



The Starboard Side Report

The week ending April 12, 2013

In our experience, it is best to turn off and tune out financial media at major tops and bottoms. Their coverage of news events tends to create emotions that are the enemy of the successful long-term investor. The sensationalistic aspect of news reporting tends to exacerbate the feelings of panic over loss at the bottoms and the fear of missing out on wealth at the tops. How quickly everyone seems to forget that the world was falling apart in late 2008 and that the media had a field day playing into those fears. This sensationalistic coverage caused many an investor to panic out at the bottom. In early 2007 at a major cycle top, we were repeatedly told that real estate prices have never declined in history so there was nothing to worry about. Flipping houses was the route to untold riches and retirement bliss. We all know how that ended for the housing market and the banks that financed the boom. In early 2000, investors were told that there was a “new economy” that deserved new pie in the sky valuations and growth metrics specifically for the technology world. Brand new companies with no earnings were doubling every couple of months and it was perfectly normal according to the talking heads on CNBC. Now, here we sit near another major cyclical inflection point with investors being sold the newfound mantra that stock prices will never decline as long as the Federal Reserve is printing money. “Cash is trash” and “don’t fight the Fed” are this cycle’s dotcom and real estate mantras to get investors locked in at the top of the cycle once again. What could possibly go wrong!

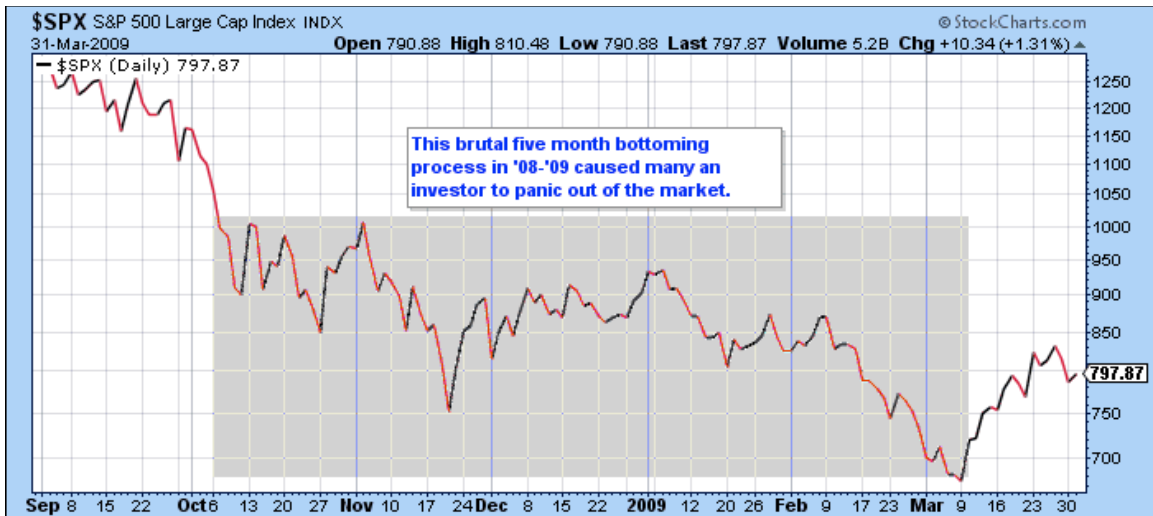
On the flip side of the market’s emotional roller coaster, the precious metals sector appears to be in the capitulation bottoming phase of a brutal 18-month cyclical bear market that has seen an index of gold and silver mining stocks down 52%, silver down 47% and gold down over 20%. Not surprisingly then, we are getting media types piling onto the process by declaring the death of the gold bull market. Anyone that lived through the October 2008 through March 2009 market bottom can attest to the fact that bottoms are a painful process to go through. *We do not* believe the secular gold bull market is dead, but there was definitely some technical damage this week that will have to be assessed in the days ahead. Based on our findings, we *may* decide to make some tactical adjustments in order to properly manage risk. However, our long-term outlook remains very positive for the sector (both the mining stocks and the price of gold/silver).

Below we highlight the topping and bottoming of the S&P 500 during the last cycle and then show both the top and the bottoms together in the big picture.

