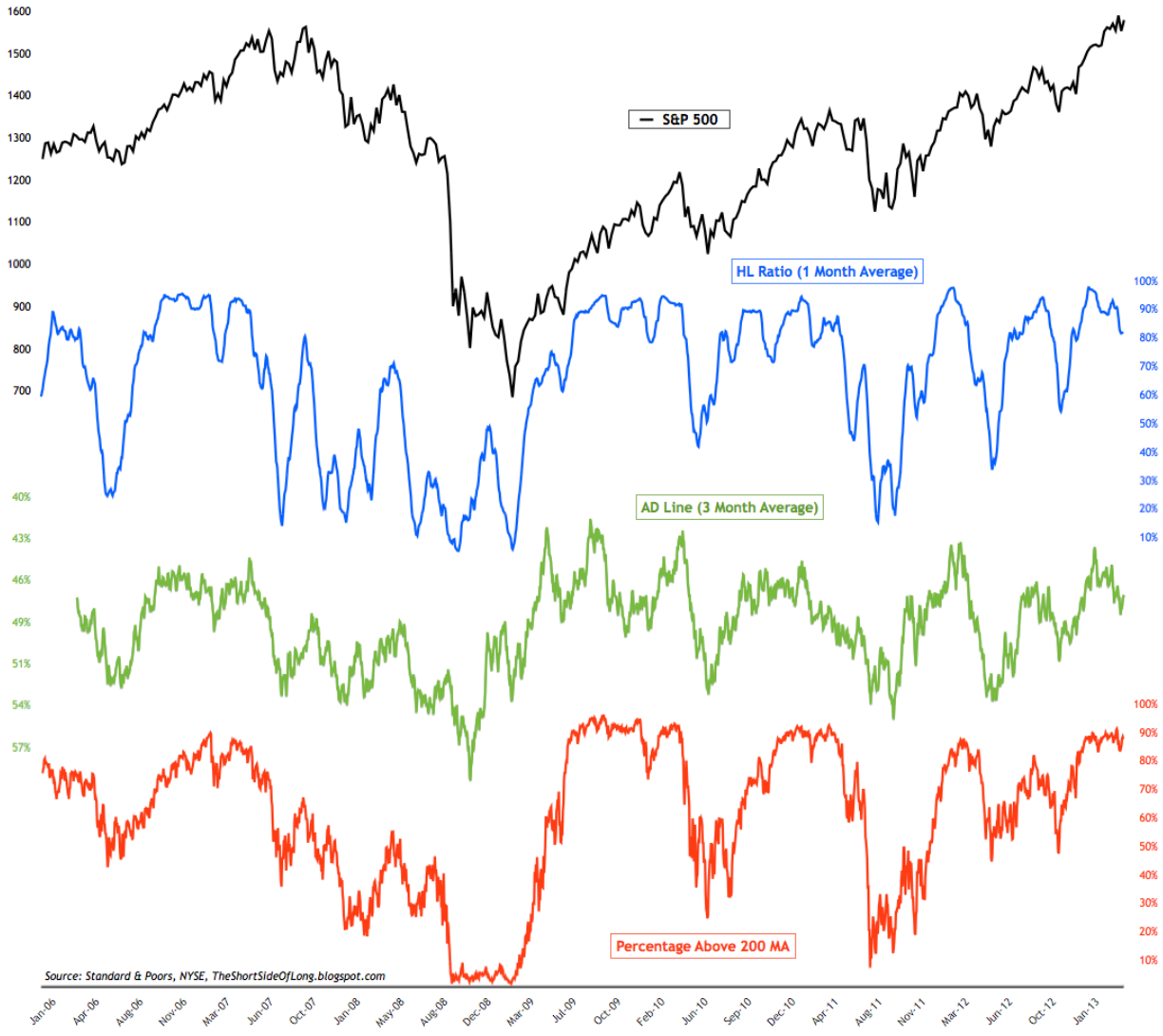
Sentiment Surveys | Fund Flows | Volume & Volatility | **Performance & Price** | Breadth





Equity Indicators

Sentiment Surveys | Fund Flows | Volume & Volatility | Performance & Price | **Breadth**

