

FWIW: S&P/Gold and Dow/Gold ratios look way out of whack; IMO prospect of substantially accelerating inflation isn't causing this relative pricing anomaly

1:00 PM Wednesday August 10, 2011

Dear XXXX:

I don't often comment on market/pricing issues any more, but I do think that present values of the S&P/Gold and Dow/Gold ratios are anomalous and thus perhaps important to at least watch.

The apparent pricing anomaly in the above-noted ratios has come to my attention because about a month ago XXXX mutual friend XXXXXXXX called and said that he'd like to XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
XXx Barron's stories published back in 1986, 1988, and 1999
(we were right about many things that we had forecasted) as well as outline current 'big picture' thinking
about the future based mostly on my recent work on advanced energy sources in the context of Lattice.

During my spare time in the ensuing weeks since XXX'Xs call, I went back and reviewed updated data on many things that I had routinely followed back in the past but hadn't much looked at since the inception of Lattice. One set of broad-brush indicators (or market 'barometers' if you will) that I have watched on-and-off for more than 30 years since the beginning of my commodity trading days in the 1970s are the S&P/Gold and Dow/Gold ratios.

For whatever it is worth, based on what is shown in selected chart data, the S&P/Gold and Dow/Gold ratios look way out of whack; please see the charts and my comments thereon found further down below.

I must admit that I have never explicitly arbitrage-traded either of these ratios. Also, while the liquidity in nearby instruments seems adequate on both sides of such a trade, I don't know whether positions could presently be initiated at attractive numbers and rolled forward through time (it might take a while for the ratios to self-correct) with reasonable execution costs. Lastly, today's extreme market volatility could make it extremely difficult if not dangerous to try to initiate a well-executed starter position anytime soon.

All that said, and irrespective of whether it is really feasible to trade the equities/gold spread strictly on its own, I do think the present anomaly in the ratios is perhaps telling us something important about the markets and possibly major relative mispricing of different asset classes.

The bottom-line of what is shown down below my name is as follows:

1. Today, based on history, prices of U.S. equities (proxy is S&P 500 index) are unusually *inexpensive* in comparison to the price of gold

2. Gold is not presently expensive because of a soon-to-be rapid acceleration in overall rate of inflation. In my view, that scenario is very unlikely, especially given the reduction in government fiscal stimulus now starting in the U.S. and Europe. Recent behavior of U.S. Treasury securities supports that notion --- yields on the long-end of the debt markets (which Fed has very little direct control over) have actually gone *down* significantly since the latest market break began. As of mid-session this morning, the 30-year US Treasury bond was being priced to yield 3.53%; if a pending inflationary surge were the underlying factor spooking today's equity markets, long bond yields would be going *up* not down. Three-month T-bill rates are within a rounding-error of zero%; no hints of inflationary pressures there either. The fact is that the U.S. economy is still quite weak and there is little demand for short-term credit --- U.S. consumers aren't in good enough financial shape to help run-up hard asset prices and create inflationary pressures.

3. Today, the price of energy (its proxy being the real price of crude oil) is very expensive in historical terms. This is for good fundamental reasons based on a well-documented relationship between per capita energy consumption and per capita GDP that holds true for practically every country on earth. While the economies of the U.S., Europe, and Japan are presently in relatively weak,

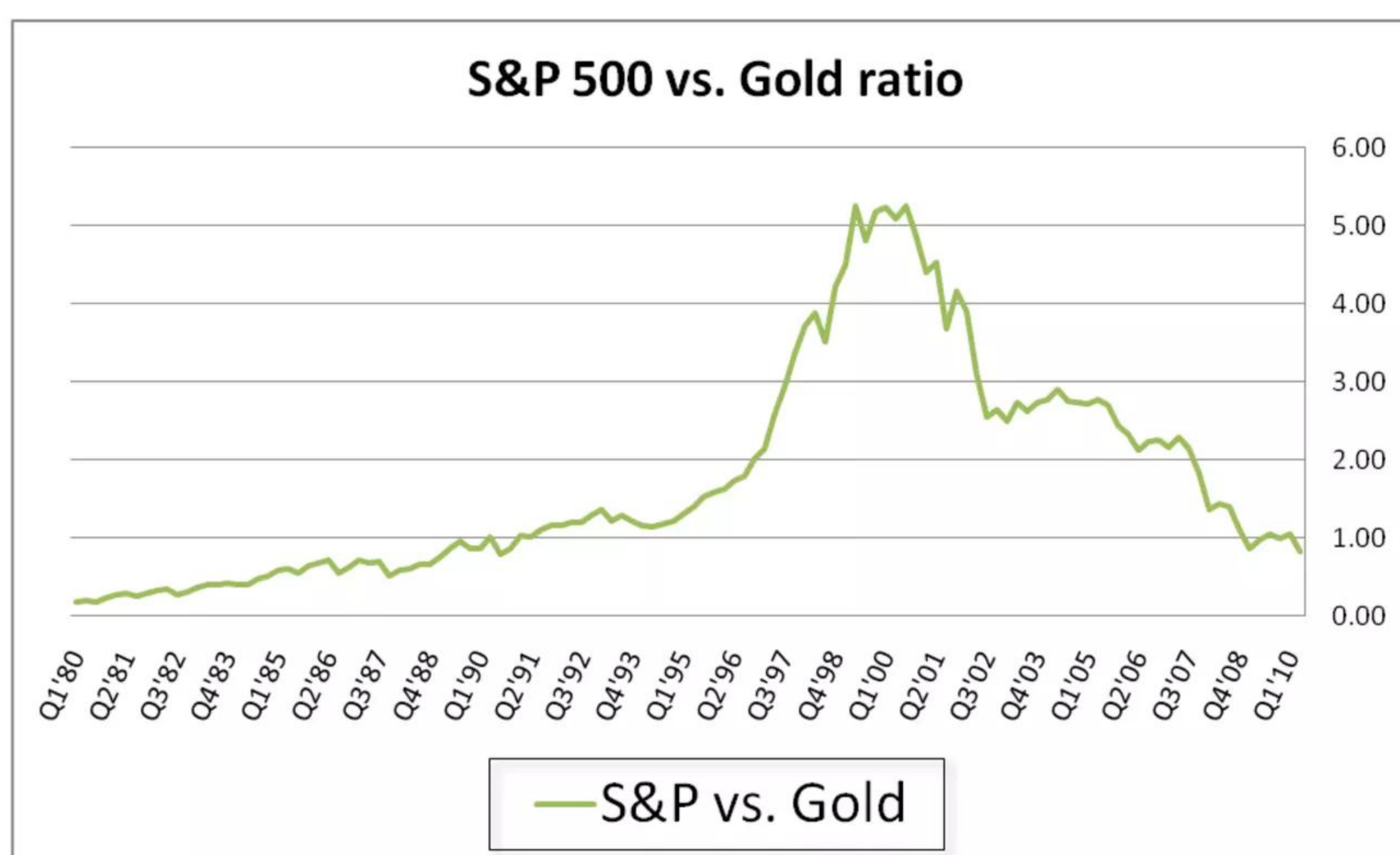
slow-growth modes, the Chinese and Indian economies are now positively booming, along with a smattering of other not-well-heralded countries (TV talking heads and media pundits seem to ignore this lately, for whatever reason). That said, I wouldn't be anxious to be short oil in the foreseeable future. If the U.S. and Europe can finish crawling out of the recession without too many more serious setbacks, once global GDP growth finally reaccelerates, the price of oil will again begin to increase rapidly and could easily reach \$150 – \$200/barrel within a year or two following reacceleration before corrective market forces level it out and stabilize it. On the other hand, if the U.S. and Europe experience a double-dip recession and India and China slow somewhat as a result, the price of oil could slide down to \$50 - \$60/barrel and stay in that price range until the global economy decisively recovers.

4. Actually, if there is a really nasty 'wild card' surprise potentially lurking out in the world economy somewhere, it's that we might slowly slide into a depression, not move toward some sort of global runaway price inflation in hard assets. That said, I must confess it does bother me that I can't exactly explain quantitatively why the gold price is running-up the way it has been of late --- perhaps it has its roots in fears about the unknown safety of the European banking system in the event of a wave of catastrophic sovereign debt defaults. However, even if that were true, in my opinion in the end it's still probably more a matter of current market psychology/fear levitating the gold price rather than being caused by any of the 'hard,' well-documented macroeconomic inflationary factors that have unquestionably driven the price of gold up and down in the past, at least in my experience.

Lastly, although the apparent trigger for the present market drop and truly fearsome, seemingly random up-and-down volatility would appear to be quite different (the Fed is not tightening here, but remaining very accommodating for the near-term future as Ben Bernanke promised yesterday), FWIW the way the markets are behaving during the past two weeks, including almost palpable fear and mass confusion about the future, somewhat resembles October 1987 to me. But that is just a non-quantitative, qualitative gut feeling based on what I remember from trading through that particular crash 24 years ago (BTW - I was buying conservatively-sized positions in selected stocks for myself and my clients with market orders during the scariest runaway part of the '87 break --- although they were genuinely frightening to initiate, those trades proved to be quite profitable in the end).

