Volume 18 | Issue 1 . March 1, 2013

LONGWAVE group

THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

IAN'S INVESTMENTMENT INSIGHTS

Special Edition

Gold vs. Paper

One of the most important things that we can learn from an understanding of the Long Wave Cycle is that investing in gold and investing in paper (general stock market) are contrary to one another. This contrariness is apparent in each of the Long Wave Seasons. I'll explain. When stocks (paper) are the choice of the season, there's absolutely no interest in investing in gold and precious metals shares, because it's easy to make money investing in the stock market and in this milieu there is nothing for investors to fear. The two seasons in the Long Wave Cycle during which the stock market flourishes are the Spring and Autumn and investing in gold and gold shares is generally not a money making venture during these two seasons.

Spring signifies the rebirth of the economy following the winter economic depression and stock prices rise in conjunction with the strengthening economy. Spring in the current cycle commenced in June 1949 with the Dow Jones Industrial Average (DJIA) priced at 161 points. Spring ended in February 1966 when the level of the Dow Jones Industrials peaked at 995 points.

I call the Autumn season of the Long Wave Cycle the 'feel good period,' because it has always been the speculative season in the cycle, when investing in stocks, bonds and real estate has been rewarded by huge capital gains. Autumn in the present Cycle started in August 1982 when the Dow Jones Industrials bottomed at 777 points. Autumn ended with the stock market peak in early 2000 when the DJIA reached 11,750 points. During Autumn the price of gold dropped from $850 (U.S.) per ounce in 1980 to $250 (U.S.) in 1999 and 2001.

Investing in gold and precious metal shares reaps significant returns in the other two seasons, summer and winter.

The Long Wave summer has always been the inflationary season in the cycle, because there has been a war in each of the Long Wave summer seasons financed by a significant increase in the money supply, which leads to a period of high inflation and a corresponding increase in the price of gold. The first cycle summer war was the War of 1812; in the second summer cycle it was the U.S. Civil War; in the third cycle it was the First World War; and in the present cycle, the summer war was the Viet Nam War. In the present cycle at the start of summer in 1966 gold was priced at $35.00 (U.S.) per ounce. At the end of summer the gold price reached $850.00 (U.S.) per ounce; whereas the stock market as measured by the Dow Jones Industrial Average started summer valued at 950 points and ended summer at 777 points.

The Long Wave winter has always been the season of deflation and depression brought about by a collapse in the huge debt bubble, which has for the most part been accumulated during the Long Wave autumn. The following table tells the story:

U.S. Debt by Sector

SECTOR	BEGINNING OF AUTUMN 1980 Q4 (U. S. Dollars in Trillions)	CURRENT 2012 Q3 (U. S. Dollars in Trillions)	PERCENTAGE CHANGE
Financial	$0.585	$13.779	2,257%
Federal	$0.928	$16.351	1,662%
Household	$1.396	$12.845	820%
Non-financial Corporate	$0.914	$8.366	815%
State and Local Government	$0.344	$2.985	767%
Non-corporate Business (Farm)	$0.555	$3.772	580%

The onset of winter is signaled by a peak in stock prices such as in 1837, 1873, 1929, and in the current cycle, 2000. The ensuing debt collapse has always led to a banking crisis, resulting in numerous banking failures. In the previous Long Wave winter, between 1929 and 1933, 10,000 U.S. banks went out of business. The winter bear stock market which parallels the debt collapse leads to devastating investment losses. These stock market losses compound the deflationary spiral brought about by the collapse of the debt bubble. In the midst of this developing financial devastation people, en masse, buy gold, which is considered money sine qua non. This enormous urge to hoard gold has always been a panic reaction to the economic and financial chaos which is the earmark of a long wave winter.

As the third long wave winter crisis deepened between April 1931 and March 1933 and the bank failures multiplied, there was a huge rush to own gold. *"Foreigners cashed not only their American stocks and bonds, and also their dollars and hauled American gold away by the boatload. Americans converted their paper dollars and bank deposits into gold coins and stashed them in mattresses, hid them in basements or attics or took them on one way trips to Bermuda or the Bahamas."* The Kondratieff Wave Analyst, January 1986, P. 8

It was not just the physical metal which people wanted; they also wanted to own shares in the companies that produced gold; those exploring for the precious monetary metal; and those companies that were preparing to put their gold discoveries into production.

"In the early months of the Depression, astute investors began to move some of their funds into gold mining stocks, even though the devaluation of the U.S. dollar was not even considered imminent or even a possibility. The floating of the British pound in September 1931 (Britain left the gold exchange standard system), however, and the worsening of the banking crisis, which caused a sharp increase in gold hoarding in the U.S. and shipments of U.S. gold abroad, marked the beginning of a major bull market in gold mining stocks." The Kondratieff Wave Analyst, October 1987, P. 115.