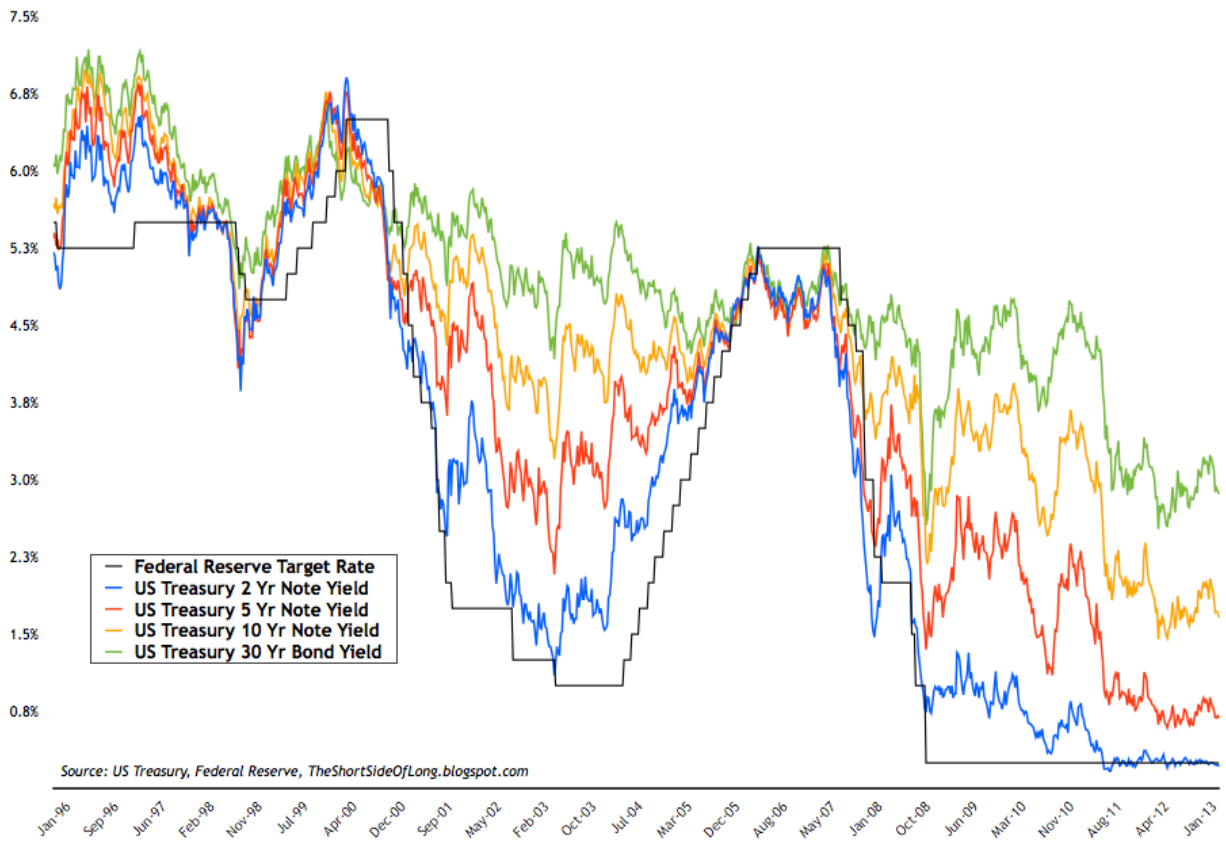


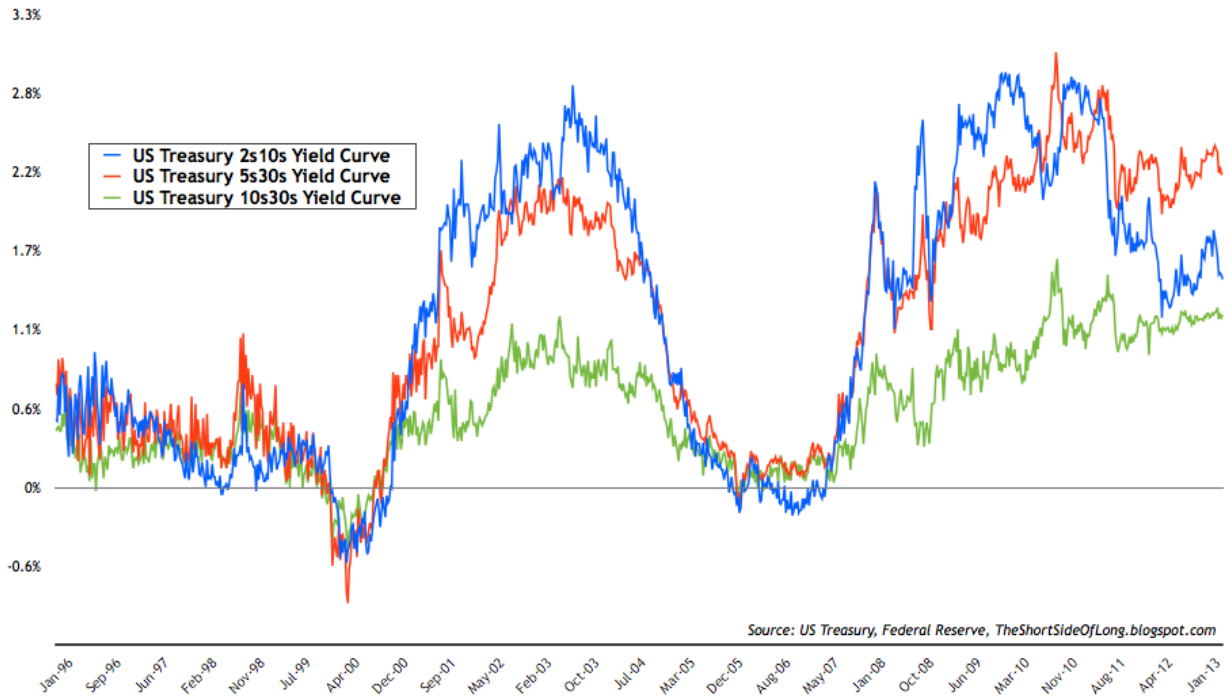
US Equity Sectors	Short Term (Above 10 MA)	Medium Term (Above 50 MA)	Long Term (Above 200 MA)
S&P 500 (Large Caps)	73.0%	63.8%	85.7%
Semiconductors	66.7%	60.0%	73.3%
Technology	59.3%	38.9%	66.7%
Discretionary	81.5%	78.5%	89.2%
Financials	79.3%	70.7%	89.7%
Industrials	81.8%	50.0%	93.2%
Materials	61.5%	38.5%	73.1%
Gold Miners	84.6%	0.0%	0.0%
Energy	96.0%	44.0%	72.0%
Health Care	53.8%	66.6%	89.7%
Staples	58.1%	87.1%	100.0%
Utilities	92.0%	100.0%	100.0%
Uptrend (50% +)	13	8	12
Downtrend (50% -)	0	5	1
Overbought (90% +)	2	1	3
Oversold (10% -)	0	1	1

Source: TheShortSideOfLong.blogspot.com

Bond Indicators

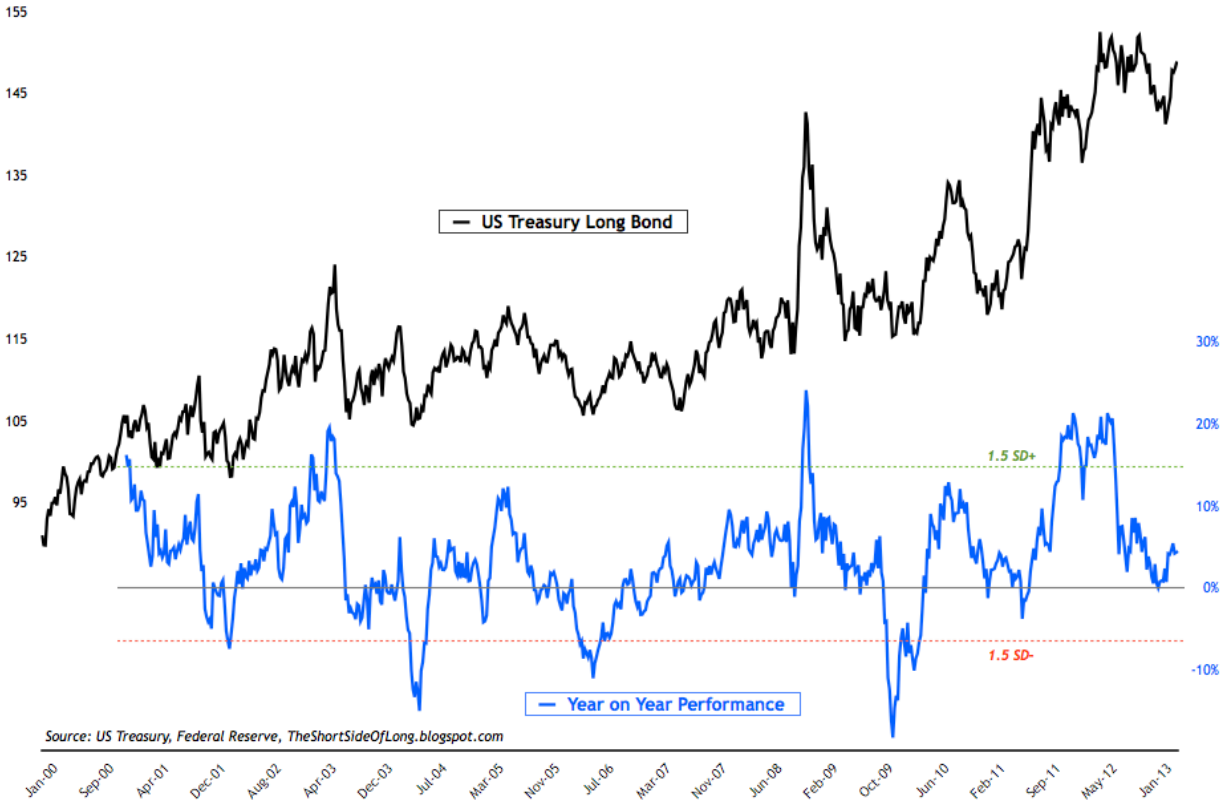
Interest Rates & Yield Curves | Performance & Price | Credit Spreads | Break Evens