We can discuss this whenever you wish. BTW – mid-session this AM the S&P vs. Gold ratio hit 0.64

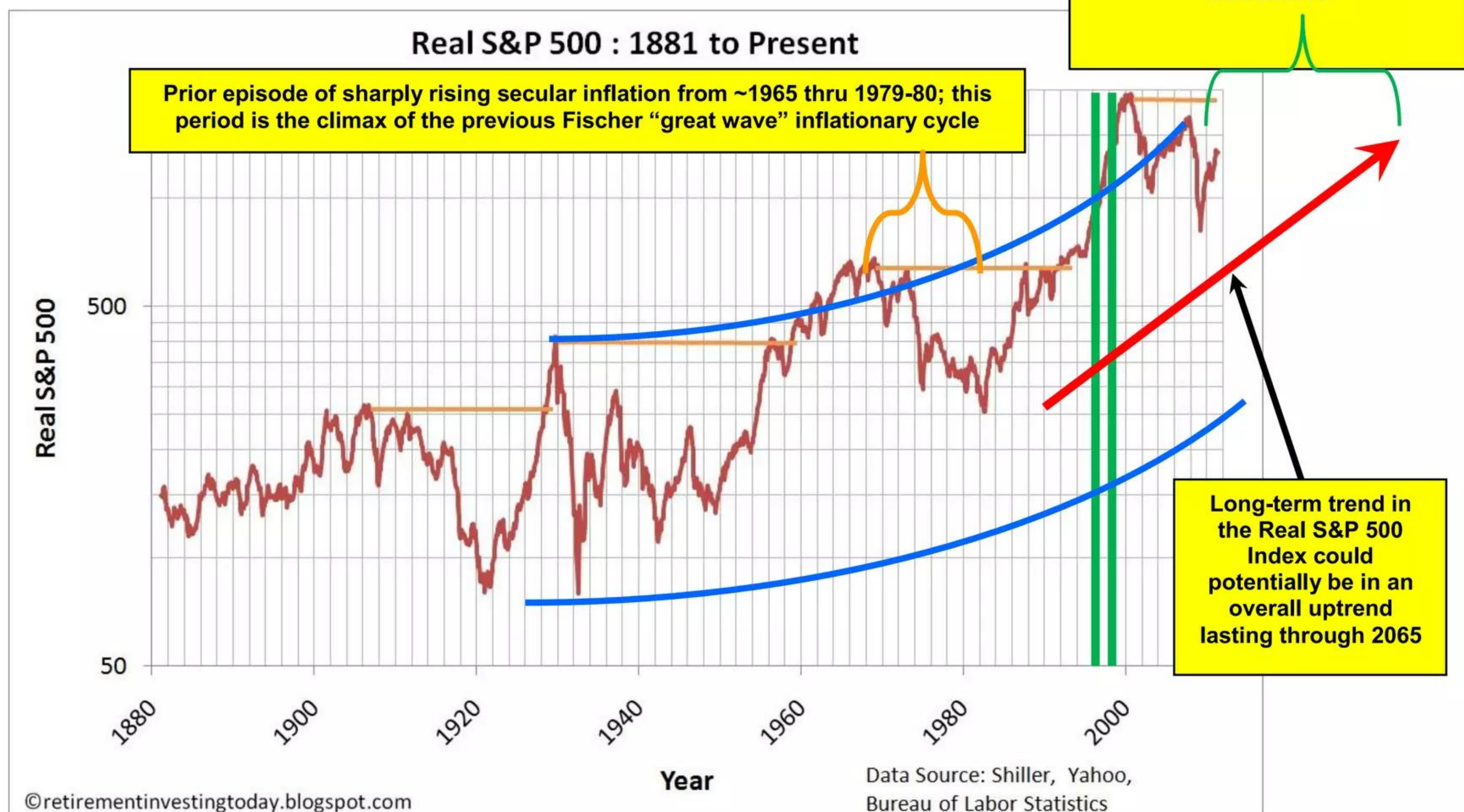
Best regards,
Lew
(312) 861 – 0115



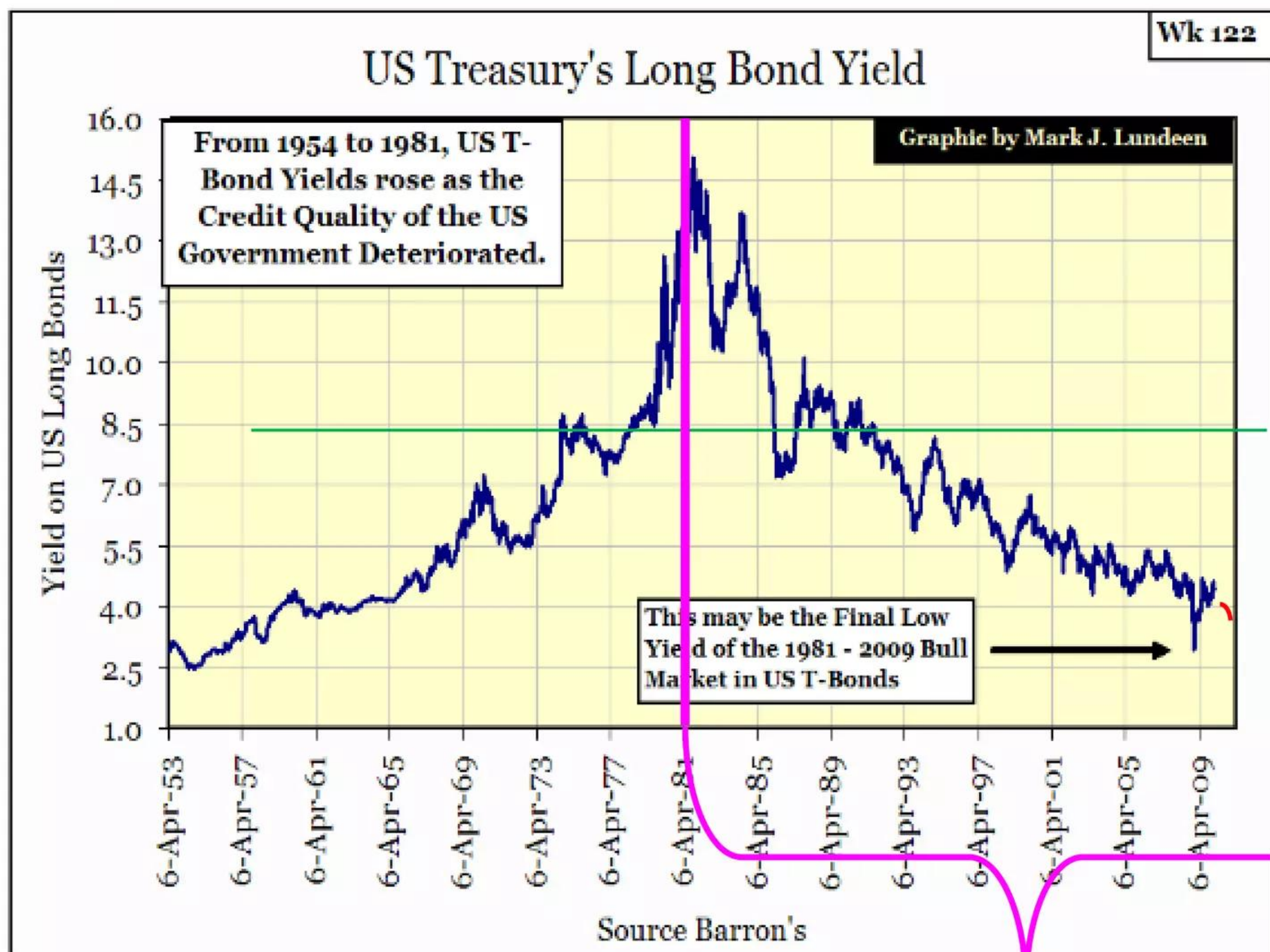
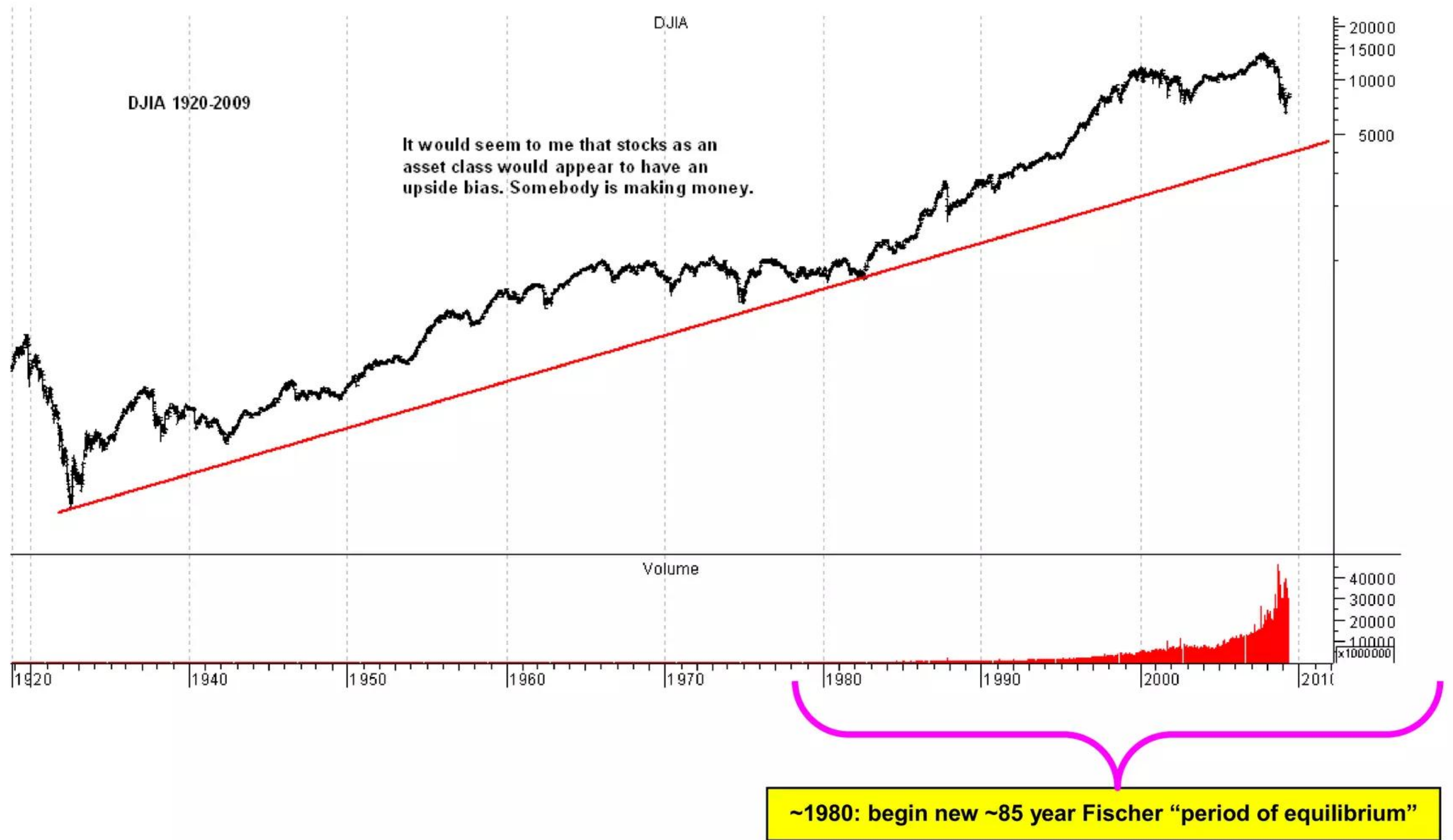
Real (constant dollars) DJIA from 1920 through May 2011

