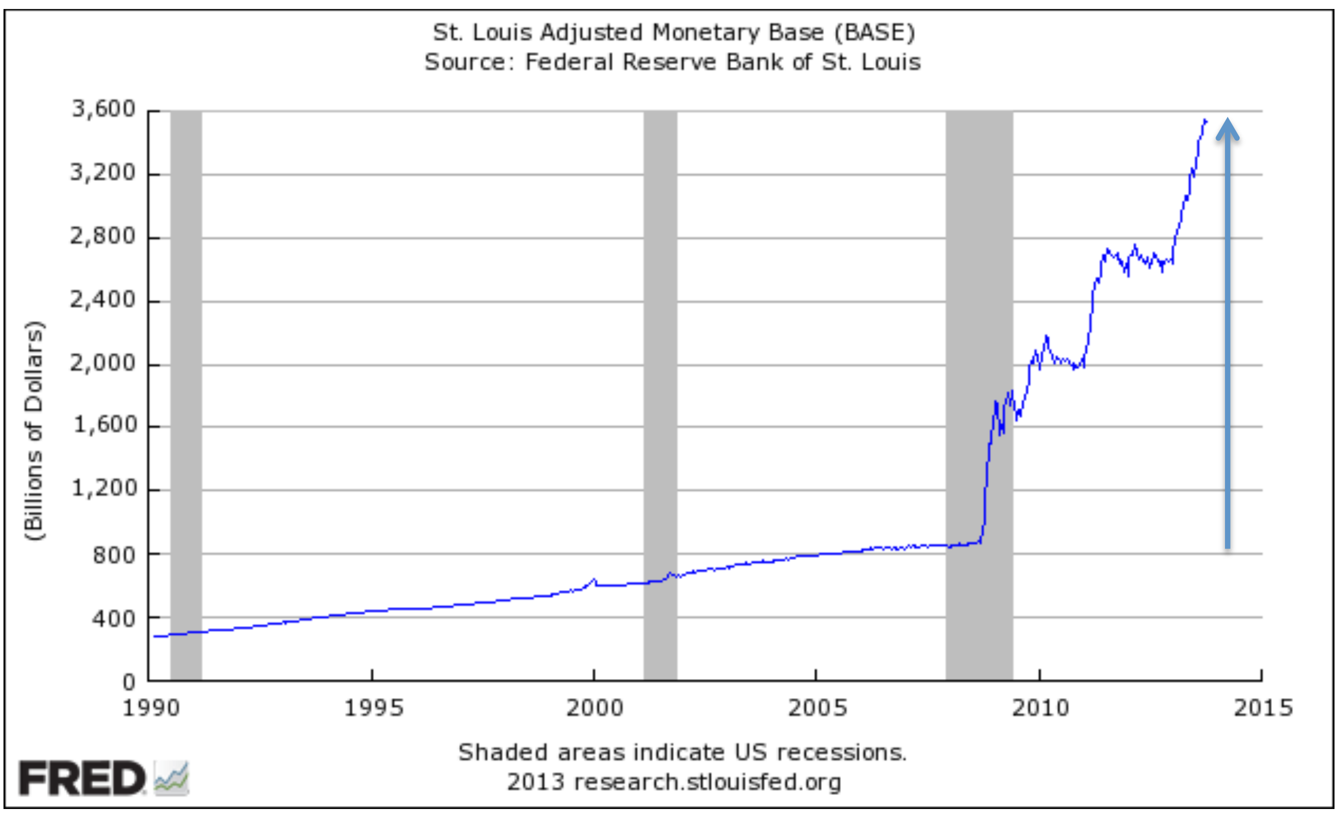
The Starboard Side Report

The week ending October 11, 2013

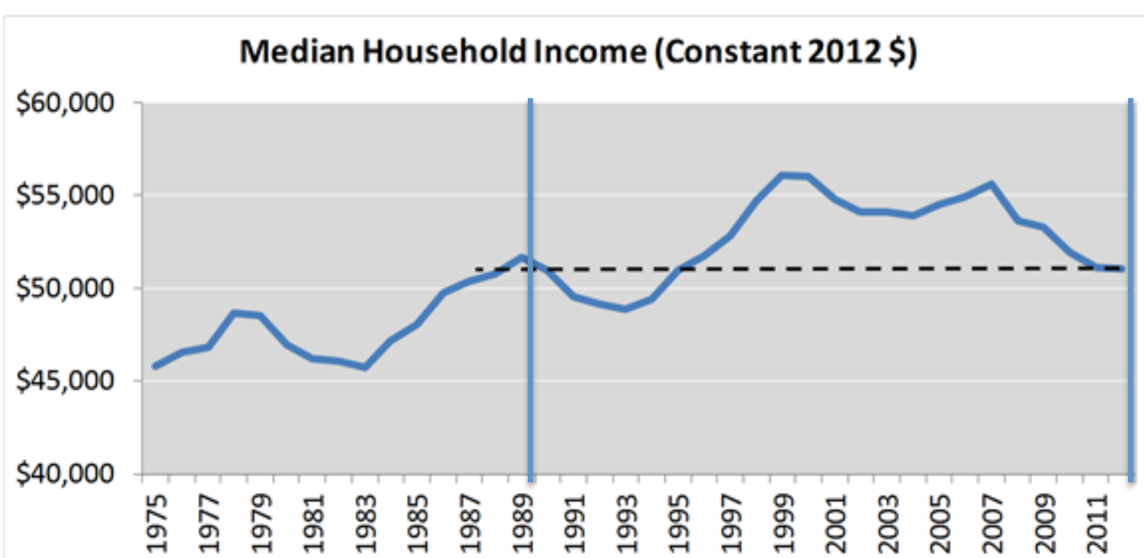
The government shutdown drama is creating a lot of two-sided volatility. This has become more commonplace since the world changed after Lehman Brothers blew-up in 2008. The political economy in the US can really be divided into BL (before Lehman) and AL (after Lehman). The political circus in Washington over the shutdown and debt ceiling limit are just symptoms. The root of the problem is really our massive debts and implicit Federal Reserve asset price subsidies. As much as politicians want the remedy to be painless, history proves that extracting ourselves from this mess will be anything but. The Federal Reserve's quantitative easing program is actually encouraging Congressional dysfunction and inaction by creating the illusion of prosperity. Why should Congress make any hard choices about the future as long the stock market keeps posting a new high every month? All the while the wealth divide between "the haves and have nots" grows ever deeper. The Fed's balance sheet is now almost $3 Trillion (with a T) higher than before Lehman and nine times its level in 1990!

US Monetary Base (1990 – Present)



This liquidity is finding its way into asset markets, not the real economy. This has greatly increased the wealth gap in the US post Lehman.

$3 Trillion spent and no real economic progress to show for it outside of the stock market. The first chart below shows that the percentage of the US population with a full-time job is stuck near generational lows. The second chart is even more disturbing in that median household income (adjusted for inflation) is back down to the same level it was 25 years ago! Unlimited quantitative easing is a reckless program that will turn out to be one of the most disastrous economic experiments ever undertaken. We will learn once again that unstable growth via debt creation is not the same as truly sustainable economic growth.