S&P 500 Index Topping (May 1, 2007 to December 31, 2007)



S&P 500 Index Bottoming (September 2008 – March 2009)



S&P 500 Full Cycle Bear Market (August 2006 – April 2009)



The final S&P 500 chart below shows the index this year after it crossed the 1,500 threshold back in the last week of January. The resemblance to the ten-week topping process in 2007 is extremely similar. In both cases there has been a ten-week back and forth climb higher with an identical breakout in the tenth week. In 2007, that was the final move before the music stopped and everyone had to find a chair.

S&P 500 Index January 22, 2013 to Present (Ten weeks above 1,500 level)

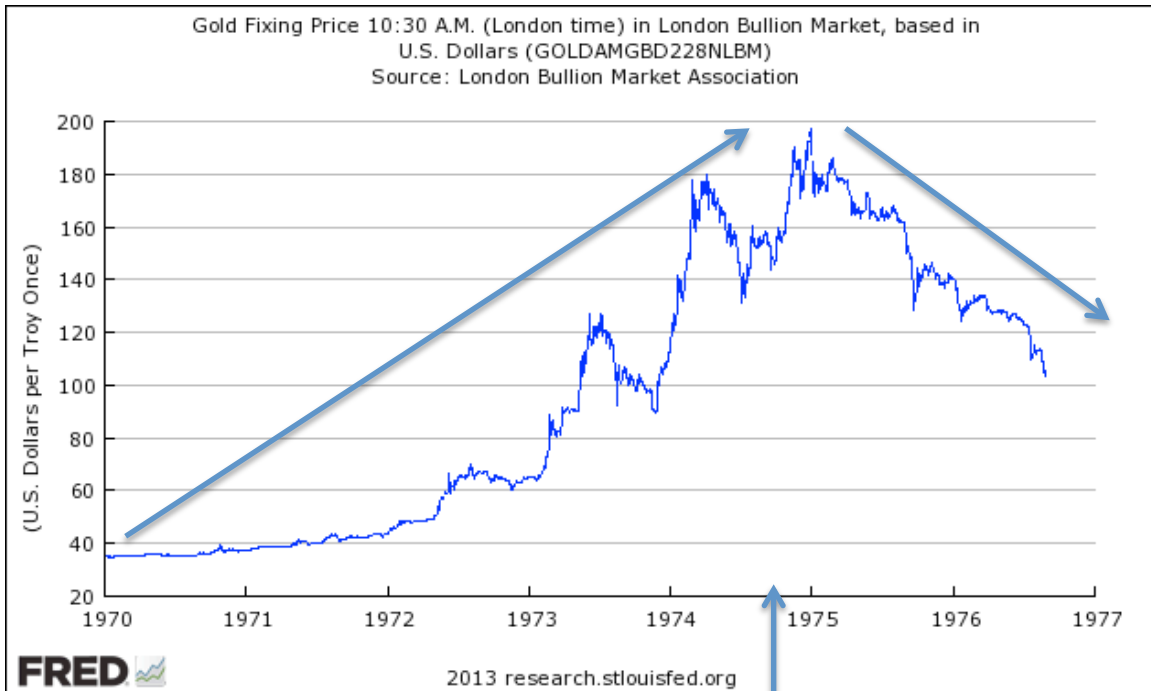


S&P 500 Index May, 1 2007 to August 20, 2007 (Ten weeks topping above 1,500 level)



As far as the gold sector, the million-dollar question facing us at the moment becomes- where is the ultimate bottom? As mentioned, bottoming processes can be *very* painful and this one is no different. Friday's decline was full-blown carnage of the kind that is typically associated with at least a near-term bottom. That should give us a relief bounce and a price reprieve that should allow us to make any needed tactical adjustments. To see where we may be going, let's look to the past. There are a lot of parallels with the 1960's and 70's gold bull market.