At the same time there was a new worldwide gold rush with many new gold discoveries being made at this time. In Canada, these discoveries were made in most of the Provinces, but particularly in British Columbia, Ontario and Quebec. According to the Dominion Bureau of Statistics, some 146 new gold mines commenced gold production in the 1930s and the country's gold production increased almost fivefold during that period; whereas silver production hardly increased at all. By 1937, staked mining claims, principally gold claims, reached a record high of 18,841 in the Province of Quebec.

"By 1940, there were, according to the Bureau of Mines, some 9,000 operating gold mines in the U.S. alone. Many of them were small, marginal operations, but some of the new mines were substantial." The Kondratieff Wave Analyst, October 1987, P. 116.

Staking, exploring and putting gold mines into production required significant capital and there were many investors keen to participate in this new gold rush. Indeed, following the stock market crash, essentially all that remained of capital flowed into the gold industry.

In general, these speculators enjoyed substantial profits. A South African-born Canadian gold fund manager told me that the South African junior Gold Mining Index enjoyed record gains during the 1930s.

Two of the largest gold producers were Dome Mines and Homestake Mining. The following table summarizes their share price performances and the substantial dividends which they paid between 1929 and 1936.

The share price of Dome Mines increased tenfold from its 1929 crash low price to its 1936 high price, whilst Homestake Mining's performance was slightly less than that. By comparison, during the third Long Wave autumn great stock bull market mania of 1921 to 1929, the Dow Jones Industrials advanced about half as much as gold stocks did in the Great Depression or third Long Wave winter. (See Table below - Homestake and the DJIA 1921 through 1940).

Gold Price fixed at $20.67 (U.S.) per ounce

	HOMESTAKE MINING	DIVIDEND	DOME MINES	DIVIDEND
Low 1929	$65	$ 7.00	$ 6.00	$1.00
High 1930	$83	$ 8.00	$10.375	$1.00
High 1931	$138	$ 8.45	$13.50	$1.00
High 1932	$163	$10.60	$12.875	$1.30
High 1933*	$373	$15.00	$39.50	$1.80

*** President Roosevelt orders the confiscation of privately held gold in April 1933.**

January 1934, President Roosevelt raises gold price from $20.67 (U.S.) to $35.00 (U.S.) per ounce.

High 1934	$430	$30.00	$46.25	$3.50
High 1935	$495	$56.00	$44.875	$4.00
High 1936	$544	$36.00	$61.25	$4.00

Some observations about these share prices are in order:

1. From the November 1929 crash low prices, Homestake shares rose by 2.5 times in value into 1932; Dome Mines share price increased in value by 110%; but the Dow Jones Industrial Average declined by 80% from its November 1929 crash low level of 198 points.

2. From their crash low share prices in 1929, Homestake's and Dome Mines' share prices increased significantly into 1933 without any increase in the price of gold.

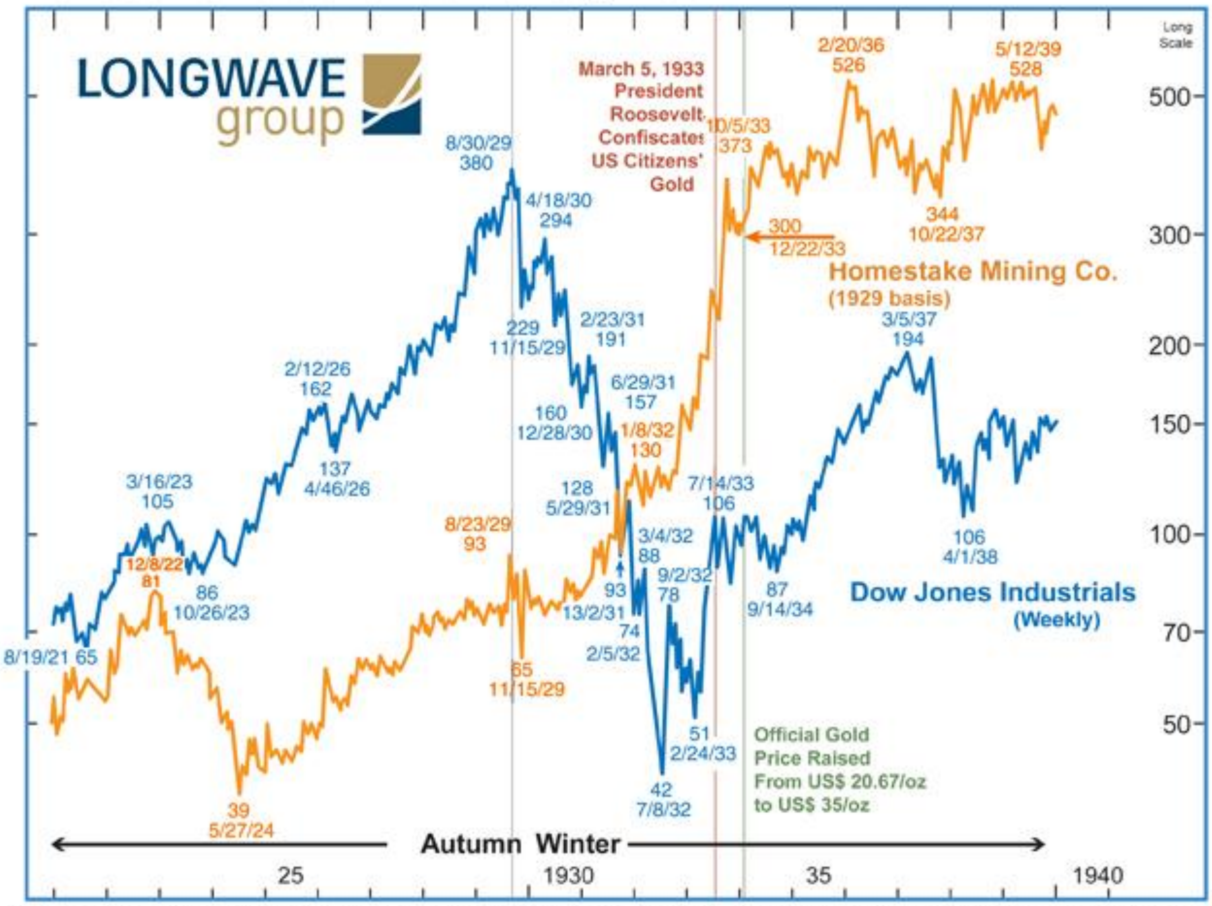
3. The same is true up to the U.S. government's confiscation of physical gold in April 1933, which confirms the desire of Americans to own, not only physical gold, but also gold shares.