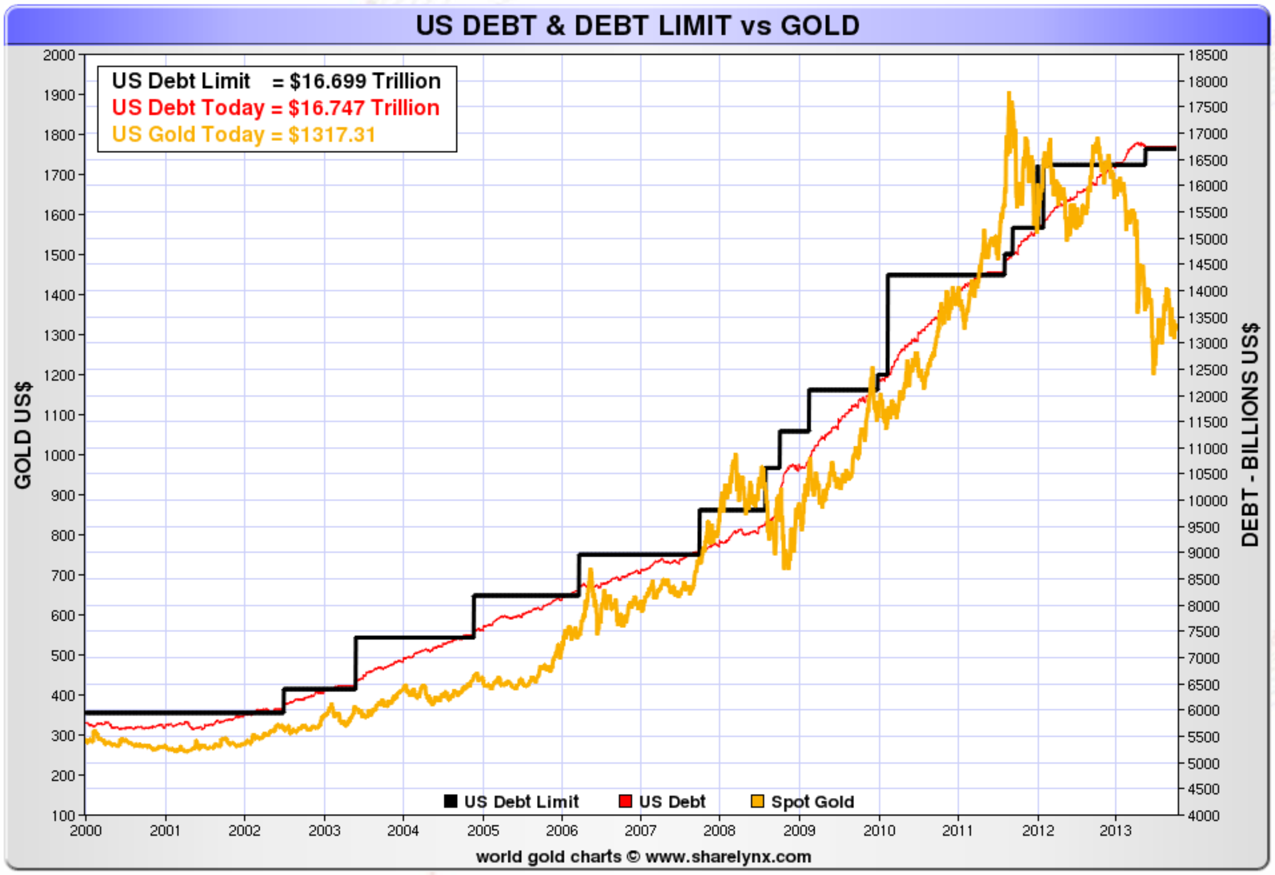


Source: CYNICONOMICS , Census Bureau.

You may ask yourself why does all this matter? The stock market is going up. Well, as we have discussed at length recently, the asset markets are going up due to easy money central bank policies more so than fundamentals. This causes capital to be *badly* misallocated, which ultimately leads to financial bubbles like the technology boom/bust and the housing boom/bust. These asset inflation episodes always end badly with vast amounts of wealth destroyed. Unfortunately, there will soon be enormous amounts of wealth destruction once again in the form of another financial crisis like 2000 or 2008. Or, perhaps, all of this money printing will stave off a crisis, but it will end up generating runaway inflation. Those preparing now for both the severe inflationary or deflationary outcome (although seemingly chicken little's at the moment) will fare the best when the stuff hits the fan. There is no doubt that politicians prefer inflation to the hard medicine of default and crisis because it tends to keep them in office longer. Yet, inflation is simply a more covert form of wealth destruction that ends up being just as painful for the majority of citizens.

The point of this rant on the current state of our political economy is to ultimately discuss what counter cyclical assets will benefit if it turns out that the financial system is not actually fixed and the markets loose faith in the Federal Reserve's ability to revive the economy off the heart attack gurney. Should loss in confidence cause another round of asset deflation and a financial crisis hits again then cash, market hedges and US Treasury bonds will do the best. Should Washington get its way in generating excessive inflation and a weaker US dollar then gold and other hard assets should do the best job at preserving capital. Again, the prudent investor *must* be prepared for either outcome. To have all of ones assets solely in US stocks will be a death sentence if the Fed loses control of the market.