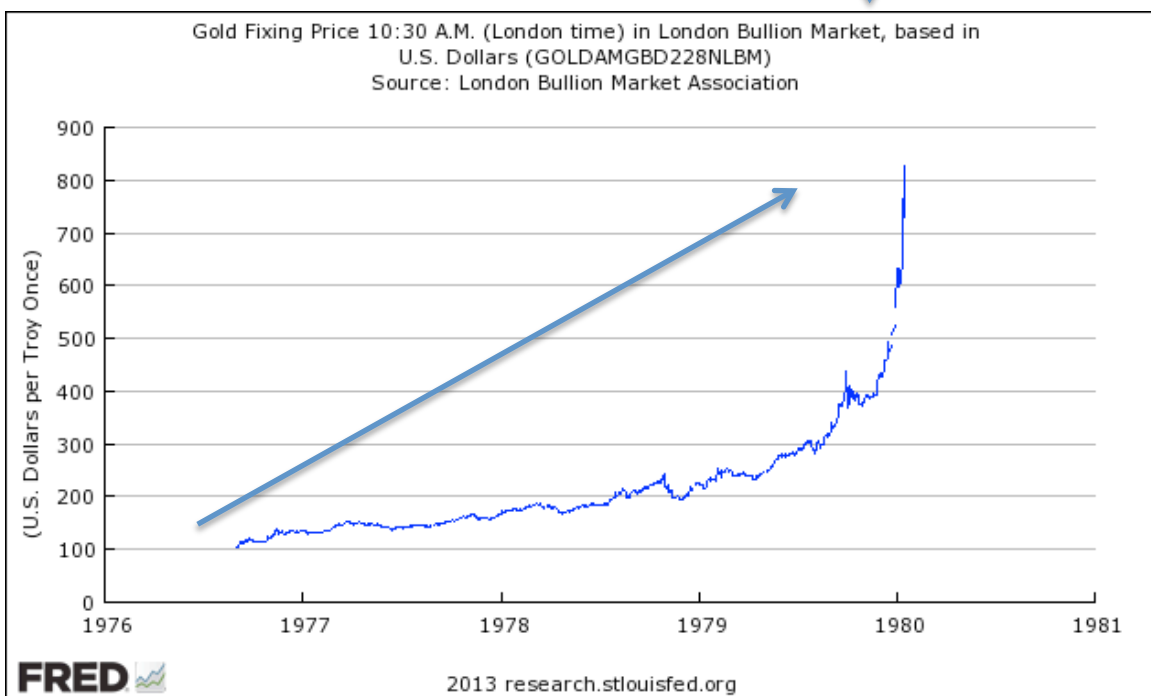
Gold Price (1970 – August 1976)



Between 1970 and 1974, gold advanced 470% but then had a 47% correction over a twenty-month span between January 1975 and August 1976.

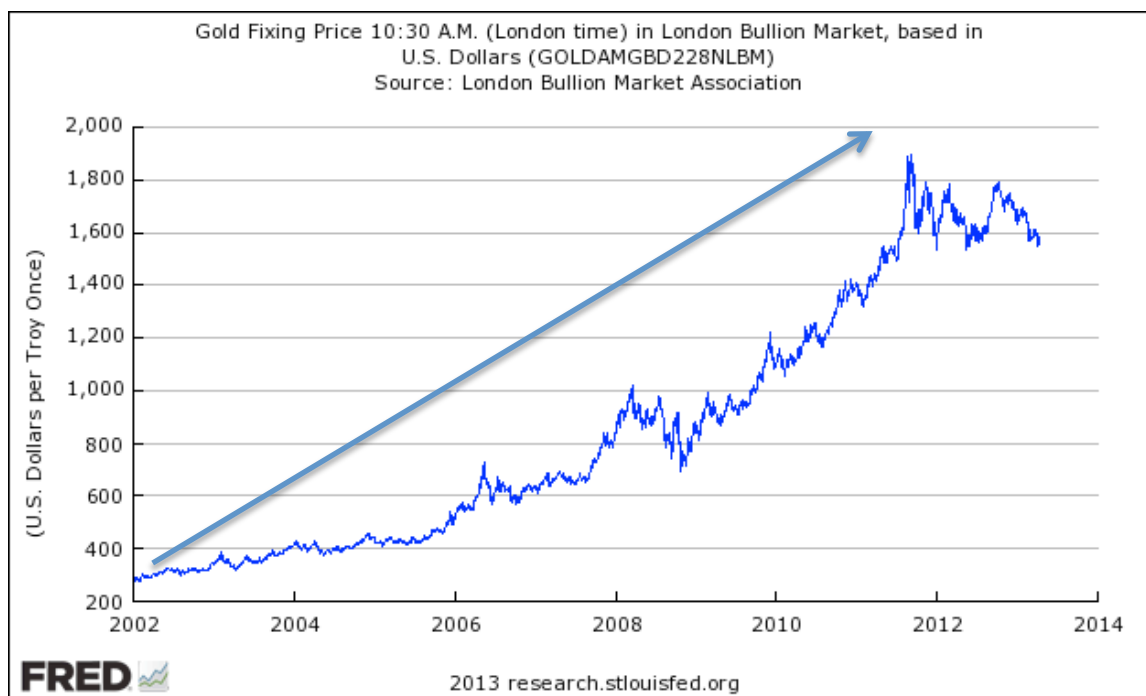
Gold then proceeded to rise eightfold over the next forty months!

