The Starboard Side Report

The week ending January 25, 2013

If a country can issue debt, have its central bank buy it, and then return the interest, what's to worry? Well ultimately government financing schemes such as today's QE's (quantitative easing) or England's early 1700s South Sea Bubble end badly..........The future price tag of printing six trillion dollars' worth of checks comes in the form of inflation and devaluation of currencies either relative to each other, or to commodities in less limitless supply such as oil or gold. To date, central banks have been willing to accept that cost – nay – have even encouraged it. The Fed is now comfortable with 2.5% inflation for at least 1–2 years.

The great question is whether the world economy really is at the start of a fresh cycle of growth, or whether the roaring asset rally of the last few months is another false dawn driven by central bank liquidity that is failing to gain economic traction. Bill Gross- PIMCO

Chart 1

In his January letter to investors, legendary bond fund manager Bill Gross called into question the wisdom of printing our way to prosperity. The chart above shows that over $8 trillion dollars has been added to global central bank balance sheets since 2007. We are firm believers that this liquidity has created a "false dawn". Ultimately, the real economy (as opposed to the financial economy) will fail to gain traction and we will slip back into recession and financial crisis. The real question in our minds is when, not if the relapse occurs. Investors are clearly all hopped up on the central bank juice at the moment, but once the wall of liquidity reverses stream everyone

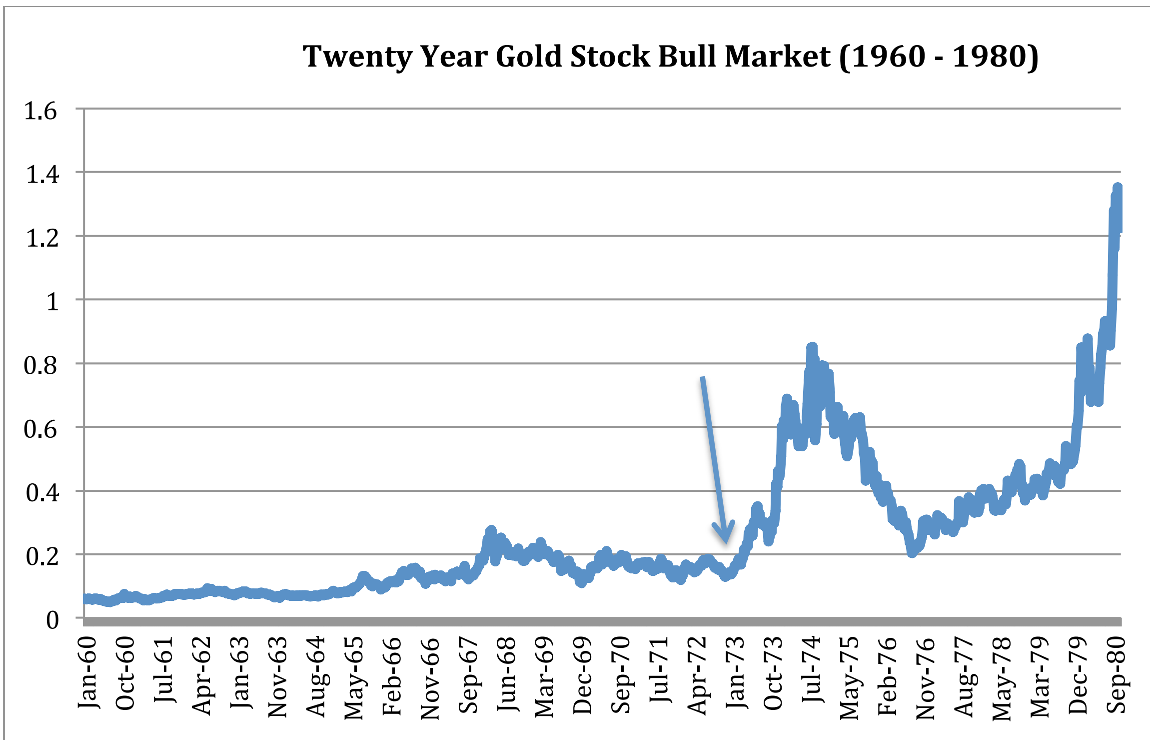
will not be able to fit through the exit at the same time. Much like the hurricanes that we battle with regularity in Florida, the key to surviving a nasty storm is to be prepared *before* the heavy winds and waves arrive. We have been battening down the hatches for the better part of a year now. We have clearly been early, but hopefully early and wrong are two different things in this case. We remain committed to disciplined capital preservation and have to be very careful not to get sucked into the final liquidity driven frenzy. On the flip side, all of this liquidity that is fueling risk assets higher will ultimately be very good for gold stocks. Gold tends to do best when economic conditions are the worst because central bankers and politicians are forced into massive stimulus efforts in an effort to boost growth. That is why gold performed extremely well on a relative basis versus the Dow between 1960 and 1980.

