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Many Questions, Few Answers

INTRODUCTION

In recent months I have received numerous queries from our readers concerning the present investment environment. Although these questions relate to a variety of investment themes, they can be narrowed down to just one major issue, which can be summarised as follows: Will the world experience deflation or inflation in the years to come, and should one therefore be positioned in bonds, or in commodities, equities, and real assets? As always, the future is unknown, and so any prediction by us or anyone else must be treated with a great deal of

caution. In addition, the world's economy is extremely complex; consequently, it is entirely possible for assets to inflate in some countries, while other countries experience asset deflation à la Japan in the 1990s.

I am pleased to begin this report with a very clear account of the current investment environment written by my friend Michael O'Higgins (miamisurf@aol.com). Michael is a successful fund manager based in Miami and is the author of numerous books, including *Beating the Dow* (HarperCollins, 1990) and *Beating the Dow with Bonds* (HarperCollins, 1999). He takes a flexible approach to investing which

enables him to shift his funds from one major asset class to another as circumstances change. As an investor, one might expect all professional fund managers to have this ability to be flexible, but one would be wrong. In a panel discussion at a recent conference in Zurich, I was surprised when a fund manager for a large Swiss insurance group (whose stock — needless to say — has collapsed) announced in front of a few hundred retail investors that stocks always go up. I suggested that he ask investors in Japan, where the stock market is languishing at a 19-year low, whether they would agree with his assessment!

Beating the Dow with Gold

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In March 1999 ("Beating the Dow with Bonds") and again in April 2001 ("The Outlook for Stocks versus Bonds"), I wrote articles for the *Gloom, Boom & Doom Report* warning readers about the gross overvaluation of US stocks and urging them instead to buy long-term US Treasury 0% coupon bonds (zeros) which, in my view, still had good return potential with low downside risk. Since then, investors in the US equity markets have suffered losses of close to 50%, while the holders of long zeros have seen their bonds appreciate by an average of over 35%.

Today, several years later, with both stock prices and bond yields having come down so much and so many asset allocation models

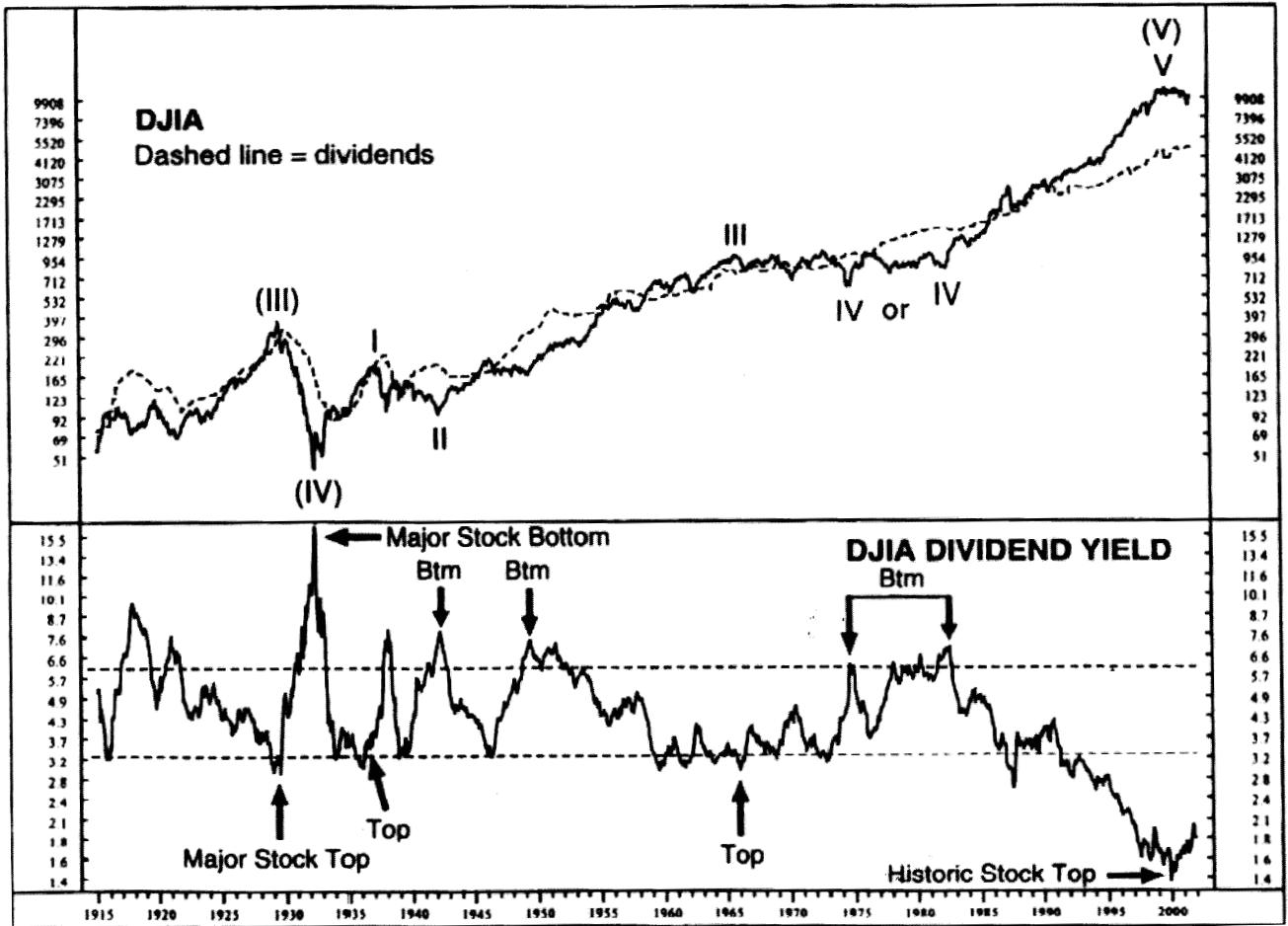
indicating stocks as the undervalued alternative, it may be a good time to re-evaluate both markets, not only vis-à-vis each other but also relative to their respective historical valuation ranges.

