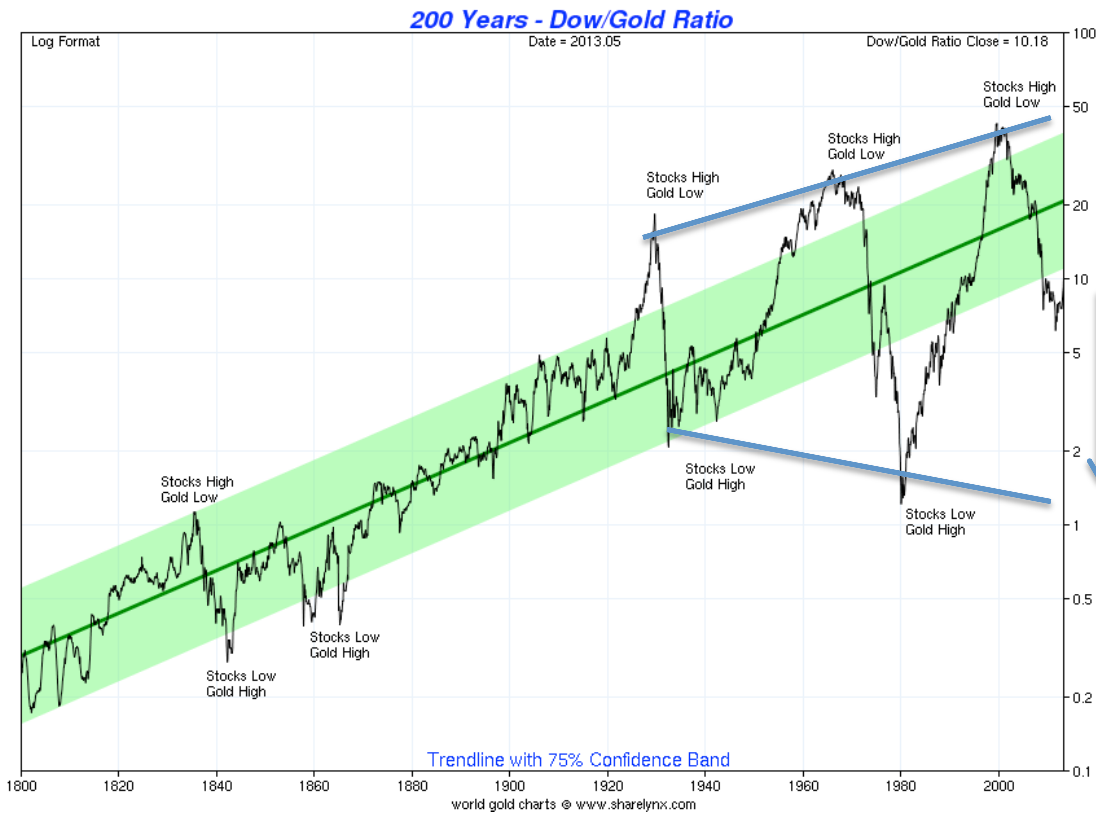
The Starboard Side Report

The week ending May 10, 2013

We want to preface this report with the fact that we are not “gold bugs” in the true sense of the word. We don’t long for a return of the gold-backed money system and we could really care less about whether we own it or not in client accounts. We have spent so much time in this report discussing gold because it has been in a bull market versus US stocks since the year 2000. We actually look forward to the day when we don’t have to discuss it anymore and defend our non-mainstream view. A few readers have commented to us that one of the things that they find hard to comprehend on the report is when we show ratio charts of assets priced relative to gold. The common refrain is, since I can’t buy anything with gold, what purpose does this serve? We wanted to try and dive a little deeper into this issue by focusing on the Dow Jones Industrial Average to Gold Ratio. It is understood that you can’t walk into a car dealership with a few bars of gold and walk away with a new automobile. We feel that the true value of gold is as a lasting *measure* of wealth of a nation’s currency, not in its actual transactional value. As a currency measurement tool that has been around for centuries and through multiple economic cycles, it serves as a great *relative* barometer to the true value of various asset classes in an investor’s home currency. While gold can’t literally buy you a new car, it can easily be transferred to US dollars and those dollars can then be used as transactional currency. If gold has been gaining ground against the US dollar, then your gold will buy you more dollars to make your transaction. In that sense, we view gold as an alternate hard currency to the US dollar that can be used to preserve wealth in tough times. Gold has proven to be a wonderful hedge against the type of monetary disorder that could result from reckless central bank money printing.

