The Starboard Side Report

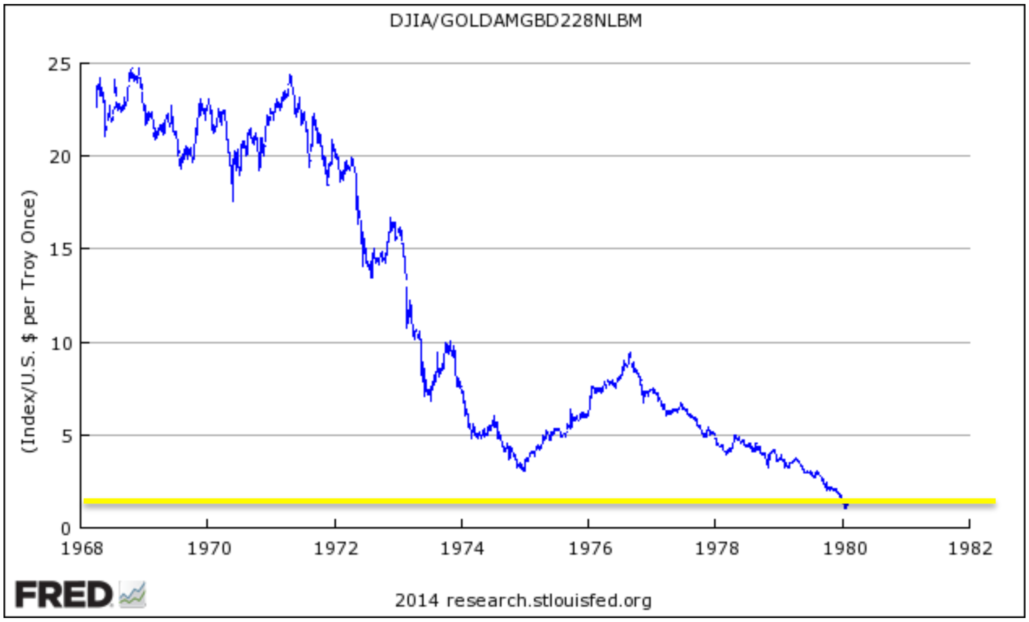
The week ending February 14, 2014

A recent conversation with a client about inflation precipitated the idea for this week's report. The general concern was that if we don't have inflation going forward then why own gold. Our reply laid out below addresses two items. First, gold can do well in both an inflationary and deflationary environment. Secondly, we believe that we have already experienced massive amounts of inflation in asset prices (rather than consumer prices) and that has set the stage for gold to rally in the years ahead.

