BUTLER, LANZ & WAGLER

For the discerning, risk-conscious investor.

May Newsletter 2013

Stocks Diverge From Reality

2013 will undoubtedly be known as the year the US stock market became completely unhinged from economic reality. This is not without precedent. It's happened many times before, in fact. However, stocks have never diverged by so much for so long a period.

There are many reasons why this has occurred, but the most obvious are as follows:

1) The Fed is printing $85 billion per month and a lion's share of the money is going into stocks.
2) Japan's recent decision to engage in mammoth quantitative easing has likely led to yen bleeding into US markets.
3) Central banks, like the Bank of Israel and the Bank of Japan, are purchasing stocks directly.
4) All central banks are crushing the interest rates on their bonds. This has forced many who would be investing in bonds, to invest in higher yielding stocks instead.

Stocks have therefore lost much, if not all, of the relationship with underlying fundamentals that supposedly drive their value. Consider the following charts.

Stocks have diverged from commodities.

Stocks have diverged from interest rates on the 10-year Treasury.

Stocks have diverged from high-yield bonds.

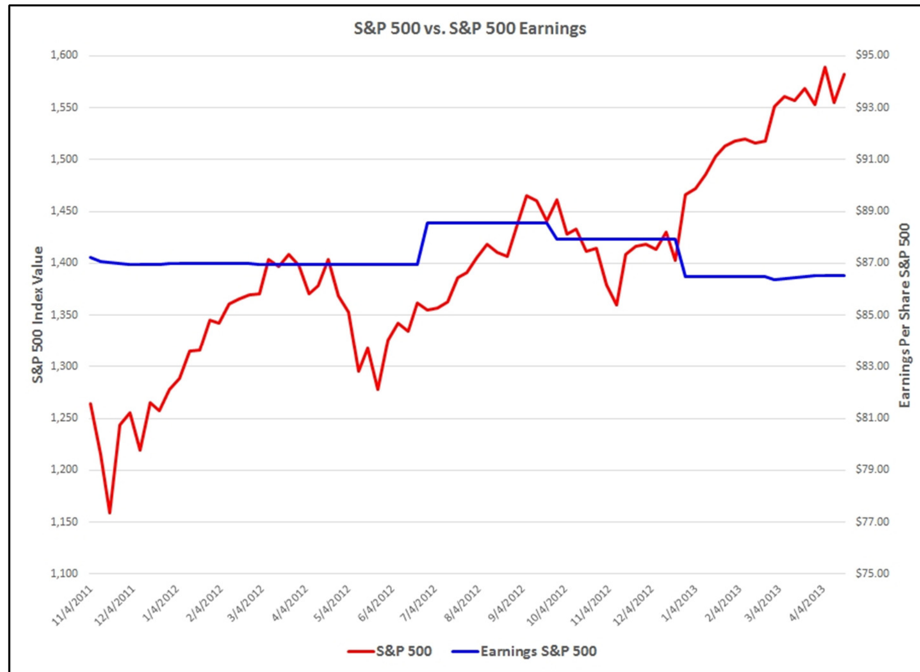
Stocks have diverged from the US dollar.

Stocks have diverged from the Dow Transports Index – which used to lead the broad market for stocks.

Stocks have diverged from the US macro-economy…in a frightening way.

In one of the more stark divergences, earnings expectations have done nothing but drop or stagnate since the beginning of the year. The stock market has done nothing but go up. Keep in mind that

"earnings" is a term Wall Street uses interchangeably with "profits." So the above chart is showing stock performance versus profit *expectations* for the S&P 500. You may rightly wonder if perhaps the expectations were too low and if the stock market actually has it right. Unfortunately, that is not the case. Actual, reported profits for the S&P 500 have been going nowhere for 18 months as the chart below indicates.



And yet, the stock market rises further. This is the most disturbing disconnect so far. If the stock market no longer reflects *expected* profit, and it no longer reflects *actual* profit, what is it reflecting? The answer seems obvious by now. Stocks are merely reflecting the monetary policies of global central banks.

Despite what many claim regarding the "cheapness" of this market, by historical standards, this stock market is neither cheap nor particularly expensive. On a price-to-peak-earnings basis, the stock market is slightly overvalued. From a pure price-to-earnings standpoint, the market is slightly undervalued. From a price-to-sales perspective, valuations are slightly elevated. **The point is, however, that this market is *significantly* overvalued relative to what the economy would dictate**. You may want to re-examine the chart on the previous page that shows the divergence between stocks and the US macro economy. Is this economy capable of growing to the extent necessary to support the revenue and profit growth expectations already embedded in stock prices? Possibly, but we would suggest that significant headwinds exist.