That brings us back to the relationship of gold versus US stocks as measured by the Dow Jones Industrial Average. By the time this gold bull market is over, our main goal is to buy as many shares of the blue chip Dow Jones Industrial Average type companies as possible by converting our gold investments back into lots of devalued US dollars. In turn, we then envision going on a buying spree and creating a portfolio of the most productive assets of the US economy at a giant discount. We use the Dow because it has the longest history to compare and it is made up of 30 of the most productive US enterprises. This first chart below tracks the ratio of the Dow Jones Industrial Average to the price of gold. The number tells you how many ounces of gold it would take to buy the Dow on any given day. The Previous cycle lows have been 2.0 ounces in 1933 and 1.0 ounces in 1980. These lows are located along the bottom blue trend line. Using the average of these prior two gold bull market tops, it gives us an estimated 1.5 ounces of gold to buy the Dow Jones Industrial Average when this gold bull market is finally over (versus 10 ounces at present). The quick math of 15,000 (current Dow level) divided by 1.5 ounces of gold projects to a 10,000 per ounce price for gold (versus 1,450 at present) without any change in the Dow Jones Industrial Average price. Since this is a ratio, if the Dow lost 50%, then the gold target price would also be 50% lower. But, for the purposes of simplicity, we'll assume that the Dow stays constant at 15,000 for the next five years.

Dow Jones Industrial Average to Gold Ratio (1800 to Present)



Source: Sharelynx

This is the big picture, which we have shown many times in this report, and which has caused some confusion. Again, the question many seem to be asking themselves is, so what? To help answer this, we decided to break down all 30 stocks in the Dow Jones Industrial Average in order to give an idea of the kind of value we are talking about when it comes to the purchasing power of gold over stocks. To assist in the process, we present the following table of each stock that currently makes up the Dow Jones Industrial Average. The first column is the price of each individual Dow stock at the start of the current bear market in January 2000, whereas the second column is the current price of each Dow constituent. For the next three columns, we show how many shares of each Dow stock one ounce of gold can buy at the respective moment in time indicated. I've highlighted Intel in blue as an example. In 2000, at a Dow to gold ratio of 40:1, one ounce of gold could be converted to US dollars and then buy 7 shares of Intel. Today, at a

10:1 Dow to gold ratio, one ounce of gold can buy you 60 shares of Intel (or 750% more stock than in 2000). Finally, in the fifth column, we see that if we achieve our target Dow to gold ratio of 1.5, than one ounce of gold will buy you 620 shares of Intel (or 934% more stock than at present and 87 times as much as in 2000)!

Dow Jones Industrial Average Components

How Many Shares Does One Ounce of Gold Buy?