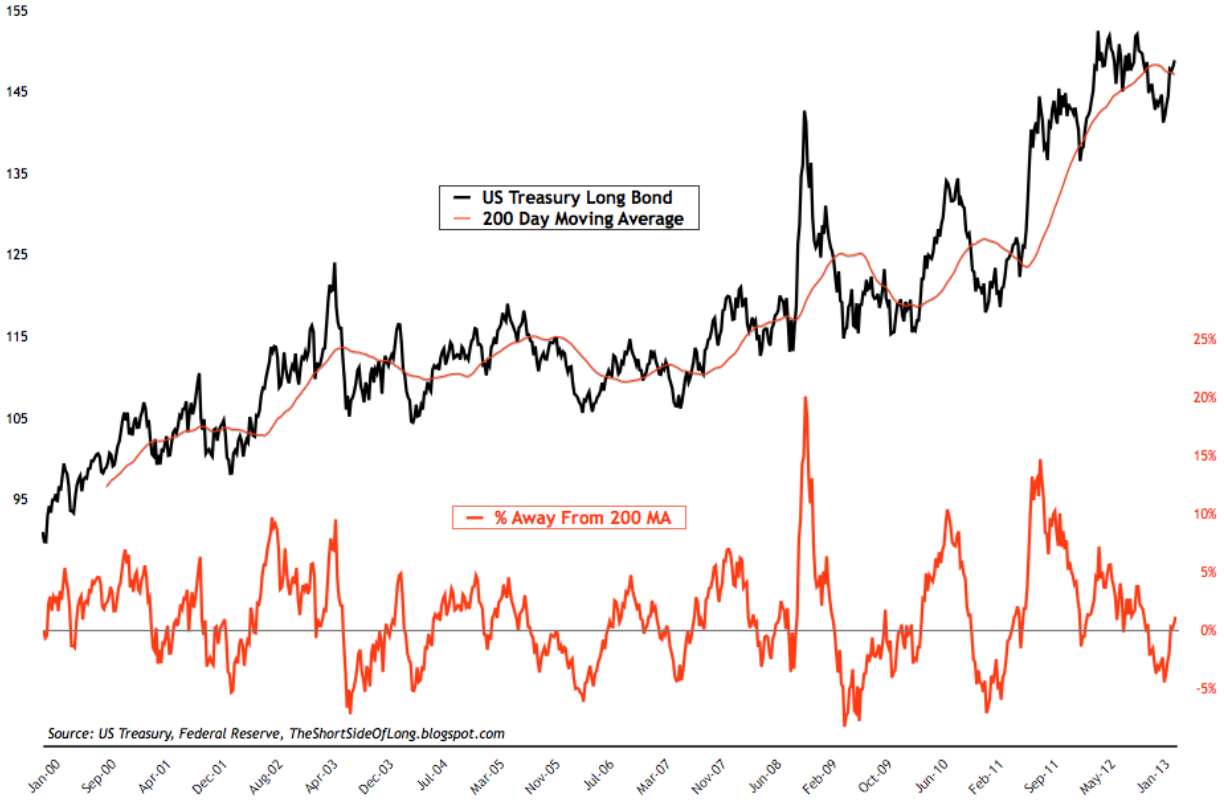




Bond Indicators

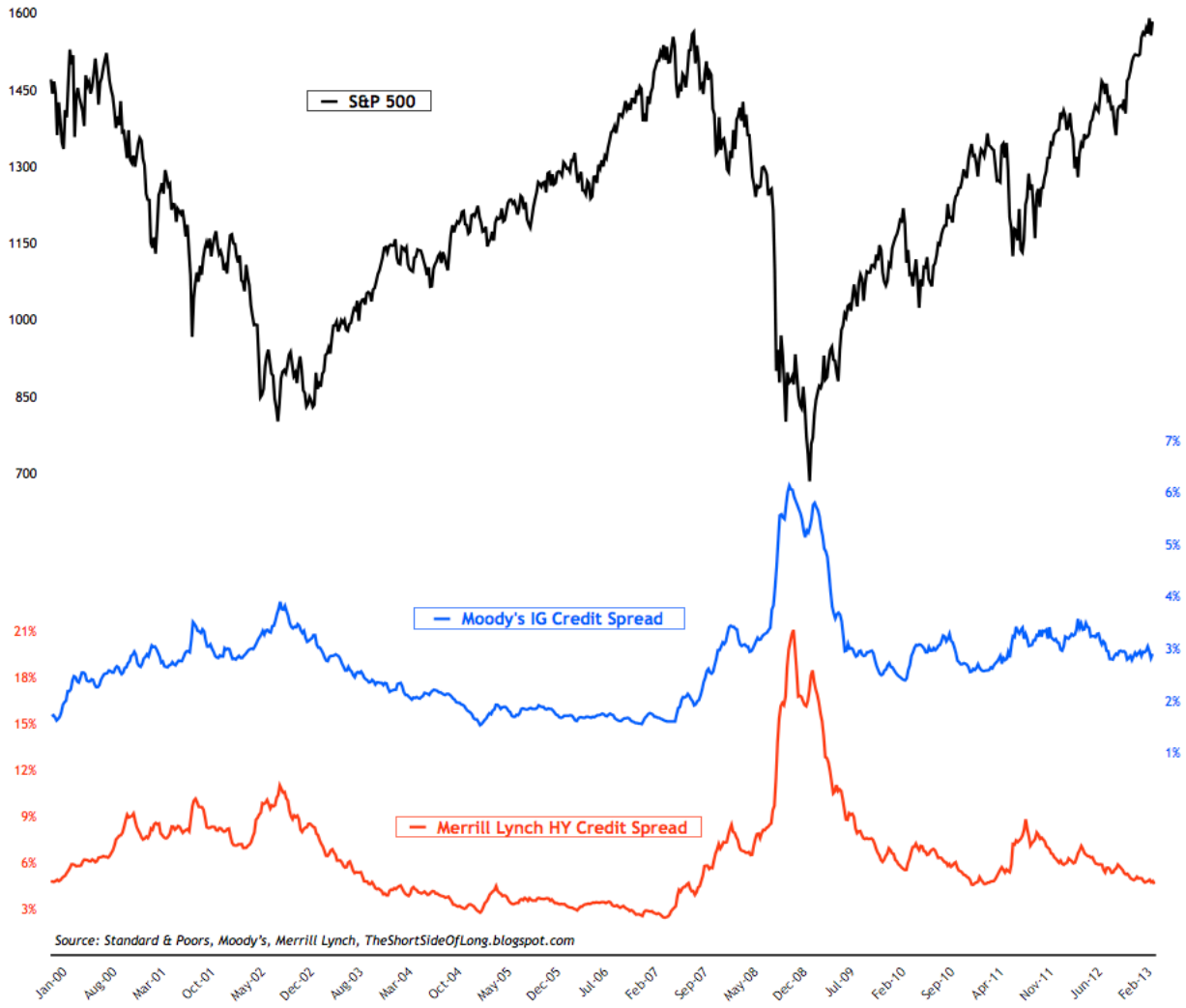
Interest Rates & Yield Curves | **Performance & Price** | Credit Spreads | Break Evens