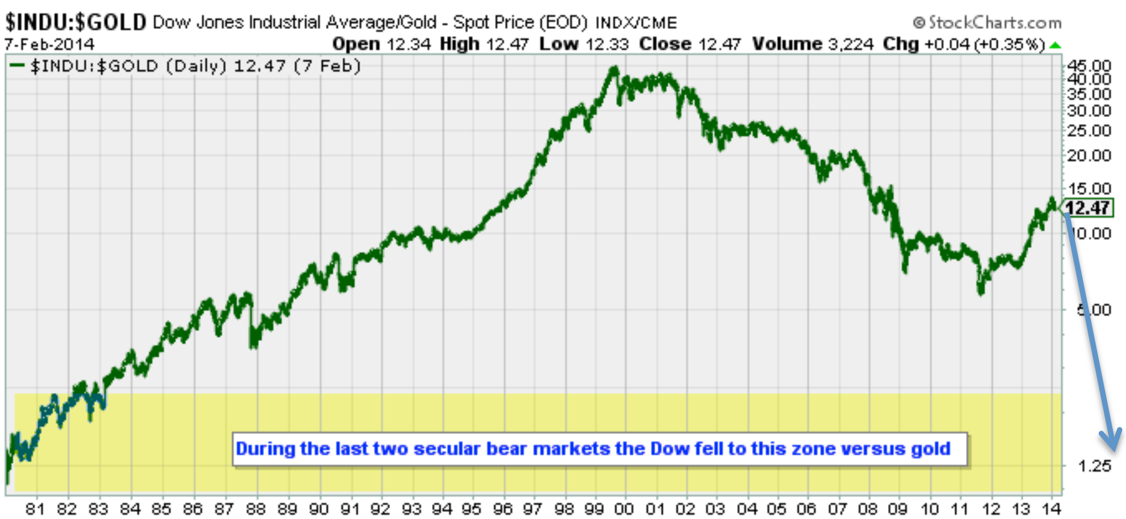
Our thesis regarding gold does not necessarily rest on whether we are in an inflationary or deflationary environment. We have mainly said that inflation is the most likely end game due to an ultimate collapse in the currency from all the money printing. However, the long-term bull market case on gold is built upon the fact that US stocks began a secular bear market in 2000 and that the gold bull market is inversely correlated to that long-term *downward revaluation* in US stocks. This makes it very likely that the gold bull market will not be over until the secular bear market in stocks is winding down and all of the systemic risk/debt is wrung out of the financial system (still a long way off). Of the last two secular bear markets in US stocks, the 1929 – 1950 episode was a deflation affair, whereas the 1966 - 1982 bear was primarily inflation driven. Gold ultimately protected capital versus stocks in both instances; all-purpose insurance is the beauty of gold as a hedge in long-term stock bear markets. It is agnostic as to what the primary catalyst driving stock valuations lower is. Both inflation and deflation compress stock multiples (or the amount investors are willing to pay for each dollar of earnings). Therefore, it can be said that gold's true worth to an investor is as an inversely correlated asset that protects capital in secular stock bear markets like the one we have been in since 2000.

1930's Dow to Gold Ratio Driven lower to 2:1 in a Deflation Episode

1970's Dow to Gold Ratio Driven lower to 1:1 in an Inflation Episode



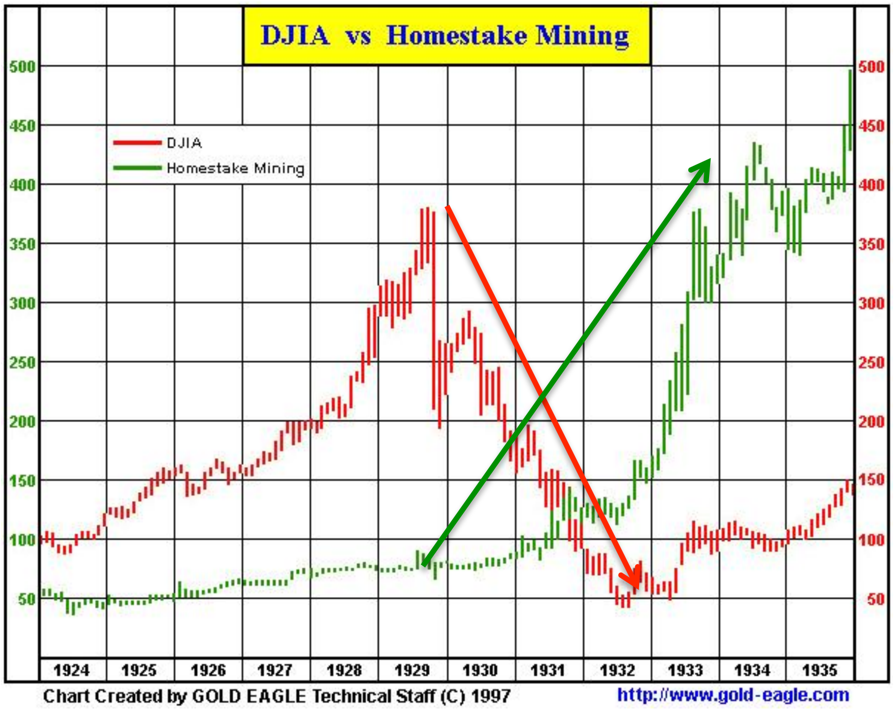
(1980 to Present) Dow to Gold Ratio Now Sits at over 12:1



The Dow to Gold Ratio is an important barometer for measuring the progress of stock bear markets. In the 1930's the Dow to Gold Ratio bottomed at 2:1 and in the early 1980's it got all the way down to 1:1. We feel that somewhere in that range (highlighted by the yellow rectangle on the chart above) is where this cycle ultimately ends. Whether inflation or deflation takes us there is not yet clear. The fact that the US is no longer on a gold standard makes a 1930's style mass liquidation of the economy and banking system less likely in this country. However, the current Eurozone currency structure and German fear of inflation makes outright deflation (consistently falling consumer prices) more of a realistic possibility over there.