Symbol	Desc	Jan-00 Price	Current Price	Jan-00 Shares 1 oz. of Gold Can Buy	Today Shares 1 oz. of Gold Can Buy	@ 1.5 to 1 Ratio Shares 1 oz. of Gold Can Buy
AA	Alcoa Inc.	41.5	8.63	7	168	1738
AXP	American Express	48.51	70.24	6	21	214
BA	Boeing	41.44	94.8	7	15	158
BAC	Bank of America	25.09	12.89	12	112	1164
CAT	Caterpillar	23.53	89.79	12	16	167
CSCO	Cisco Systems	53.56	20.38	5	71	736
CVX	Chevron	43.31	123.02	7	12	122
DD	DuPont	65.88	54.65	4	27	274
DIS	Walt Disney	29.25	66.07	10	22	227
GE	General Electric	51.58	22.68	6	64	661
HD	Home Depot, Inc.	68.75	75.07	4	19	200
HPQ	Hewlett-Packard	44.4	20.5	7	71	732
IBM	IBM	107.87	203.63	3	7	74
INTC	Intel Corporation	41.16	24.15	7	60	621
JNJ	Johnson & Johnson	46.62	85.53	6	17	175
JPM	J.P. Morgan Chase	51.79	49.14	6	30	305
KO	Coca-Cola	29.12	42.7	10	34	351
MCD	McDonald's	40.31	102.29	7	14	147
MMM	3M Company	48.94	108.01	6	13	139
MRK	Merck & Co., Inc.	63.59	45.27	5	32	331
MSFT	Microsoft	52.54	33.31	6	44	450
PFE	Pfizer Inc.	32.44	29.03	9	50	517
PG	Procter & Gamble	54.78	77.94	5	19	192
T	AT&T Inc.	48.75	37.52	6	39	400
TRV	The Travelers Cos	33.69	85.99	9	17	174
UNH	UnitedHealth Group	6.64	60.5	44	24	248
UTX	United Technologies	32.5	93.87	9	15	160
VZ	Verizon Comm.	59.33	52.91	5	27	284
WMT	Wal-Mart Stores	69.12	78.83	4	18	190
XOM	Exxon Mobil	40.28	91.12	7	16	165
DJIA	Dow Jones	11500	15000	240	1094	11316
Gold	Gold Price	291	1450	n/a	356%	934%
	Dow to Gold Ratio	40	10	40	10	1.5

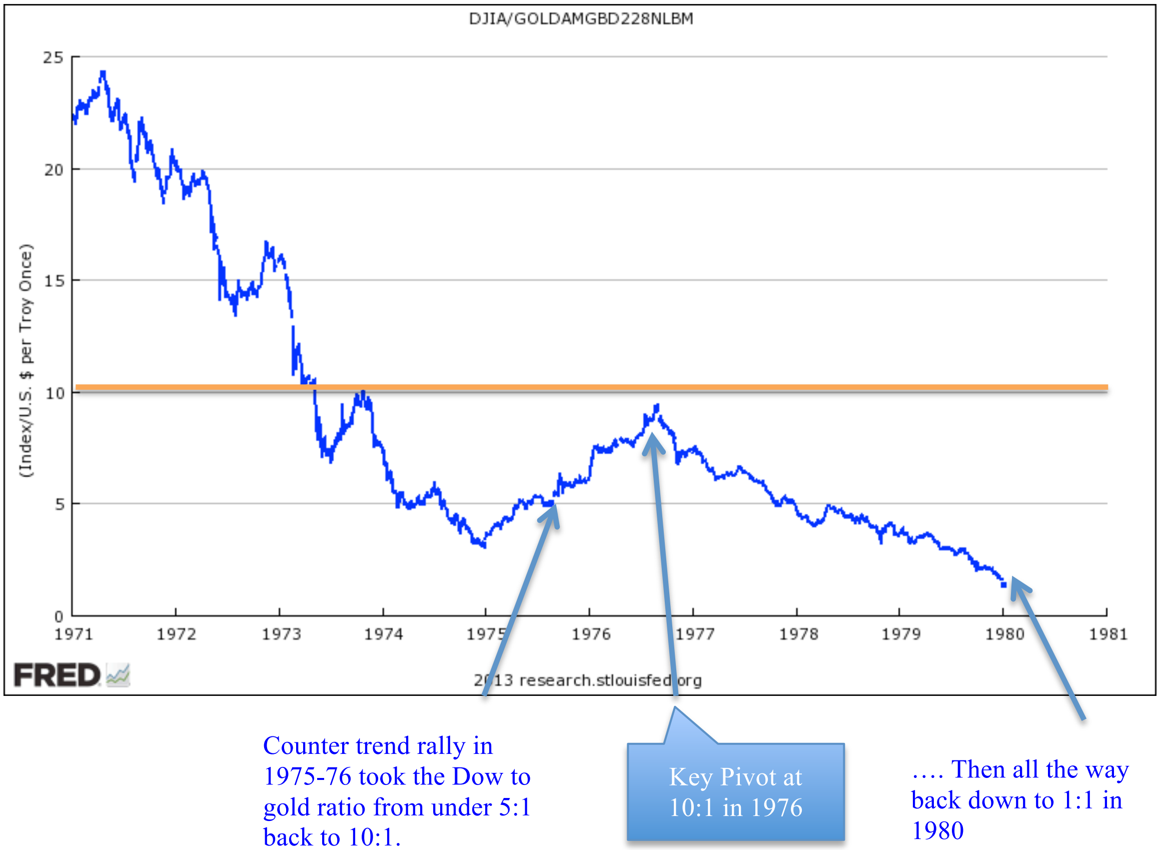
This chart helps us prove that, even though we have come a long way in this gold bull market, the final move in the ratio from the present level of 10:1 back down to 1.5:1 will have the most profound effect for creating long-term wealth in our portfolios. As mentioned, gold is simply a bull market bridge to get us to a point when the productive assets of the US economy are deep discount as they were in the 1930's and the early 1980's. Just because gold has taken a breather over the past year and a half, does not mean that the bull market is dead.