Eventually, and it is impossible to know when, the economy and profits must catch up to the stock market or the stock market must catch down to the economy. Until one or the other occurs, there is significantly more risk in US stocks than 18 months ago.

What's Going on With Gold?

From 6 am Friday, April 12th to midnight April 16th amidst Asian market trading, the price of gold bullion dropped from $1,564 to $1,330, or $234 an ounce. That's an amazing 15% two-day drop. Statisticians would call this two-day drop a "seven-sigma" event. In other words, the move was seven standard deviations greater than the average two-day price move. Or, we can expect this kind of two-day move once every 390,682,215,445 two-day periods. We should see this kind of move once every 534 million years. Or, looked at another way, there is a better chance that you are 7'7" tall than that there be a 15%

two-day drop in the price of gold. Still, we saw a similar two-day price move in gold in the early 1980s. Without getting into probability theory, we cannot conclude that the price move in gold is as rare as the statistics suggest, but we acknowledge it is a very rare event indeed.

What's interesting about the recent plunge in the price of gold is that there seems to be no shortage of diverse opinions as to *why* it occurred. If we want to know what to expect going forward for the shiny yellow metal, we should understand why it sold off in the first place.

And before we can examine the reasons for the gold sell-off, we must acknowledge that the varying opinions as to the cause are based on an equal number of varying opinions on what gold actually is. Yes, we all know it's a shiny yellow metal that can be found in a good deal of the jewelry that exists in the world. And we all know that gold has been the most prominent store of wealth for the better part of human history. Everyone can agree on that. What seems to be confusing is determining the investment characteristics of the metal. In other words, why would anyone want to hold gold as an investment in their portfolio?

Generally, when people explain the investment purpose of gold, their logic falls in one or more of the following categories:

1) Gold is a hedge against inflation
2) Gold is a hedge against fiat currency risk
3) Gold is a hedge against geopolitical risk

Let's look at each of these in detail.

Gold as a hedge against inflation. There is a pervasive feeling that gold rises in times of inflation and falls in times of disinflation and outright deflation. Many who hold this belief have been waiting for the "great inflation" that was sure to come as a result of the obscene levels of money-printing the Fed has engaged in since the early 2000s. We'll talk more about this later.

Gold as a hedge against currency risk. There is a strong negative correlation between the value of the US dollar and the price of gold. As the Fed increases the supply of dollars, and assuming a constant demand for them, its value must go down. Investors find that their dollars buy fewer goods and services than they used to. To hedge themselves against the drop in purchasing power of their dollars, they buy gold. Gold, priced in those same devalued dollars, should appreciate. It's important to note that, while this may sound quite a bit like the inflation hedge explanation above (a falling dollar is sometimes equated to broad price inflation), a falling dollar is not always accompanied by rising price inflation across the broad economy. For example, sometimes the only inflationary impact of money-printing is in the stock market, or other asset markets.

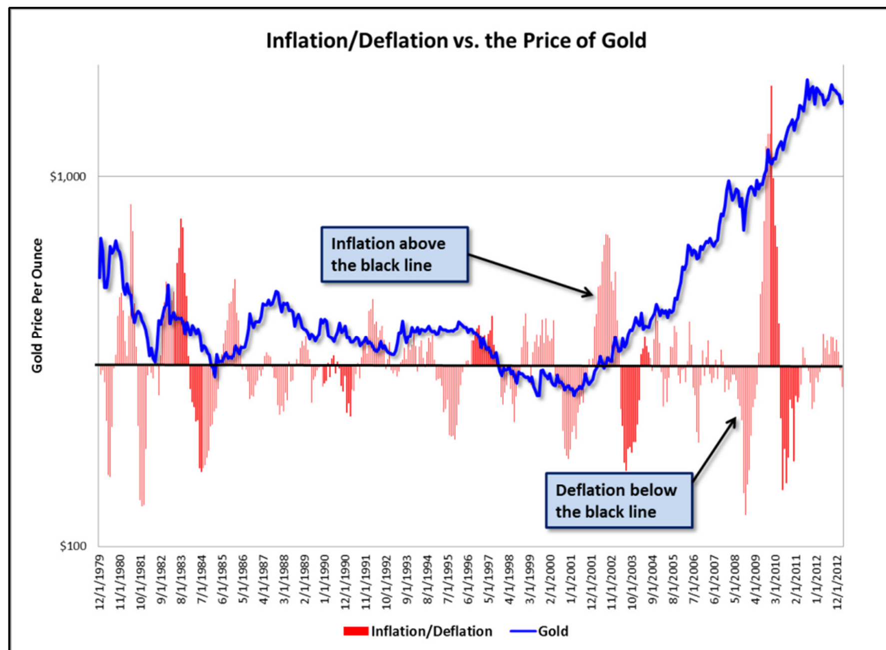
Gold as a hedge against geopolitical risk. This camp includes a subset known as "doomers," but not everyone who hedges against geopolitical risk with gold is of the belief that the apocalypse is right around the corner. Most simply believe that, as geopolitical risks manifest into crises, trust and confidence in a nation's fiat currency will erode as fear levels escalate. This is intuitive because a fiat currency - a currency which derives its "legal tender" status by decree of the State - derives its value from the trust the people using it have in the people who issue it. Issuing a fiat currency is a confidence game and when people lose their confidence in that currency, its value falls. Hard money like gold and