As the US stock market winds up its third losing year in a row — the first time this has happened in over 60 years — the vast majority of market strategists, money managers, and investors appear quite confident that the bear market is over and that a fourth down year in a row, considering that this has occurred only once in the last 100+ years, is virtually impossible. Moreover, they point out, we are in the third year of a presidential term, which has, historically, been very favourable for stocks. Unfortunately, quite the

opposite is true. Because the major stock averages remain grossly overvalued and investor sentiment continues at levels of optimism normally coincident with **market tops**, it is likely that we will need to see much lower equity prices before the preconditions for a new bull market in stocks — that is, low levels of valuation and high levels of pessimism — can be said to be in place.

That stock valuations remain too high is clear from the paltry 2.54% dividend yield on the Dow Jones Industrial Average (DJIA) (see Figure 1), the 28.4 P/E ratio on the S&P 500 (see Figure 2), and the 3.5 price/book ratio for the S&P Industrial Index (see Figure 3). That investor sentiment has stayed at

Figure 1 Stock Market versus Dividend Yield, 1915–2002



Source: Elliott Wave International, data courtesy of Ned Davis Research

Figure 2 S&P Price/Earnings Ratio, 1947–2002

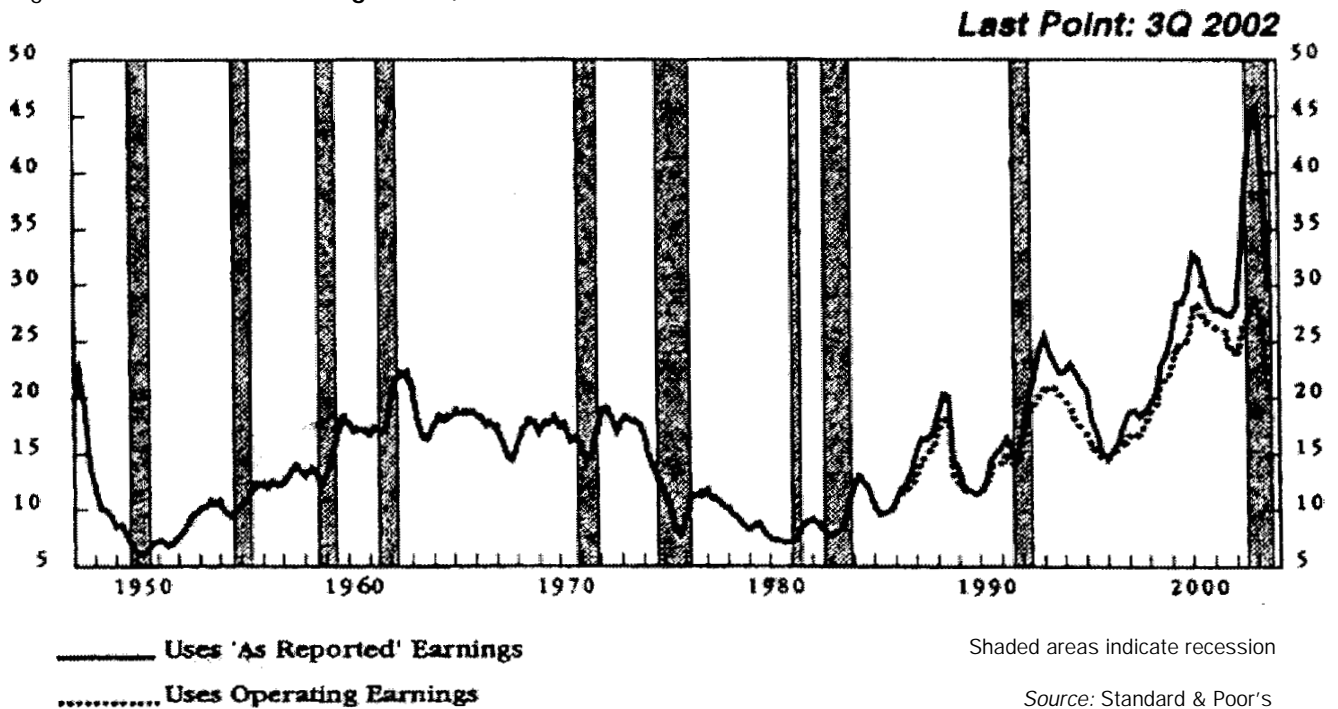
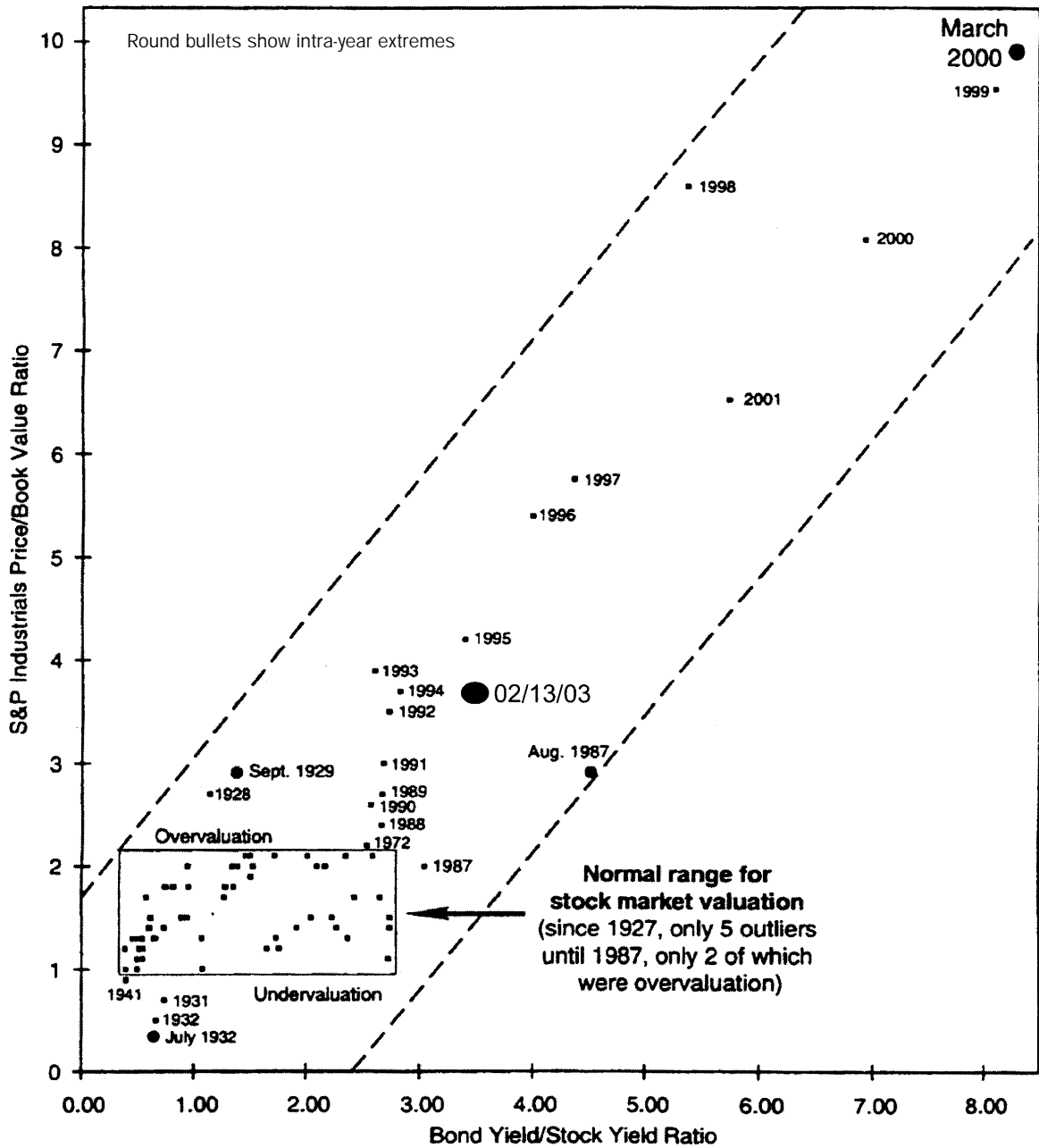
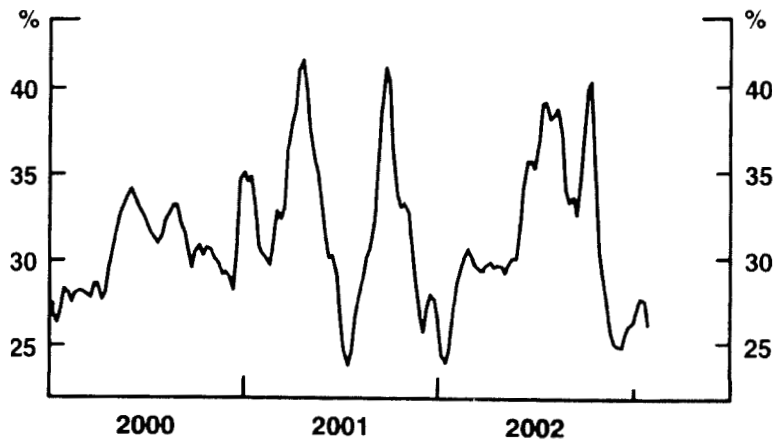


