HYPER-INFLATION – HERE WE COME?

As the Dow Jones breaks 11,000 and commodity prices surge higher, many deflationists have been left with that familiar sinking feeling as the US dollar resumes its fall and their large cash positions, from an opportunity cost perspective, begin to look questionable. Given the present circumstances, central banks are left with one of two choices:

1. Let deflationary forces win the day to the short and intermediate term detriment of the economy, financial markets and their political constituents.

2. Print more money and buy assets in an attempt to prevent deflationary forces and risk the inevitable inflation these actions will create.

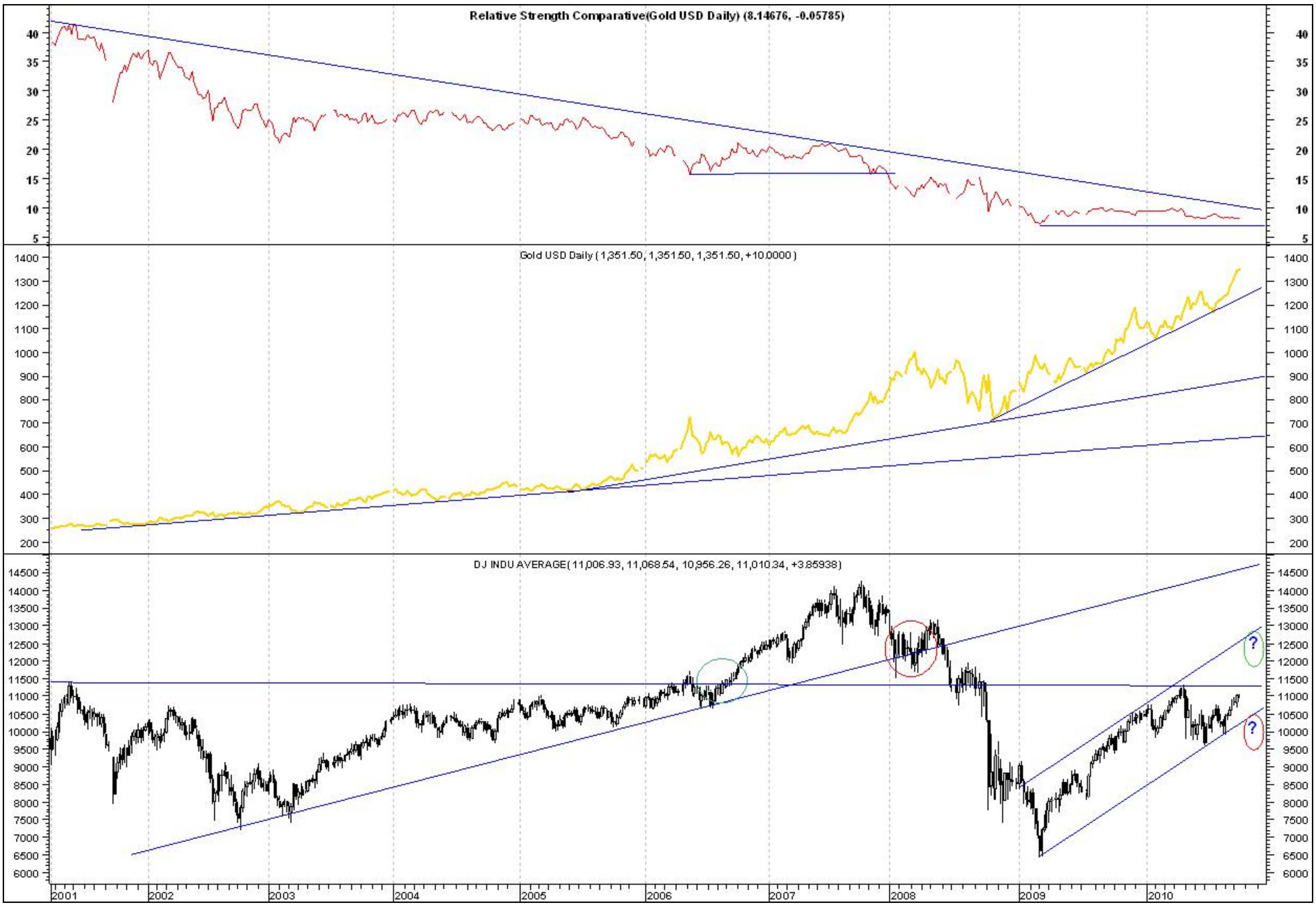
Deflationists believe this ongoing game of tag team between the US Government and the Federal Reserve has reached its conclusion and that the US dollar is the safest place to be. They see large carry trade positions unwinding as debt, denominated in US dollars and Japanese Yen, will have to be re-paid forcing both currencies substantially higher (deleveraging). We briefly saw strong evidence of this occurring in 2008 and early 2009 before intervention reversed the trend.