silver may become the only passable currency in such situations, or so the theory goes. This feeling is particularly prevalent in countries with weak governments.

The truth of the matter is that gold valuation as an investment is not physics. There are no universal laws that govern its price behavior. Different investors use different methods to gauge value in gold and different investors hold it for varying reasons. In other words, gold's intrinsic value is subjective. Each of the three camps above has elements of truth and, unfortunately, each has some problems if the core beliefs are held dogmatically. Again, gold valuation is not physics. No universal laws apply.

Now that we've identified the three main reasons people seek to hold gold in their portfolios, we should be able to easily identify the source of the precious metals sell-off in mid-April. We must simply find which of the above three fundamental reasons for holding gold changed over the past several weeks or months.

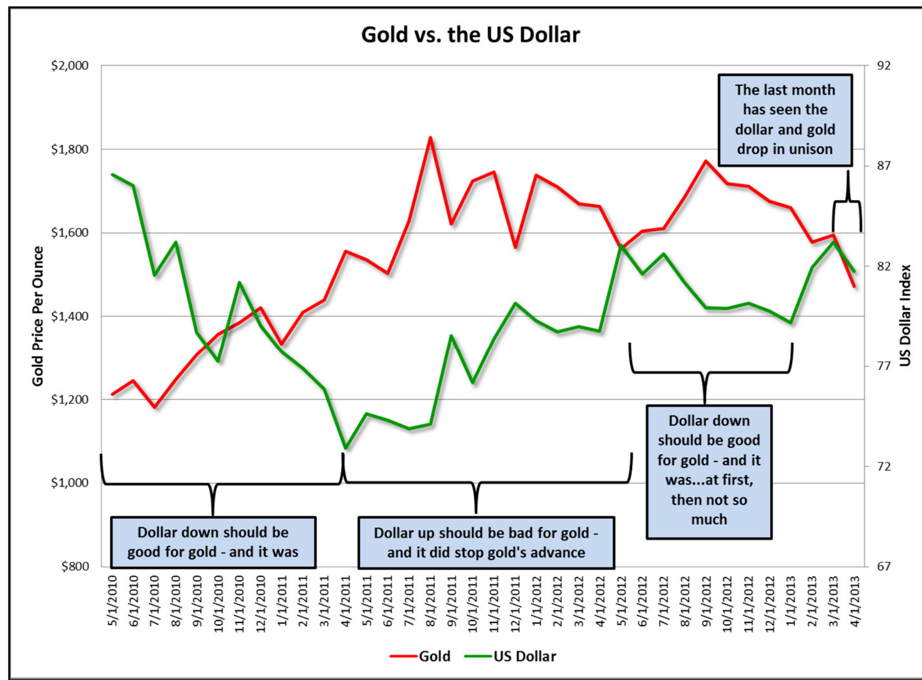
Did the inflation outlook change? Yes. But as the chart below shows, gold performs well in inflationary regimes, but not necessarily all of them.



1991 to 1992 is a good example. 1996 to 1997 is another. The early 1980s had bouts of inflationary panic and the price of gold only participated marginally in response. In fact, a statistical technique known as a "correlation study" shows only a weakly positive relationship between inflationary pressures and the price of gold.

The chart also shows periods of gold price advances coupled with *de*flationary pressures, such as 2002 to 2003 and 2010 to 2011. The evidence suggest that only extreme inflationary pressures are highly correlated to gold and that the metal can advance in the face of deflation. Gold has never been a consistently adequate hedge against inflation and the gold market understands this. Gold has been, however, an adequate hedge against *extreme* inflation. Unfortunately for those that have used gold as a hedge against extreme price inflation, the US has not had to deal with high and increasing inflation expectations since the end of the 1970s.

It is therefore unlikely that a change in inflation expectations had much to do with the sell-off, although it may well have contributed to the magnitude of the fall.