Gold Price (September 1976 – January 1980)



From the start of 2002 until the most recent gold peak in 2011, gold rallied 533%. After Friday's correction, we have now seen gold fall 21.5% from its highs over a nineteen months span. That puts the situation in line with the mid-1970's correction as a function of time (19 months versus 20 months), but clearly more risk to the downside in terms of price (21.5% loss versus 47%). A *fully* correlated price decline to that 70's corrective episode presents us with the potential for 33% more downside from these levels to a gold correction-ending price of around \$1,000 per ounce. The good news mentioned above is that gold eventually exploded for an eightfold advance after the '75-'76 correction ran its course. That would equate to 8,000 per ounce gold when all is said and done with this bull market (8x's \$1000 p/ounce). However, since 33% is still a long way to fall, we are in the process of analyzing whether reducing some risk is the prudent option at this juncture.

Gold Price (2002 to Present)

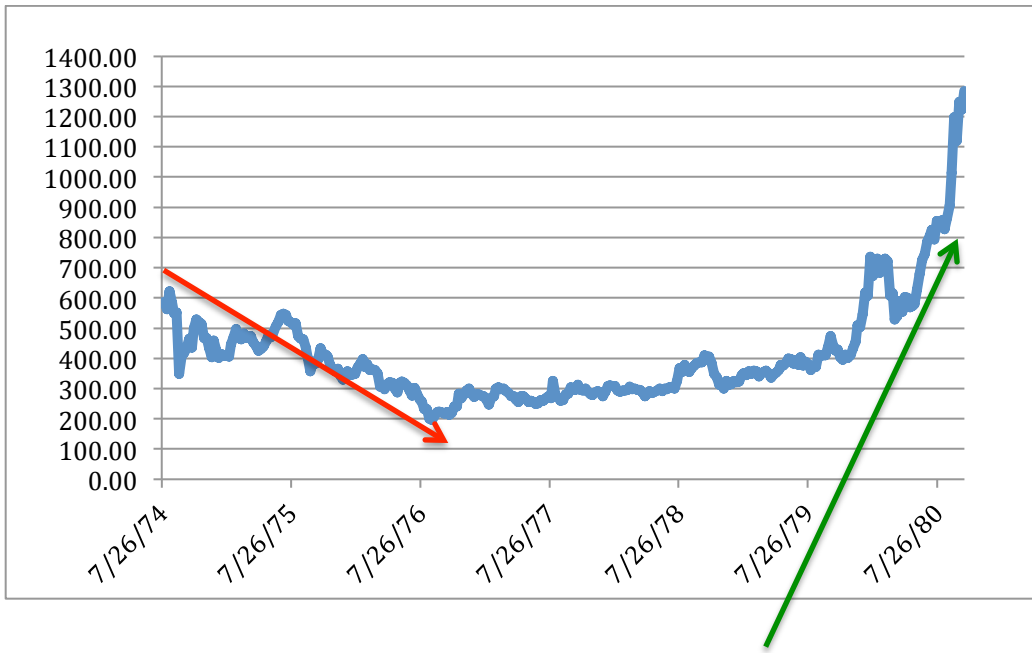


533% gain over
ten plus years.