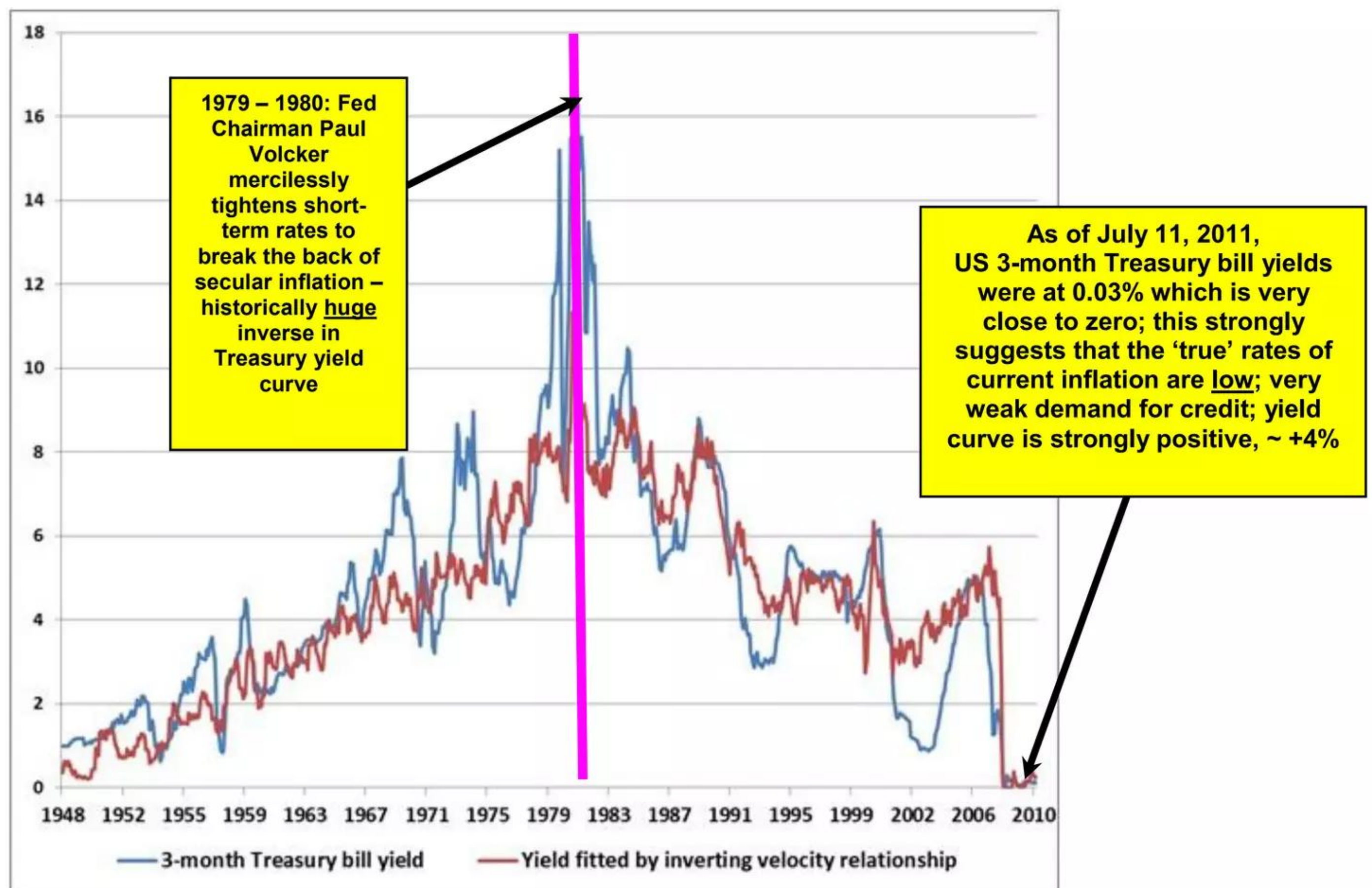


Real (constant dollars) S&P 500 from 1880 through May 2011

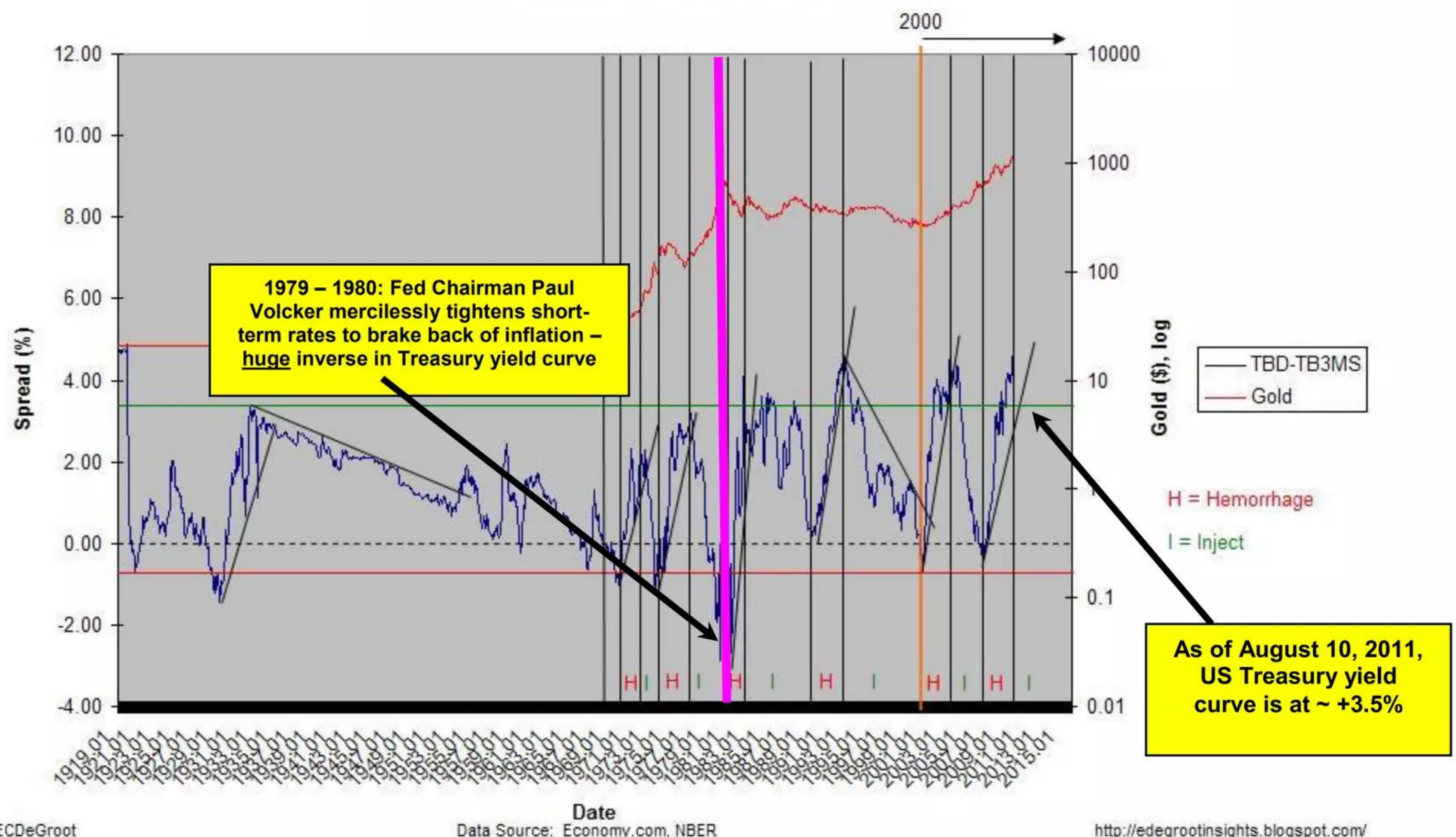


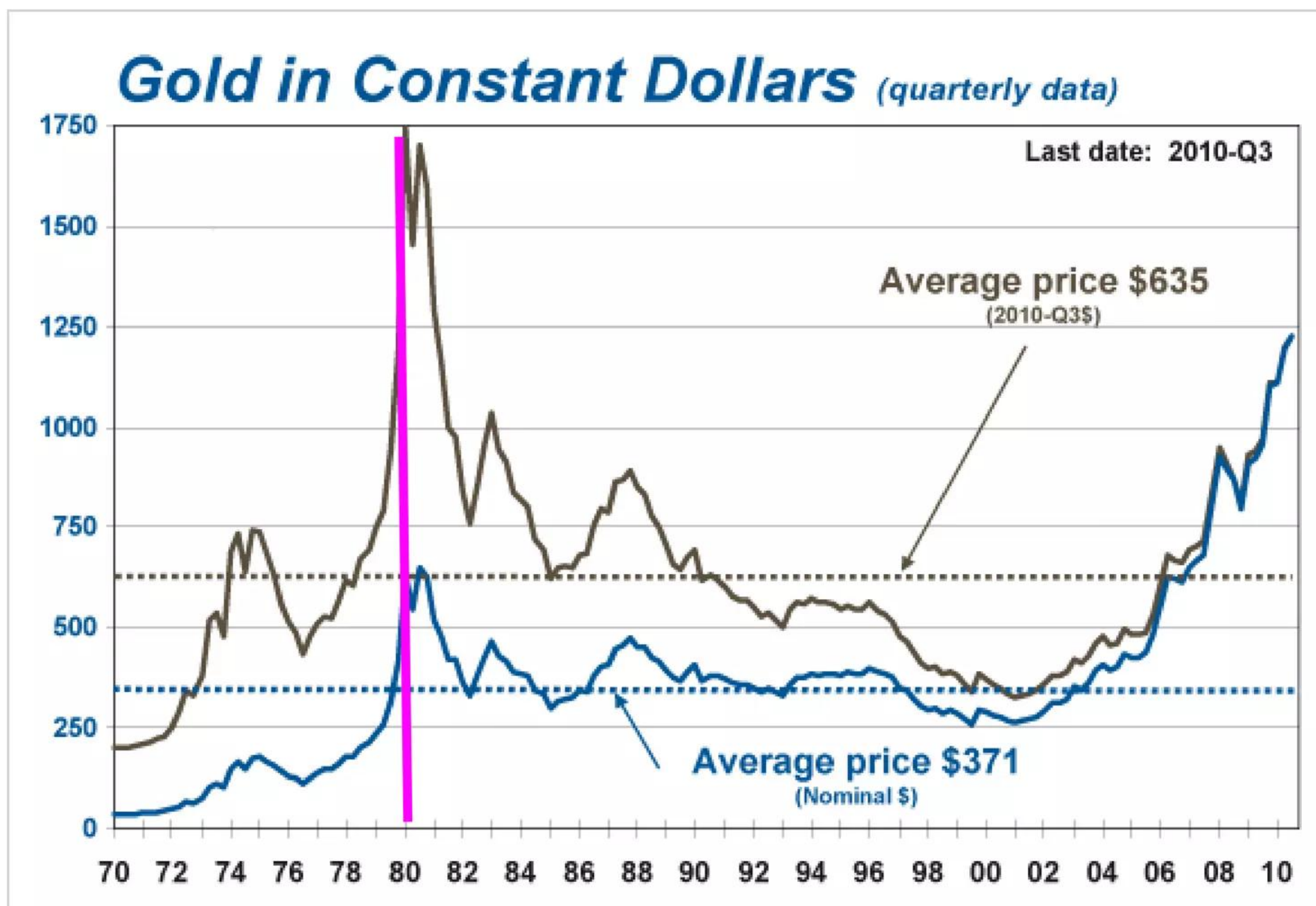
Nominal DJIA from 1920 through late 2010



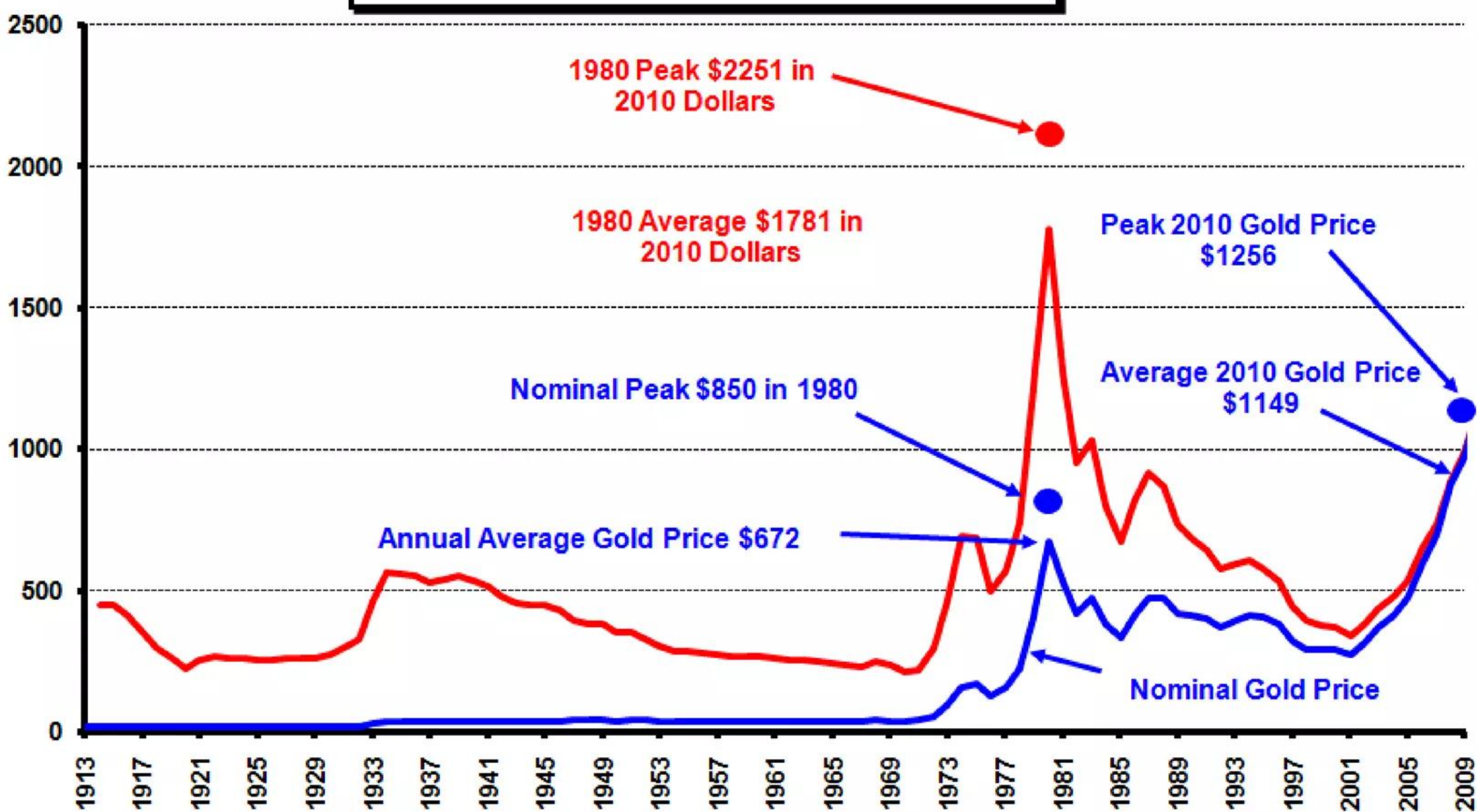