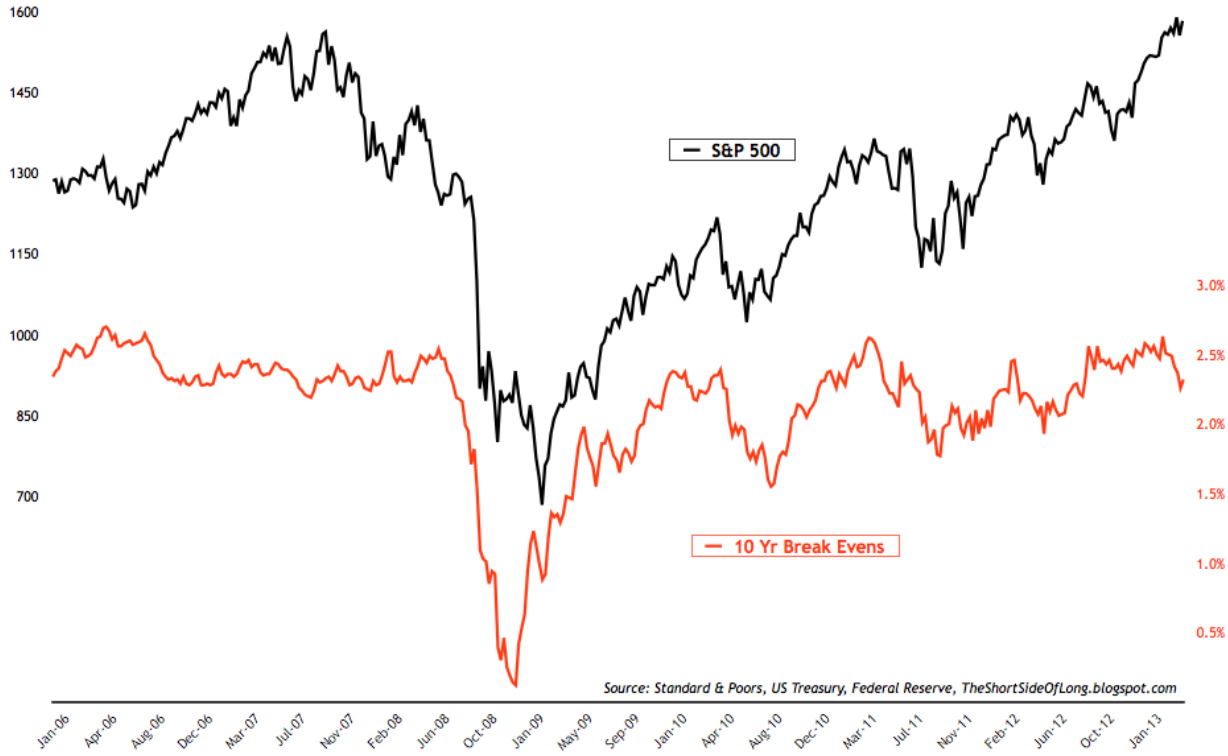




Bond Indicators

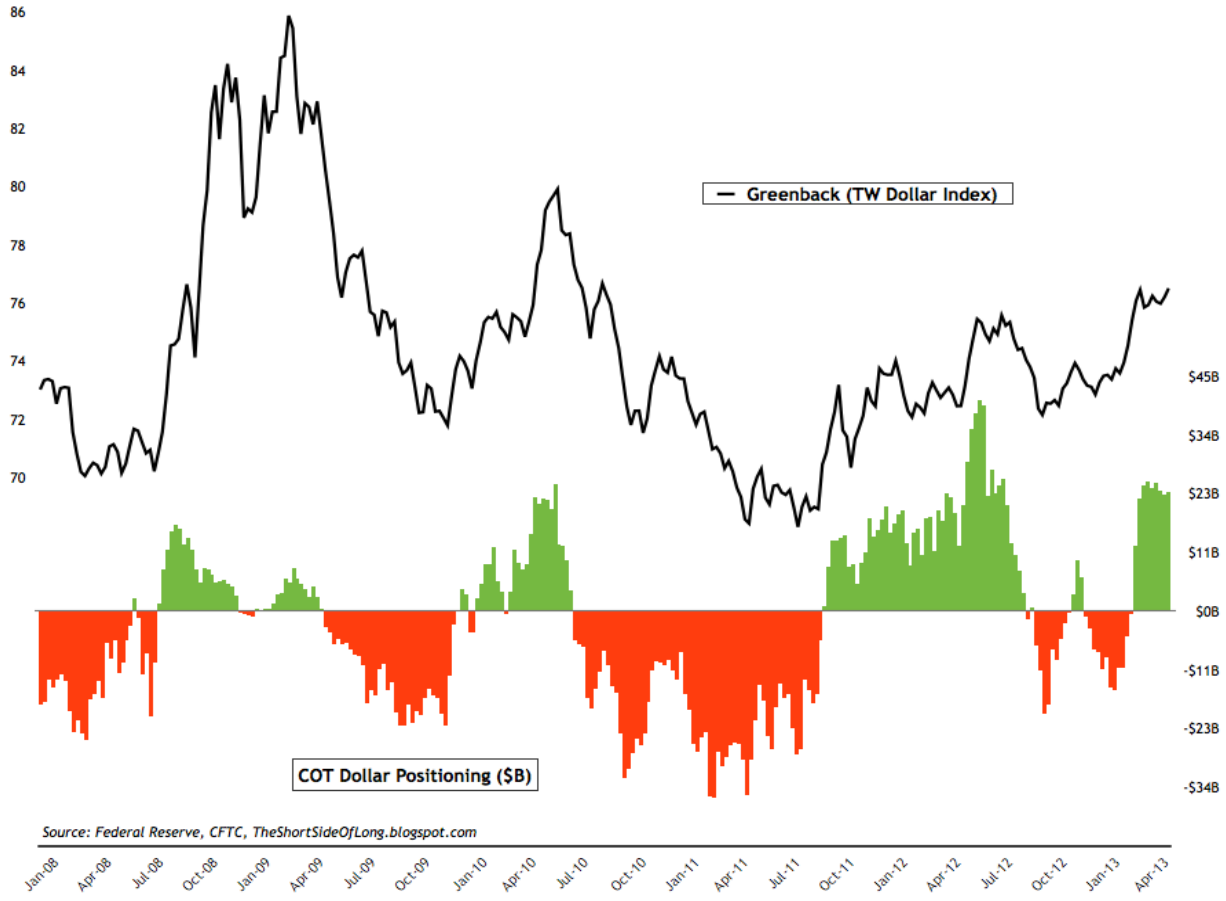
Interest Rates & Yield Curves | Performance & Price | **Credit Spreads** | **Break Evens**