21.5% correction over
the past nineteen
months.

When it comes to the gold mining stocks, the charts tell a similar story. They corrected by 68% over the two-year period between August 1974 and August 1976. That compares to a 52% correction for the gold mining stocks in this present episode at the 19-month mark. A similar trajectory would mean four more months of declines in terms of time and 33% more price downside in terms of price. We view this model as a worse case scenario.

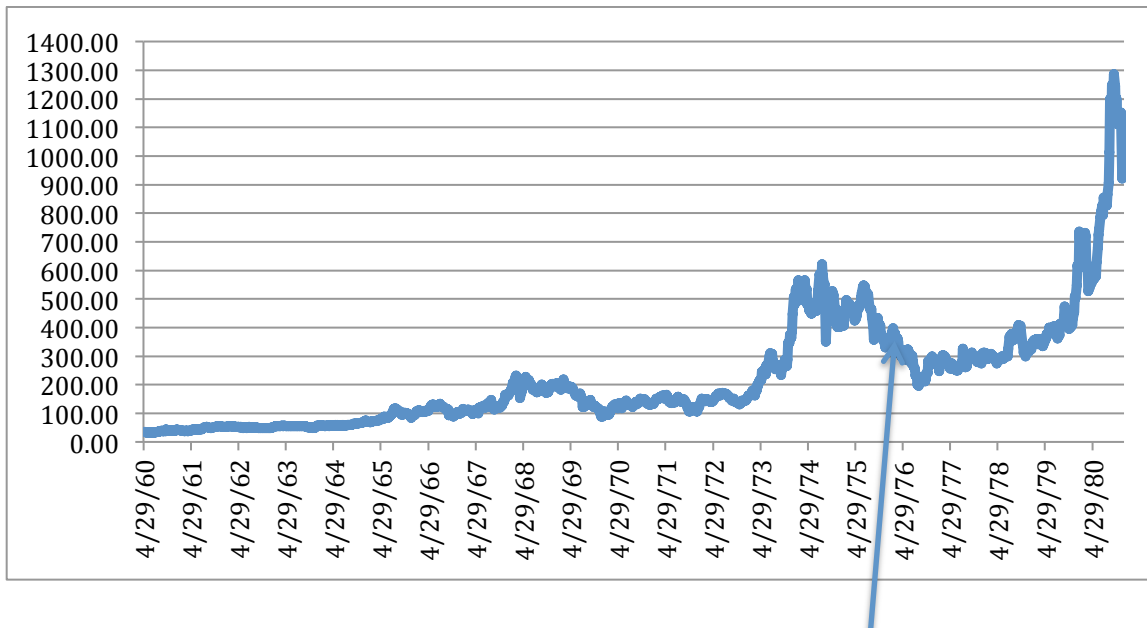
Barron's Gold Mining Index (August 1974 – September 1980)



The Barron's Gold Mining Index fell 68% during the '75-'76 bear market.

but... then rose 500% over the next four years.

Barron's Gold Mining Index (1960 – 1980) The Big Picture Bull Market



Lining up today to the 1970's experience we are about here.