What about those that hold the view that gold is a hedge against dollar devaluation? Did people suddenly expect the value of the dollar to go through the roof? It's hard to imagine such a scenario, though, when one considers what the dollar has done versus gold over the last several years.

While this reasonably strong negative correlation between the value of the US dollar and gold has held for multiple decades, it has not been particularly strong since September of 2012. Many pundits have commented that the sell-off in gold was a result of the "strength in the dollar" recently. This argument falls apart when you look at the chart. The dollar has actually dropped 1.6% since May of 2012, yet gold is down 6.4%. Since a pretty stable, long-lived, negative correlation between the US dollar and gold has fallen apart recently, the price movements of the dollar are not likely the cause of the recent sell-off in gold.

What about the use of gold as a hedge against geopolitical risk? Has the world suddenly become void of all risk? Are people now more willing to get along in a way not seen since the dawn of mankind? That's unlikely. Just a casual perusal of the headlines recently, we find:

1) Europe's debt and recession have forced many countries to openly suggest leaving the euro.
2) Terrorism has not been eradicated as evidenced by the Boston Marathon bombing.
3) Threats of the use of military force against the US have come from the leader of North Korea.
4) Tensions are building over contested islands and trade wars between Japan and China.
5) The onset of a global currency war.

Without sounding hysterical, it is clear there is still plenty to worry about. The argument that "things are getting better" may apply to specific regions of the world, but it does not apply globally.

In short, the primary beliefs for holding gold have probably not been reversed. A fall in inflationary expectations did not cause the sell-off because gold has never been a particularly consistent hedge against price inflation. It's performed well in periods of inflation *and* deflation. It's also performed poorly in each type of price regime. A strong dollar did not do the gold market in, because we have not had a "strong dollar". In fact the failure of the relationship between gold and the US dollar should indicate something else is amiss. Finally, it shocks the imagination to suggest people no longer want to hold gold because there has been a reduction or elimination in geopolitical risks.

The Value of Gold

It has also been proffered recently that gold was in a "bubble" and it had to pop, as all bubbles eventually do. Let's address this idea by first asking a question. What is a bubble? The word "bubble," when used to describe a significant upward move in an asset price, is probably overused, largely misunderstood, and unfortunately, highly subjective. Like beauty, bubble-like growth rates are in the eye of the beholder (or analyst). We prefer to define an asset price bubble, whether we're analyzing the stock market, bonds, gold or tulips, as a significant deviation between an asset's price and its fundamentals.

Often times, getting at the fundamentals of an asset involves comparing one or more of the asset's metrics with that of other assets and/or comparing them to that metric's own history. For example, if we believe that the price paid for a stock, relative to every dollar of that company's annual profit (known as the price-to-earnings ratio, or "PE" for short), is an accurate measure of a company's true economic value, we may want to compare the company's PE to the PEs of other similar companies. Or, we may want to know what kind of PE the stock has traded at in the past. Chances are, we'd want to look at both so that we can determine more accurately whether the stock is over- or under-valued.

We can use similar valuation measures for bonds. And, by comparing the yield of both stocks and bonds, we can determine which is of greater value. Unfortunately, gold does not make a profit so we cannot compute a PE. Gold does not pay a dividend or interest, so it does not have a yield to compare to other assets.

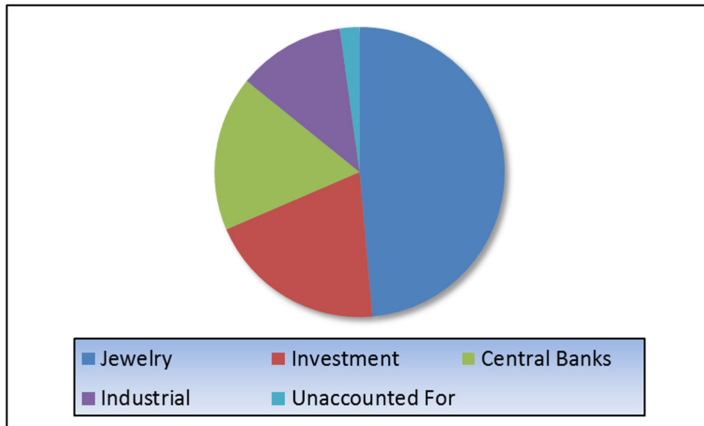
So how can we even attempt to determine the "fair value" of gold? This is a good question. It's easily answered but impossible to compute. The fair value of gold is the answer to this question when posed to every owner of gold, whether in paper (gold futures and gold exchange traded funds), or physical gold (like bars, coins and jewelry): **"How much would I have to pay you to part with an ounce of your gold?"**