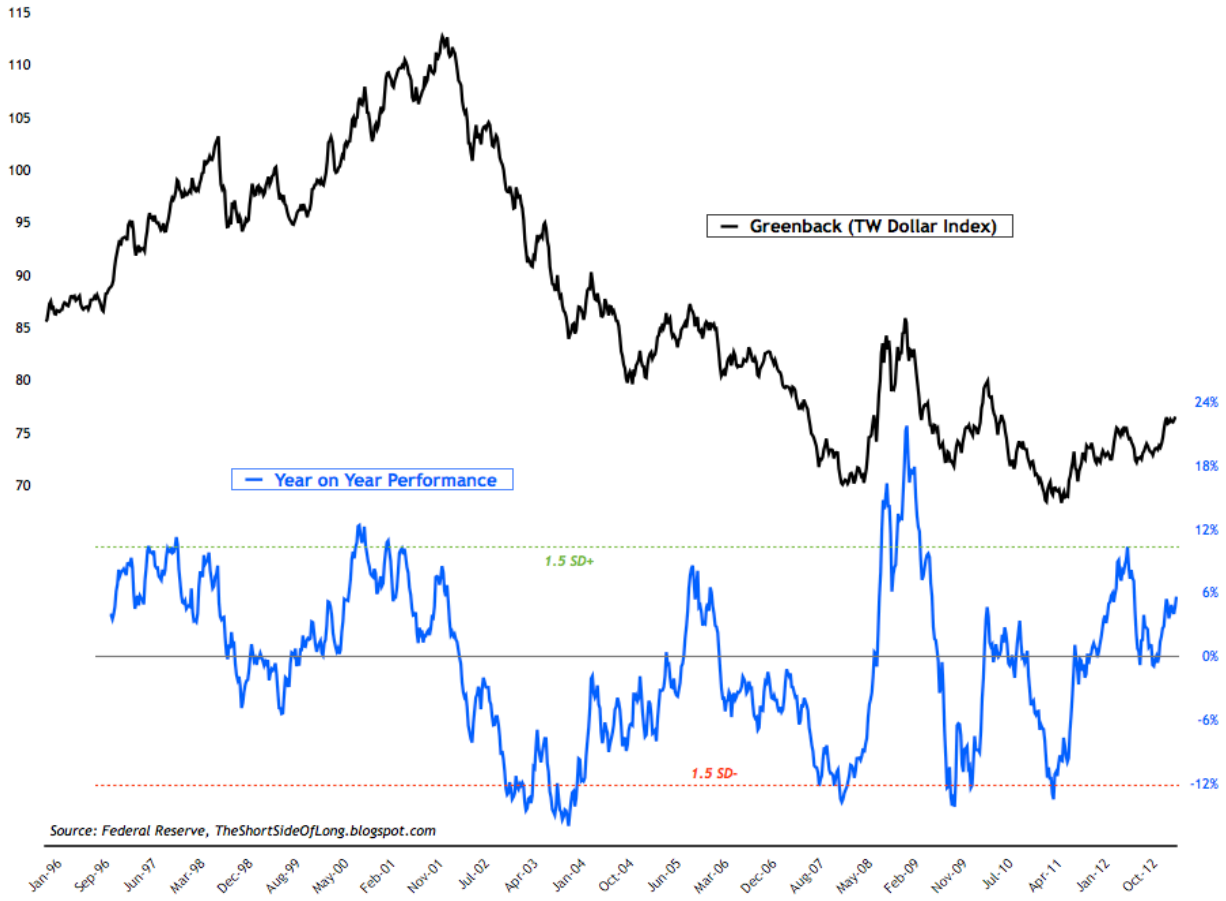




Other Key Indicators

Trade Weighted Dollar | Foreign Currencies | Precious Metals | Industrial Commodities





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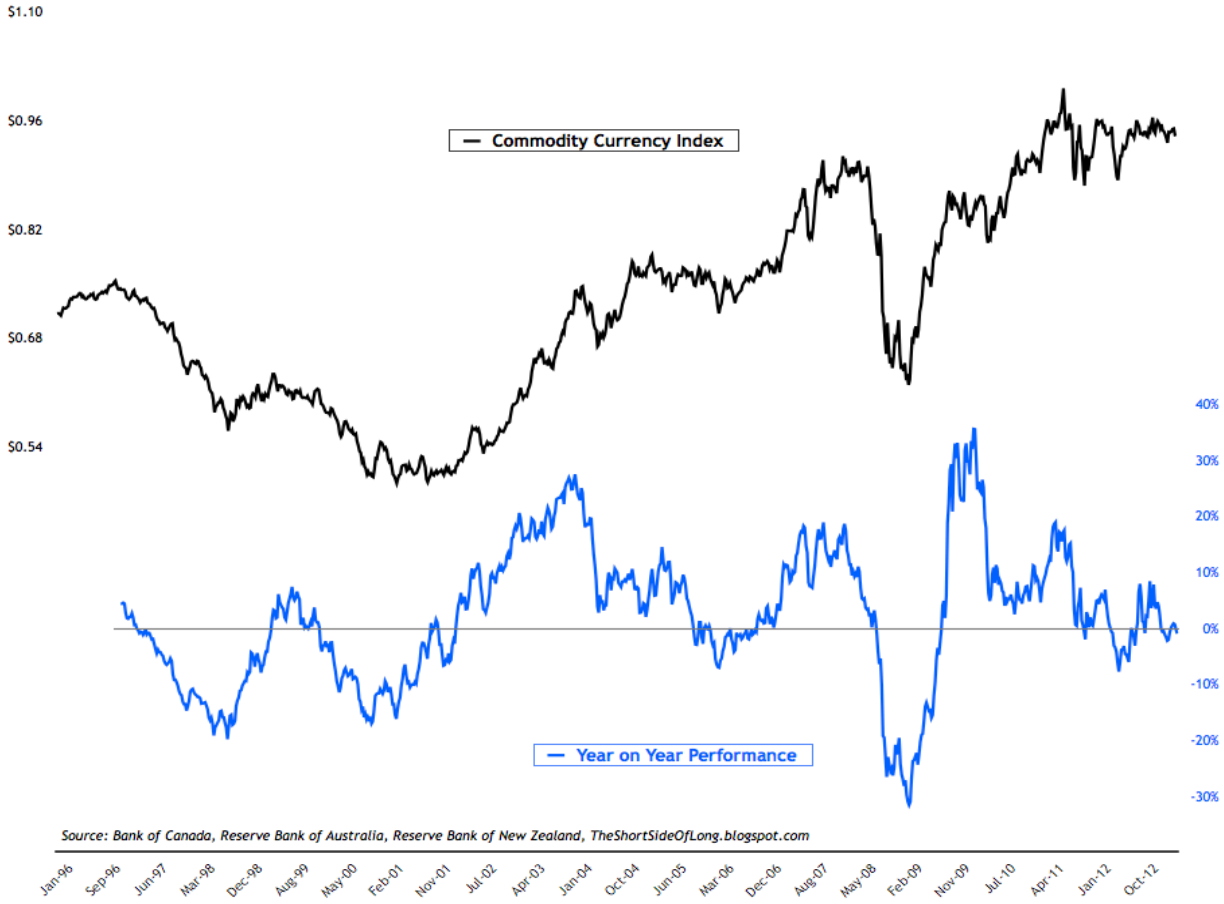

