# The Starboard Side Report

**The week ending March 8, 2013**

"Rather than reflecting confidence, loose financial conditions are being generated artificially by central banks in an attempt to buoy sentiment and encourage spending. The monetary controls are having the desired *financial* effects, but signs of success in the real economy remain patchy, and the prevailing headwinds are strong." *Simon Hayes of Barclays*

To celebrate the new high in the Dow Jones Industrial Average, we are revisiting some charts that show the Dow priced in gold. The reason this is important is that it shows how much money printing and interest rate fixing have debased the value of money since the financial crisis began. This is one of the only ways to illustrate the true effects the legacy debt burden is having on the US industrial economy. In addition, it helps to show that the US stock market is nowhere near a true secular bull market like the one that occurred in the 1980's and 1990's.

**Dow Jones Industrial Average Priced in Gold (October 2007 – Present)**


Two important points to take away from this chart: First, the rally off the October 2011 low has seen the Dow rally 53% in gold terms. It is now back to the level it was resting at before the double whammy of the Euro crisis and debt ceiling debacle in the summer of 2011. This countertrend rally off the October 2011 bottom is why it has been a painful time to be a gold bull and US equity bear. Second, the Dow has clearly not just achieved a nominal new all-time high using this metric. **In fact, the Dow is still <u>50% below</u> its 2007 high when priced in gold.** During a true equity bull market (like in the 1980's & 90's), indexes like the Dow achieve highs in both nominal and real terms.

We have been focusing a lot on the big picture to try and help keep clients and ourselves patient in the grand scheme of things. As such, we present the big picture of the Dow priced in gold going back to 1980.

**Dow Jones Industrial Average Priced in Gold (1980 – Present)**


Here we can see that the Dow's recent strength can be chalked up to a counter trend rally in a fierce bear market that began in 2000. Furthermore, the price of gold would still have to rise sevenfold to get back to the old 1980 relationship (marked by the green horizontal line on the bottom of the chart).

Gold is not the only indicator that is telling us that the US economy remains mired in a deep funk. The entire economy is based on a subsidy of artificially cheap interest rates. The stock market would probably collapse if rates were allowed to rise back to their 2007 levels. The longer the Federal Reserve perpetuates this game of interest rate rigging, the more painful the ultimate endgame will be. The Fed is leading the country down the same road to ruin as in the past cycle with housing. We trusting the same exact credit addicted people and policies that drove the economy off the cliff in 2008. Below we see the desperate situation in interest rates.

**US Treasury 3-Month T-Bill Rate (2005 – Present)**

Those that are calling for the end of the gold bull market and the birth of a new bull for the Dow Jones Industrial Average are ignoring the elephant in the room. Manipulated interest rates and non-stop money printing are creating the illusion of recovery when none would exist without them. The markets and the economy need to stand on their own two feet before the financial crisis can be left in the rearview mirror. In 1980, it took Paul Volker taking interest rates up to 17.5% before the gold bull market died and a new equity bull was born. A move of half of that in rates today would blow-up the entire banking system. Keeping the gas pedal on monetary stimulus with stocks at their all-time highs is one hell of a risky strategy.