4. Following the confiscation of physical gold, the only way Americans could own gold was by owning shares in gold companies.

That was then and this is now. We are in another Long Wave winter similar to the previous Long Wave winters. The similarity ends, however, in that all Long Wave winters are characterized by a bursting of the debt bubble, which in previous winters has been short in time, but very destructive. This winter has been prolonged by massive intervention on the part of the world's central banks to avoid the debt bubble collapse. As we have previously written, the worst of the past Long Wave winter was over by 1933. Between September 1929, the peak of the autumn stock bull market and the signal of the onset of winter and March 1933, U.S. gross domestic product (GDP) collapsed by 45%, the Dow Jones Industrial Average lost 90% of its value, 10,000 U.S. banks failed and U.S. unemployment reached a peak of 25%.

In the following chart we can see how devastating the stock bear market was following the autumn bull market peak in September 1929, but the whole bear market which cost the Dow 90% of its value was over in less than three years. This time it is different and the Central Banks have essentially propped up the stock markets through massive monetary infusions into the banks. Not only that, but also the U.S. Federal Reserve has as much admitted that it is active when the stock market is vulnerable. Dick Fisher of the Dallas Fed recently said, *"The Fed has artificially sustained the markets."* Also, remarks from Ben Bernanke and prior to him, Alan Greenspan, confirm how important the stock market is to overall consumer confidence and ergo the U.S. economy. Here are just a few examples of the many which I have on file: *"I think we are underestimating and continue to underestimate how important asset prices, very specifically equity values, are not only for shareholders and the like, but (also) for the economy as a whole."* Alan Greenspan Dec 3, 2010; *"And higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending: increased spending will lead to higher incomes and profits that, in a virtuous circle will support economic expansion."* Ben Bernanke, Washington Post, November 4, 2010.