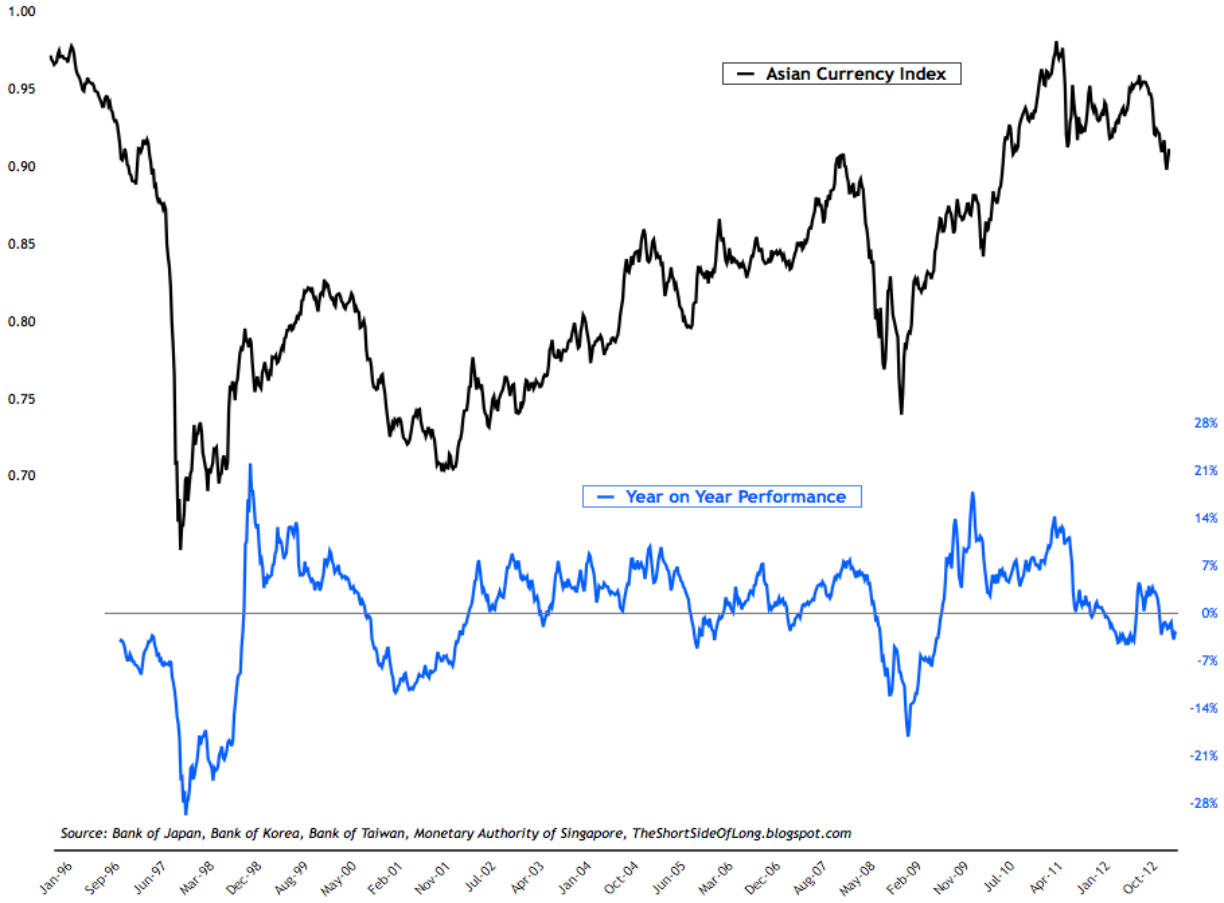

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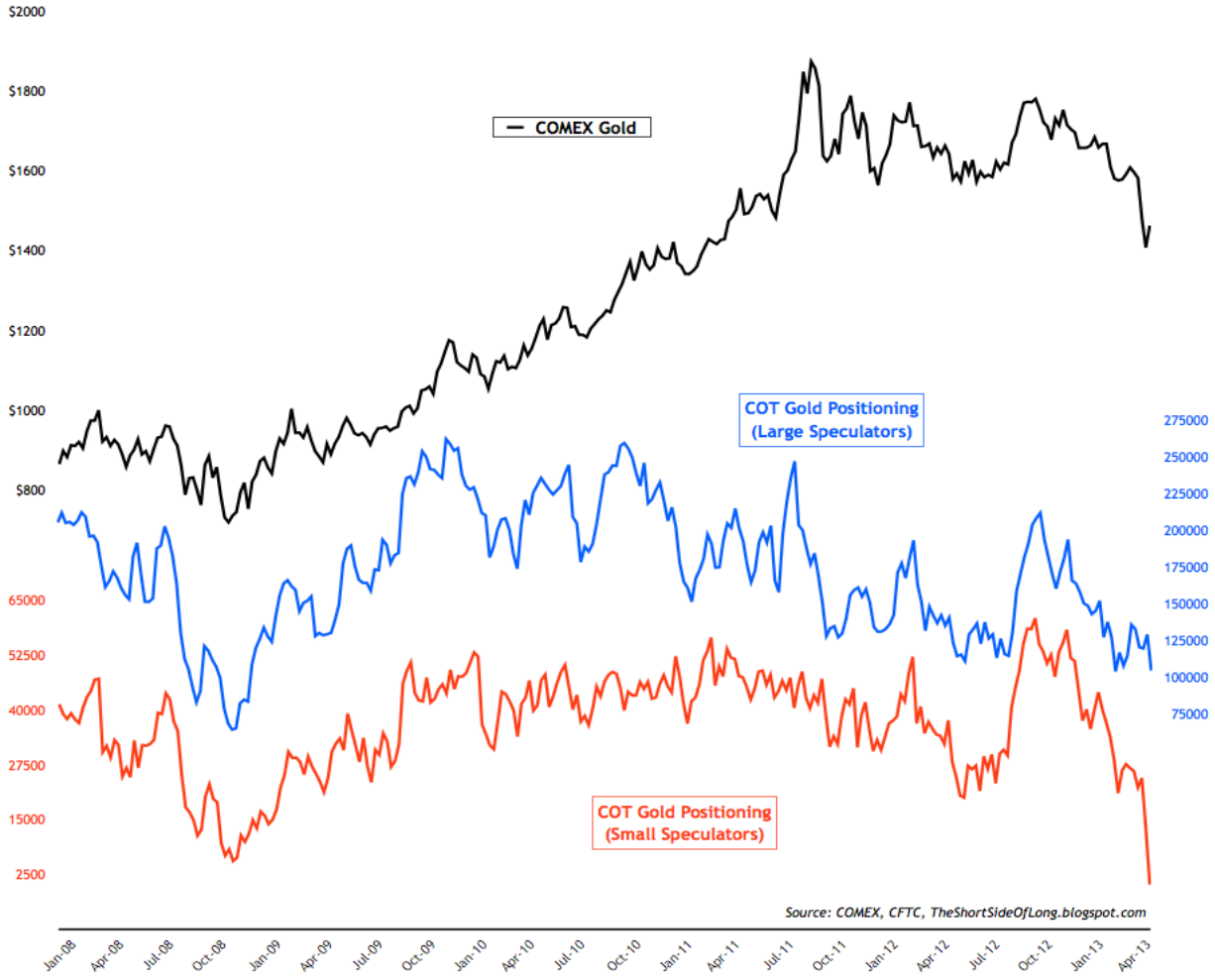