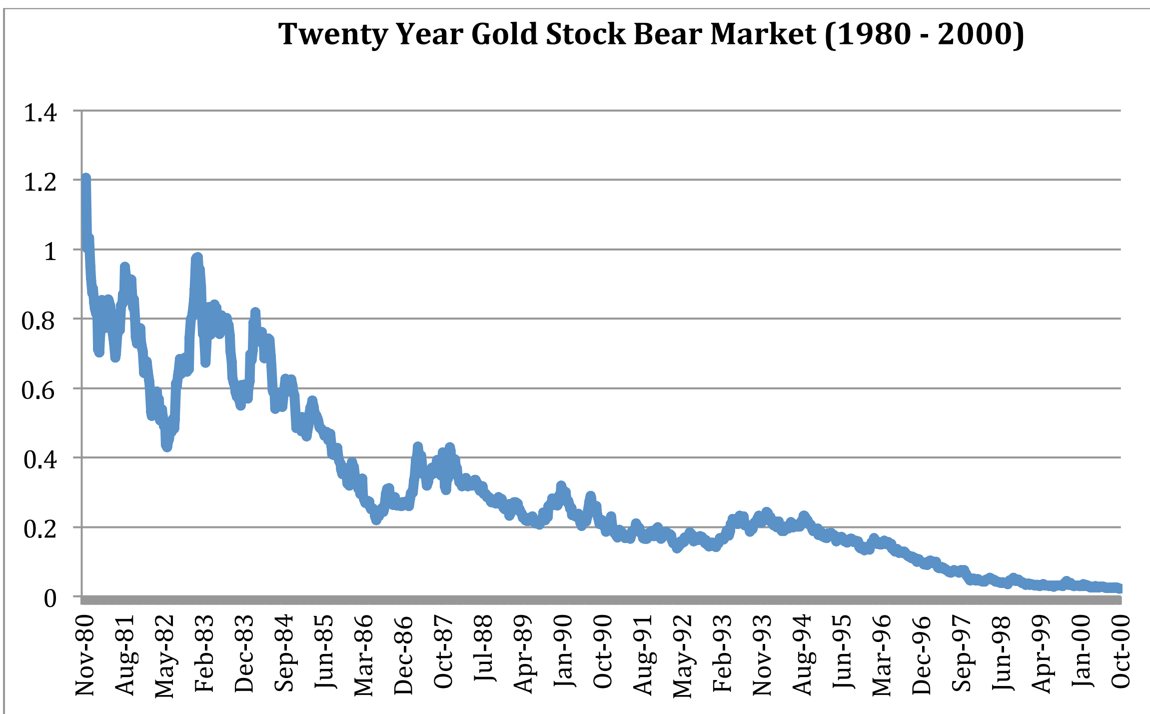
To see where gold stocks may be going, we have to look at the long-term cycles of this asset. In our opinion, the best way to view this is through the relative strength relationship between gold stocks and the Dow Jones Industrial Average. Between 1960 and 1980, gold stocks experienced a huge bull market that took the sector to dizzying heights as the Barron's Gold Miners Index (BMGI) produced a nearly thirtyfold advance when measured against the Dow. Due to the excesses created by this boom, the hangover was extremely bad and there was a massive long-term rotation out of gold and into more attractively valued Dow stocks. This trend lasted for the next two decades and the BGMI fell 98% versus the Dow over the next twenty-years before its ultimate bottom in October of 2000. These back-to-back twenty-year cycles can best be viewed below in the relative strength charts of the Gold Mining Index. When the ratio pictured in these charts is rising, then gold stocks are doing better than the Dow Jones Industrial Average and vice versa. In 2000, another gold bull cycle was born and once again gold stocks have benefited from long-term capital rotating out of overvalued Dow stocks.

We are now thirteen years into this most recent twenty-year yin-yang cycle for gold and US stocks. The important point that we will try to get across below is that the last seven years of the cycle are when the most explosive gains occur. In fact (as we will show below), the first twelve years of this bull gold cycle is eerily similar to the first twelve years from 1960 through 1972.