U.S. Treasury Yield Curve: US LT Treasury Bond Yield- 3M US Tbill Yield (TBD-TB3MS) and Gold London PM Fixed

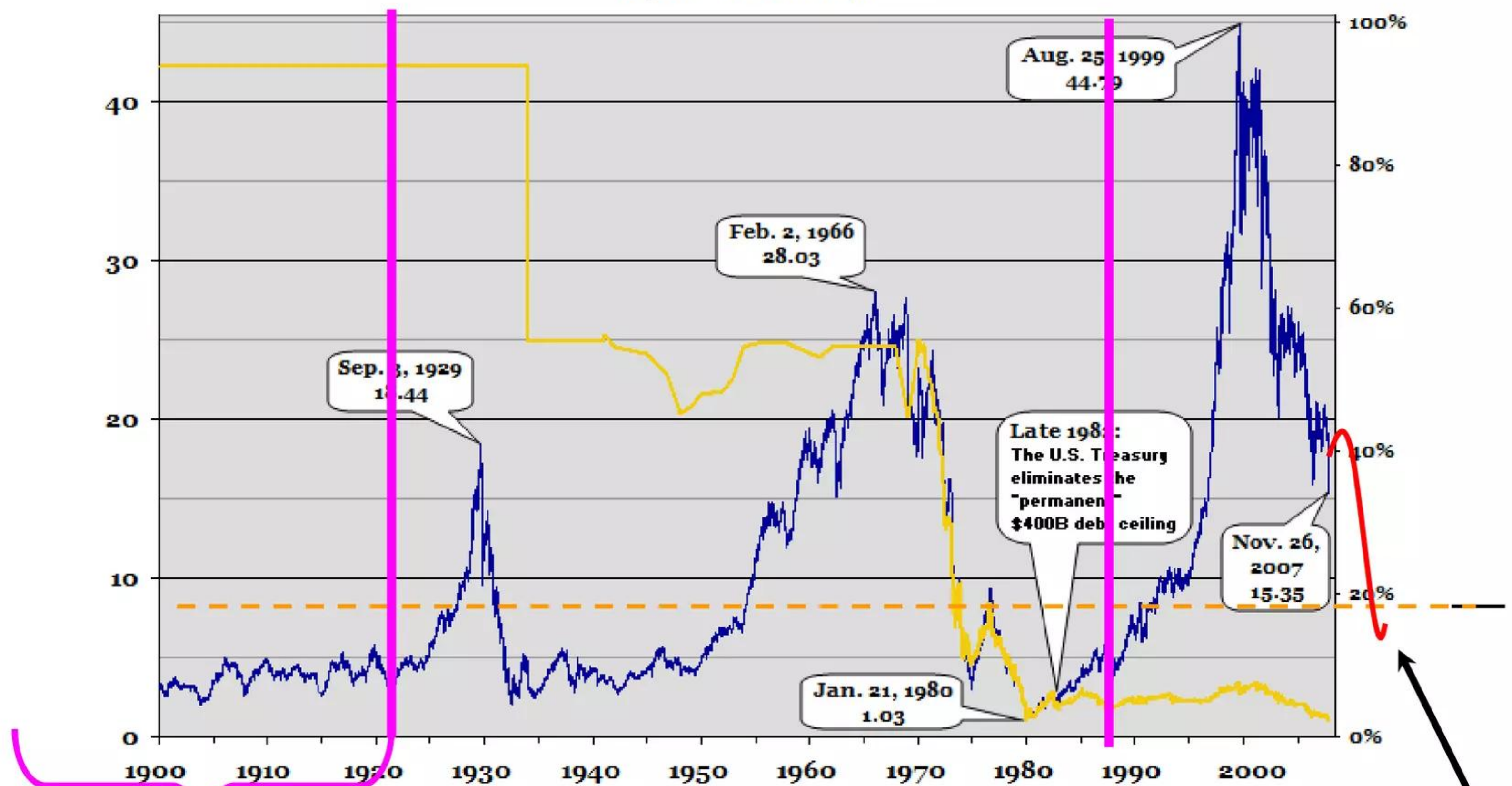




**Inflation Adjusted Annual Average
Gold PRICES (1914-2010)**
In May 2010 Dollars
© www.InflationData.com
Updated 06/24/2010