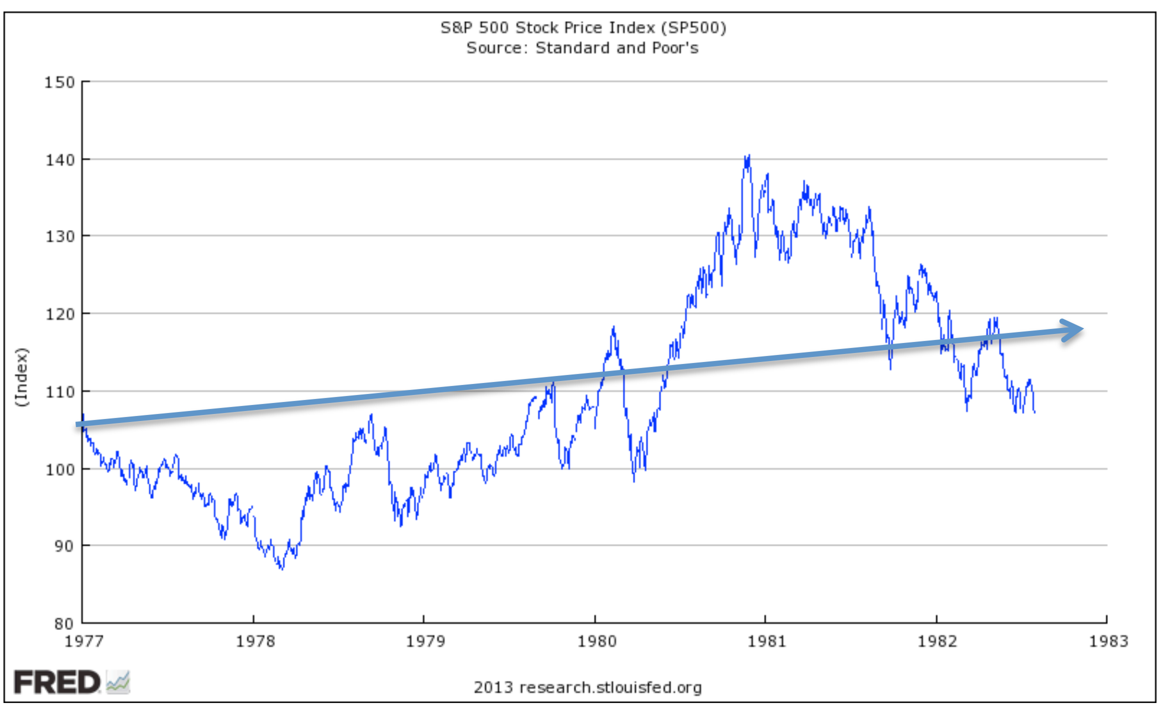
The S&P 500 is now returned all the way back to its all-time closing high 1,550. This is the level that was first achieved in the year 2000 at the peak of the dotcom bubble. However, the following S&P 500 "Real" Index chart shows that the S&P Index is still 25% those levels when it is adjusted for inflation. Importantly, it is now bumping up against solid resistance at the downtrend line.

**S&P "Real" Index = Nominal S&P 500 Index Price ÷ Annual Rate of Inflation**

**S&P 500 Real Index (1999 – Present)**

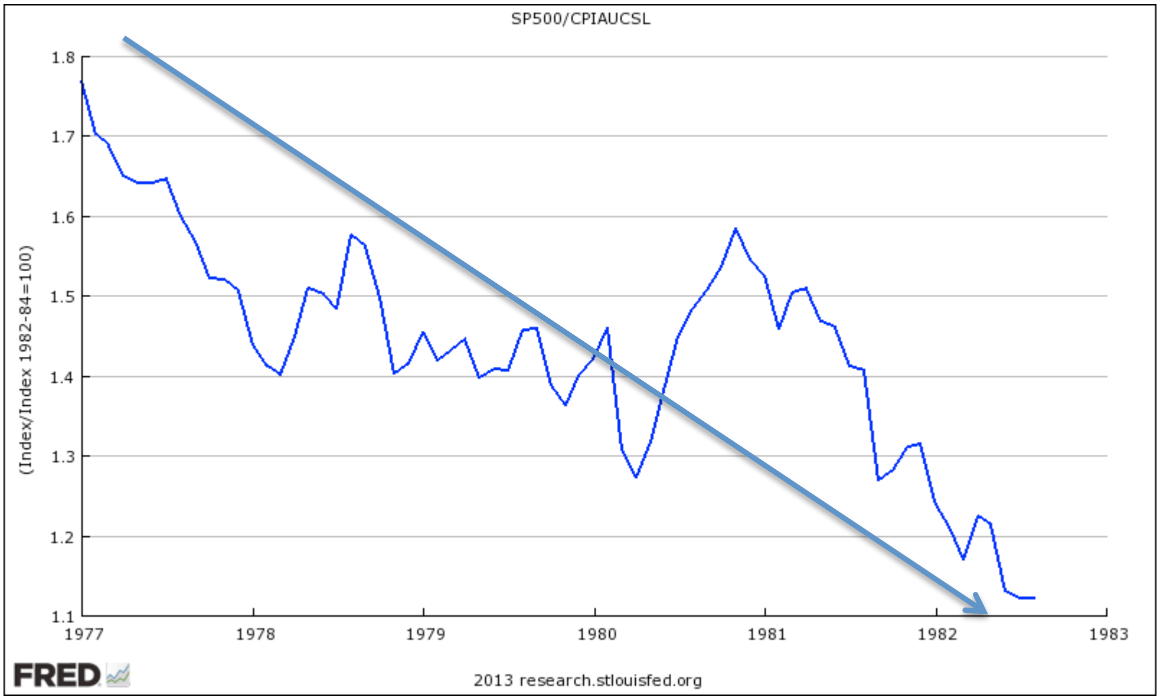
Ultimately, an investor's success must be measured against inflation. The S&P 500 Real Index can fall down to the boxed zone on the inflation-adjusted chart above in one of two ways. The S&P 500 Index (numerator) can cascade lower like it did in 2001/2002 and 2007/2008. Or, stocks can keep rising, but inflation (the denominator) can rise even faster. As we see it, the stock market is rapidly closing in on a major inflection point that will show the way forward. Behind one door is the asset deflation route like 1929, 1974, 1987, 2002 and 2008. These are rip roaring cyclical bear markets that wipe out between 40% & 60% of stock heavy investment portfolios. Behind the other door is an inflationary outcome like the one experienced in the late 1940's and 1970's. Portfolios that are fully invested in traditional equities (and bonds) at these levels without inflation protection are ignoring both risks and will likely lose in either scenario. Option two falls into the *careful what you wish for* line of thinking. Those rooting for higher stock prices from these levels have to understand that this will likely open a Pandora's box of nasty inflation and equal uncertainly. Our analysis point to it being mathematically improbable for investors to obtain higher **real** returns from current price levels. Again, that means any stock price appreciation going forward from here will increasingly be wiped out by the effects of inflation. A good old-fashioned bear market might be more welcome than $200 oil or $500 trips to the grocery store. Hard assets and precious metals are one of the best ways to hedge that inflation risk that lurks behind door number two. Cash is the best hedge against the binary risk of outright stock price declines that door number presents.