Next is a chart that shows the importance of the 10:1 ratio (where we reside at present). History points to this 10:1 level as being a key inflection point. As the chart above states, the 10:1 ratio was the level of a major two-year consolidation between 1992 and 1994 when the chart was heading in the other direction in favor of the Dow. Once this consolidation ended in late 1994, the final launch of the Dow bull market commenced (thirteen years after it began).

Dow/Gold Ratio (1980 – Present)

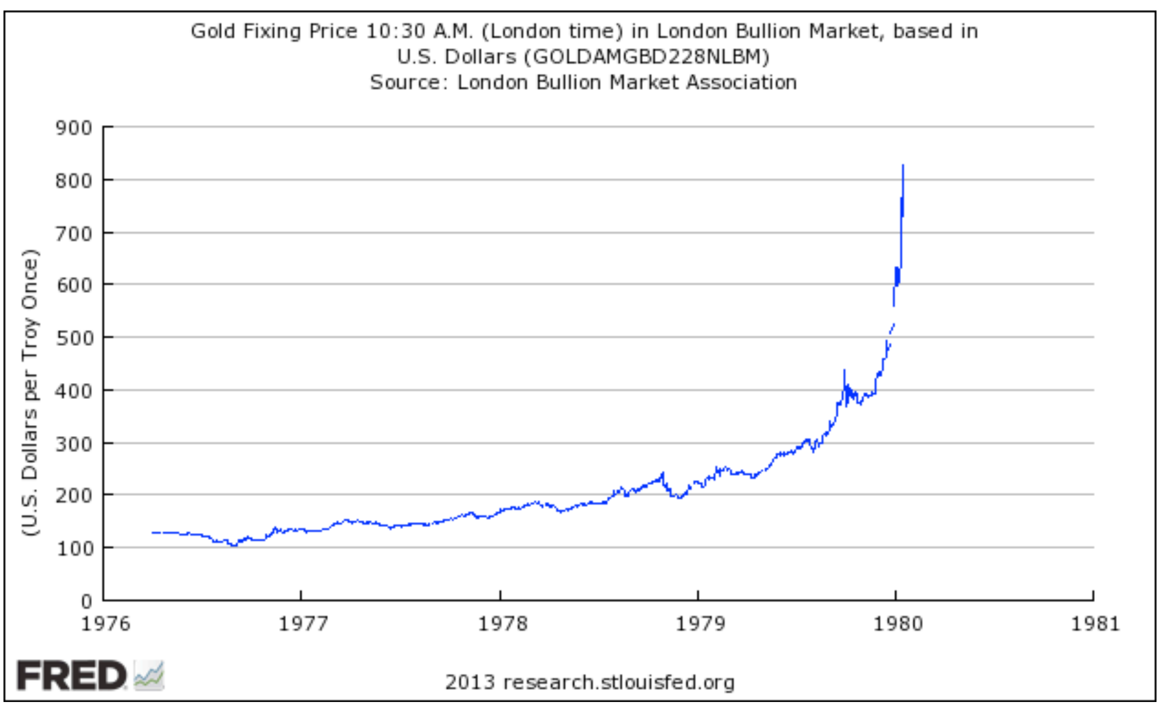
In 1976, the 10:1 level also served as an important point from where the final leg of the gold bull market launched. Between 1970 and 1975, the Dow/Gold Ratio went all the way from 25:1 to below 5:1. Then in 1975/1976, this ratio chart staged a furious rally as gold declined and the Dow rallied (much like the past two years). This took the ratio all the way back to 10:1 and brought many out of the woodwork to call the gold bull market dead. The arrow on the chart below highlights that key pivot point in 1976. After gold bottomed and the Dow topped out in the fall of 1976, the ratio exploded lower from 10:1 to 1:1 over the next three years.