The first two charts are the full twenty year cycles with 1960-1980 being a gold stock bull market whereas the 1981-2000 period was a very clear Dow Jones Industrial Average relative strength bull market. The arrow on the first chart is the equivilent of where we are today on the time continuum of the cycle the the 1960 to 1980 gold bul cycle. As you can see, the best gains were still ahead when the last cycle ended its twelveth year. This is actually pretty standard bull

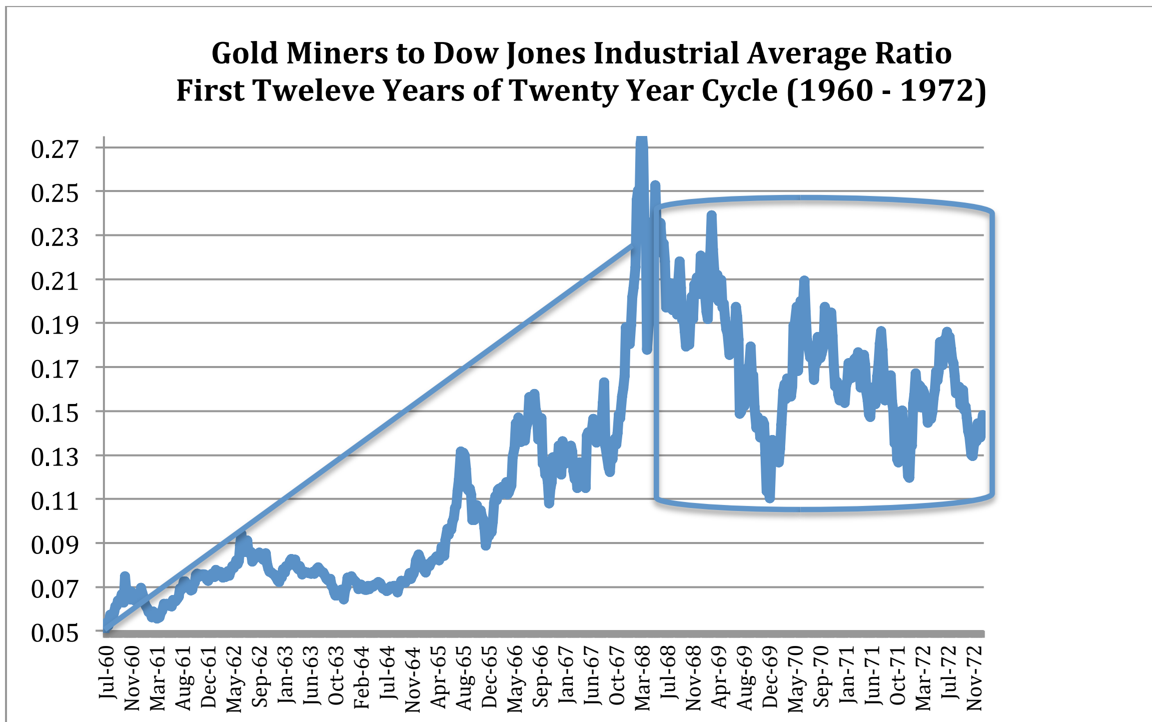
market price action with the most spectacular gains occuring in the final third of most bull markets.





