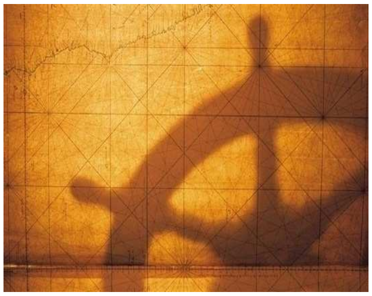
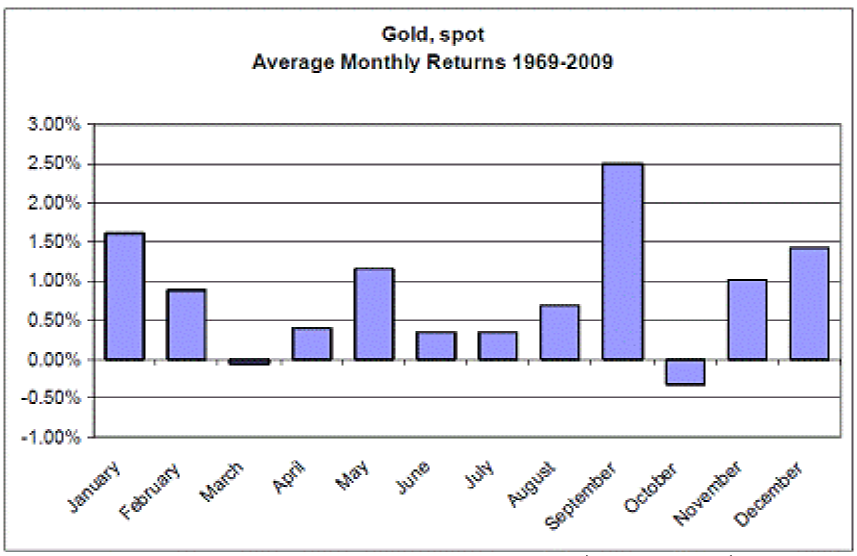


The Starboard Side Report

The week ending September 11, 2009

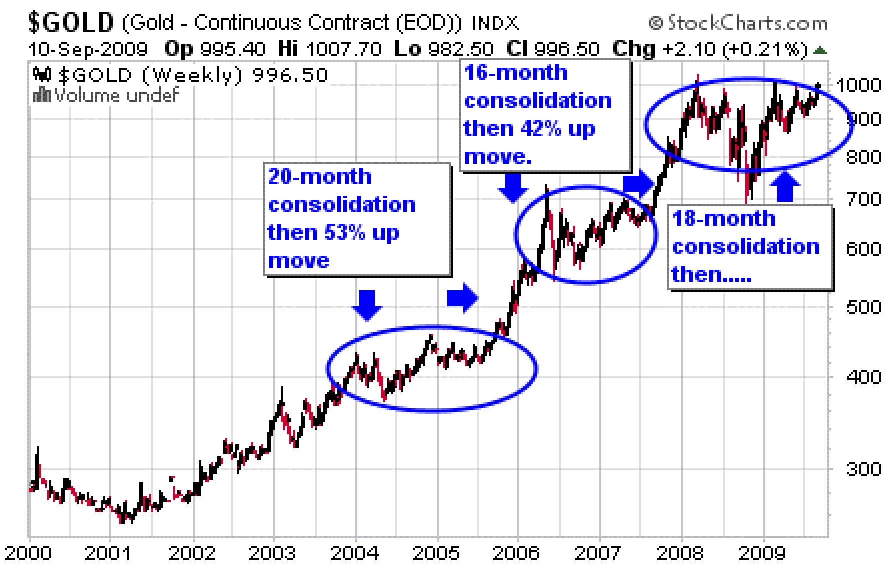
Even though stocks have had a good run so far in September, that does not mean we are out of the woods in regards to seasonal volatility. As we discussed in our last report, the September and October time frame has historically been a tricky one for investors. We still can't rule out a quick 5-10% decline that takes out some of the short-term euphoria that has developed. That being said, we are still very optimistic that the markets will have a relatively strong finish to the year.

Even though September is usually a poor month for the broad market indices, certain assets have been known to buck the trend and perform well in this month. Below we have a monthly breakdown of the price of gold that shows September as the best month for the yellow metal. Gold is on the verge of breaking out of an eighteen month consolidation pattern and appears poised to begin another leg higher when priced in US dollars.



Gold is heading into its seasonally strong period just as the charts are indicating the end of an 18-month consolidation may be upon us.