Dow/Gold Ratio (1971 – 1981)



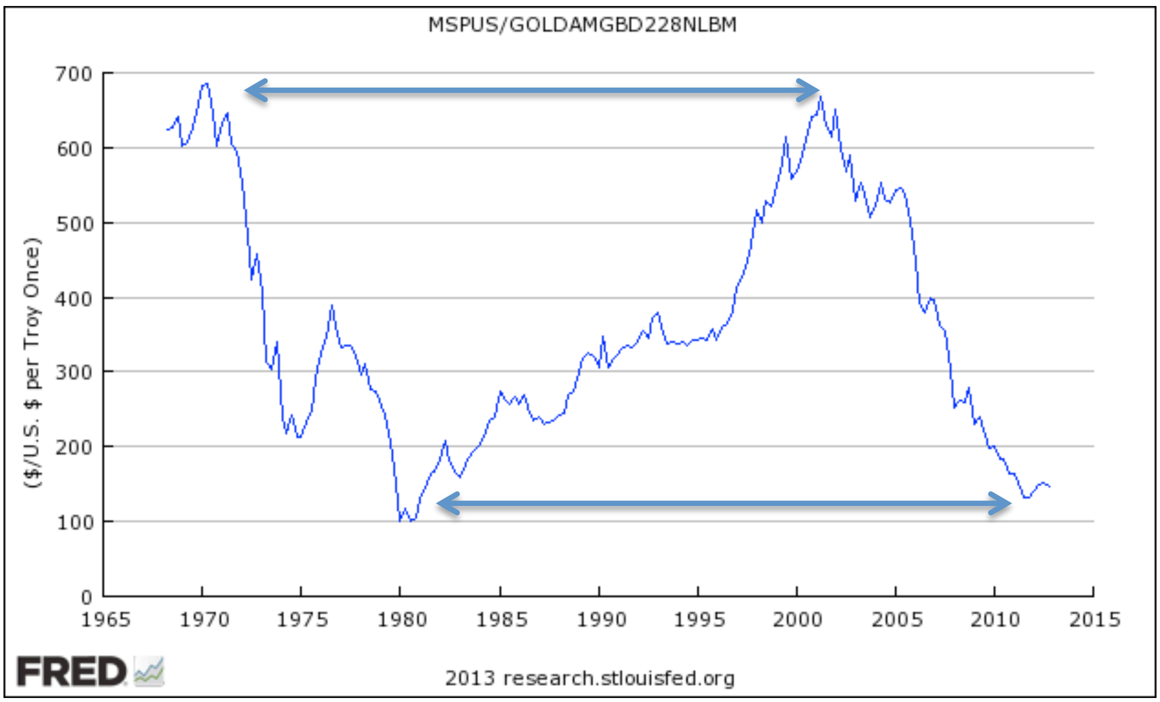
This is what a move from 10:1 to 1:1 in the Dow to Gold Ratio looked like for the actual price of gold.

Gold Price 1976 – 1980 as Dow/Gold Ratio Goes from 10 to 1



One final analysis to reinforce that this cycle work is not witchcraft, but rather a good way to view large waves that move from overvaluation to undervaluation as measured by gold. The real estate boom-bust cycle is clearly spelled out in this ratio chart of the median price of a US house versus gold. At its most recent peak in April 2001, the price of a US home was 667 times greater then an ounce of gold. That was just below the 1970 peak of the prior cycle when the ratio was 684. The top arrow on the chart connects these two cycle peaks. Wouldn't you know it, just as much symmetry was exhibited in the down cycles with the 1980 bottom occurring at a 100:1 ratio and the most recent 2011 bottom in housing to gold ratio bottoming at a very similar 131:1. The bottom arrow on the chart connects these two cycle troughs.