Dow / Gold Ratio vs. Gold / Constitutional Dollar (1900 - Nov. 2007)

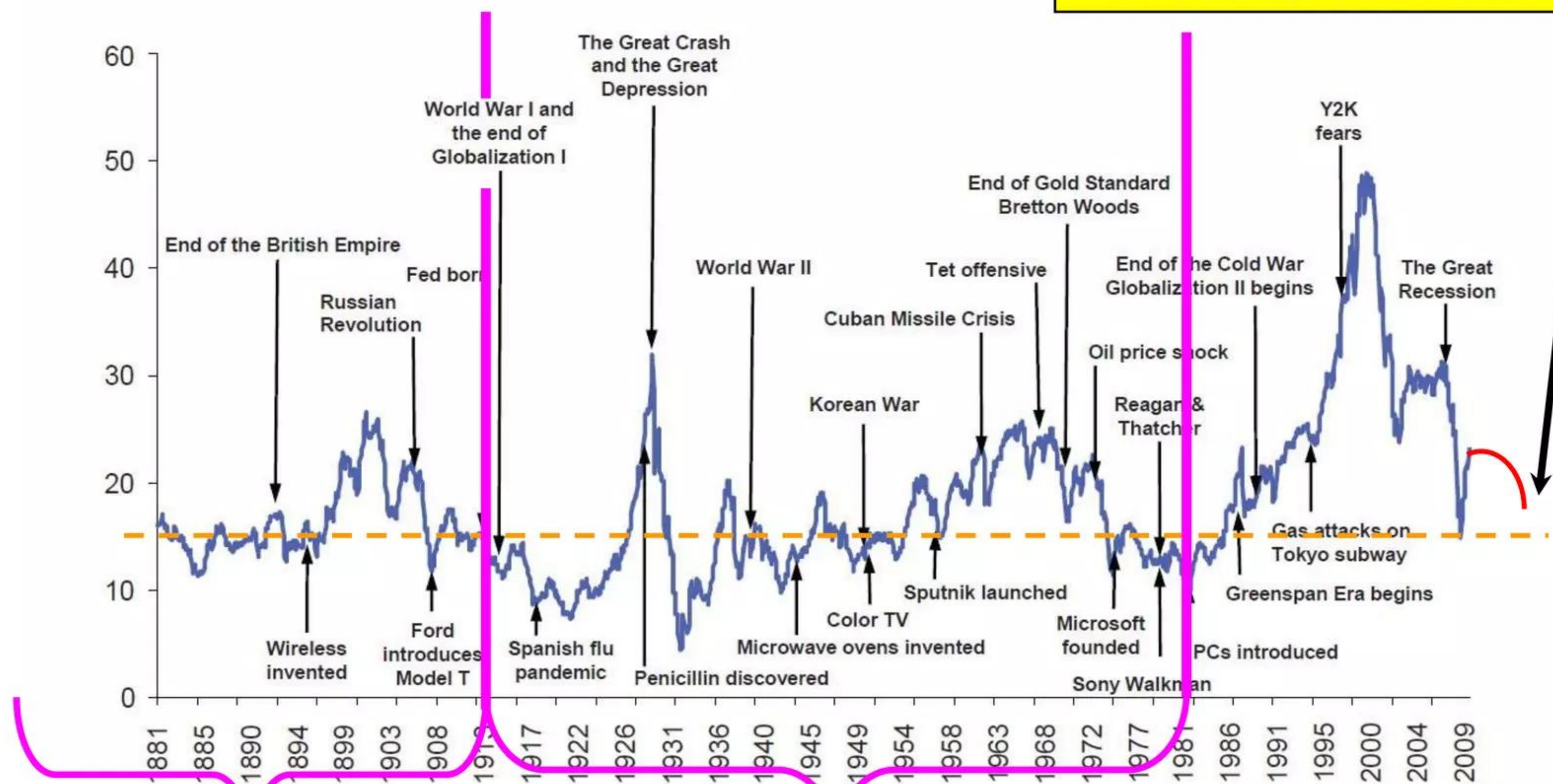


Ending of earlier "period of equilibrium" is ~1913

The Graham & Dodd P/E for the S&P 500

On August 10, 2011, Dow/Gold ratio = ~6.3 thus stocks not very expensive by this measure

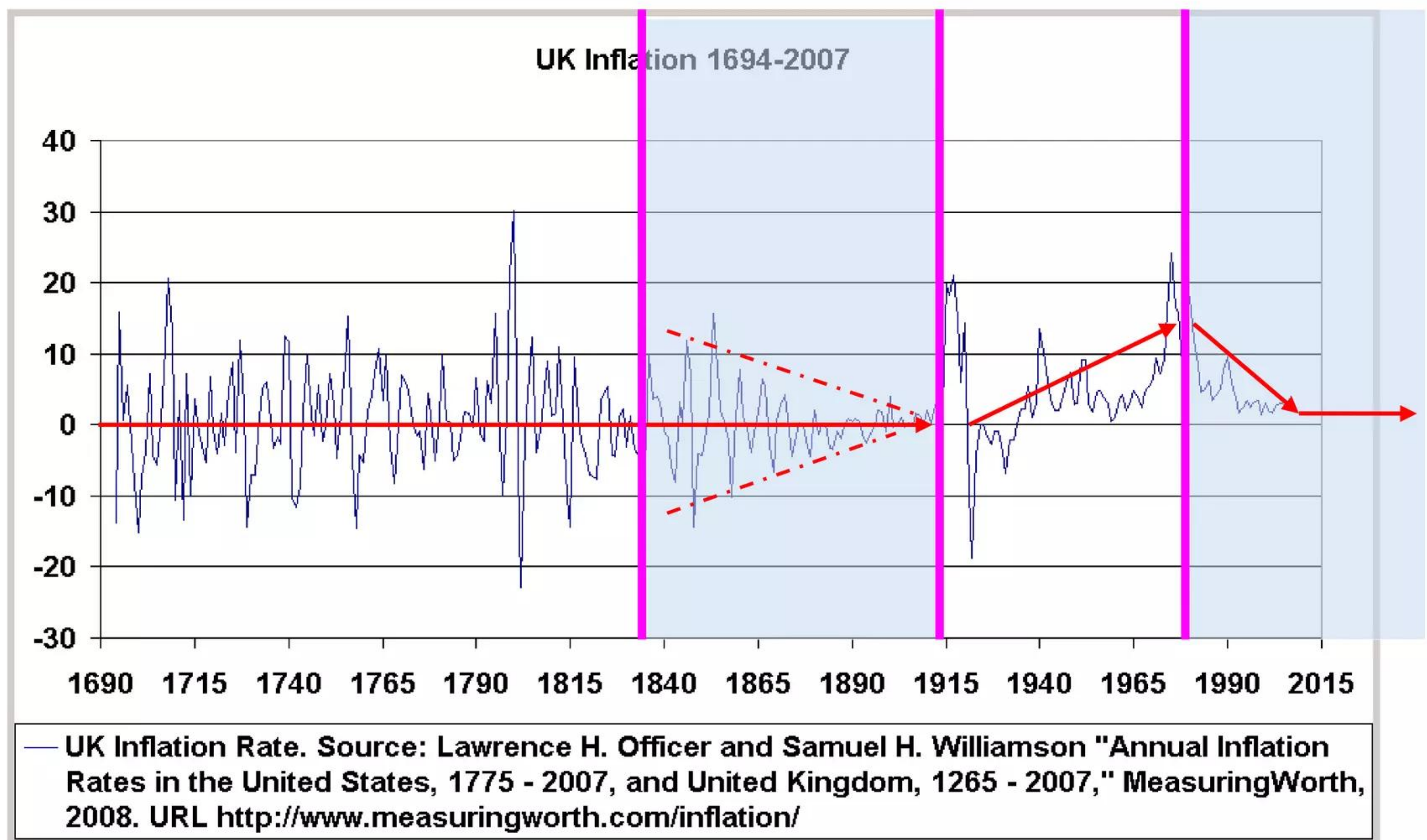
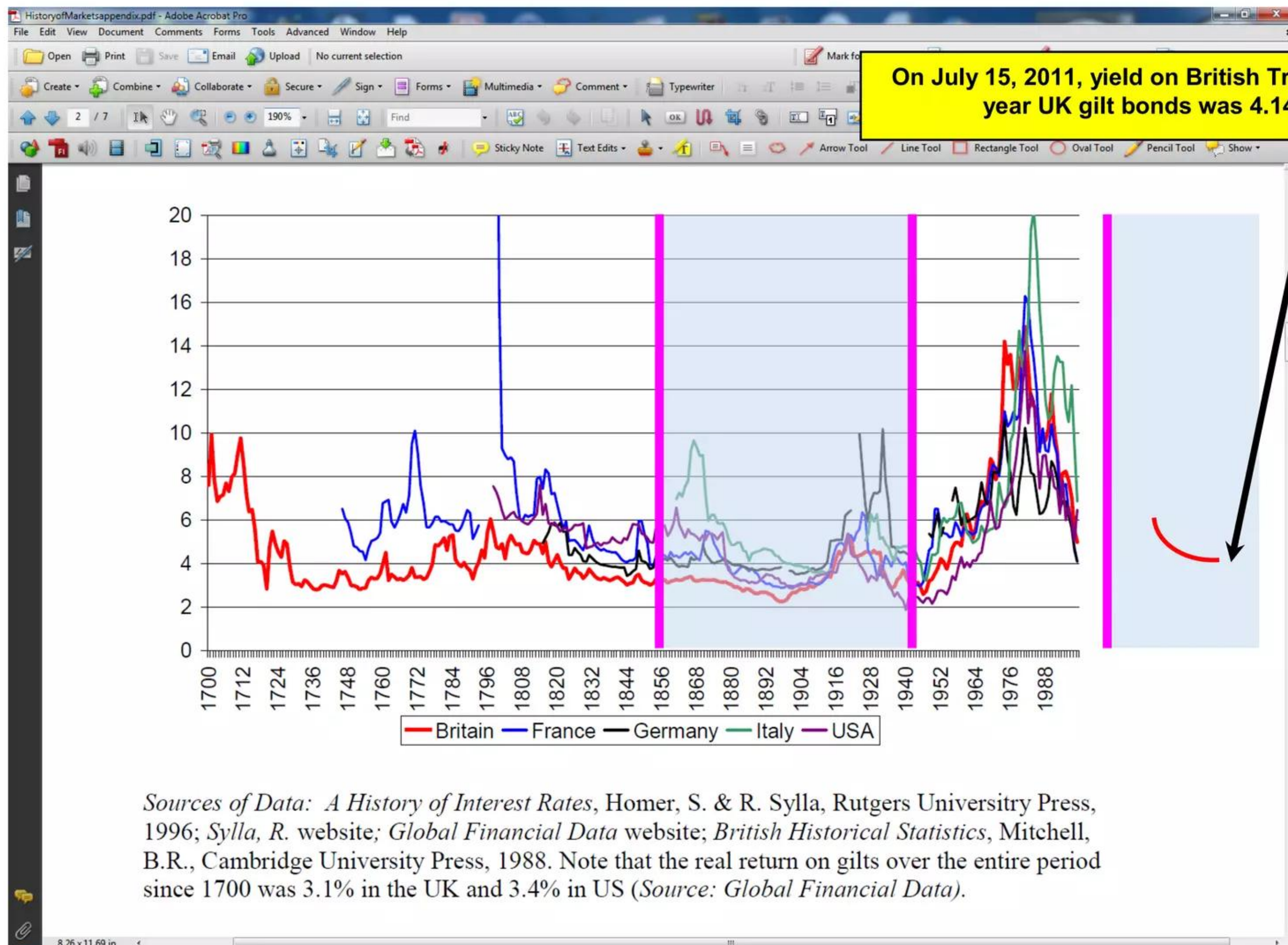
On July 15, 2011, S&P 500 P/E ratio = ~16.7 stocks not very expensive by this measure