Like we said, that's impossible to compute. But the concept is critical in understanding gold, as this particular difficulty is unique to the shiny precious metals. Other assets pay dividends, interest, or represent a claim on financial profit. Other commodities (and gold *is* a commodity) require significant storage space and cost to keep for a lengthy period of time. There is no other commodity that has the value per ounce that precious metals do. Therefore, precious metals require much less storage space and cost to store for an extended period of time. In addition, unlike other commodities (like feeder cattle, corn and copper) gold is not consumed, per se'. More pointedly, gold is not usually destroyed by consumption. To consume gold is to buy it and keep it. Someone, somewhere, is holding almost every ounce of gold ever mined.

So what does this mean in terms of valuing gold? It means that gold, unlike other assets, has a bifurcated market. **Gold has an exchange market, dominated by speculators, and a saver's market, dominated by coin collectors, jewelry enthusiasts and bullion buyers**.

According to the World Gold Council, 174,100 ounces of gold have been mined since man first discovered the metal. We add 1.7% to that stock every year through mining operations. In other words, we pull about 2,960 ounces out of the ground every year.

Why is this important? Because unlike other asset markets, like stocks, there is a significant portion of the gold market that has no intention of selling its gold 99.9% of the time. They don't hold gold as an investment. They hold it for the enjoyment of collecting certain coins, to adorn themselves or for financial protection. The following charts are critical to understanding the gold market:

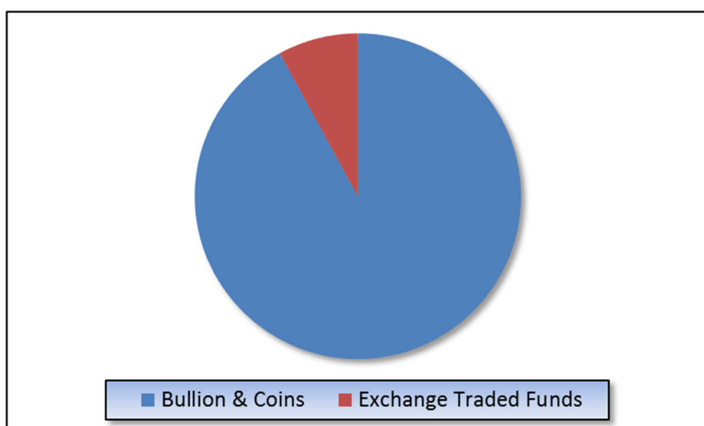


Let's first consider who holds the total stock of above-ground gold currently (see chart to the left). The holders of jewelry (49% of the total) tend to hold it long term. Gold jewelry is not bought today and sold in three years because the price of the piece appreciated. Jewelry owners tend to be passive holders of that gold.

Central banks own 17% of the world's gold. If we are to believe the official statistics, they are also mainly passive. However, for every story one hears about a central bank selling gold, we hear that other central banks are buying. For example, Russia and China have made it no secret that they are actively looking to increase their holdings of gold. It is true that from time to time, a central bank announces its intention to sell some gold. This is rare, however. Central banks are generally passive holders of gold. At the very least, central banks are not buying gold on the dips only to sell it at a profit six months later. They do not speculate, as there are other reasons why a central bank would hold gold, primary among them, the need to diversify their reserves away from foreign fiat currencies.

About 12% of all above-ground gold has been used for industrial purposes such as dentistry, electronics, computers, aerospace and medical. A tiny bit of the metal is actually lost in these processes, but just a little. Much of the 2% in the "unaccounted for" category is probably due to these losses. Clearly, those that engage in the industrial processes that require gold are not doing so for any investment purpose whatsoever.

That leaves the "investment" category. "Investors" own 20% of the world's gold. Suffice it to say that some of this gold is subject to the whim of speculators and some of it is not. We should break out the "investors" category further to make the point:

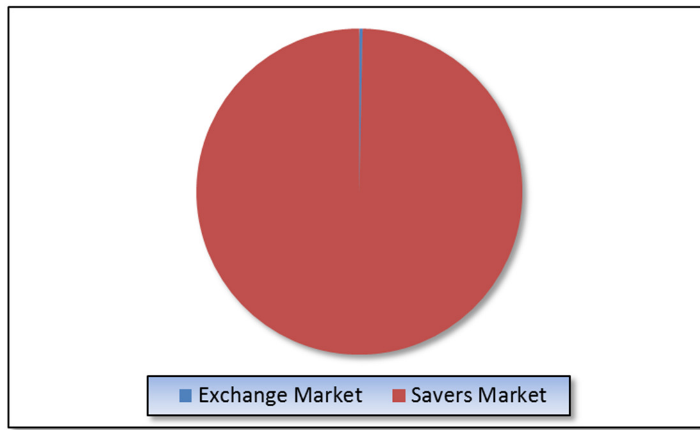


The chart to the left shows that less than 8% of the "investment" category is exchange traded funds (ETFs), the preferred trading vehicle for speculation in gold. The remaining 92%+ of the category is those that invest in bullion and gold coins. People that invest in bullion are looking for protection from something - whether that's inflation, Armageddon, an overzealous government, or an increasingly worthless fiat currency. They