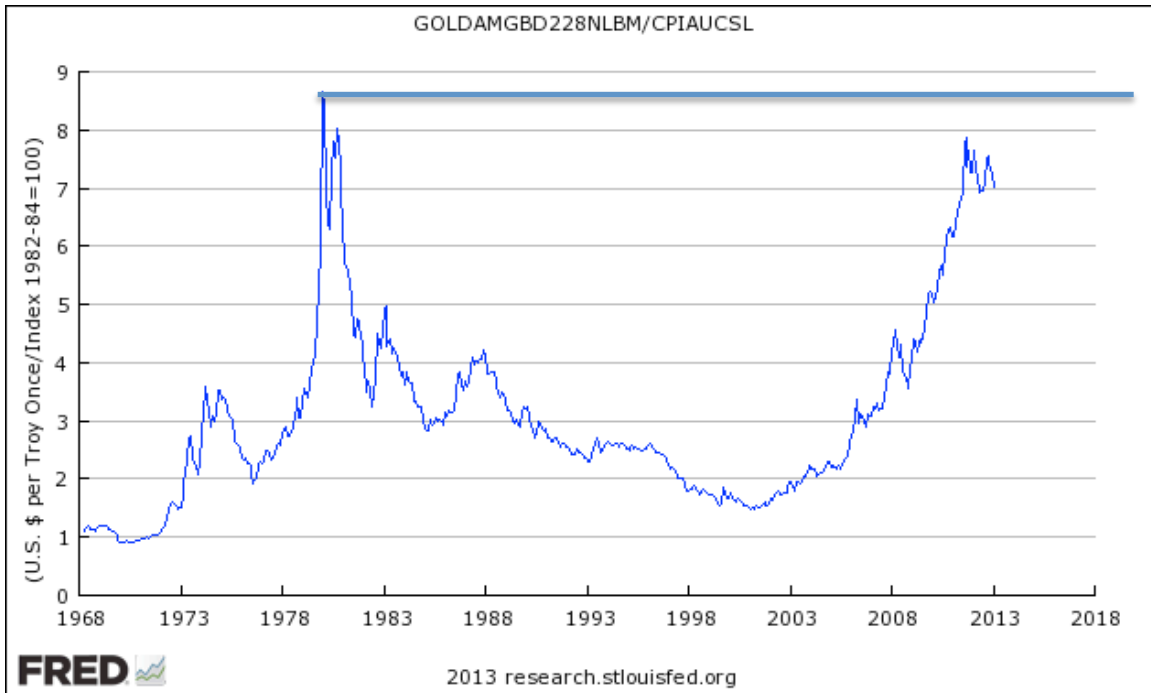
This 1970's bull market had advanced 1700% into the 1974 top versus a 900% move for the NYSE Gold Miner Index (GDM) in the 11 years into the most recent 2011 top. Therefore, maybe we do not need a 68% correction to wipe out the excesses. Perhaps the smaller percentage advance means that the 52% that the GDM has already declined is much closer to a bottom. The oversold readings we are getting right now are off the charts for many of the leading gold miners. Friday's capitulation has taken many of our technical readings below the October 2008 bottom, so a big bounce is due at the very least. This is why our worst case 1976 decline scenario may not come to fruition.

NYSE Gold Miners Index (2000 – Present)

