The Starboard Side Report

The week ending June 21, 2013

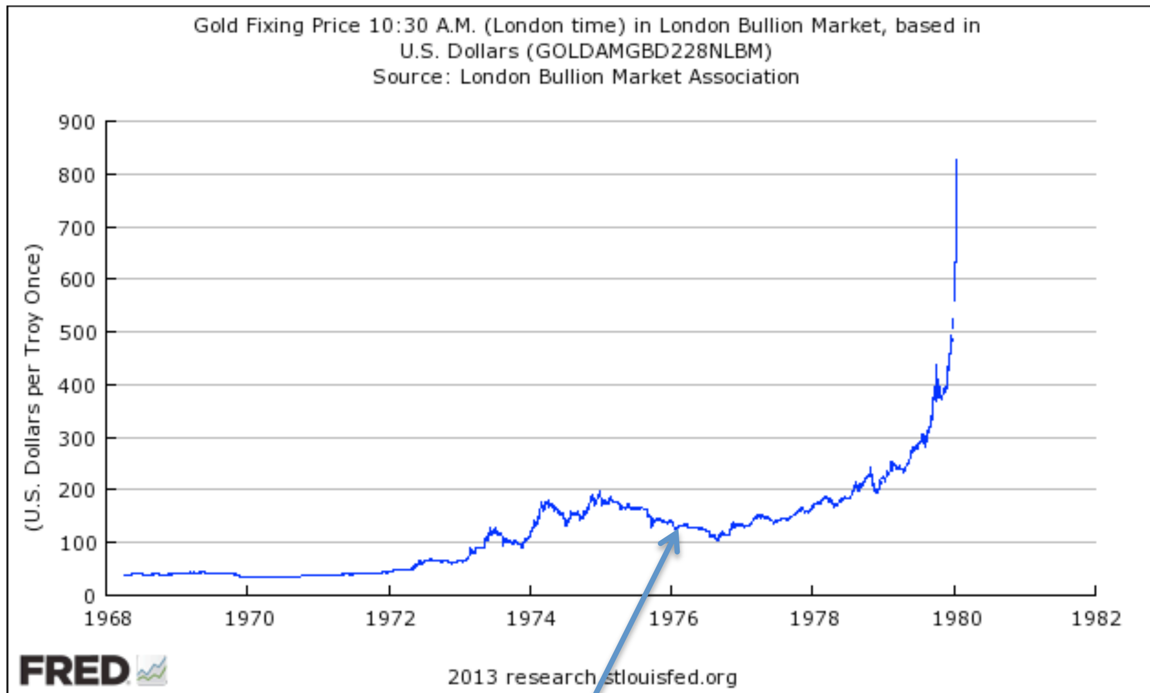
"The biggest risk in the markets today is a loss of confidence that Bernanke can hold this thing together. In my opinion there is a very large false sense of security that they know what they are doing and can indeed wield a wand to control asset prices. However, at the end of the day, this is still a confidence game. They can only do so if the markets believe that they can. If the markets lose faith, then all bets are off and the costs and unintended consequences could be severe." Vincent Foster, Minyanville.com

We decided to lead off with the above quote because it is very pertinent to our bullish thesis on the precious metals sector. Gold and gold mining stocks have been in a two-year *cyclical* bear market because the Federal Reserve has encouraged investors to take excessive equity and bond market risk. Once the illusion of this permanent Federal Reserve backstop to asset prices comes unglued, the long-term gold bull market that began in 2000 should resume with a vengeance. The positive fundamentals that drove the gold bull market higher have not changed. To paraphrase James Grant of Grant's Interest Rate Observer, **the price of gold is the reciprocal of faith in central banks**. Should the markets lose confidence in Ben Bernanke to hold this whole thing together (as the quote above suggests) then gold will be a direct beneficiary. In the meantime, gold and gold mining stocks are getting thrown away as everyone across the globe scrambles for liquidity following the recent bond market rout. The precious metals sector has been the worst performer over the past six months; so its poor relative strength is causing it to get thrown out harder and faster than most other equity assets. Short sellers are now piling on to the group and helping to drive it even lower than last months' depressed levels. On the flip side, the most recent surge to new highs by the US equity market has been accompanied by a gradually deteriorating global economy. Yet, investors are reluctant to sell their US stocks because of their strong relative strength and the fear of missing out on another upside rally. What investors in US stocks seem to be ignoring is that the disconnect between the benchmark S&P 500 Index and its underlying fundamentals has rarely been greater. We are still holding firm to our belief that the precious metals sector is in the process of making a major cyclical *bottom* and the S&P 500 is in the process of making a major cyclical *top*.