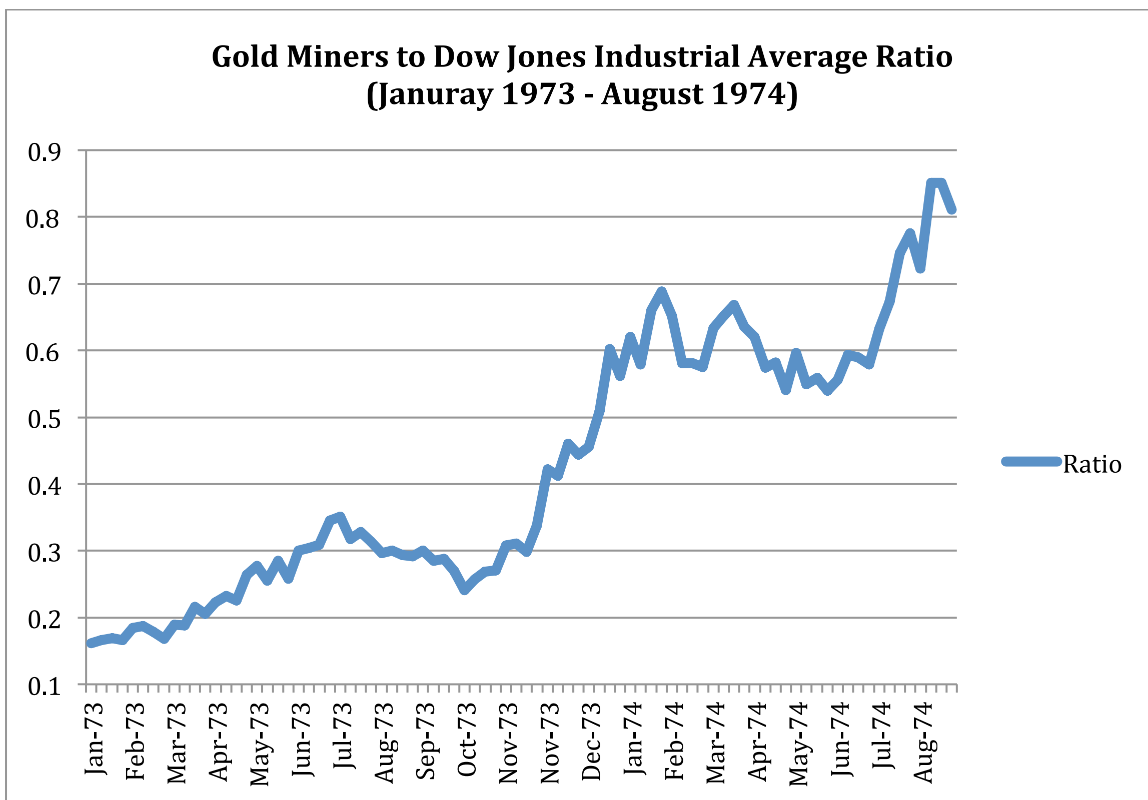
The next two charts are a close up of the first twelve years of the last gold stock bull market and the first twelve years of this current gold bull market. As you can see the patterns are

remarkably similar. Seven years of strong relative gains against the Dow and then a five-year consolidation (that included a 50% correction in value against the Dow Jones Industrial Average)