Figure 3 Year-end Stock Market Valuation for the S&P 400 Industrial Index, 1927–2001



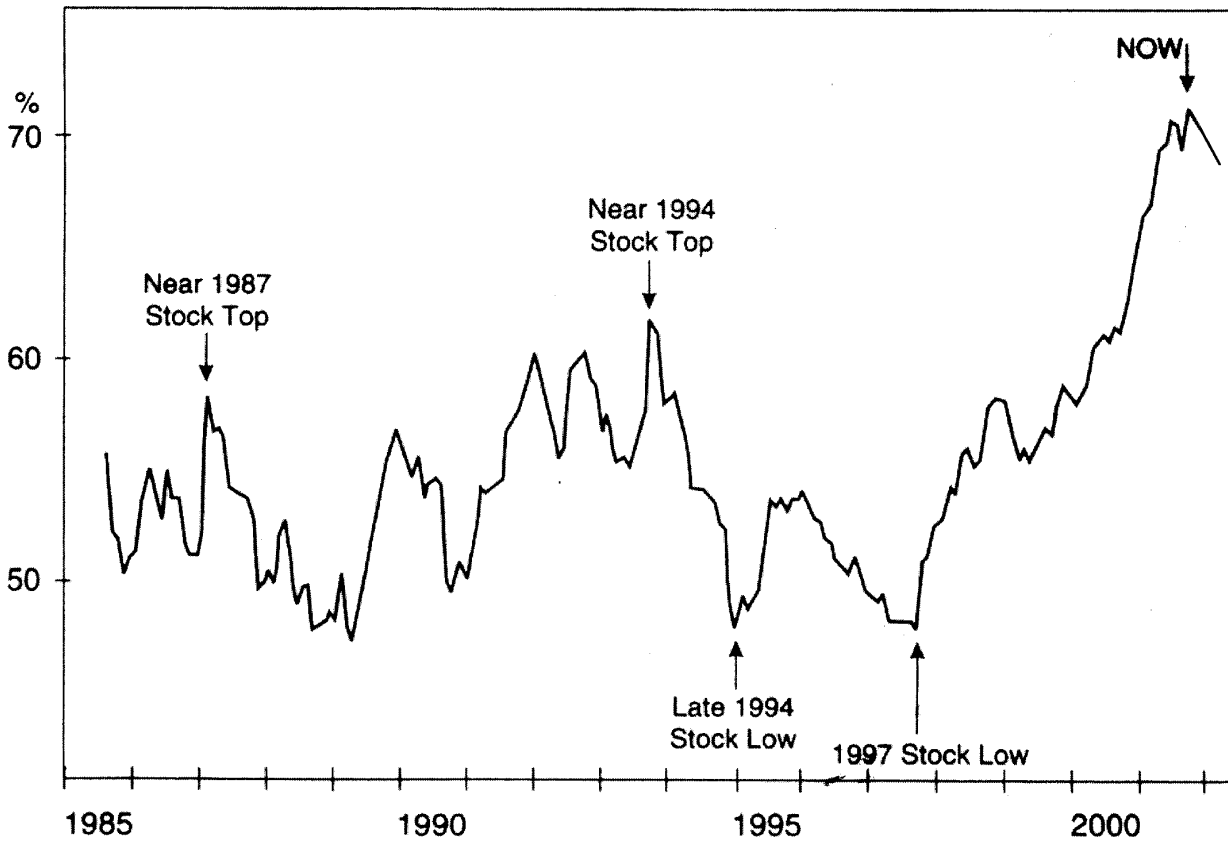
Sources: Elliott Wave International, AAA Corp. Bond Yield/S&P 500 Dividend Yield, data courtesy of Paul Montgomery