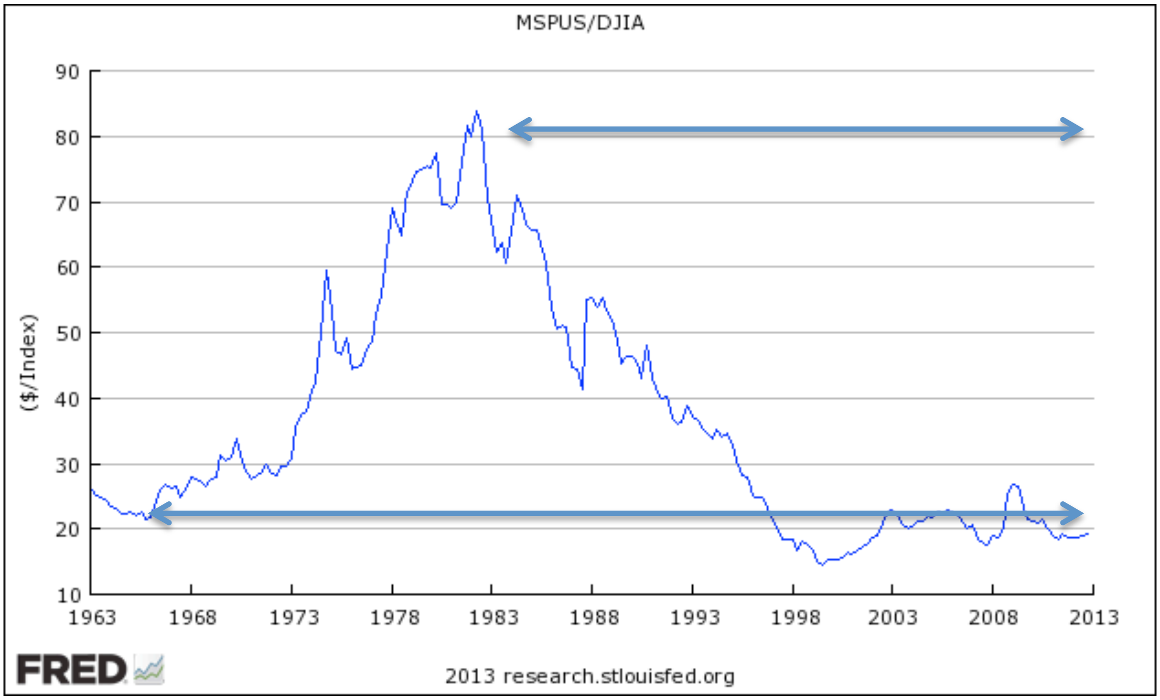
US Median House Price to Gold Ratio



Again, the Dow/Gold ratio is at 10:1 and we expect it to bottom somewhere under 2:1

While we are looking at the ratio of assets to one another to determine relative value, let's complete the circle by showing the median price of a US house versus the Dow Jones Industrial Average. This is another metric that shows us how truly overvalued the US stock market still is at present. In fact, this chart makes real estate an absolute bargain compared to US equities.

Ratio of US Median House Price to Dow Jones Industrial Average (1963 – Present)



In order to get back to the same 1982 ratio where the Dow was considered cheap versus US real estate, then the Dow would have to fall by 80% all the way to 3,000! Of course, since this is a ratio, they can meet somewhere in the middle with the Dow falling and real estate prices rising over a period of years (or much less likely, real estate prices could quadruple with no change in the Dow). However, the over arching take away is that the Dow Jones Industrial Average remains an overvalued asset. As a reminder, the similar valuation gap that existed between the Dow and US house prices in the late 1960's was narrowed through huge Dow price declines in 1973-74. This analysis is interesting because it backs up many of the valuation studies we have been featuring that point to the US stock bubble in the late 1990's being so big that the market remains as overvalued as it was at the *start* of the 1930's and 1970's stock bear markets (even though we are thirteen years into this bear).