Homestake and the DJIA 1921 through 1940



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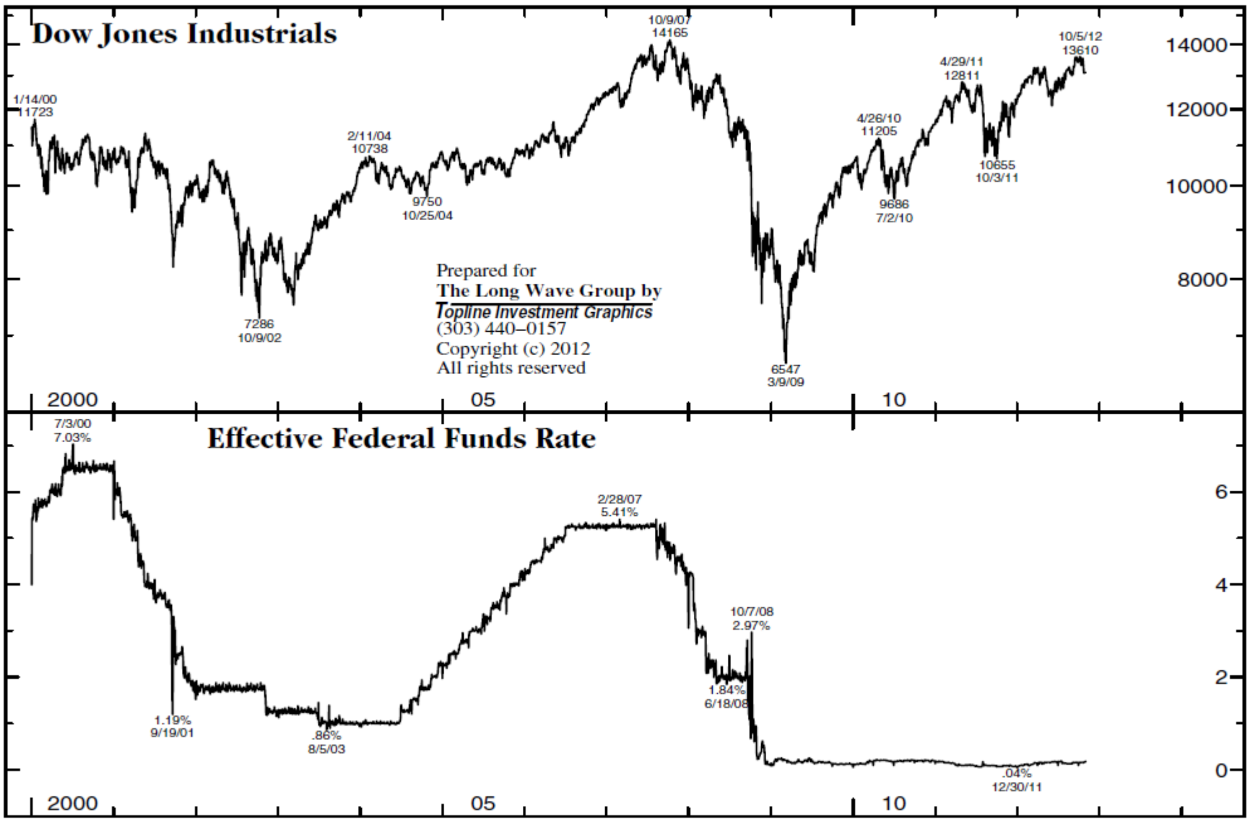
These shenanigans have helped maintain stock market prices at levels which, at the present time, have just surpassed the all-time high of 14,200 points for the DJIA. Unlike the previous winter bear markets, during which there was no central bank interference in the natural process of devastating stock price losses, this winter bear market has been ongoing for better than thirteen years. This means that the worst of the winter stock bear market lies directly ahead of us.

During this winter bear market there have been two mini bear markets. The first occurred between January 2000 and October 2002 when the DJIA dropped from 11,750 points to 7,286 points, equaling a 38% loss; the second happened between October 2007 and March 2009, when the DJIA dropped from 14,200 points to 6,547 points, equaling a 54% loss. Neither of these two mini bear market losses reflects the huge gain experienced in the preceding autumn stock bull market when the Dow rose from 777 points in August 1982 to 11,750 points by January 2000 for a massive 1500% gain. This, by far, dwarfed the 'Roaring Twenties' third Long Wave autumn stock bull market when the Dow gained a little less than 600%. That gain was followed by the winter bear market, which lost 90% of its value in less than three years.

Compare the following chart of the current winter stock bear market with the predecessor winter bear market shown in the chart above. Clearly, in this bear market there has been official intervention in an effort to right the sinking stock market and on two occasions that intervention has been successful. This is evident by the manipulation of the Federal Funds Rate, which was lowered in the first mini-bear market of 2000-2002 from 7% to less than 1% and in the second mini-bear market of 2007-2009 from 5.4% to essentially zero. Moreover, through several different monetary expansion programs the U.S. Federal Reserve has made trillions of dollars available to the banks at no charge. The current quantitative easing program, through the purchase of U.S. Treasurys and mortgage-backed securities is feeding one trillion dollars per annum into the major U.S. banks.