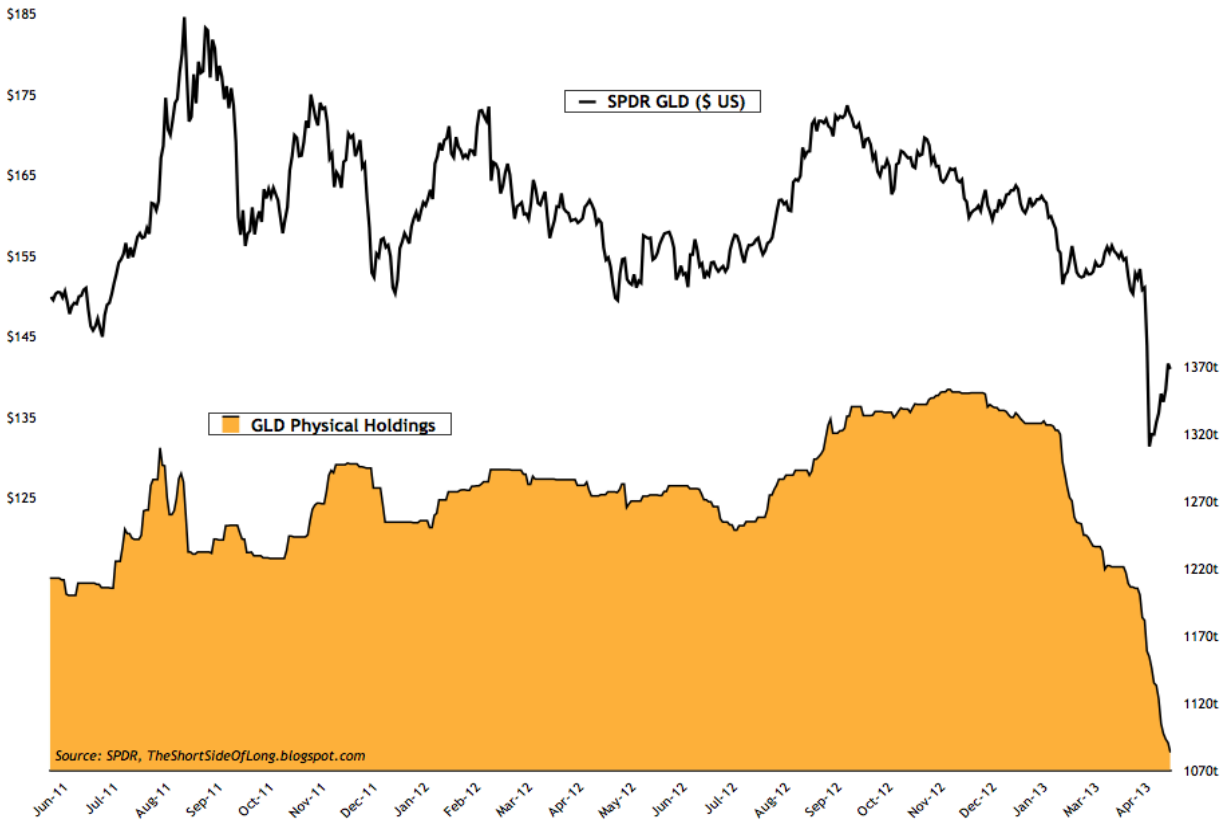

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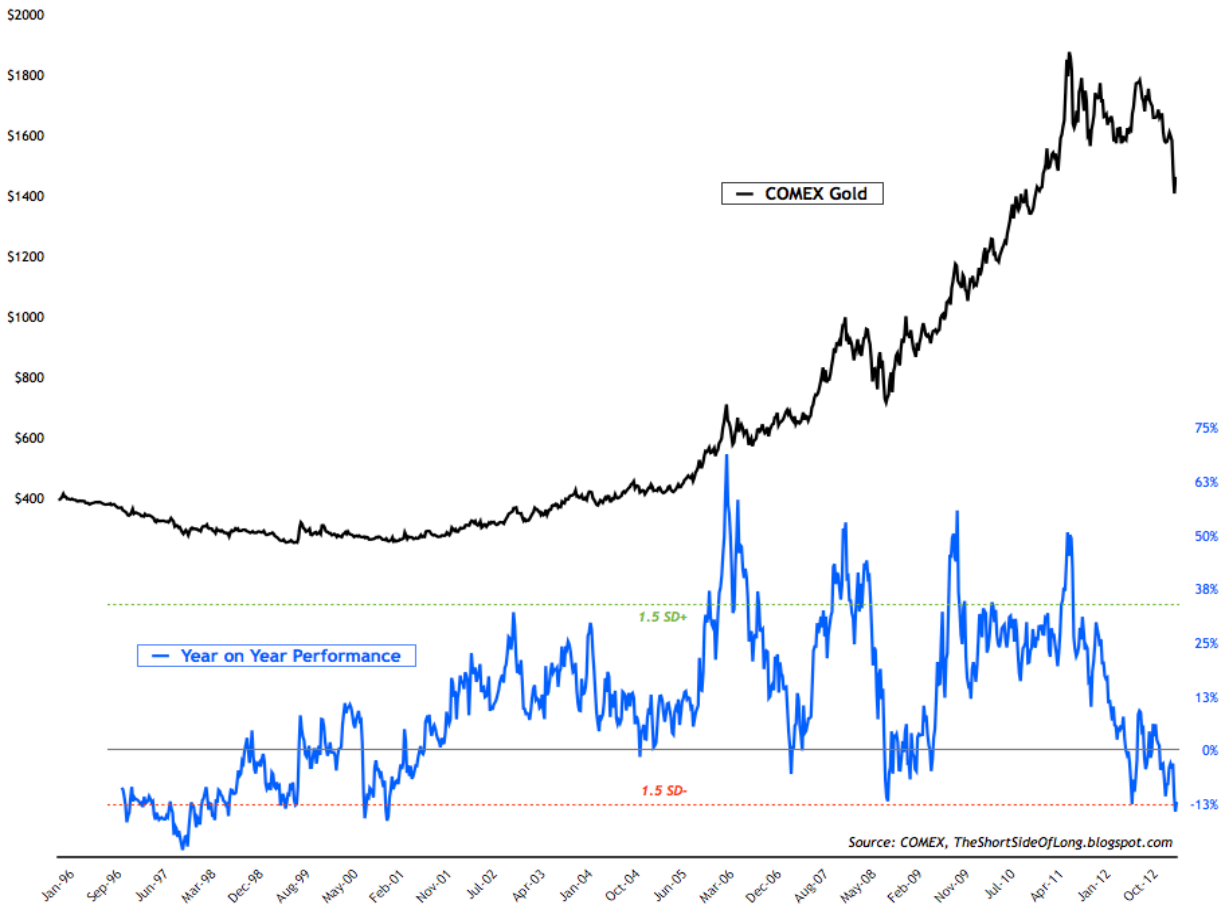