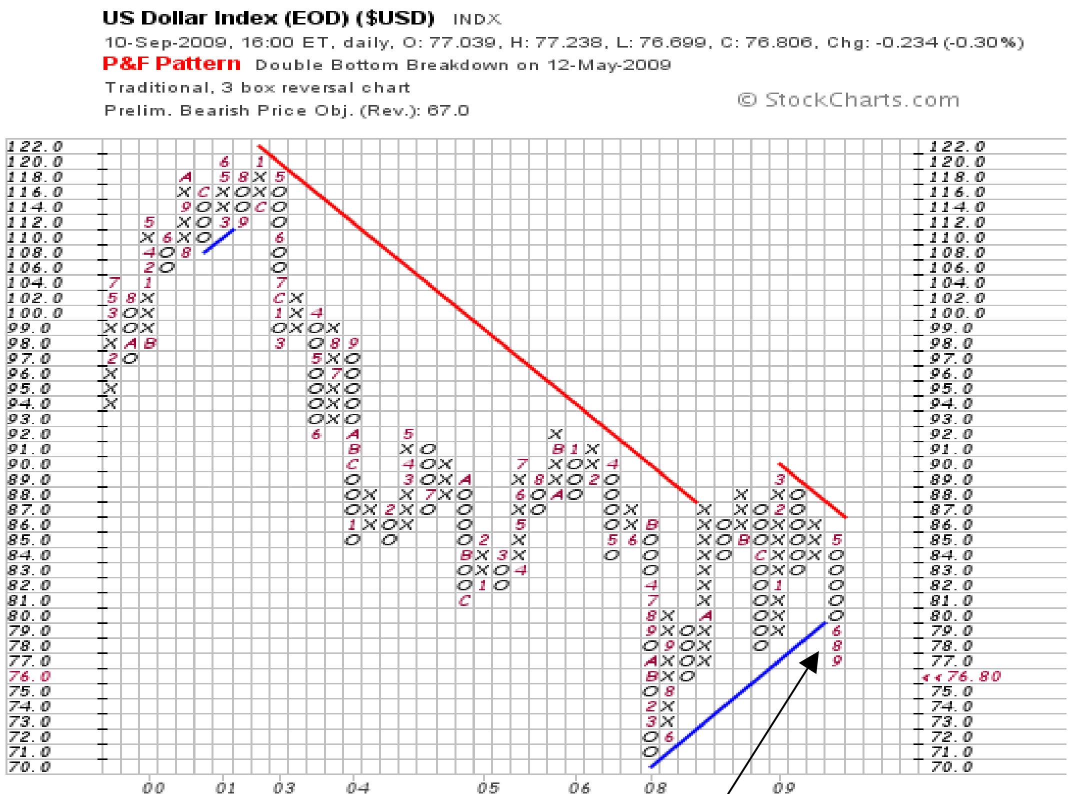
Four out of the next five months are favorable for gold prices. The chart below shows that the last two times we have had a similar set-up (i.e. entering the seasonally strong period after a long-consolidation), it has been an outstanding time to be invested in gold. Each of the last two big legs higher have occurred in the September though May time frame. Precious metal stocks have performed even better with an average gain of 53% for the Amex Gold Miners Index during these gold price surges.



Below is a ratio chart that shows the Amex Gold Miners Index divided by the price of gold. This shows a great deal of upside in the gold sector if we are to assume that the stocks are heading back to the top of their cyclical trading range versus the underlying metal.

Assuming gold stays at $1000 p/oz there is still 40% upside in the miners to get back to a ratio of 1.75. However, should gold break out of its trading range and have another 50% burst to $1,500 p/oz, then we could conceivably see the Gold Miners Index double from these levels to get back to the 1.75 ratio. Either way, we see very compelling risk reward in the precious metals sector over the next several months.