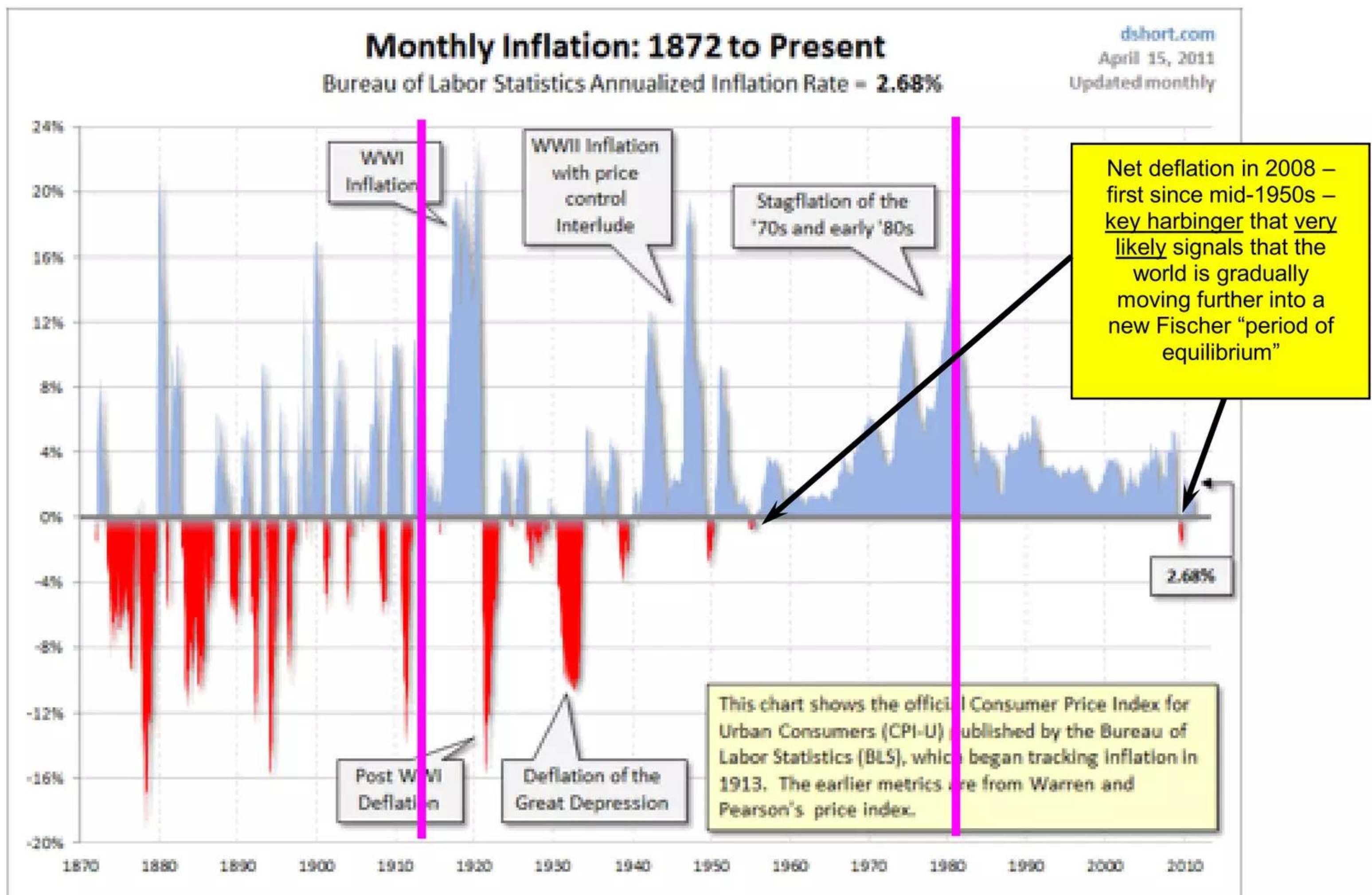
Earlier "period of equilibrium" from ~1828 to 1913