Figure 4 Percentage of Bearish Advisors (Smoothed), 2000–2003



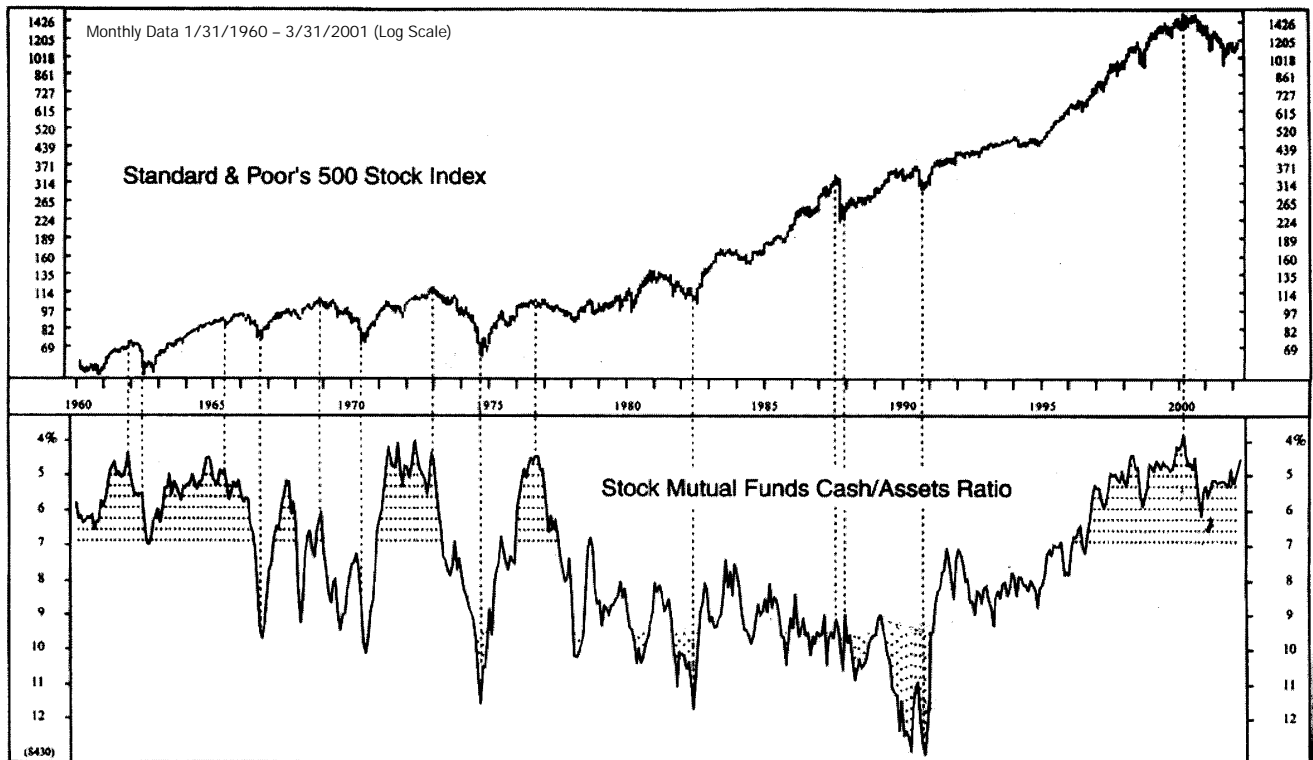
Source: Investors Intelligence

Figure 5 **Brokers' Recommended Stock-allocation Percentage, 1985–2003**



Source: *Elliott Wave International*, data courtesy of Merrill Lynch Quantitative Strategy

Figure 6 **An Indicator of Professional Psychology, 1950–2003**



Sources: Investment Company Institute, chart courtesy of Ned Davis Research

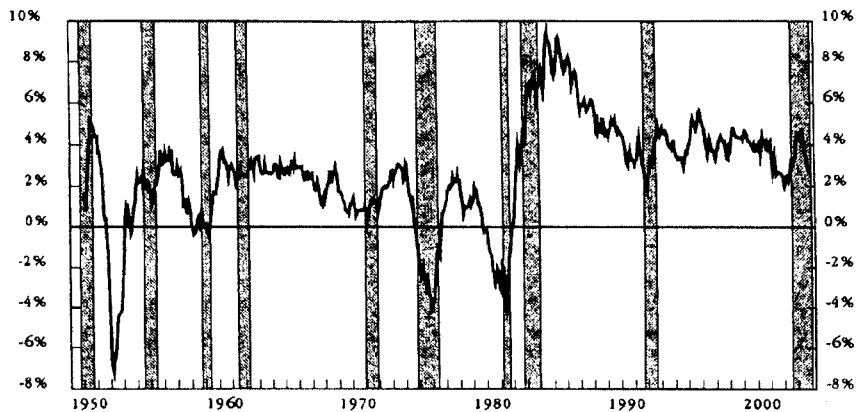
levels more reminiscent of **market tops** is clear from Investment Newsletter Sentiment, which is showing under 30% bears (see Figure 4), and from the fact that Wall Street investment strategists' recommended percentage allocation to stocks is currently at 68% (see Figure 5) and that the level of cash being held in equity mutual fund portfolios is at a measly 4.6% (see Figure 6).

If we look at long-term US government bonds from the same points of view, we find them slightly undervalued in relation to their historical relationship to inflation — that is, a “real yield” of around 2.5% versus their long-term historical average of 2% over the nine-year moving average of CPI, which currently stands at 2.46% (see Figure 7) — but bond market sentiment has reached extreme levels of optimism, which historically has occurred at bond market tops (see Figure 8). In addition, the price of gold, which has correctly forecast the trend in long-term interest rates 80% of the time since 1967, is in a strong uptrend (see Figure 9).

So, assuming that I am correct in believing both stocks and bonds to be unattractive, where does one look for satisfactory returns in a world of 1¼% money market rates and 5% long-term bonds? In one word, gold! Why gold? Because it is undervalued, under-owned, and in a strong uptrend after 20 years in the investment doghouse. Not only that, but gold has historically served as a great hedge against the kind of falling stock market and weak economy that we are likely to experience going forward.

Looking at gold's relative value, it is hard to believe it, but only 23 years ago, in January 1980, an ounce of gold and the DJIA sold at roughly the same price — that is, \$850 (see Figure 10). Over the ensuing two decades, the DJIA rose by almost 12 times to 11,000, while gold's price fell by 70% to \$250 an ounce, thereby pushing the DJIA/gold ratio up to almost 44 times in July 1999 in the midst of the technology stock mania of 1998–2000. Since then, with stocks down almost 50% on average,