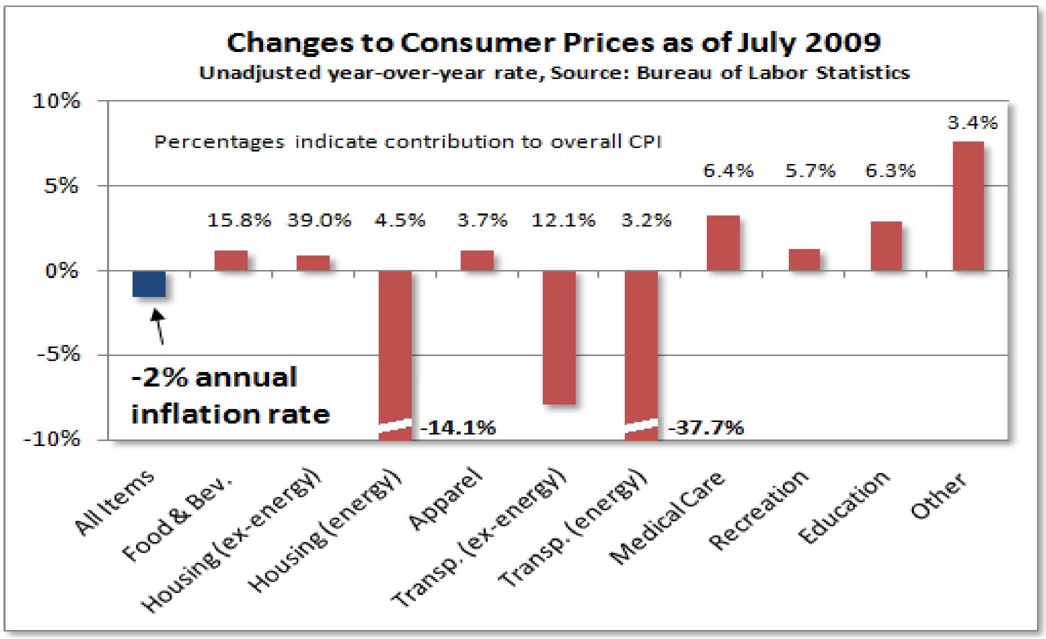
One thing that the recent upswing in gold prices may be telling us is that more US dollar weakness and/or inflation are right around the corner.



We believe the counter trend rally in the US dollar may be over. The point and figure chart above shows a breakdown of the up-trend line that goes back to last June.

This indicates to us that the Federal Reserve is achieving success in its attempt to inflate away our massive debts. The only two ways out of this crisis have always been either default or debasement of the currency with the latter betting much more politically palatable. It is this fundamental fact that creates such a compelling investment environment for gold and why it is one of the few asset classes in a bull market this decade. The gold bull market was jump started in 2001 thanks to the easy money tactics that Alan Greenspan's used to bail the economy out of the technology bust. The even easier money tactics used to mop-up the real estate and credit bubble will only provide more fuel for the gold rally. We believe exposure to gold is a great way to hedge against reckless central bank policies. Using the same plan to get us out of the mess that got us into it in the first place is hardly sound policy. It is going to take *much* higher interest rates and *much* more fiscal discipline to break the back of this powerful bull market in gold. Neither are on the horizon any time soon.

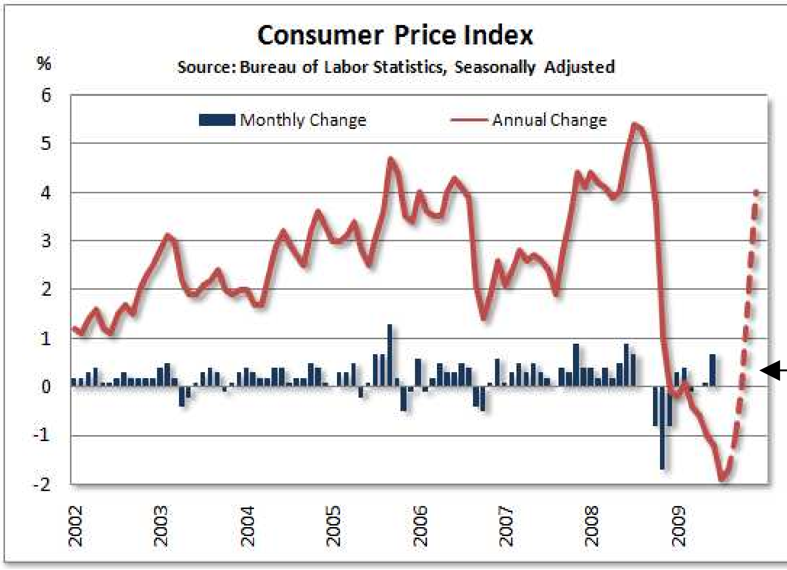
This takes us to inflation, which is the by-product of all of this Federal Reserve created liquidity. We came across some interesting research last week by Tim Iacono that predicts a sudden reversal in the Consumer Price Index (CPI) between now and the end of the year. Recall that in our last report, we showed a chart of CPI plunging into negative territory over the past year due to drastically lower year-over-year comparisons. However, when you step back and look at the big picture, prices are still much higher than at the start of the decade. Our analysis concluded that we are not anywhere near the deflation that hit in the 1930's. Iacono provides a nice detailed breakdown that hammers home the point that recent price declines in the CPI have largely been a mirage brought about by the collapse in oil prices, not a broad based price collapse. Seven of the ten major components of CPI are still in positive territory despite a 2% overall decline. As you can see below, the energy component of housing (-14.1%) and transportation (-37%) have driven the majority of the 2% decline in the annual rate. Come December though, we are going to start to see 75% year-over-year *increases* in the price of oil. This will dramatically reverse the energy components of the CPI into positive territory and officially put the nail in the coffin of this deflationary scare.