As far as the gold stocks, gold mining was in its infancy in the 1930's and Homestake Mining was the only major mining company listed on the US exchanges. Here is a chart of Homestake versus the Dow during the 1930's deflation.

Dow Jones Industrial Average vs. Homestake Mining (1924 – 1935)



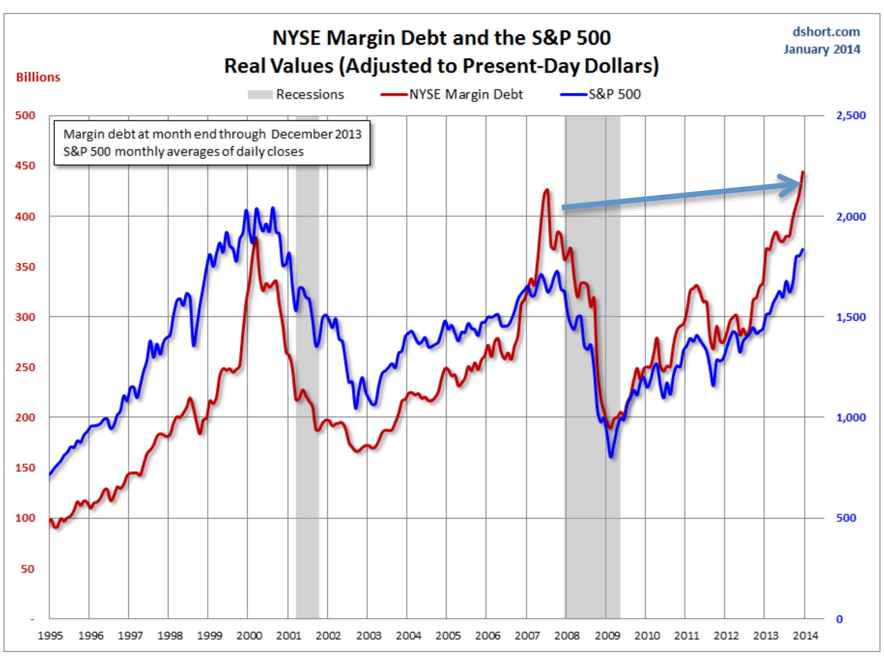
During the worst of the Great Depression when deflation was at its worst, Homestake rose threefold versus an 86% decline in the Dow. Conversely, during the 1970's inflationary bear market in stocks, the gold mining sector was also one of the best performing assets. Gold and gold stocks have a very good history of preserving capital for investors during bear markets. This capital can then be used to buy quality corporate assets at rock bottom prices/valuations after the bear market has run its course.

Look no further than 2008 as to the reason gold works in a deflationary environment. The amount of stimulus needed to extract the economy from the credit market's collapse was such that gold's appeal became self-fulfilling. Gold bottomed four months before every other asset. In Pavlovian fashion, financial crisis now equates to future stimulus in the minds of today's well-trained investors. The Federal Reserve has not hidden the fact that it wants to generate inflation and prevent deflation at all costs. It has not worked so far, but that does not mean it won't or that they will stop trying. It is this constant trying and meddling in the economy that puts a bid under gold even during deflationary episodes. Ultimately, though they will try to debase the currency in order to protect the banking system (see Japan's overt currency debasement over the last 18 months for how this would play out). One fact lost on many is that the Fed ultimately works for the banks, not the American people. The Fed's balance sheet has gone from $800 million to over $4.0 trillion! It is not out of the realm of possibility that the balance sheet will equate to US GDP ($16 trillion) by the time the Fed is done printing money. In late 2011, the Federal Reserve clearly made the decision that another asset bubble was better than another recession so close to the 2008 financial crisis. We believe that this will turnout to be a massive miscalculation that ultimately will cause much more pain and unintended consequences down the road. This Fed intervention in the economy has led to massive amounts of inflation, but it is occurring in the asset markets instead of consumer prices.