Inflationists believe this fall in the US dollar is very much by design. They maintain that the Federal Reserve and the US Government have both the arsenal and the will power to ensure this devaluation game continues. With both government and private debt levels now at unimaginable levels, they think this has quite literally become a game of **"kick the can down the road".** The major rule in this game is there are no rules, hence the longevity.

In summary, deflationists think we have reached the end of the road. Inflationists believe the road is long and we have further to travel. The evidence is again leaning in favor of the inflationists. I use the word "again" because many deflationists have been predicting the end of the road since 2001. All theories inevitably have to stand up to what actually occurs. The Federal Reserve has recently intimated more QE in an attempt to squash any prevailing deflationary forces. Even recent talk of more of the same has seen a predictable rally in just about everything. That is at least in nominal terms.

I would now like to share with you three charts which suggest we are very much approaching the cross roads in this inflationary verse deflationary arm wrestle. The first is a chart of the Dow Jones index. The second chart looks at the silver price and the third is a chart of Australia's major gold miner Newcrest Mining. All three compare the performance of the index, commodity or security in question with the price of gold. As a rule, when deflationary forces take hold, the gold price tends to outperform. When inflationary forces return and the markets are awash with liquidity, gold tends to either hold its ground or underperform against the three items in question.

Dow Jones v Gold



In the above chart we have the Dow Jones Industrial Index in the bottom section, the gold price in the middle section and finally the Dow/Gold ratio at the top. For the entire decade the gold price has outperformed the Dow Jones index. This has been telling us for some time that equity markets have been one of the major beneficiaries of monetary inflation. These gains were only nominal in nature. It is amazing how many people actually believed these increases were real and for legitimate reasons. These same people also believe that the gold price has only started rallying in recent years as a result of the GFC (a fear driven rally they call it). Gold's outperformance was actually a warning of what was to come. If we look at the sharp post GFC rally in the Dow, we see it has again been shadowed by the gold price, signaling to us nothing has changed. This inflation fueled rally may see the Dow test old highs or it may not get that far. It all depends on what nasty surprises lurk just beneath the surface and how well governments and central banks around the world can manage each situation. With dividend yields now starting to exceed corporate bond rates in the US, the stock market continues to be a major beneficiary of this vast liquidity. Other beneficiaries include the higher yielding commodity currencies such as the Australian dollar, which is again approaching parity with the US dollar. The important line in the sand, as far as the Dow Jones is concerned, looks to be 11,200. A definitive break through this level would suggest to me inflationary forces, for the time being, are well and truly back in control. A continuation of the Dow's failure to outperform gold in any meaningful way will signal to us that this rally, like past rallies, will be on borrowed time and lack legitimacy. You only have to look at the precarious state of the US economy to see that something doesn't add up. On the other hand if we roll over from here and head south, this is likely to see a rally in the US dollar and deflationary forces will resume control.

Silver v Gold

Another chart which suggests inflationary forces are resuming control is that of the silver price. We have finally taken out old highs at around US$21/oz and our reverse head and shoulder formation is complete. This is an incredibly bullish development. A look at the middle section of the chart shows that the silver price has been outperforming the gold price since the beginning of 2009, with a move now possible to the top of the channel at 0.0185 (or 54 in the gold/silver ratio). Just to repeat, silver outperforms gold during inflationary episodes but underperforms during deflationary events (such as the GFC). Our shorter term target for silver is US$26/oz. Assuming this sees the silver/gold ratio hit the top of the channel, this would imply a gold price of around US$1,400/oz (54 x US$26). We are well on the way. A clear break above 0.185 (54) in the silver/gold ratio would confirm to us that inflation is well and truly back in control. The measurement of the reverse head and shoulder pattern implies an intermediate term target of US$29/oz, which indicates this Silver/Gold ratio downward (deflationary) channel may get broken. Generally speaking, the silver price has a strong correlation with equity markets, supporting a possible short to intermediate term bullish assessment of the Dow Jones index. If the downward channel remains intact, however, and the Gold/Silver ratio bottoms out at 54 (silver/gold would top out at 0.0185), this may see a reversal of this interim inflationary trend. Gold would start outperforming silver again, probably in the process of a correction phase, whilst equity markets would more than likely get hammered again coupled with a rally in the US dollar.