Please note: the percentages above the red bars are the category weighting not the price change. The price change is only listed for the two energy components (-14.1 and -37.7%). Seven out of ten CPI components are exhibiting year-over-year price increases (as indicated by the red bar height being above zero), but the CPI is still down 2%. This reflects the drastic nature of the energy price crash.

Source: Tim Iacono Iacono Research

As a result of the above, we appear on the verge of getting a "V" shaped rebound in the CPI that is going to drive real interest rates (after factoring in inflation) well below zero. Historically, negative real interest rates have been extremely bullish for gold and inflation hedges. Below are two charts to illustrate the potential reversal in CPI and the long-term picture of real interest rates. If the Federal Funds rate stays at 0.16% as expected, a 4% inflation rate would equate to real interest rates of -3.84%.



Potential "V" bottom in inflation this fall. Should oil prices stay at these levels then we could see the headline CPI as high as 4% by the end of December.

Source: Tim Iacono Iacono Research

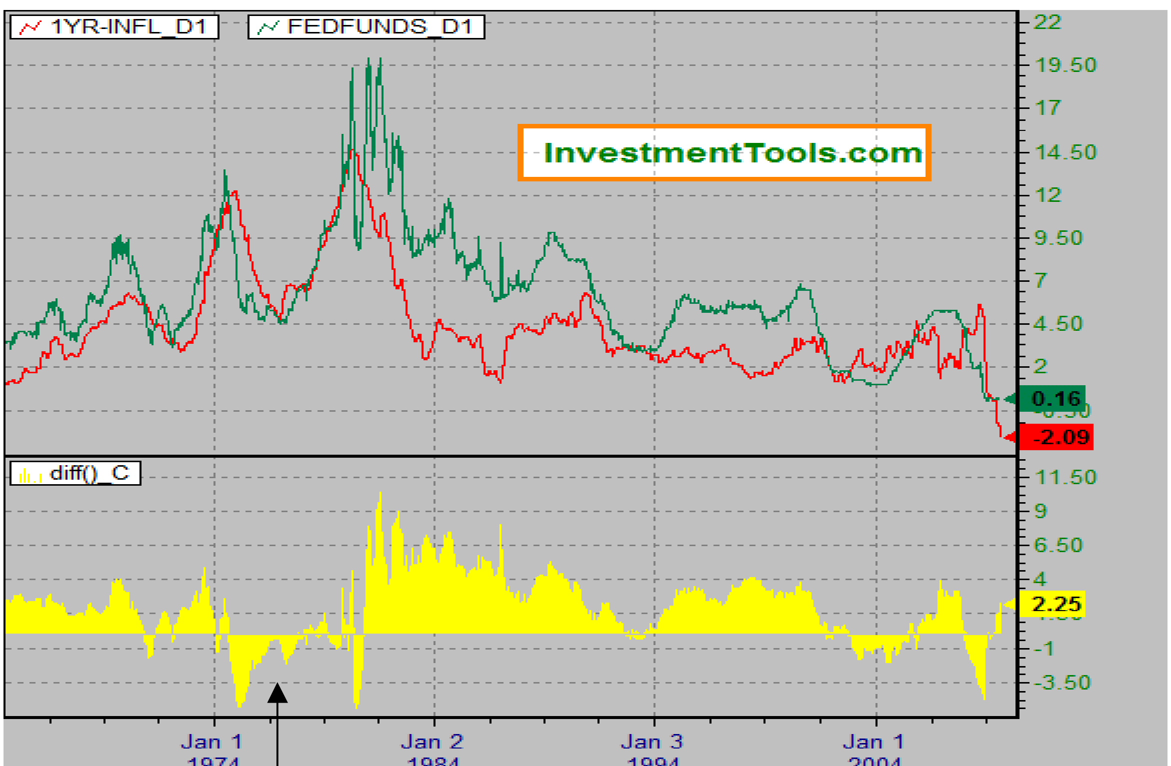


Chart created with NeoTicker EOD © 1998-2007 TickQuest Inc.

The federal funds rate (green line) is 2.25% above the rate of inflation (red line) at present. This means real interest rates are +2.25%. However, should the CPI increase back towards the 4% range by the end of the year, it would mean extremely negative interest rates once again. Negative rates are very bullish for gold and other inflation hedges such as commodities.

It is no coincidence that the last major bull market in gold and commodities occurred in the second half of the 1970's when real interest rates were negative for a majority of the time (i.e. yellow line below zero line). Negative interest rates are highly inflationary because they penalize cash holdings and encourage speculation (usually in tangible assets).