It is important to look at this inflation breakdown between the more traditional Consumer Price Index (CPI) and the more modern central bank version known as Asset Price Inflation. Asset price increases are fine unless they are built on the back of artificially cheap credit and high valuations. Excessive leverage causes markets to become disconnected from their fundamentals. This speculative culture leads to malinvestment, asset bubbles and the boom-bust economy that we have been living in for the past 15 years. Therefore, even though asset price inflation can lead to the *impression* of feeling wealthier at first, it is equally as dangerous as consumer price inflation when all is said and done because asset bubbles always collapse. The busts that keep following central bank booms are gradually chipping away at the once proud capitalist foundation of the US economy. The chart below shows that NYSE Margin Debt (red line) is back above its 2000 and 2007 peaks. Once again, we appear to have another asset price inflation built by speculators trading stocks using massive amounts of borrowed money.

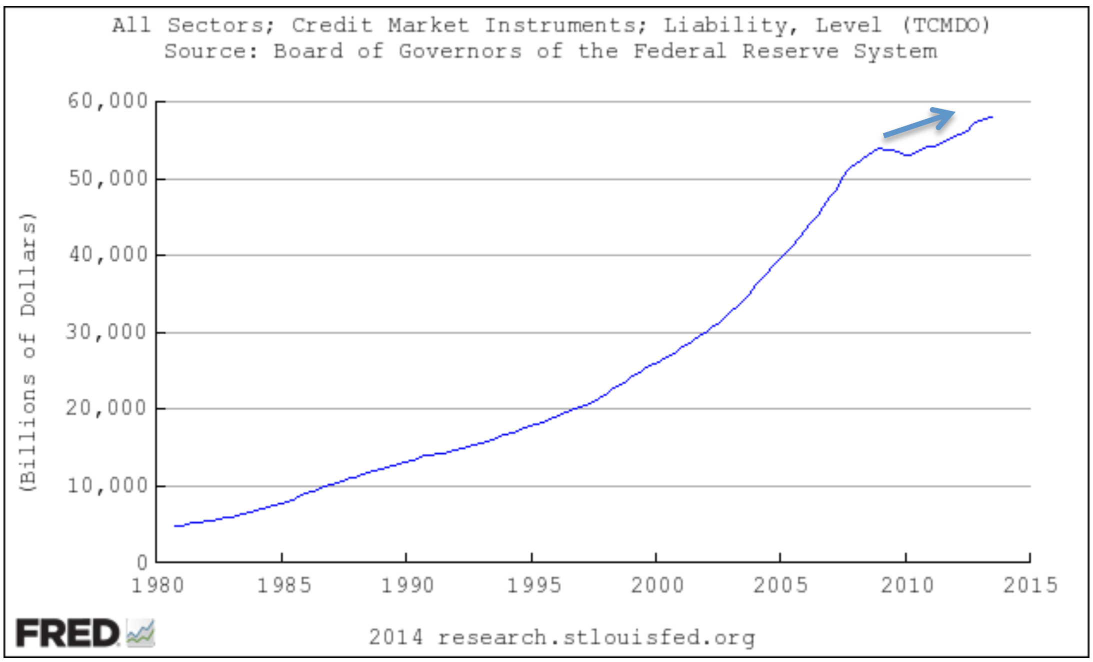
NYSE Margin Debt and S&P 500 Adjusted for Inflation

(1995 – Present)



Furthermore, as the next chart shows, total system wide credit is also back above its 2007 peak. This also speaks to the shaky foundation that this most recent asset price inflation episode has been built upon. In addition, it illustrates the likely need for even more Federal Reserve rescue stimulus the next time the economy falters. The structural problems in the credit markets have not been addressed, only papered over. This provides further structural underpinnings for the gold bull market. The fact that gold has been the best performing asset class since the Fed started tapering QE in December shows that investors are worried about the consequences once this excessive money printing comes to an end. Nobody really knows what will happen once the hamster wheel of Federal Reserve stimulus stops spinning.