Newcrest v Gold (Australian dollars)

Our third chart is along similar lines to what we have already looked at. The Newcrest Mining chart is in the bottom section, the Australian dollar gold price is in the middle section (ETF representing 1/10th of an oz of gold) and the relationship between the two is at the top. During deflationary events, the Aussie dollar gold price outperforms Newcrest as the Aussie dollar get's sold off on the reversal of the carry trade. During inflationary periods, where appetite for risk increases, the Newcrest share price outperforms the Aussie dollar gold price. If you cast your eye to the top section, you can see this ratio has been trading in a downward sloping channel since 2006. This is similar to Silver's relationship with the gold price (last chart). As part of the last issue, I wrote an article indicating that Newcrest might be ready for a correction, given we seemed to be bumping up against resistance of this downward sloping trend of the ratio (I had drawn the trend line differently). This indicated the Aussie dollar gold price was outperforming Newcrest, signaling more deflationary pressures ahead. I was admittedly wrong. I did qualify this in the closing comments of our newsletter by suggesting the US Federal Reserve may just be preparing for more inflationary action and that the extreme bearish sentiment may have been a warning that the opposite of what many of us expected was likely to occur. In retrospect, that's exactly what happened. Looking at the above chart, the question now is whether this downward channel of the Newcrest/Gold ratio is about to be broken. A clear break to the upside would support our theory that the longer term inflationary trend is back in force. If Newcrest, along with equity markets, pulls back sharply from here and the Aussie dollar corrects resulting in a rally in the Australian dollar gold price, this would support a deflationary scenario. We will watch this over the coming weeks and months with great interest. At this stage it looks as though inflation will be the winner.

CLOSING COMMENTS

Last issue we made the following comment:

"If the gold stocks, along with the silver price, start to decisively outperform the gold price in the coming weeks and months, this could be our signal to become more aggressive in our investment approach. With all this talk of deflation, we may just be gearing up for the mother of all Fed/Government induced inflationary efforts, where investor appetite for risk increases dramatically. If this occurs, the consolidation in the gold price will remain brief."

Well this is exactly what we have seen since and is the reason why we have never advocated trying to play this latest consolidation period too cleverly (it has been unusual and very difficult to predict). My feeling is the markets are such that you probably don't want to be fully invested in gold and silver stocks, despite the overwhelming bullish characteristics we are seeing in the charts. Whilst I have always been in the inflationist camp, I think those who dismiss the deflationist's arguments do so at their own peril (as we saw in 2008). There are a myriad of things that could come from left field which central banks and governments will find difficult to manage and control. This will see more market shocks and more volatility as scared money moves its way around different asset classes. Nobody really knows for sure how long this game will last and exactly how it will all play out. I continue to advocate a healthy mix of bullion and precious metals stocks. We like to use the stocks for greater leverage, with the ultimate aim of building a larger bullion position

For those of you that are new to the precious metals sector or may for whatever reason still be sitting on the sidelines sweating bullets, fear not. The beauty of this sector has always been that there are bargains to be found no matter how bullish the conditions. You just need access to the right information. Two months ago we generated some research reports for the GoldNerds Pro subscribers. The results thus far have been very pleasing to say the least. As per usual, however, there are some interesting laggards well worth a look. Half the battle in this game is patience. You never know when the market is going to discover seemingly unloved undervalued stocks. To give you an example, we presently have an Australian gold stock on our focus list which is producing gold profitably with a mine plan out to 2015 (with excellent exploration potential). They are profitable to the point of actually accumulating a healthy bullion inventory. Despite strong market conditions, this company is trading at about its cash and bullion value (something I have not seen since the height of the GFC). The Enterprise value is therefore close to zero and investors are getting some very solid gold mining assets for next to nothing! In my humble opinion, the value of a professional GoldNerds subscription has always been the means to discover these types of companies the market, for whatever reason, has missed or chosen to ignore.

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