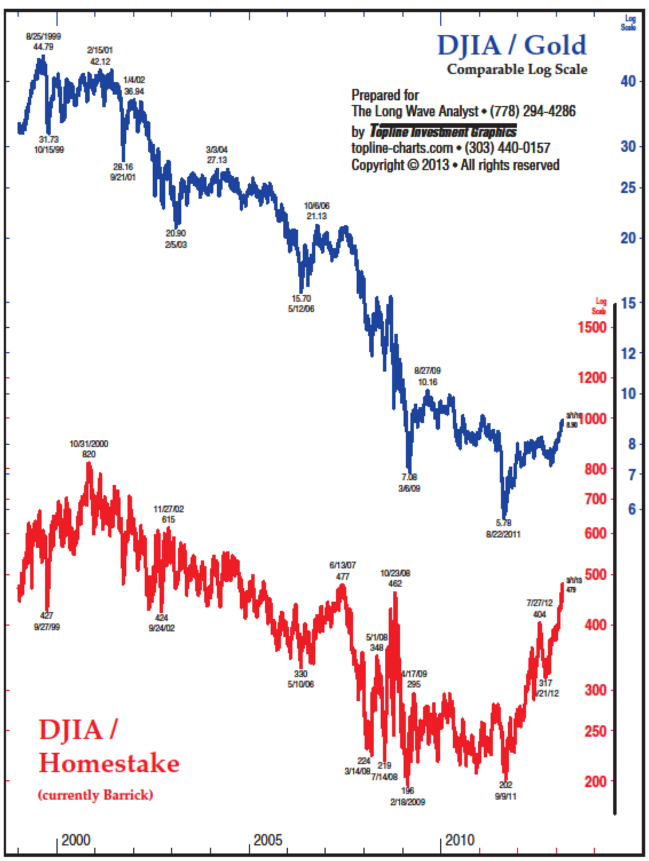
However, when the winter bear market resumes, and it will, the U.S. Federal Reserve will have no ammunition which it can use to combat it. Administered interest rates are still effectively at zero and monetary printing is already ridiculously excessive. There will be nothing that the U.S. Federal Reserve can do to arrest the coming stock market collapse.

In the meantime, aided and abetted by the U.S. Federal Reserve, paper assets are rising in value and have been doing so since March 2009. Under these circumstances there is absolutely no reason for investors to choose to buy precious metals and precious metal stocks. Gold is the money of fear and when stock prices are rising perhaps to new record highs investors have no reason to be fearful.

In the face of rising stock prices, precious metals and precious metal stocks have been in a downtrend since September 2011 and the DJIA has advanced 20% since then.

INDEX	PRICE September, 2011	PRICE March 2, 2013	% CHANGE	RATIO September, 2011	RATIO March 2, 2013
HUI	526	352	-33%	1/22	1/40
Gold	$1,920	$1,581	-18%	1/6	1/8.9
DJIA	11,717	14,090	+20%	__	__

In the table above you can see that since the gold price and the gold stock prices, as measured by the HUI, peaked in September 2011 they have dropped considerably relative to the price of the Dow Jones Industrial Average. In that time gold stocks (HUI) have dropped by 82% and the price of gold has fallen by 48% versus the price of the DJIA. In other words, over the past few years paper assets have been the investment security of choice rather than hard assets.



The previous chart gives us another perspective of the relative values of gold and gold stocks versus the DJIA. I have selected this time frame, 1999 to the present, because it effectively captures the relationship of the value of gold and gold stocks, in this case Barrick Gold (ABX) to the value of the Dow Jones Industrial Average from the onset of the Long Wave winter. In August 1999, the ratio of gold price versus the DJIA reached a peak of 44.75 to 1. In other words, at that time the price of almost 45 ounces of gold was required to equal the value of the DJIA. The ratio of the price of Barrick Gold shares to the value of the DJIA reached a peak in October 2000 at the value of 820 Barrick shares to equal the DJIA. Since those two high ratio values, the Dow/Gold price ratio has come down to as low as 5.78 to 1 in August 2011, meaning that it now only required the price of 5.75 ounces of gold to equal the value of the DJIA. The Dow/Barrick price ratio reached a low in February 2009 and again in September 2011, when the price of 200 Barrick shares equaled the DJIA.

Since those ratio bottoms in August and September 2011, paper values as indicated by the values of the general stock market have been rapidly increasing relative to the price of gold and the price of gold shares. As of the March 1, 2013 the DJIA has increased 54% relative to the price of gold and 137% versus Barrick Gold's share price. By comparison, the TSE Venture Exchange, within which the majority of junior mining stocks are listed, reached a peak in value in March 2011 at 2,465 points with the DJIA trading at 1,109; the ratio at that time was 502. Currently, March 5, 2013, the ratio stands at 1,286, which means that in two years the Venture Exchange has lost 156% relative to the paper valued stock market.

The tide is about to turn.

Long Wave winters have never been favourable to investing in paper assets, particularly stocks. The winter stock bear market always mirrors the action of the preceding autumn stock bull market. Big price moves to the upside are followed by big price moves to the downside. If the third Long Wave autumn bull market 1921 to 1929 which saw a gain in the DJIA of a little less than 600% was followed by a winter bear market loss of almost 90%, what might one expect this winter bear market loss might be following an autumn stock bull market between 1982 and 2000 that gained 1,500%? My answer is a lot greater than the 56% mini bear market experienced between 2007 and 2009.

If you think somehow that the fifth Long Wave spring stock bull market has just begun and that stock prices are destined to go much higher just as they did between 1949 and 1966, think again. A Long Wave spring begins when most of the debt, particularly consumer and corporate debt has been all but eliminated during the course of the winter. Obviously, that is not the case at this time (See debt numbers above). A Long Wave spring commences with consumer confidence at a very low ebb as it was in 1949. That is not so today; in fact, consumer sentiment as measured by the University of Michigan Index is currently approximately 50% higher than it was in August 2011.