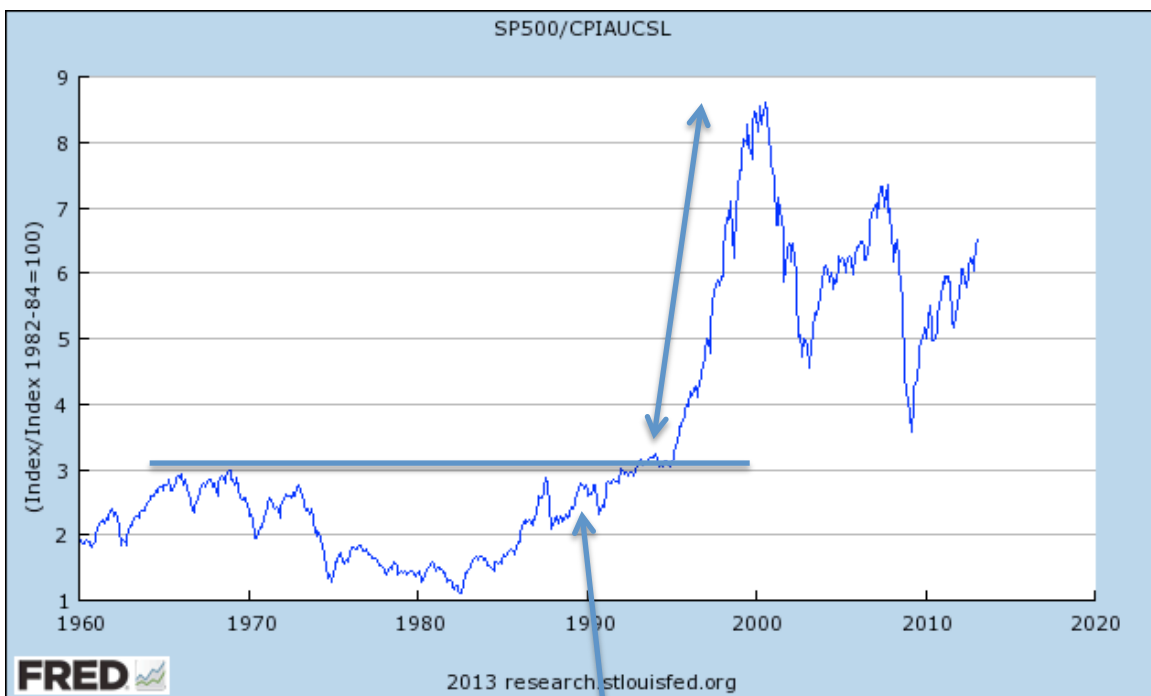


Our study of the 1970's gold bull market is one reason that we still believe that the long-term bull market in gold has much higher to go before all is said and done. Another key reason for our continued long-term bullishness is the fact that the price of gold has not even eclipsed its inflation adjusted high price of the prior bull cycle. Throughout history, it has been extremely rare for a bull market as strong as the one in gold to end without posting a meaningful new inflation adjusted high. The first chart below shows a forty-five year look at the inflation adjusted gold price. Gold is still 20% below the old 1980 prior cycle high. The second chart is an example of a bull market pausing at a prior cycle high, but ultimately busting through it.

Inflation Adjusted Price of Gold (1968 – Present)



S&P 500 Adjusted for Inflation (1960 to Present)