Total Credit Market Debt Outstanding (1980 – Present)



There was no CPI inflation in the late 1990's, but there was rampant asset price inflation from the tech bubble. This asset inflation ultimately led to a gold rally once it was time to mop up the bubble because the cleanup required excessive stimulus (gold bullish & dollar bearish). Although the CPI was generally higher during the next phase of asset inflation (real estate bubble), it was not off the charts inflation like we saw in the 1970's. Gold did well in the years after the real estate bubble popped because even more stimulus than after the tech wreck was needed to revive the damaged economy and failing banking system.

Here we are once again and the Fed has produced yet another massive dose of asset price inflation based on artificially cheap credit. This one has led to possible bubbles in US small cap equities, student loans, subprime auto loans, corporate bonds and emerging market debt/currency markets. Once again, this asset inflation cycle will end badly and require stimulus to mop it up (leading to a resumption in demand for gold). It really is a vicious cycle. One of these times the market might finally lose faith in this gong show the Fed is running. If that happens, it will further push money in the direction of gold and collapse the Brenton Woods dollar system that has been in effect since 1971. A good rule of thumb is "gold is the reciprocal of the markets faith in central bankers." So while some can't see any way that we are going to have inflation, we would tell you that we have already had it in a huge way. It has simply manifested itself as another bout of dangerous credit driven Asset Price Inflation, not the Consumer Price Index inflation variety. Both asset price inflation that leads to bursting bubbles and traditional CPI inflation are bullish for gold. Asset inflation usually *precedes* gold price rallies whereas CPI inflation in more coincidence with gold price rallies. One more point, it is important to note that gold is heavily in demand in other parts of the world where the traditional CPI inflation is more of a problem (China, India & Russia etc).

Whether traditional government reported CPI inflation returns to the US economy in the near term is anyone's guess. There are a lot of headwinds and overcapacity in the system that point to the worst-case scenario of hyperinflation not occurring anytime soon. But again, we do not believe that is going to prevent gold from resuming its bull market that began in 2000. The downside of asset inflation episodes is that they are ultimately very deflationary as we saw in 2001 and 2008. However the upside for gold is that central bankers have in their DNA to fight those deflationary forces with everything they've got; and that is ultimately bullish for gold (and bad for the US Dollar). The added benefit to gold as an investment in an economy that is so overleveraged is that it also functions as financial disaster insurance. Perhaps that will be its most valuable role in the back half of this bull market as the dollar based monetary system gets rebooted.

Gold Secular Bull Market (2000 – Present)

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The consensus view is that gold's most useful purpose in an investment portfolio is as inflation insurance. We have tried to spell out why that is not necessarily the case. We showed that gold has protected capital in both inflationary and deflationary environments. The reason being is that both inflation and deflation greatly compress stock multiples (or the valuation that investors are willing to put on each dollar of earnings). Therefore, it can be said that gold's true worth to an investor is as an inversely correlated asset that thrives in secular stock bear markets like the one we have been in since 2000. Additionally, we tried to illustrate that we already have had a massive dose of inflation in the form of asset price inflation in the credit and stock markets. While it feels good while it's happening, asset price inflation leads to bubbles that ultimately are as damaging as run away consumer price inflation. The final role for gold in a portfolio is as insurance against a breakdown in the global monetary system. Gold will play a part in the new world monetary order once the debt in the system eventually overwhelms the ability to pay it back. Anticipation of a new world order is the reason that China has been buying up as much gold as it can get its hands on over the past two years. Those countries that have the greatest reserves of gold will have a key seat at the table and hold bargaining power when the new monetary system is put in place. Such currency regime transitions have tended to occur every several decades and we are overdue for another. The global economic outlook is not as rosy as the record highs in the US stock market would have you believe. There is change coming to the financial system that has been in place for the past four decades and gold is still very well positioned to benefit as the transition intensifies in the years ahead.