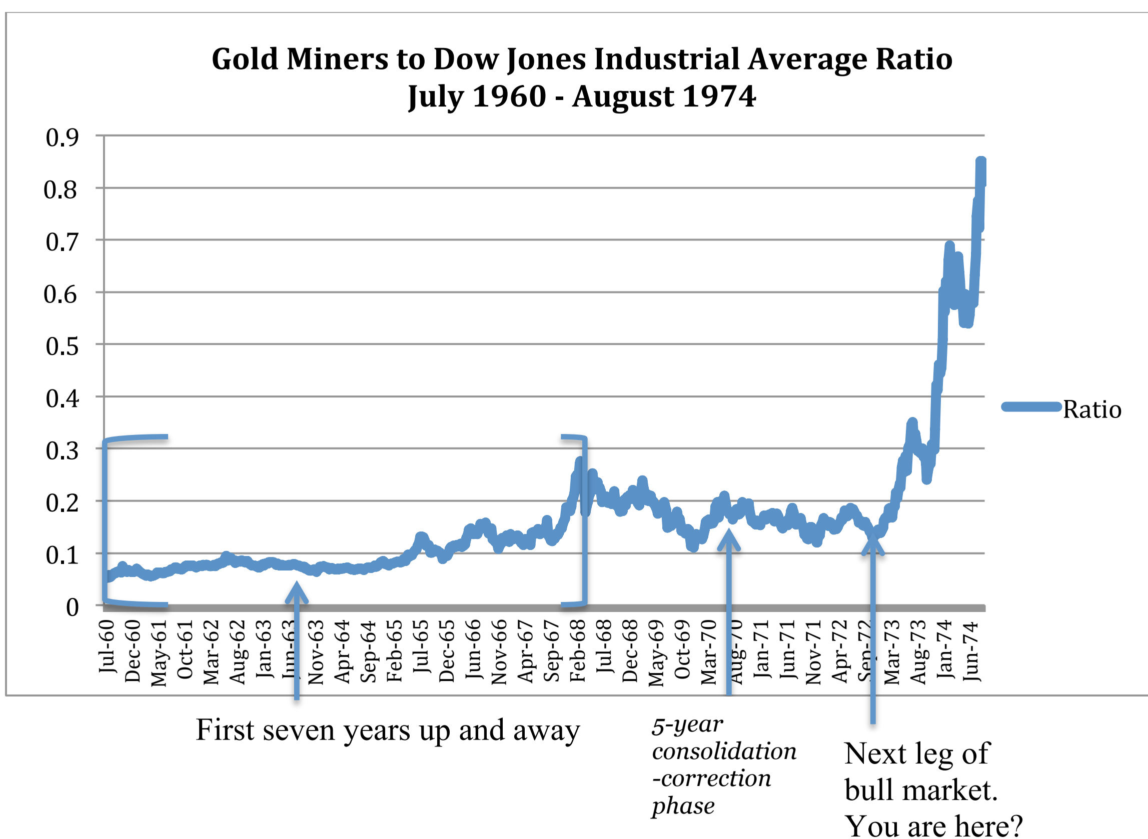


Gold & Silver Miners Index to Dow Jones Industrial Average Ratio
First Twelve Years of Current Twenty-Year Cycle (2000 – Jan 2013)

The next chart looks at the twenty months (Jan 1973 – August 1974) that followed the five-year consolidation show above. As you can see, the gold miners outperformed the Dow by 450% over this time period. It was equal parts gold stock strength and Dow Jones Industrial Average weakness that pushed the relative strength ratio higher in gold stock's favor.

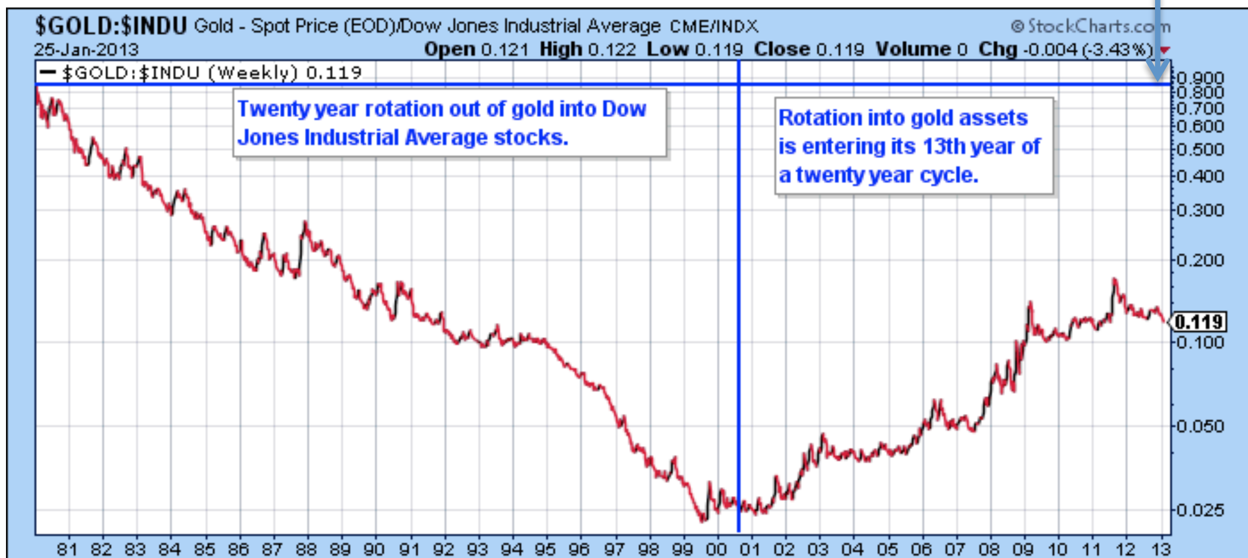


This next chart is a bigger snapshot that includes the gold stock bull cycle from 1960 through the huge advance in 1973 and 1974. We can see the five year consolidation amounted to just a blip on the radar when all was said and done. We are hoping the same can be said when we look back at the current five year consolidation twenty months from now.



Stock investors are the current beneficiaries of central bank liquidity. However, we expect this sweet spot to be fleeting as the economic realties of an overly indebted world come back to the forefront. At some point soon, this will cause the pendulum to swing back in favor of the precious metals investor and the gold stock bull market will resume. Once this inflection point arrives, there are $15 trillion reasons why the gold market's next move should be a powerful one. We remain extremely positive on gold stocks and feel that we are close to the end of a frustrating period for gold investors. Much like the period from 1973 to 1980, the final third of this gold bull market that began in late 2000 has the potential to be quite spectacular. The unprecedented size of the current government-financing scheme being implemented only reinforces this point. Gold (the metal) is still cheap relative to the liquidity that's been pumped into the system during the great credit bubble that started over twenty years ago. The final chart below shows good relative value remains for gold versus the Dow Jones Industrial Average.

Seven more years and 650% for gold to get back to the line from which it came back in 1980.



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