Currently bullish and bearish sentiment for stocks and gold are essentially diametrically opposed. Bullish consensus for stocks are at very high levels and the risk factor measured by the VIX Index (S&P Volatility Index) is trading near five year lows, which indicates that there is virtually no fear with regard to investing in the stock market. Intermediate and long term price levels are overbought, although it appears that the DJIA could climb to approximately 14,500 points. That should be the extent of the move, which will complete a high price in the stock market that will not be attained again for perhaps 25 to 35 years.

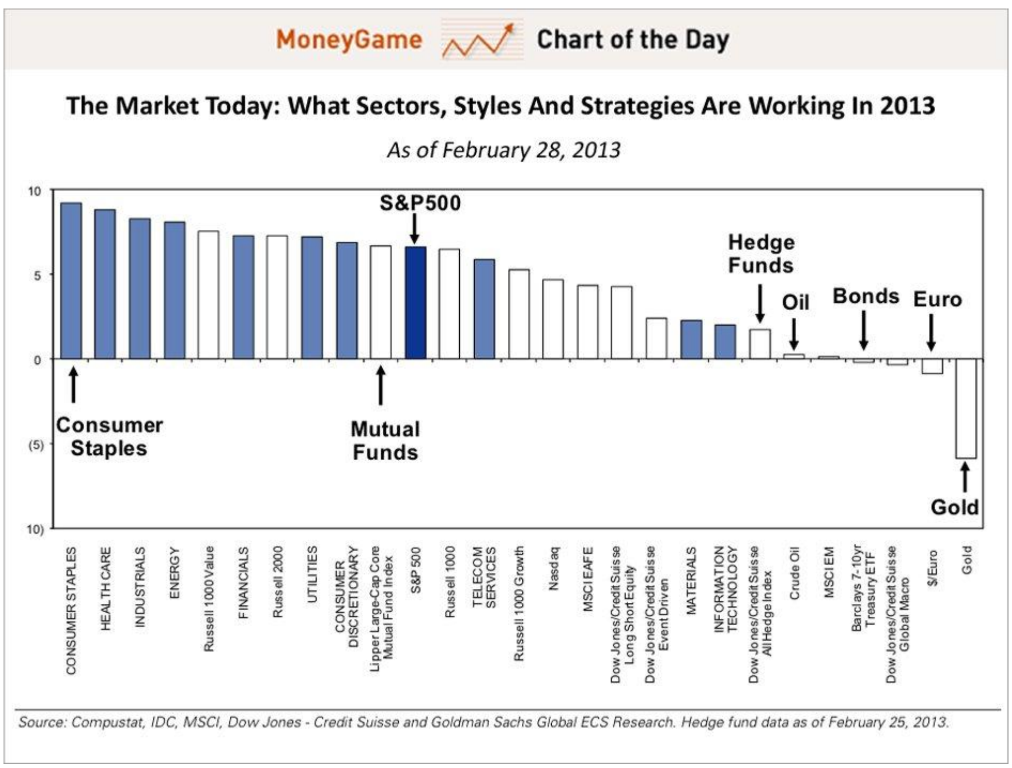
In the meantime, contrary to this extreme bullish consensus now registering for the stock market, extreme bearishness is focused on the precious metals and the precious metal stocks; in particular, the junior precious metals mining stocks. A similar discrepancy was much in evidence in 1999. "Two weeks ago data released by the Commodity Futures Trading Commission showed hedge funds and other investment managers shorting gold in record numbers. The number of bearish contracts held by professional speculators reached above 90,000 for the first time since mid-1999. (The Dow/Gold ratio reached its peak in July 1999 when it required almost 45 ounces of gold to equal the Index). It is ironic to juxtapose that with the rosy picture 10 years ago this month when the number of bullish contracts held by professional speculators first broke above 100,000 contacts." Przemysla Radomski, Resource Investor, March 5, 2013.

By several different measures gold and gold stocks are very oversold suggesting that downside price action is limited, whereas upside price potential is significant.