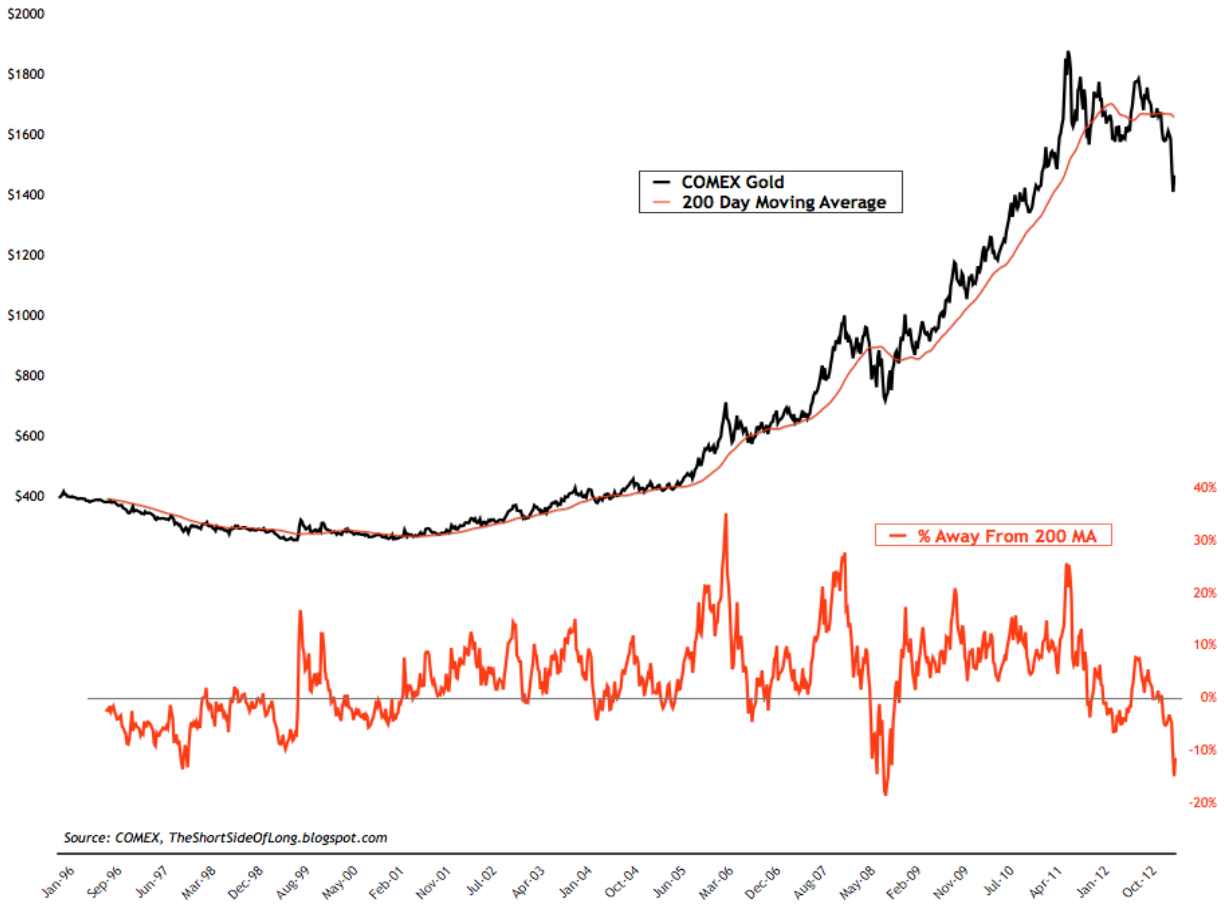

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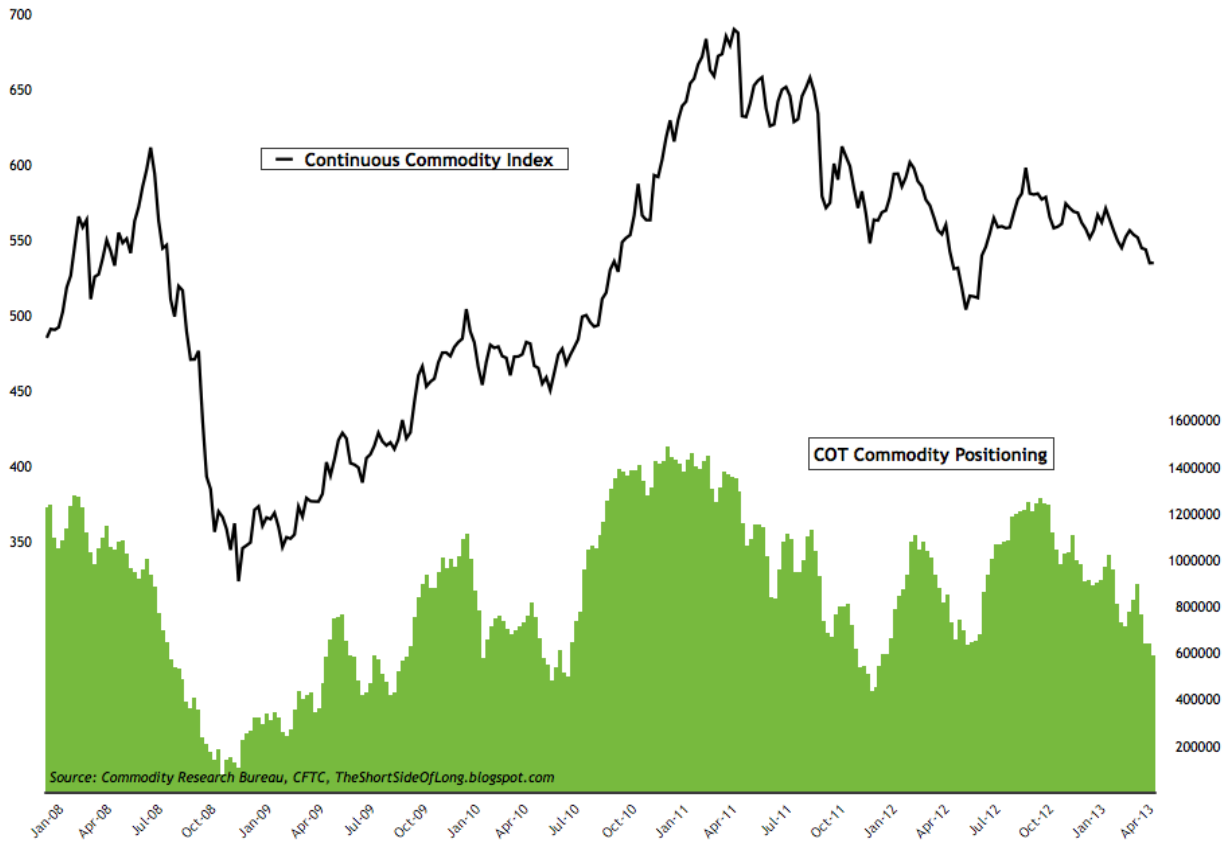

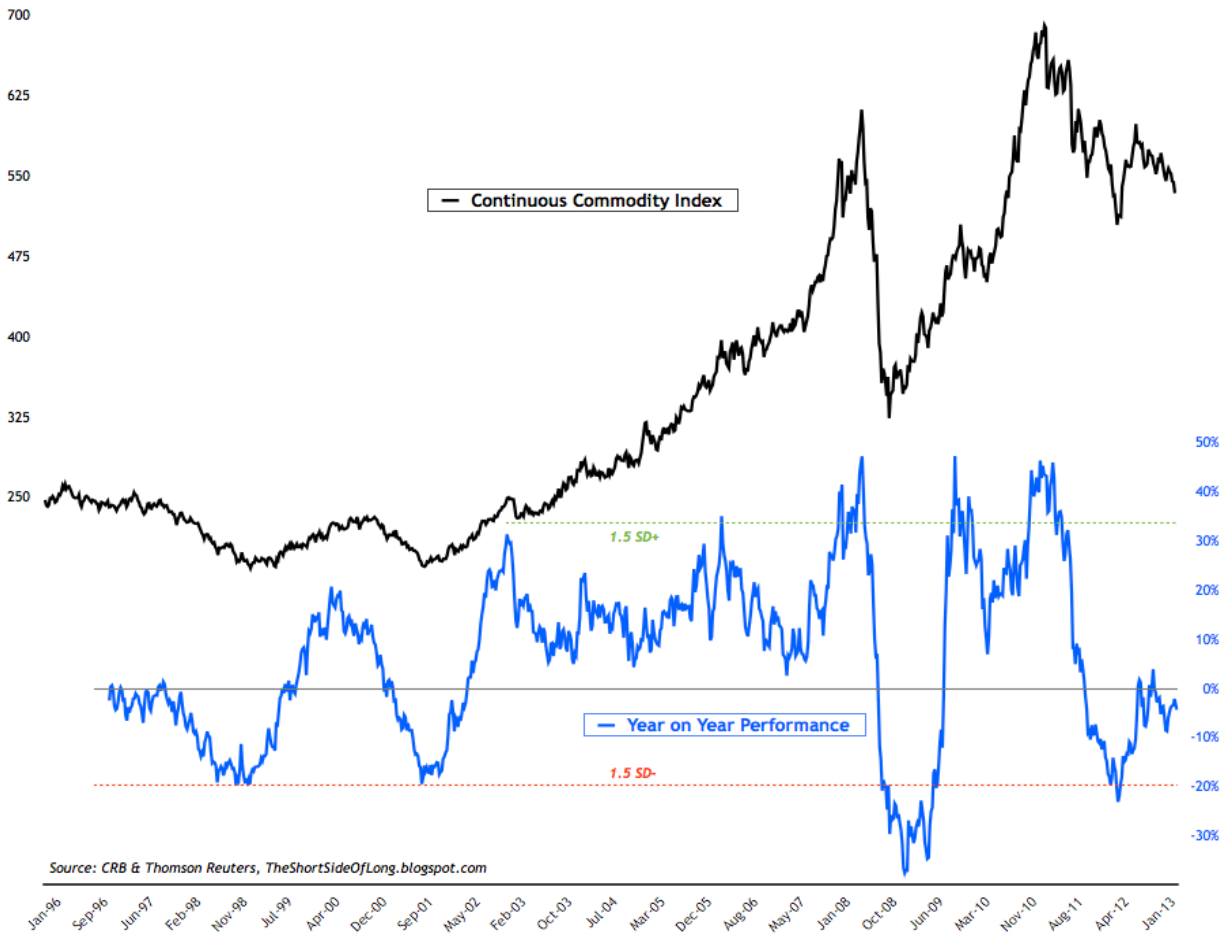

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