The following chart shows that the debt ceiling has been raised from $5.5 trillion in 2000 to $16.7 trillion at present. Since the turn of the century, gold has shown a good knack for climbing to each new plateau of debt. It has proven to be a good way to hedge against the ever expanding mountain of debt that the US needs in order to run the country effectively in the absence of the private credit markets (that were crippled after Lehman failed). The two times that gold overshot the debt ceiling on the upside were the two corrective episodes in 2008 and 2011. We believe that this chart does a good job of illustrating the massive overshoot on the downside for gold over the past year. When the bottom finally arrives the mean reversion could be swift.

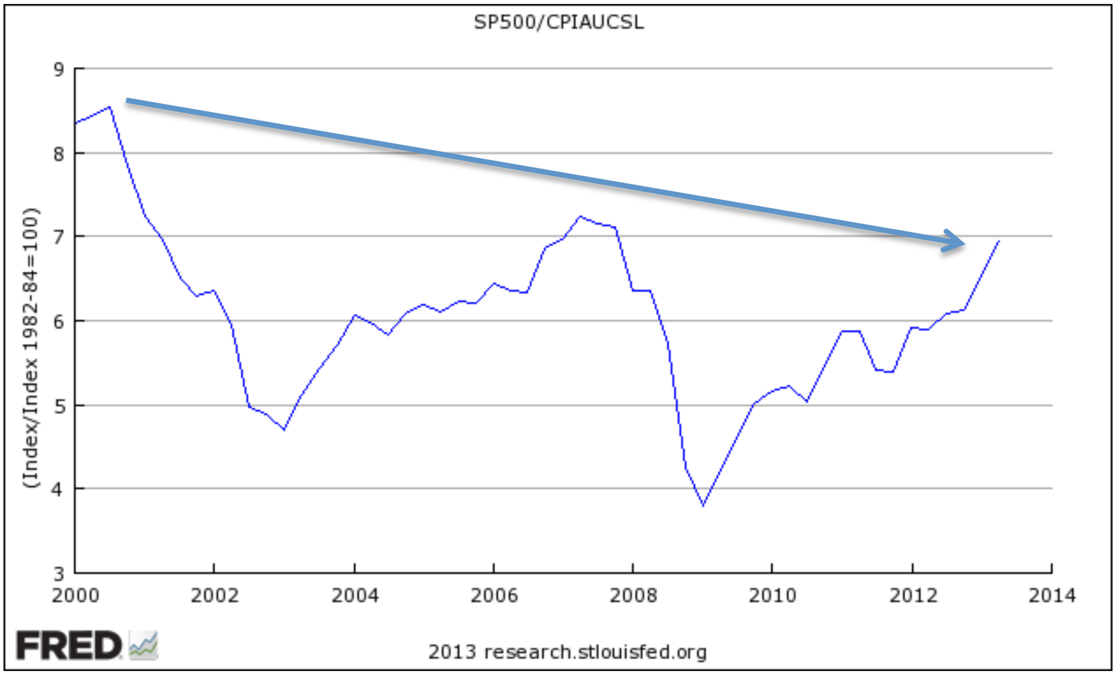


Source: Sharelynx

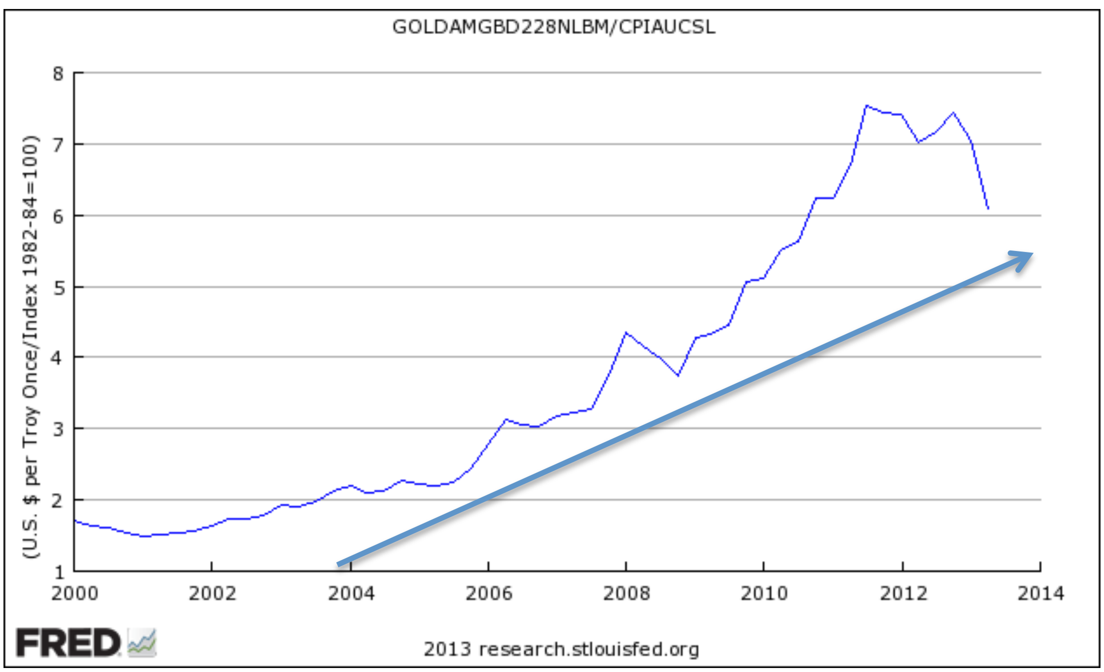
Following the last debt ceiling negotiation in 2011, the ceiling was raised by roughly $2 trillion to $16.5 trillion (black line). A similar increase this time around and gold would have to trade up above $2,000 per ounce (65% above current levels) in order to reconnect with the US debt limit.

It is extremely important to see how gold has preserved capital versus inflation since 2000 when the first equity bubble burst. Inflation adjusted analysis is a key to seeing the actual performance of assets over long periods of time. If an asset goes on to a new inflation adjusted high after each inevitable corrective episode, then it is deemed to be in a secular bull market. If it does not go on to a new inflation adjusted high after each cyclical corrective episode, then it is deemed to be in a secular bear market. The charts below help to illustrate that the S&P 500 is mired in a structural decline and gold is in a structural bull phase (despite the current turmoil). Gold's counter-cyclical value will come front and center once the structural debt and asset subsidization issues of the US economy (that we discussed above) come back to the forefront. These are structural remedies that must be dealt with; gold's bull market and the US equity structural bear market are directly related to this reality. We feel there are still several more chapters yet to be written in this saga.