Fischer "Great Wave" of inflation from ~1914 to 1980

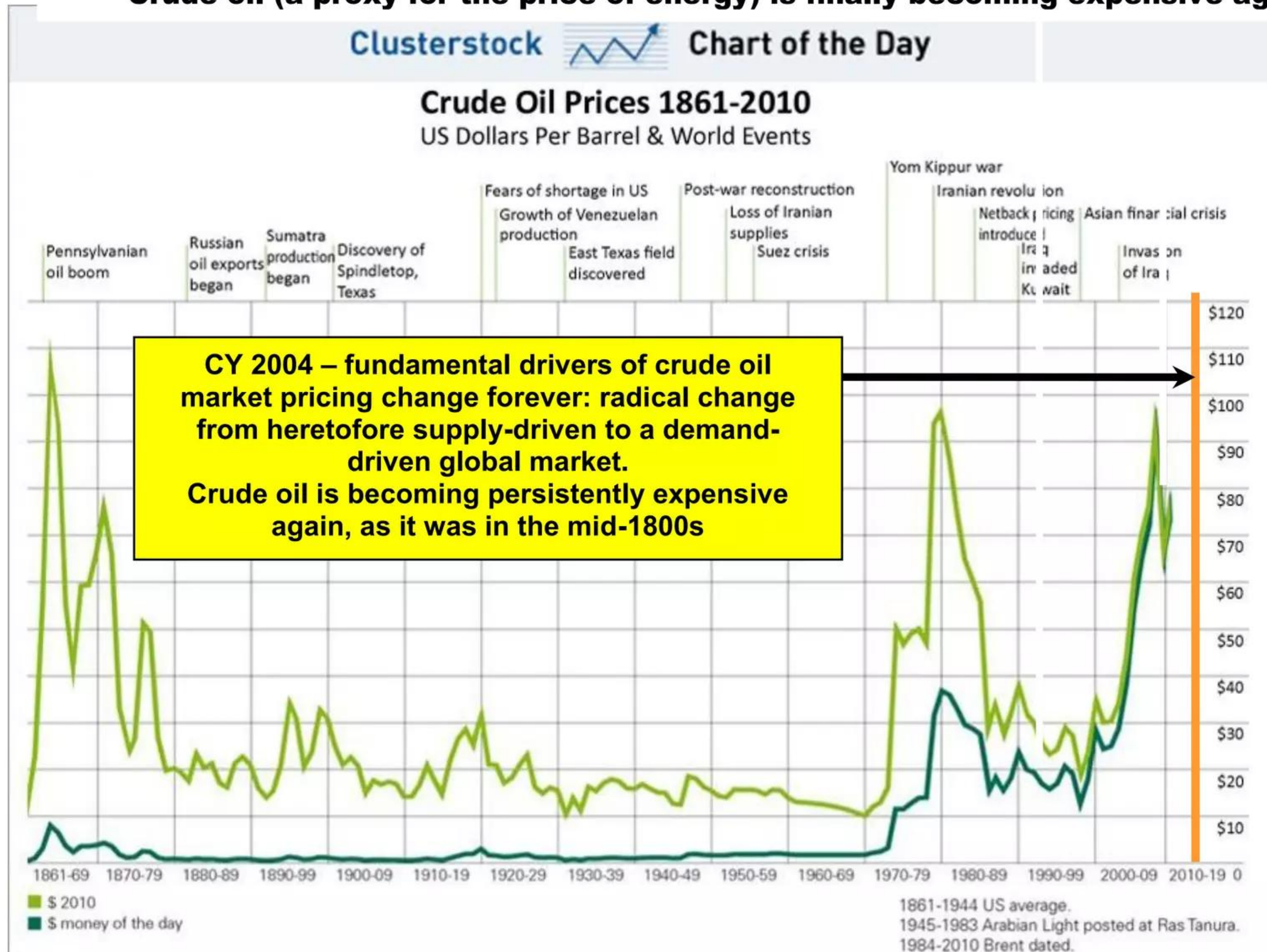
GMO, Shiller



Difference between earlier equilibrium period and inflationary era are clear below



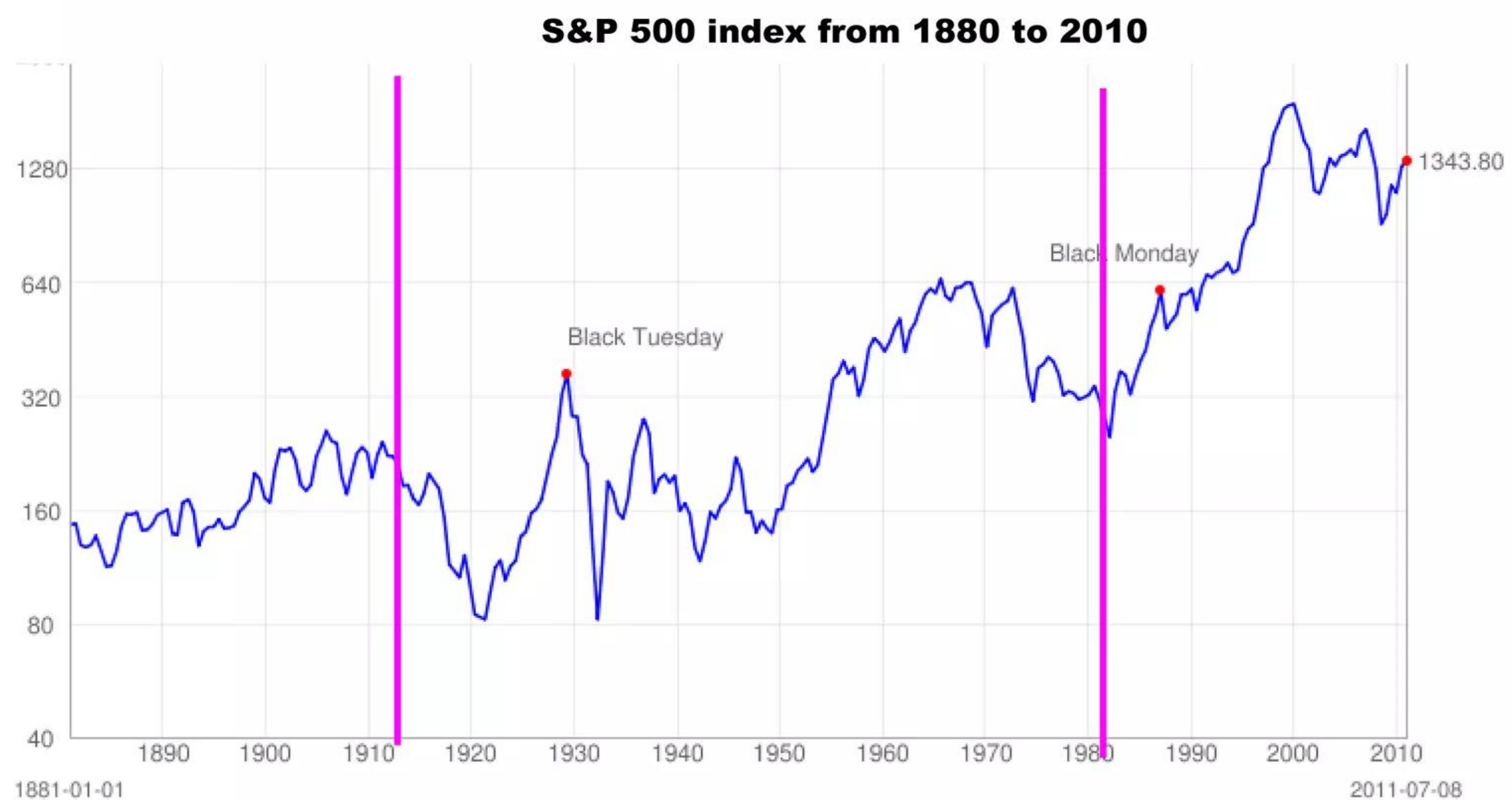
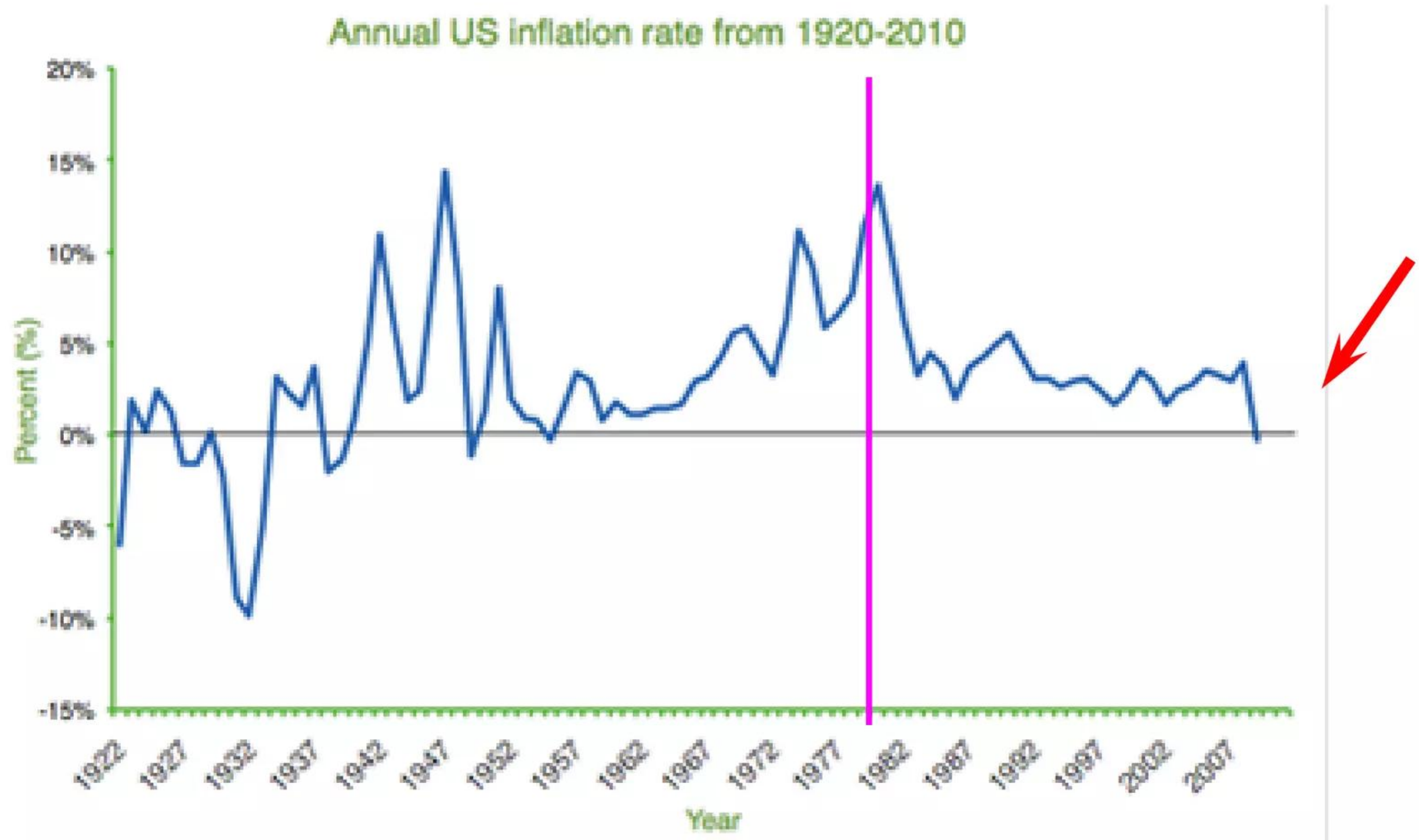
Crude oil (a proxy for the price of energy) is finally becoming expensive again



The fundamental change in oil prices that occurred in 2004 (as evidenced in the chart above) is very well explained on page 39 of Thomas Friedman's latest book, *"Hot, Flat, and Crowded"*, where he says,

"The pivotal year that told us we were in a new era in terms of global energy supply and demand was 2004, says Larry Goldstein, an oil expert at the Energy Policy Research Foundation. 'What happened in 2004 was the world's first demand-led energy shock.' Here's what he means: In 1973, 1980, and 1990, we saw sudden oil price spikes because of wars or revolution in the Middle East, which sharply limited the supply of oil. What happened in 2004 said Goldstein, was a price shock that was simply the product of long-term trends that pushed demand well ahead of supply, spurred in large part by a sudden leap in demand by China...Two things happened that year. All the shock absorbers, all that spare crude, product, and refining capacity, disappeared, and demand for energy took a great leap forward, due to China's growth. At the start of 2004, the International Energy Agency [IEA] predicted that global demand for crude oil would grow by 1.5 million barrels a day that year, said Goldstein. 'Instead, it grew by three million barrels a day, and [demand in] China alone grew by over one million barrels a day,' he said. And because all three of the traditional shock absorbers were gone, that extra demand could not be cushioned."