We wanted to revisit a couple of charts this week on why we think now is not the time to throw in the towel on the precious metals sector. The first deals with the concept of mid-cycle corrections. In the prior gold bull market in the 1960's and 1970's, there was a brutal mid-cycle correction in gold that also coincided with a rally in the US stock market. This is not the first

example of a broad US stock market rally taking liquidity away from and interrupting a gold bull market. In the twenty months from December 30th 1974 to August 31st 1976, gold lost 48% as the S&P 500 rallied 60%! Over the past twenty-one months, gold has lost 34% as the S&P gained over 50%. Here is the gold bull market in the 1970's and the blip that corrective episode eventually became.

Gold Price in US Dollars (1968 – 1980)

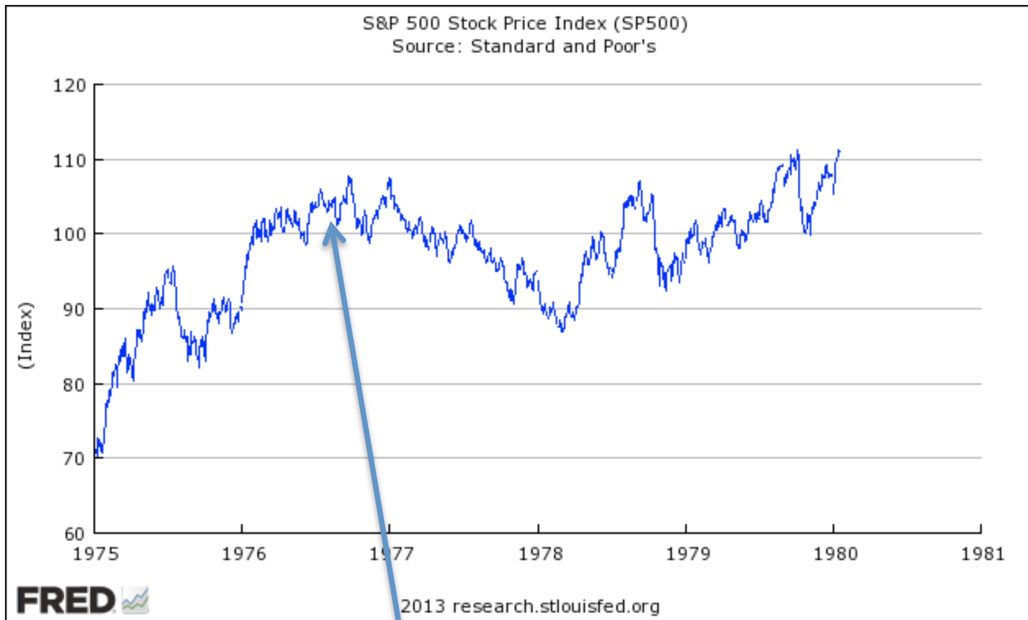


48% gold correction in '75-'76.

We feel those that throw in the towel at these depressed levels risk leaving similar late stage bull market gains on the table.

As the chart illustrates, once gold finally bottomed, it set the stage for a powerful sevenfold advance over the next four years. It was not a coincidence that the *bottom* of the gold correction in 1976 coincided with the *top* of a two-year rally in the S&P 500. We believe a similar dynamic is at work here in that once the false underpinnings of the equity market rally are finally questioned, then liquidity can start to flow back in the direction of gold.