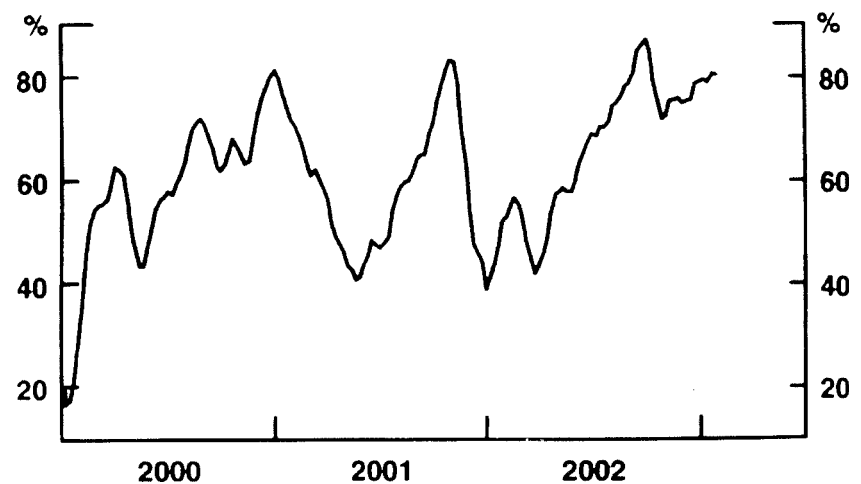
Figure 7 **Real 20-year Treasury Yield (adjusted with year/year % change CPI), 1960–2003**