**S&P 500 Nominal Price Index (1977 – August 1982)**

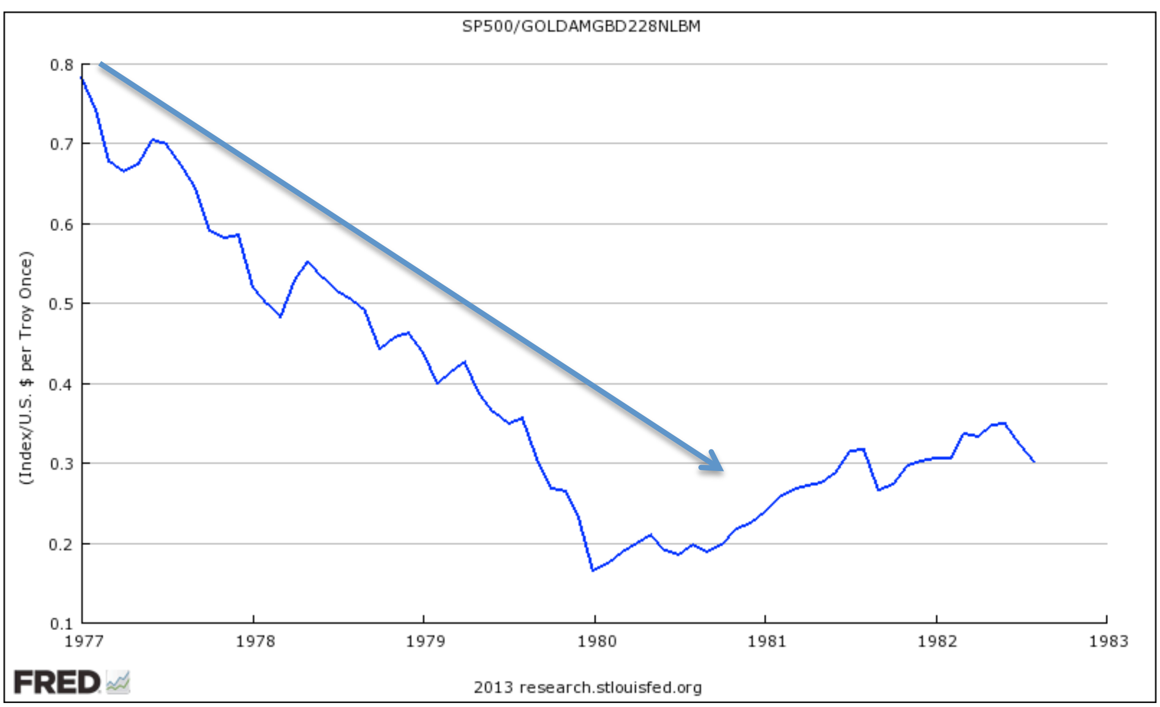


The S&P 500 chart above shows that on a nominal basis the S&P 500 did not do that bad between 1976 and 1982. Mainly, it trended up with a few rolling corrections. At the end of the day, it was about 10% higher when the official 80's bull market kicked off in August 1982. However, let's look at that same period price-adjusted for inflation and also priced in gold.

**S&P 500 Real Price Index (1977 – August 1982)**



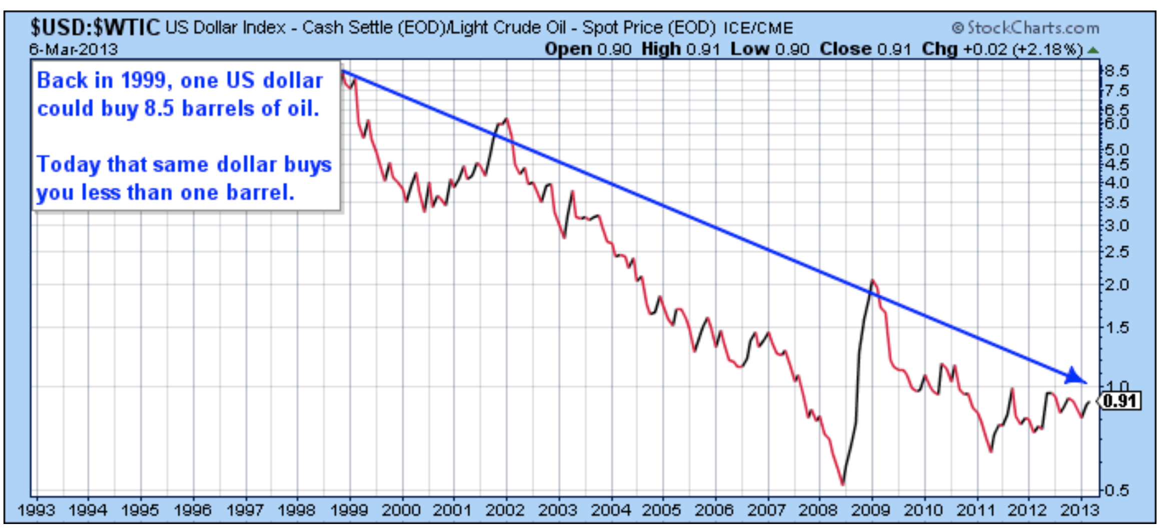

**S&P 500 Priced in Gold (1977 – 1982)**



In the final six years of the S&P 500 bear market in the 1970's, the index was up about 10% on a nominal basis, but lost 37% in real (inflation adjusted) terms and a whopping 75% when priced in gold. Again, the only reason that the S&P 500 bottomed against gold in 1980 and then a bit later in inflation adjusted terms was due to Fed chairman Paul Volker raising rates up to 17.5%. We know that this real versus nominal pricing can get a bit abstract and tough to digest. However, we must stress how incredibly important it is to understand these pricing dynamics. If the Federal Reserve insists on brazenly manipulating stock prices higher, the cost will be felt one way or another. As the saying goes, there are no free lunches in investing.

Let's look at one final chart to show an extreme measure of the Federal Reserve's failure to reign in their reckless polices. It is the price of one barrel of oil versus the value of the US Dollar Index. In 1999, one dollar could buy 8.5 barrels of oil on the global stage. It can now buy a paltry 0.91. That is an 89% loss in purchasing power. This is a microcosm of what the future holds in store for commodities and consumer goods of all kinds if the Federal Reserve insists on keeping their foot on the monetary stimulus gas pedal. Again, we remain confident that our two-sided risk management approach (to protect against both asset deflation and consumer price inflation) is the most prudent way to weather the storms that lie ahead.

**US Dollar versus Crude Oil (1999 – Present)**

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*Please note: It is the Client's responsibility to notify us of any changes that would influence their financial needs.*