are not likely to be quick-triggered sellers of that protection.

Those who own gold coins have done so for a variety of reasons, ranging from protection to the sheer enjoyment of collecting to establishing a pool of assets that can be gifted to loved ones in life or in death. Again, these people are not looking to speculate on the price of gold with these coins.

If we get back to the gold market bifurcation, we can see that the 49% of gold in the hands of jewelry owners is not actively engaged in gold trading. We see that 12% of the world's gold is in the hands of commercial interests who use the metal in manufacturing a number of goods. They are not at all interested in trading gold. The 2% of the above-ground gold that is unaccounted for is not likely held by any person who is in a position to sell it. Most of the time, central banks are holding their 17% for diversification purposes and the price of gold matters not one bit to that end. They do occasionally sell gold, but profit is not the reason the metal is held.



That leaves the "investor" category - made up 92% of passive collectors and protection-seekers and 8% true speculators. That 8% of the investment category is a mere 1.58% of the above-ground total stock of gold. Even if we add the freshly mined gold annually to the speculative category, that still accounts for only 3.23% of the total above-ground stock (note the disparity in the chart to the left).

Speculators dominate the exchange market. Every other category is in the savers market. **Here is the critical point: most of the time, despite its relatively tiny size, the speculators' market sets the price of gold!** The much larger savers market will react to that price, if they react at all, and occasionally even influence the exchange market price. Knowing this, gold experts shouldn't have been surprised to learn that since the price of gold hit $1,330 overnight on the 16th of April, the following has transpired:

1) Shortages have been reported by dealers in gold and silver coins globally.
2) Swiss refineries are struggling with dramatically increased global demand for their refined gold bars.
3) Gold dealer Robert Mish reports strong demand for physical gold with buyers outpacing sellers 5 to 1 since the gold sell-off. Gold coins now command a higher premium than normal and delivery times are 2 to 3 weeks out as inventories are depleted.
4) Fearing Yen devaluation by the Bank of Japan, the Japanese are on pace to be a net buyer of gold for the first time in 8 years.
5) According to the Financial Times, Haywood Cheung, president of the Hong Kong Gold & Silver Exchange, the exchange had "effectively run out of most of its holdings," and had not "seen this gold rush for over 20 years."
6) The world's largest jeweler (Hong Kong based Chow Tai Fook) confirmed that it had run out of gold bars.

7) The US Mint (commonly believed to be gold buyers' last option) ran out of 1/10 ounce American Eagle gold coins as supply was overwhelmed by demand. By the end of April, the mint had set a monthly record for gold ounces sold.
8) The United Kingdom Mint, one week after the gold sell-off, reported they were on pace to double the previous month's total gold coin sales.
9) Standard Chartered Plc said on April 23 that its gold shipments to India in the week prior exceed the previous weekly record by 20%. And India has tried to restrict gold imports by imposing a 6% tax on those imports. It had been 3% up until late 2012.

This is just a smattering of anecdotal evidence to suggest that while the exchange market sold off, the savers market reacted to the lower price of gold and silver as if it were a discount. There is a temporary physical gold shortage. While the exchange market sets the price of gold on a daily basis, the savers market can set the price from time to time.

All of this leads us back to the place where we started. If we want an accurate "fair value" price for gold, we should ask the holders of the gold in the savers market, **"How much would I have to pay you per ounce of gold to get you to sell me an ounce?"** The market for physical gold has given us a partial answer: more than the $1,330 that the exchange market drove it down to. The savers market thought $1,330 was a bargain.