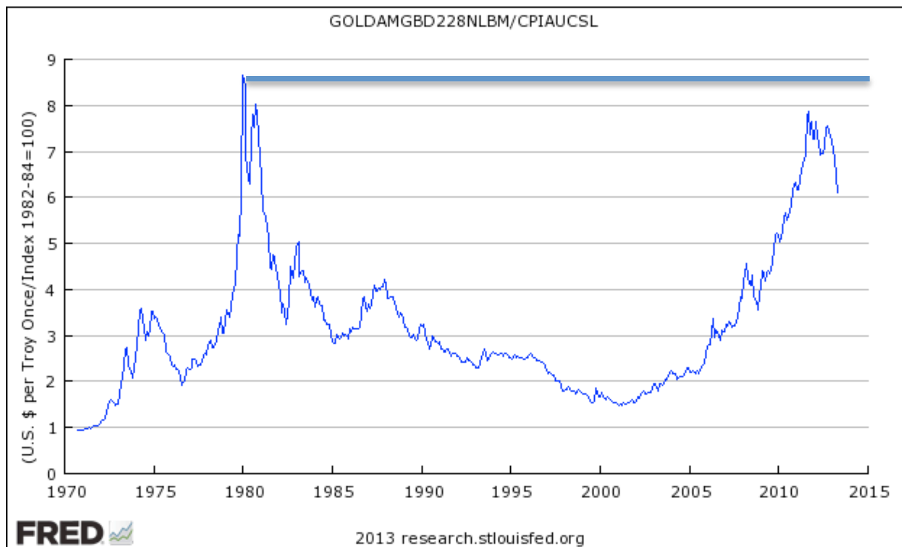
S&P 500 Index (1975 – 1980)



Gold bottoms here after S&P 500 had rallied 60% over 20 months. As the chart shows, the S&P 500 did NOTHING over the next four years while gold gained 700%.

Many are starting to make the argument that the 2011 top in gold was the top of a gigantic bubble that is now in the midst of deflating. We strongly disagree with that statement for two main reasons. First, the inflation adjusted high of the prior bull cycle has not yet been reached. Bull markets as strong as the one that gold started in 2000 have rarely (if ever) end without achieving a new inflation adjusted price peak. The line on the chart below marks the 1980 inflation high that has yet to be breached.

Inflation Adjusted Gold Price (1970 – Present)

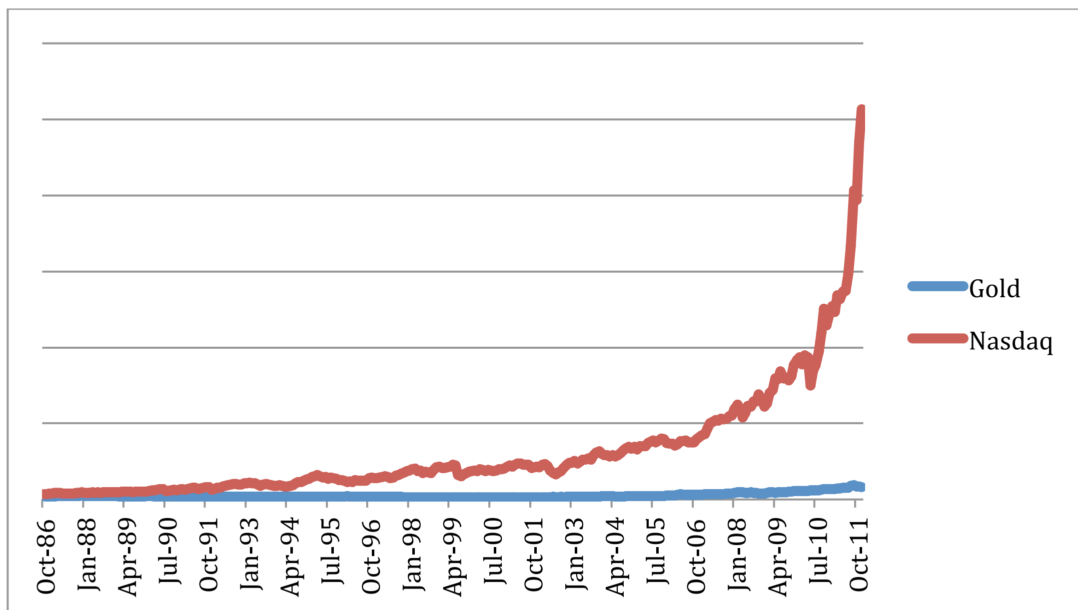


The other reason that we scoff at the notion that the gold bubble has already popped is how tiny its advance has been when compared with the Nasdaq stock bubble. In the twenty-five years leading up to the top of the tech stock bubble, the Nasdaq Composite Index gained 7255%!! By comparison, gold was only 350% above its twenty-five year price level at the most recent top in September 2011 and would have to trade at $32,000 per ounce to equal the dizzying advance of the Nasdaq bubble. Tech stocks were 30% of the US stock market at their peak and many had their *entire* 401k plan loaded with tech stock funds. We were nowhere near that type of euphoric sentiment at the most recent cycle peak for gold in 2011.