S&P 500 Index Adjusted for Inflation (2000 - 2013)



Gold Adjusted for Inflation (2000 – 2013)



The two charts could not be more important. The S&P 500 is lower than it was in both 2000 and 2007 when adjusted for inflation (down 18% and 2% respectively). Gold on the other hand (despite its two year bear market) is much higher than both its 2000 and 2007 price levels (up 260% and 65% respectively). If inflation is the outcome we face, then gold will be much needed *insurance* against that outcome.

Despite the buzz around the US stock market, blue chip stocks (as measured by the Dow) have gone nowhere over the past five months.

Dow Jones Industrial Average (Past 5 Months)

Should the debt ceiling be resolved over the next week, then we may be forced to hold our nose and get some equity market exposure in order to not be left out of a year-end rally. This would be very selective and very short-term. The areas of the world markets that are showing the strongest relative strength are in Europe. This is also the area of the world where the valuations are more reasonable. The final two chart below show that after five years working out the Euro debt mess, the European Union is starting to make a convincing relative strength bottom against the US market. This has the potential to become the start of a multi-year run of positive relative strength. While the US market is one of the most expensive in the world, the Eurozone has some of the most attractive valuations on a cyclically adjusted price to earnings ratio. As such, this market warrants watching in the weeks ahead. The first chart below is a relative strength chart of Euro blue chips versus US blue chip stocks. Again, the tide appears to be turning in favor of Europe. The second chart shows the STOXX 50 in isolation. Whereas the Dow is 14% above its 2007 high, the STOXX 50 is still 27% below its 2007 peak. The Euro certainly has its share of structural issues, but their issues are more "baked into the cake" at the moment.

Euro STOXX 50 vs. Dow Jones Industrial Average Relative Strength (10 years)

Euro STOXX 50 Index (2003 - 2013 years)

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