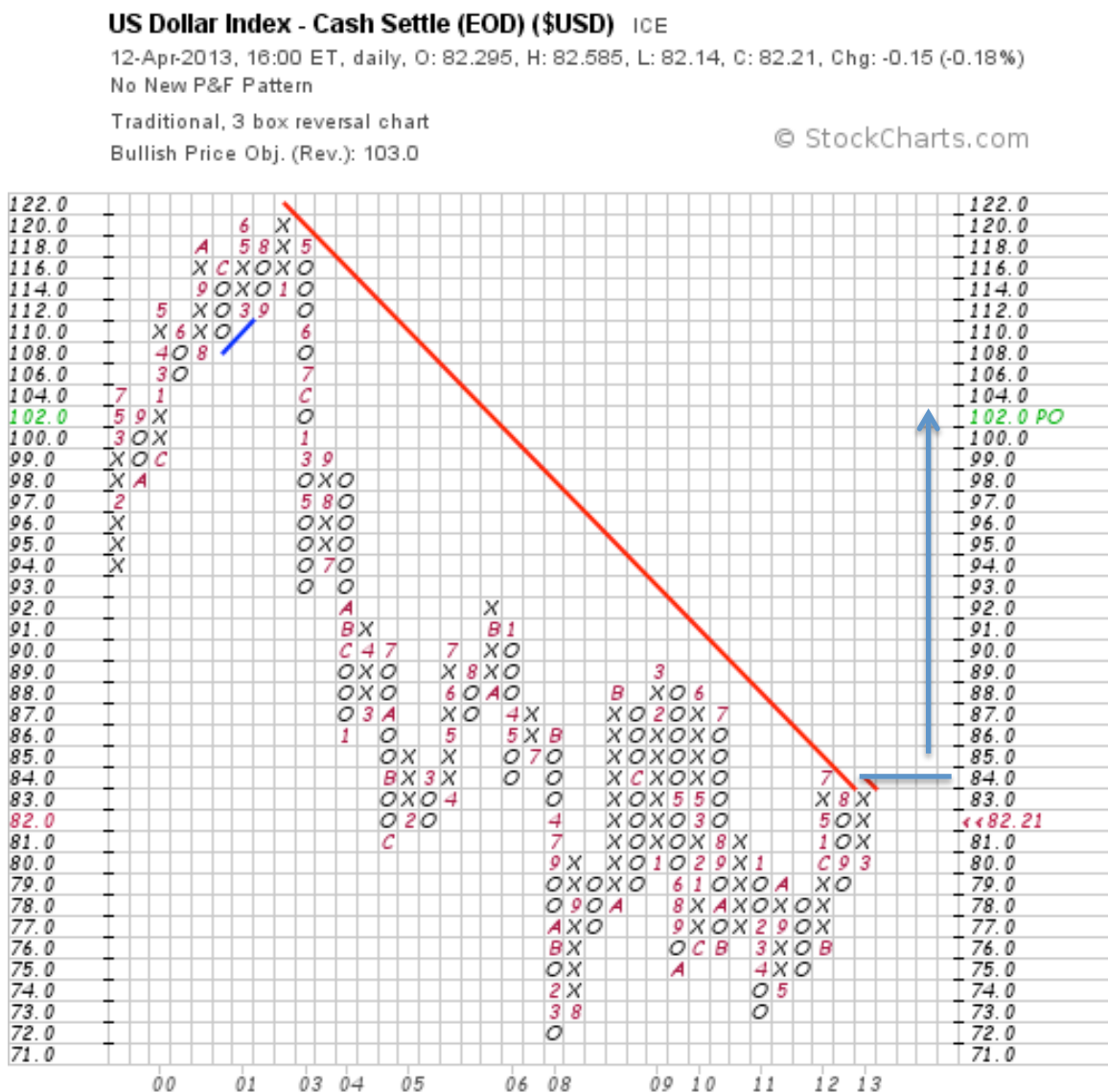


Gold bull market is the equivalent of here (1990) when compared to the 1980-2000 S&P 500 bull market.

In the early 1990's, the S&P 500 had just gone through the 1987 crash and the 1990 recession/S&L crisis. Some used the opportunity to proclaim that the end of the bull market that started in 1982 had arrived (much like we are seeing in the gold market at present). However, the chart

above shows that the market had not even hit a new inflation adjusted high at that point and went on to rally another 185% in real terms (416% in nominal terms) over the next nine years. How can those calling gold a bubble possibly back that up when seeing that the gold price has not even posted a new inflation adjusted high? It would be the equivalent of saying the S&P 500 was in a bubble in 1990. The study of inflation-adjusted prices is very important to long-term cycle work.

One final item we are keeping a close eye on is the status of the US Dollar Index. The reason that the dollar is important to gold is that they tend to trade in inverse directions. Historically, when the dollar declines, gold rallies and vice versa. US dollar strength is what turned us cautious on gold and commodities back in late 2011 and may be poised to do so again. The following chart is very important to the big picture commodity story.



The red line is a downtrend line that goes all the way back to the dollar's structural top in 2001. A decisive break of that downtrend will most likely be bad for risk assets throughout the globe because it would signal a contraction in global credit/liquidity. This would mean that deflation/deleveraging is starting to overwhelm the debt laden global financial system again. From our perspective, a move to 85 on this index would be a major red flag that points to a deepening global recession scenario and away from inflation for the time being. The blue arrow is the potential US Dollar target price should it breakout here. The next chart below illustrates what the US Dollar Index did in 2008 with the credit crisis in full bloom.

US Dollar Index (April 2007 – March 2009)



In conclusion, we see the euphoria behind the recent gains in the S&P 500 as severely misplaced and recommend very selective use of financial media. Investors are at risk of getting burned for a third time in the past thirteen years due to the misguided belief that the Federal Reserve can keep the market disconnected from fundamentals for an infinite period. Despite the new all-time highs, we remain convinced that the broad market is actually in the midst of a major topping process that could very well signify the end the bull market that began in 2009. A sharp rally in the dollar would most likely be deflationary and bad for all global risk assets including US stocks due to a liquidity contraction. This could have negative implications for our inflation hedges in the commodity realm and we are assessing this exposure. Meanwhile, the gold sector is at a key inflection point. While we still see big upside in the years ahead for gold and silver prices (i.e. the long-term bull market is *not* dead), the technical damage inflicted this week, in conjunction with a strengthening US dollar, could mean more choppiness ahead before a new gold sector rally phase can begin. The most encouraging thing that points to an imminent bottom for the precious metals sector is oversold readings consistent with the major bottoms in 2000 and 2008. That could mean that Friday's extreme panic selling was actually a major capitulation day or at

the very least a major short-term trading bottom. The bottom line is that the markets are increasingly destabilizing under the surface as we discussed in our prior two reports. In general, this causes us to remain risk adverse and very selective in our portfolios.

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