25 years leading up to the Nasdaq Composite Bubble Top

Versus

25 years leading up to Gold's September 2011 Cyclical Peak

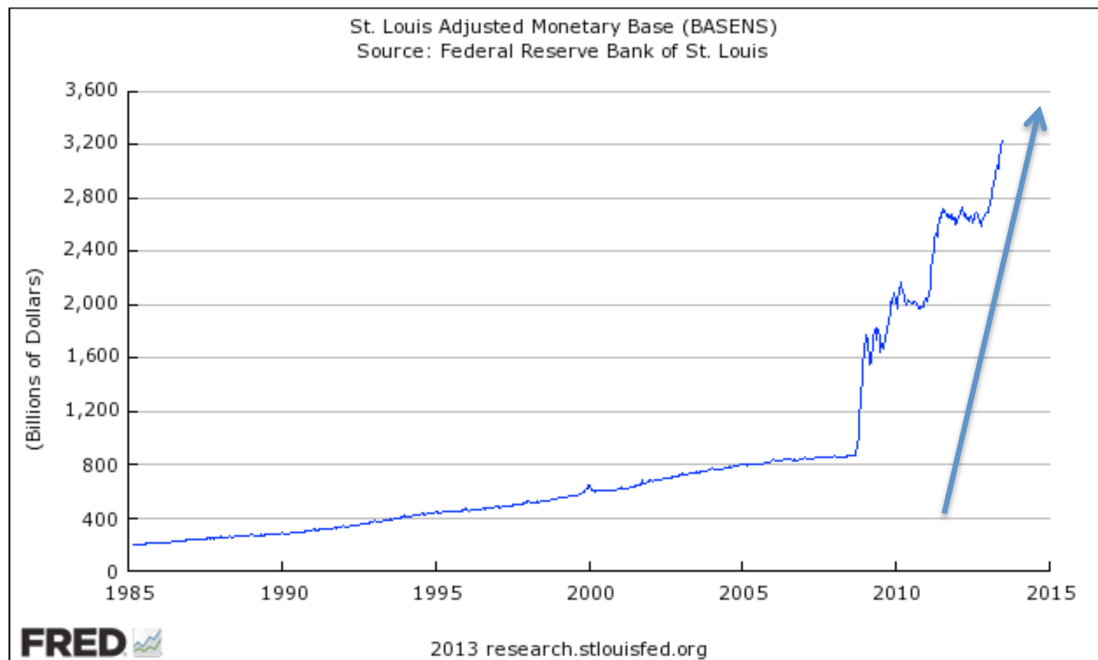


Sources: Yahoo.com and Federal Reserve Bank of St. Louis

Federal Reserve money printing and excessive government debt are two of the major fundamental underpinnings of the gold bull market. Based on these two metrics we think that the fundamentals of gold have only gotten stronger over the course of this mid-cycle correction. A key aspect that has gotten lost with the talk of the Federal Reserve tapering its quantitative easing policy is how the Fed has now expanded their balance sheet to over $3.2 Trillion. If we look at the amount of gold backing that money, it points toward much more upside ahead in order to fully reflect the excess money creation since the financial crisis in 2008. The first chart below shows the parabolic lift-off in the Federal Reserve balance sheet over the past five years. In our mind, this is *the* story of the "recovery" the US economy has experienced since 2009. The Fed is buying up all of the mortgage and treasury debt they can get their hands on and thereby