Attempts at "Fair Value"

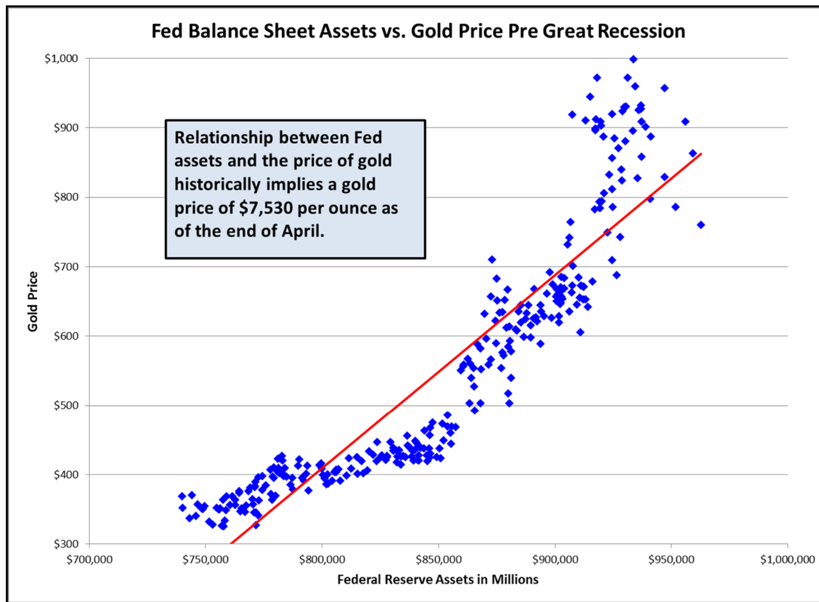
Make no mistake – the best way to ascertain gold's fair value would be to ask every gold saver how much it would take to get them to part with their gold. Unfortunately, we cannot do this. We don't even know who these savers are. We can much more easily determine gold's fair value in the exchange market and simply assume the real fair value – that determined by the much larger savers' market – is significantly higher.

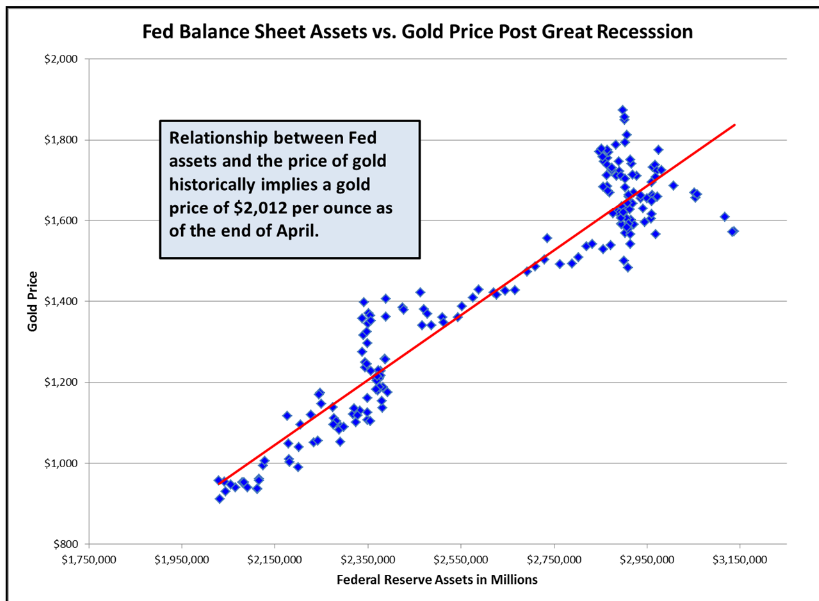
One way to get an idea of gold's exchange market fair value – if one believes that gold is the opposite of fiat currency – is to simply look at the historic relationship between the money supply and gold prices. If we do this, we need only go back to August 15, 1971 when President Nixon took the US off of the gold standard completely.

According to the historically positive correlation between money supply and the price of gold, the current $9.5 trillion supply of fiat money in the system ***implies a value of gold of roughly $1,435***. As of the end of April, gold was trading at $1,472.20, which means gold is 2.59% *over*valued.

We can also compare the historical price of gold to the assets held by the Federal Reserve (mainly US Treasury securities). This is just another way of getting at the exchange market fair value by assuming gold is the exact opposite of the fiat currency issued by the US Treasury. That assumption, by the way, is based on the fact that gold has value because the free market says it does, while a fiat currency has value because a government says it must. When the Fed buys assets, it creates fiat currency out of thin air to pay for them. People seek safety from currency devaluation by buying gold, among other assets.

The first chart below shows a very high degree of correlation between the value of Fed-owned assets and the price of gold. It also ***implies a gold price of $7,530***. That may be a little high. The data went up to the onset of the Great Recession.





The second chart covers the time period after the official end of the Great Recession (June 2009) to present.

One can see a similarly strong linear correlation between the amount of assets of the Fed and the price of gold. However, this data ***suggests a price of gold of just over $2,000 per ounce***. That's more realistic. A simple average of the three implied prices results in a per-ounce price $3,659.