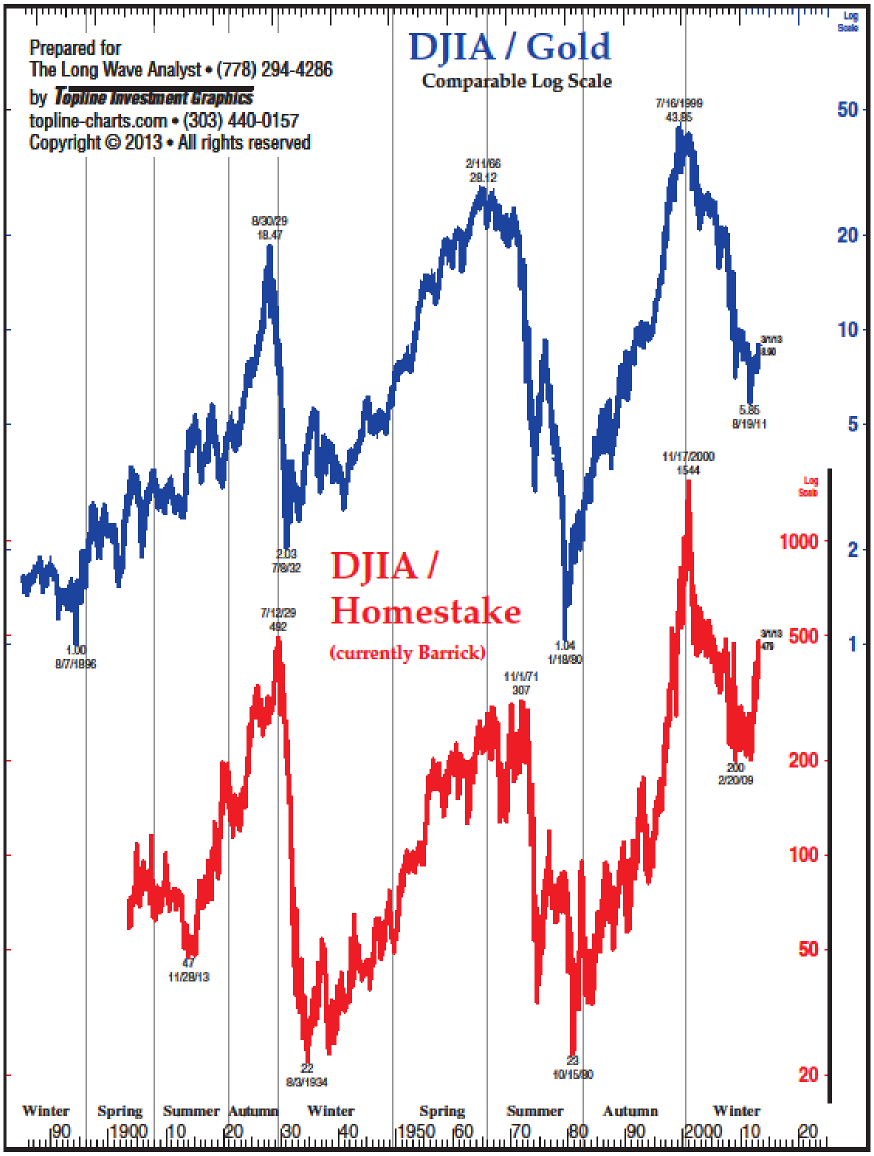
Gold funds are experiencing significant redemptions, which means that they are unable to help finance the junior precious metals companies. Without capital many of these companies will starve to death.

It's not just the junior precious metals companies that are in trouble; their senior counterparts are experiencing huge write-downs on several of their projects and many CEOs have been fired.

The chart below says it all. Gold and gold stocks are certainly out of favour and the bearishness that is currently pervasive throughout the precious metals sector is in fact bullish to any contrarian such as me.



In 1871, Baron Rothschild is purported to have said *"Buy when blood is running in the streets."* While the streets are not running with blood at this time to those invested in precious metals, it certainly feels that way and I am buying.



The above chart is one of my favourites, it is the Dow/Gold ratio and the Dow/Homestake (now Barrick Gold) ratio (The value of the DJIA divided by the price for an ounce of gold in the upper portion of the chart and the DJIA divided by the share price of Homestake Mining/Barrick Gold in the lower portion). I like the chart so much because I have added the Long Wave Seasons to it. By doing so, anyone should be able to recognize that the ratio reaches extreme highs and extreme lows during the Long Wave seasons and generally at the end of a season.

Studying this chart made me realize that we only have to make four investment decisions during our lifetime. We buy stocks at the beginning of Spring and sell them at the end of Spring when the ratio reaches a high. Then we buy gold at the Spring high and sell it at the end of Summer when the ratio reaches an extreme low; at which point we buy stocks for the big autumn stock bull market. We sell stocks when the ratio reaches an extreme high at the end of autumn and buy gold for the winter; then sell gold and buy stocks when the ratio reaches an extreme low. Isn't that easy. Of course, no stock broker is ever going to tell you to do this, but then very few stockbrokers understand the Long Wave Cycle and even if they wanted you to invest following this very simple formula their bank-owned firms' compliance department would never allow it. After all, according to them, investment in gold is far too risky whereas investment in paper assets, especially bank paper is virtually without risk. We are about to see that notion disabused.