Dramatic increases in crude oil prices since 2004 are an unmistakable signal from energy markets that oil supplies and increasing demand are on a collision course; they in disequilibrium. Price charts don't lie.



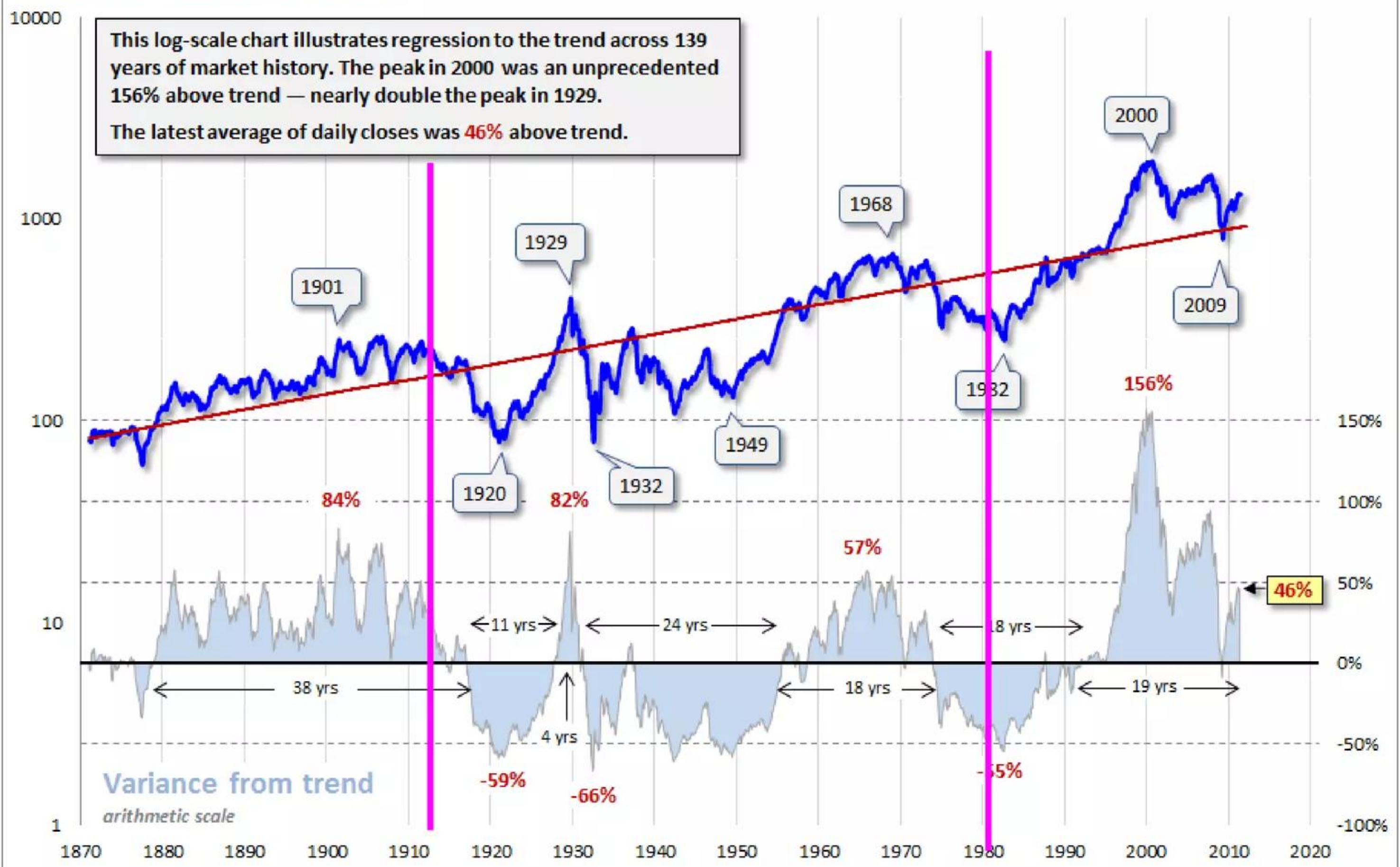
S&P Composite Index: Regression to Trend

dshort.com

June 2011

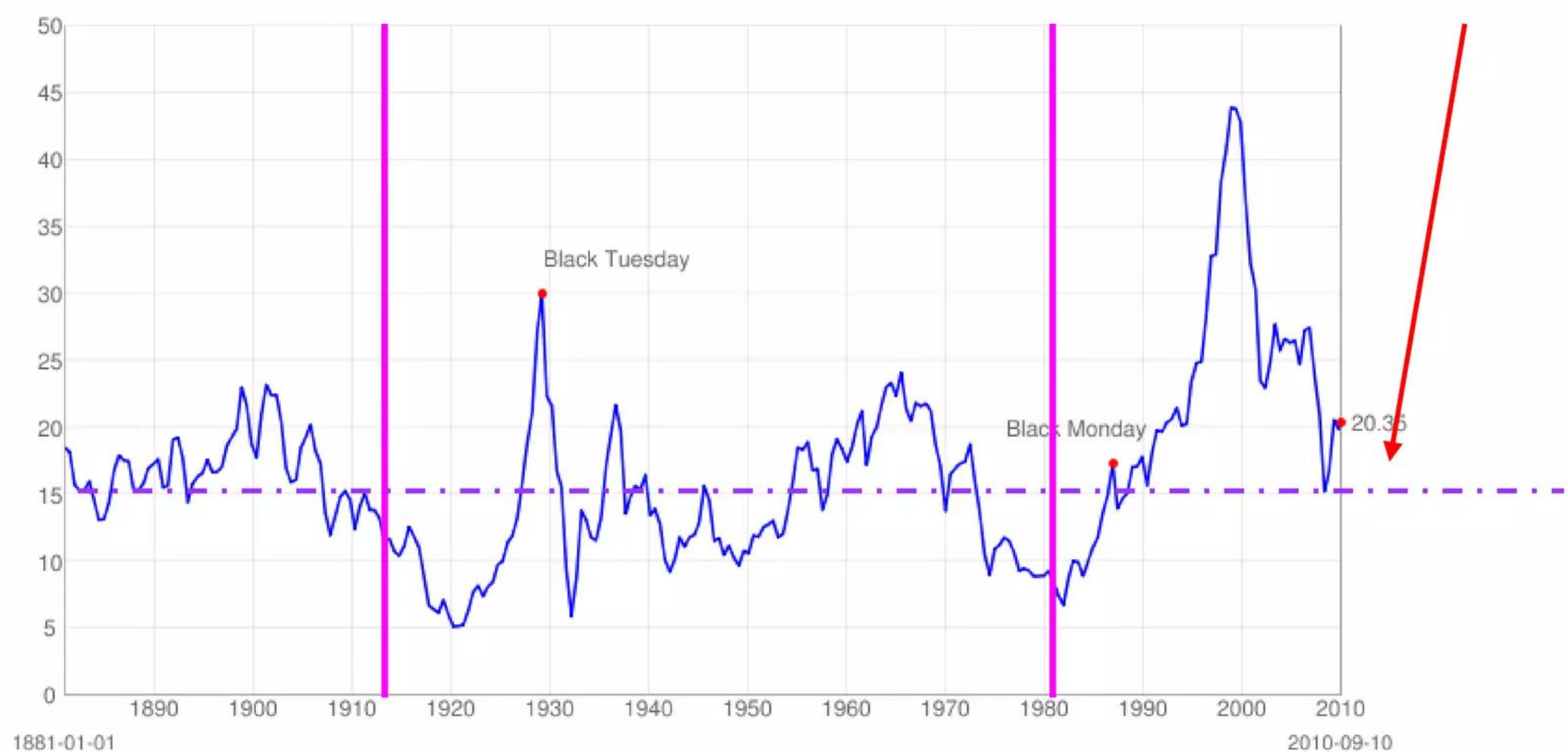
Real (inflation-adjusted) Price since 1871 with Regression

Variance measured below



P/E ratio of S&P 500: 1880 to 2010

As of July 20, 2011, the P/E ratio of the S&P 500 is at around 19, which is close a long-term 'typical' value for the S&P index



Regarding the present investment climate: gold and crude oil are relatively expensive compared to other alternative types of investments; long- and short-term interest rates are relatively low by historical standards (thus, being long 30-year U.S. Treasury bonds may have limited upside potential, barring a global depression); real estate values have returned to more normal levels and are presently very illiquid in the U.S. and elsewhere; current inflation rates are relatively low in the U.S. (-0.4% in 2009; +1.6% in 2010), Europe, and Japan; while stock price levels have corrected from interim highs in real terms (while not unusually low, stock P/E values are presently not unusually high either --- actually, somewhat 'average').

Thus, the long-term secular uptrend in stock prices, amazingly, still appears to be intact. Although stock markets could easily go sideways in a choppy up-down pattern for another 1 – 2 years as the current global economic mess slowly sorts itself out, the most likely outcome in my opinion, again barring some sort of an economic depression, is a resumption of the long-term secular bull market in equities as we move somewhat further into the future past the present economic 'speed bumps'.

In conclusion: if I had to make a 5 - 10 year buy-and-hold portfolio decision today, the asset class most likely to outperform all others over that time horizon would still appear to be the US stock market.

***** **END** *****