Source: Federal Reserve, Bureau of Labor Statistics

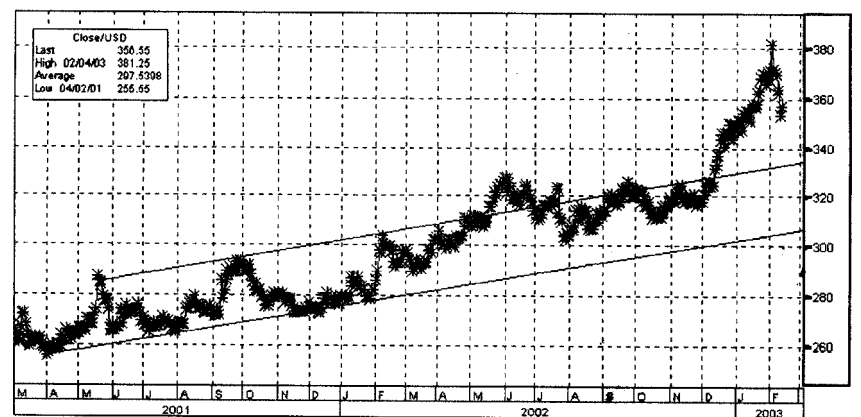
Shaded areas indicate recession

Figure 8 **Bullish Sentiment on Bonds (4-week m.a.), 2000–2003**



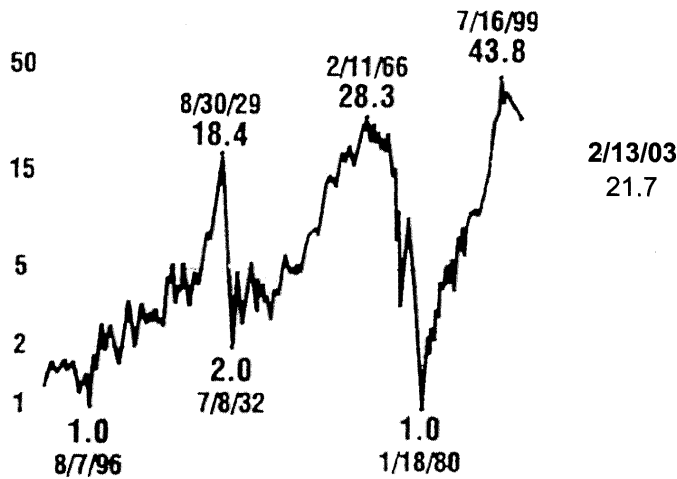
Source: Market Vane's Bullish Consensus

Figure 9 **Gold, 2001–2003**



Source: Bloomberg

Figure 10 Gold versus DJIA, 1896–2003



Source: Topline Investment Graphics

Table 1 Stock Market Reaction to Fed Easing Streaks

	Change in S&P, Months After First Easing			
	6	9	12	15
5/21	-0.8%	+4.8%	+19.8%	+24.0%
5/24	+13.8%	+26.0%	+25.3%	+32.8%
2/30	-10.8%	-29.5%	-27.6%	-40.8%
5/33	+9.9%	+28.0%	+14.2%	+7.8%
11/57	+8.3%	+18.2%	+30.1%	+35.7%
6/60	-0.8%	+12.0%	+14.6%	+17.5%
6/70	+19.1%	+31.8%	+31.9%	+31.5%
9/74	+23.0%	+35.6%	+24.3%	+30.2%
6/80	+16.5%	+16.3%	+15.5%	+3.2%
8/81	-11.7%	-10.2%	-15.4%	+6.5%
6/82	+27.0%	+38.5%	+51.7%	+52.4%
10/84	+9.6%	+16.8%	+13.0%	+26.3%
3/86	+2.6%	+7.0%	+25.9%	+29.7%
11/90	+19.9%	+23.5%	+22.4%	+30.9%
9/91	+5.2%	+5.4%	+8.1%	+12.5%
1/01	-9.8%	-19.3%	-14.4%	-16.7%
Average	+8.7%	+14.9%	+16.9%	+20.0%

Index Performance since January 3, 2001

	1/3/01	2/13/03	% Change
Fed Funds	6.50%	1.25%	-80.8%
DJIA	10,945.80	7,749.87	-29.2%
S+P 500	1,347.56	817.37	-39.3%
NASDAQ	2,616.69	1,277.44	-51.2%
Gold Spot	268.15	356.95	33.1%
Gold Stocks	50.54	138.09	173.2%

Table 2 Performance of Gold versus DJIA, 1968–2002

Year	Gold Price % Change	DJIA
1968	14.86%	4.3%
1969	-12.61%	-15.2%
1970	7.17%	4.8%
1971	16.47%	6.1%
1972	48.69%	14.6%
1973	72.24%	-16.6%
1974	66.30%	-27.6%
1975	-24.85%	38.3%
1976	-3.99%	17.9%
1977	22.41%	-17.3%
1978	37.01%	-3.2%
1979	126.55%	4.2%
1980	14.45%	14.9%
1981	-31.57%	-9.2%
1982	13.94%	19.6%
1983	-16.50%	20.3%
1984	-19.19%	-3.7%
1985	6.94%	27.7%
1986	20.41%	22.6%
1987	21.93%	2.3%
1988	-15.11%	11.9%
1989	-1.95%	27.0%
1990	-2.52%	-4.3%
1991	-10.07%	20.3%
1992	-5.63%	4.2%
1993	17.54%	13.7%
1994	-2.39%	2.1%
1995	1.19%	33.5%
1996	-4.64%	26.0%
1997	-21.44%	22.6%
1998	-0.75%	16.1%
1999	-0.25%	25.2%
2000	-5.46%	-6.2%
2001	2.46%	-7.1%
2002	24.77%	-16.8%