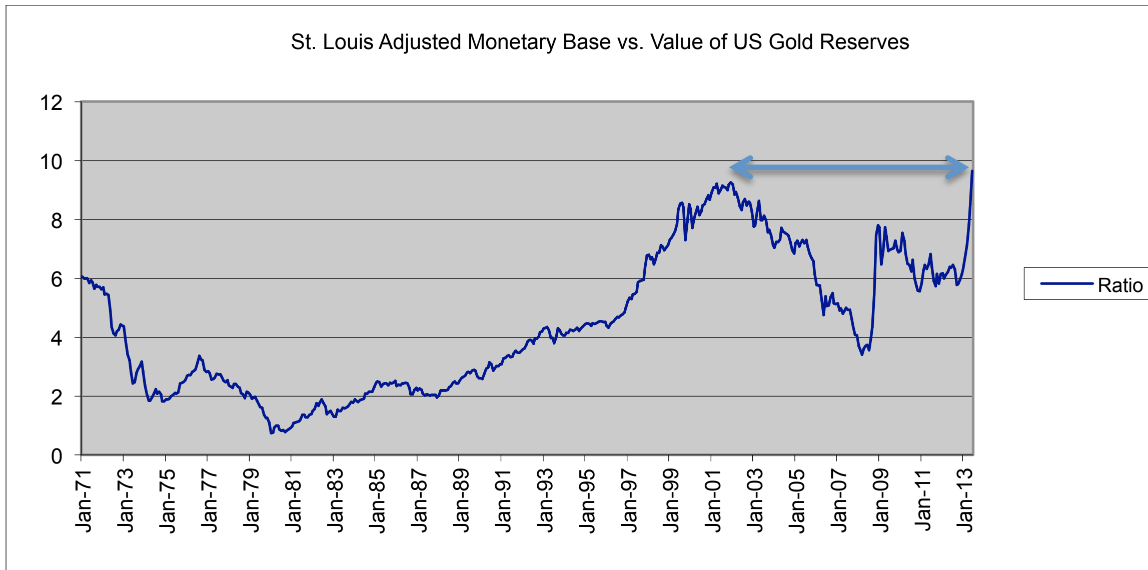
artificially propping up the interest sensitive sectors of the economy, like finance and real estate. We are starting to see the artificial nature of this strategy in recent price reaction to rising interest rates. Like a heroin addict losing access to his juice, the market has had a withdrawal seizure over the past four weeks at the *mention* of slowing this money-printing scheme (please review last week's report for more detail on this).

St. Louis Adjusted Monetary Base (Federal Reserve Balance Sheet) 1985 - Present



With this increase in money printing, in conjunction with the decline in the price of gold, our next chart below shows that the assets on the Fed's balance sheet backed by gold are now ABOVE the level that marked the start of the gold bull market in early 2001! In our opinion, the importance of this cannot be over stated. At the peak of the prior gold bull market in 1980, we had a one-to-one ratio between the Fed's balance sheet and the value of gold reserves of the US government; it is now back to a nine-to-one. Gold would have to trade at $12,000 per ounce to achieve that 1:1 ratio again versus $1,300 per ounce today. Easy math makes that an eightfold increase, similar to the sevenfold increase in gold during the last four years of its 1970's bull market.

St. Louis Adjusted Monetary Base vs. Value of US Gold Reserves (1971 to Present)



Sources: Federal Reserve Bank St. Louis Federal & World Gold Council

The other fundamental underpinning of the gold bull market is the amount of debt that has built up in the financial system over the past two decades. Private sector debt creation led the charge during the housing bubble, but massive amounts of government debt have been issued since 2008 in order to mop up the mess. Additionally, large amounts of toxic ill-funded private sector debts have been transferred to the US government balance sheet. Therefore, many bad debts have not gone away, they have simply been transferred. Eventually, these liabilities have to either be inflated away or defaulted on. In addition to the legacy debts left over from the financial crisis, the government has had to step in and provide stimulus to fill the dramatic void of private sector demand that disappeared. This has led to massive fiscal deficits and the need to constantly increase the debt-ceiling limit in order to pay for stimulus. Tom Fitzpatrick of Citigroup has an interesting chart that he calls the “stairway to hell” that refers to the statutory debt limit versus the price of gold. According to Fitzpatrick; "As can be seen from the chart [below], Gold has never stayed below that “stairway to hell” for very long. Given that the debt limit number is going to continue higher, a re-emergence of Gold strength looks inevitable. A lot of “considered opinion” suggests that by the end of the present electoral term (end of 2016 when new presidential elections take place), that the US debt limit will be at around $22 trillion USD." That would put gold at $3,500 per ounce by the end of 2016.