The peak in the Dow/Gold ratio at 43.85/1 occurred in July 1999 and the peak in the Dow/Barrick Gold ratio at 1,544 occurred in November 2000. These ratio price peaks indicated the onset of winter and from that point investors should have exited the general stock market and positioned themselves exclusively in precious metals and precious metals stocks. We can confidently predict that from those ratio highs we are moving to extreme lows much as at the end of the second Long Wave winter in 1896 when the ratio reached 1/1; or during the third long wave winter when the ratio reached 2/1 (The reason it didn't go lower was that the price of gold was fixed at $20.67 (U.S.) per ounce); or at the end of the current cycle summer when the ratio again dropped to 1/1.

As you can see from this chart the Dow/Gold ratio from the autumn ending peak dropped to a low of 5.85/1 in August 2011 and since then the ratio has climbed to 8.9/1 effective March 1, 2013. That's a 65% reversal. The Dow/Barrick ratio reached a low 200/1 in February 2009 and since then has climbed to 479/1 on March 1, 2013. That's a 140% reversal. The price of gold bullion has fared much better than the price of the precious metals stocks against rising stock prices.

The most important question to answer is where are these ratios likely to bottom? I already have a price target for the DJIA so that answers 50% of the question. My winter bear market bottom is Dow 1,000. I suggest you read my special edition on the website '**Dow 1,000 Is Not a Silly Number**' to understand how I reach that number. Yes I know that given the current price level of the DJIA, such a price target seems outrageous and portends economic and financial chaos; but these are the characteristics of a Long Wave winter.

As for the price of gold, I have randomly selected $4,000 (U.S.) per ounce although I believe it could be much higher and simply unobtainable at any price given how dire things are likely to be once the politicians and central bankers lose control of things.

That would set the Dow/Gold ratio at 1/0.25. This is much lower than the 2/1 experienced in the previous Long Wave winter. As I have already written, the price of gold was fixed at that time, and we do know that there was such a huge demand to own gold that President Hoover was warned that the U.S. Treasury was running out of gold to back the dollar. Thus, one of the first things that President Roosevelt did upon assuming office in March 1933 was to confiscate all the physical gold owned by Americans in order to replenish the Treasury.

My target low for the Dow/Barrick Gold ratio is 1/5. Dow 1,000 points and Barrick Gold $200 per share. My $200 per share price is reached by simply reducing the previous low ratio of 22/1 by 75%, the same reduction that was used in the Dow/Gold ratio.

We are on the cusp of a major change in trend. For the DJIA and other stock market indexes, that change in trend will be to the downside and is likely to be every bit as frightening as was the 2007-2009 stock market collapse. Our initial downside target for the DJIA is 5,900 points. For gold, silver and the precious metal stocks the major trend reversal is to the upside.

Evidence of these trend reversals is, in the case of precious metals and precious metals prices a weekly closing price above the levels shown in the following table and for the DJIA a weekly closing price below the level shown in the table.

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INDEX	PRICE Weekly Close
Gold	>$1,710
Silver	>$33.00
HUI	>460
TSE Venture Exchange	>1,255
Barrick Gold	>$36.50
DJIA	<12,450

Most investors fail to recognize major trend reversals during the initial stages of the reversal because they view any correction in price as simply a pause in the ongoing trend. In the bullish reversal that we are predicting for precious metals and precious metal stocks it may be at least a few months before this reversal is recognized by all but a few astute investors. In the junior stocks this will make financing difficult until this trend reversal has been recognized by the majority of investors, who will then return to investing their money with the precious metals fund managers.

As for the general stock markets, the major trend reversal might be recognized fairly soon, especially if the reversal is accompanied by a substantial drop in share prices over a short period of time, which we think is likely. As in the 1930s, a massive capital flight to gold and the precious metals companies will occur, once the bear market resumes in earnest accompanied by an economic and financial maelstrom. Are you ready?

To prepare for the resumption of a major new bull trend in precious metals and precious metals stocks you might consider purchasing some junior companies with large gold/silver in the ground assets, good management, and with money in the bank. You can buy these companies for a miniscule amount of paper dollars for the precious metals assets that they already own in the ground and these companies are continuing to grow their assets. Many of the companies in the 'Companies that I Like' section of the website fill the criteria, including Freegold Ventures, Orex Minerals, Temex, and Terraco. Alliance Mining has raised money and will be drilling some of its highly prospective properties near Prescott, Arizona. Given our very bullish outlook for the gold price and the prices of precious metals mining stocks, these share prices should be considerably higher within 6 to 12 months. In conclusion, I leave you with a quotation, which given the current circumstances is most appropriate: *"You have to chose between trusting to the natural stability of gold and the natural stability of the honesty and intelligence of the members of the government. And with due respect to these gentlemen, I advise you, as long as the capitalist system lasts, to vote for gold."* George Bernard Shaw

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“Those who cannot remember the past are condemned to repeat it.” Santayana