and gold's price having risen by over 40%, the ratio has dropped to around 22 times but is still more than twice the 11 times average of the past 100+ years and 22 times the level of 23 years ago. In other words, the price of gold could more than double and it would still be reasonably valued relative to stocks. Of course, if it went back to the levels of 1980, 1932, or 1896, it could go up by 1,000% to 2,000%.

But undervaluation is not enough in itself to make an asset class attractive. A catalyst is necessary to bring out the value. Two such catalysts are already at work.

First, we are probably somewhere in the middle of a major secular bear market and economic depression, along the lines of 1929–1932. The strongest evidence of this, in my view, is that, not only has the stock market

declined for three years in a row, but two of the years have been in the face of a string of 12 Federal Reserve Board interest rate cuts that have dropped short-term rates by 81% — that is, from 6½% to 1¼%. The only other time this has occurred in the United States was from 1929 to 1932 (see Table 1). In addition, just like in 1929–1932, when the only NYSE stock that rose in price was Homestake Mining, the best-performing equities over the past two years have been gold shares. During the 35 years since 1967 that gold has traded *freely* — its price was fixed at \$35 an ounce from 1933 through 1967 — it has normally risen when stocks have declined (see Table 2). In the major bear market of 1929–1932, the price of gold rose 69% while the DJIA lost 89% of its value. In the secular bear market of 1968–1974, as the Dow

dropped by 46%, the price of gold rocketed up by 360%.

Second, beginning in November, there has been a sudden change in US government policy, from fighting inflation to preventing deflation. If one considers the effects on the US budget deficit of the war on terrorism, the economic stimulus package recently proposed by President Bush, and the recent anti-deflation speeches by Federal Reserve Chairman Alan Greenspan and fellow Federal Governor Ben Bernanke, one must conclude that the era of the US government fighting inflation is over.

As a result of all of the reasons given above, if you want to “beat the Dow” in the current environment, do as King Ferdinand of Spain was reputed to have suggested in 1511: “Get gold”!