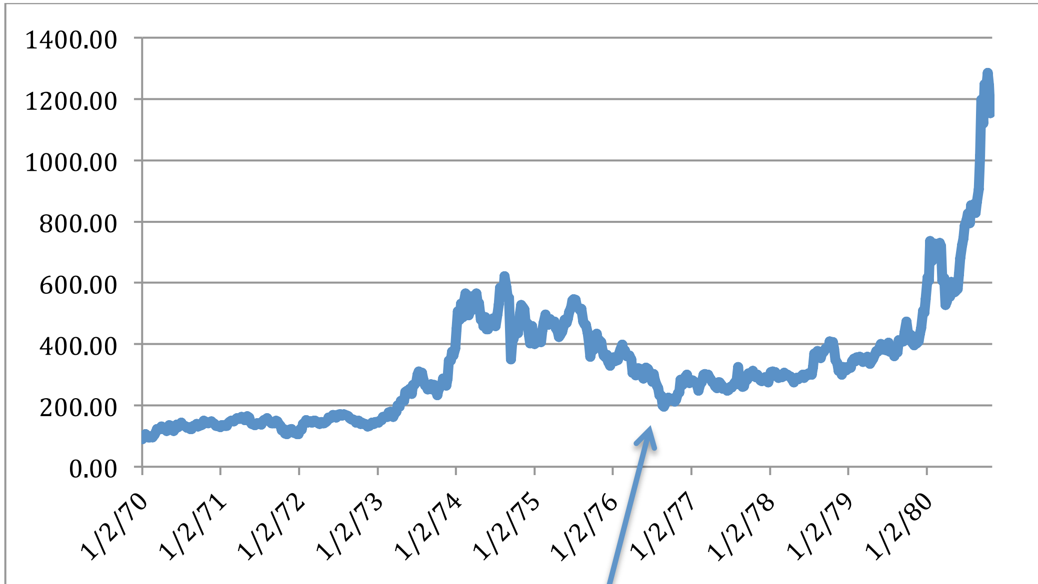
Overlay of the trajectory of the debt limit and the Gold price

(2000 – Present)

Source: Tom Fitzpatrick Citigroup via King World News

During the aforementioned mid-cycle gold correction in the mid 1970's, the gold mining stocks got hit harder than the metal itself. That has clearly been the case this time as well. The AMEX Gold Bugs Index has lost 65% since September of 2011. That is in line with the 1976 bottom that saw the sector end the correction cycle with a 68% loss. That two year mid-cycle correction set the stage for a marvelous run over the next four years when gold miners became the best performing sector in a sideways-to-down stock market. The Barron's Gold Mining Index gained 500% over the final four years of the gold bull market.

Barron's Gold Mining Index (1970 – 1980)



Source: Sharelynx

68% mid-cycle correction in 1976 was followed by a 500% four-year rally.

The following chart shows the Amex Gold Bugs Index since the start of the gold stock bull market in late 2000.

In both 2000 and 2008, when the Wilder's RSI Index reached the oversold level of 30 (green arrows), it indicated the bottom was very near for gold stocks. Once that extreme washed out level is reached the proverbial rubber band has been stretched so far that it snaps back rather violently. Gold stocks doubled the next six months after the 2000 bottom and doubled in just two months after the 2008 bottom finally reversed. Adding additional evidence of a bottom fast approaching is the fact that we have reached the long-term support line indicated by point "3" on the above chart. This is a powerful technical confluence that should encourage buyers to step-up and short-sellers to cover their short positions. The logic of markets is to buy low and sell high. Yet, time and time again investors get scared when the "buy low" moment finally arrives because bottoms are a VERY difficult *process* and always filled with bad news. We believe history may be on the verge of repeating. When we look back at this moment in time four years from now, it may be viewed as a key inflection point much like September of 1976. The final chart below of the S&P 500 is the polar opposite of the AMEX Gold Bugs Index shown above. Please notice how the US stock market has just started to roll over after kissing the upper line of the trend channel we have drawn (blue arrow). In addition, the Wilder's RSI Index of the S&P 500 is rolling over from above the overbought zone (red arrows). This is a very similar topping set-up to 2007. The lower channel support line for the S&P 500 is 48% below current prices. As uncomfortable as it feels, from a risk-reward standpoint, we are much more comfortable owning the asset at a bottom of the long-term support channel (gold stocks), rather than the asset that is dangerously overvalued and overbought (US Stock Market).

S&P 500 (1982 – Present)

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