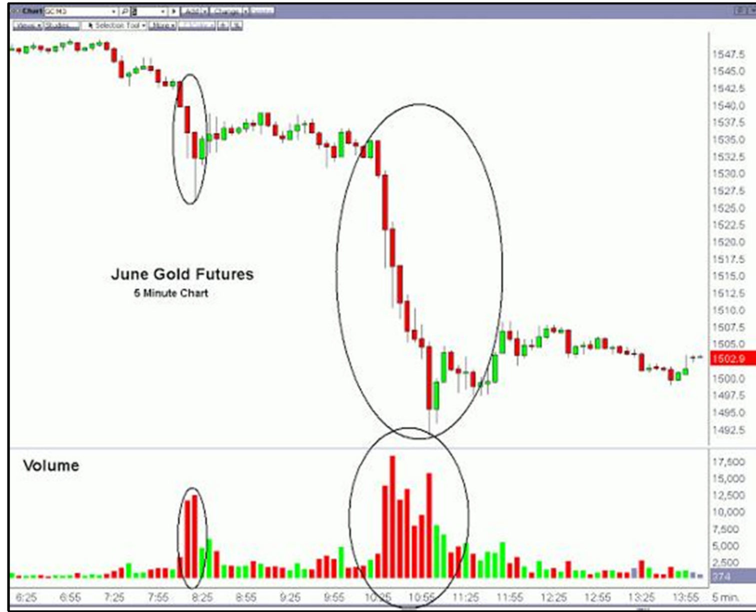
Again, it would be best to obtain gold's fair value by asking the savers of gold what their lowest parting price would be. Absent that, all we can do is look at what past relationships would tell us about the exchange price. And at that price - an average of $3,659 per ounce - gold is undervalued at $1,472.

One may be wondering how gold crashed from a mid-April 2013 price of $1,600, which was already $2,000 below our fair value estimate. In other words, how does gold crash when it's already trading at a price significantly below fair value? That's a great question. There are three potential answers:

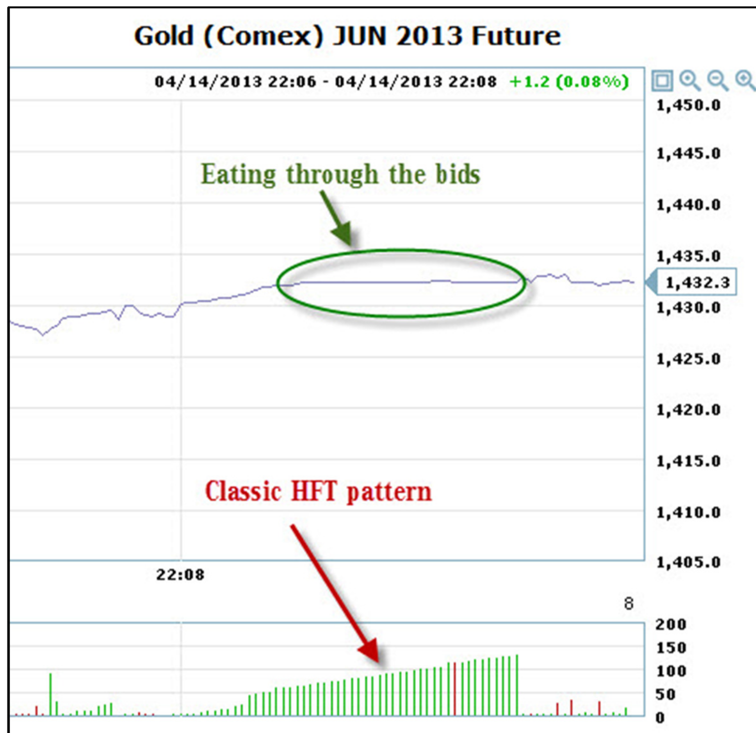
1) Normal portfolio reallocations. Many professional and institutional investors have said that they sold significant portions of their gold over the past several months for a variety of reasons. One reason often cited is that "stocks were a greater value." Many added that they thought the US economy was about to go into vertical growth mode. How they came to that conclusion still eludes us, but clearly, if that is your belief, perhaps stocks are a better bet.
2) The Fed does not like gold. Keynesians do not like gold. We have many Keynesians in Washington, D.C., most of them at the Treasury and Fed. They do not want you in gold. The Fed does not want you in bonds, so they have kept interest rates very low. They want you to take risk. They hope that forcing you to take risk will get the economy going again. For the same reason, they do not want you in a non-productive asset like gold. Therefore, many have

theorized the bulk of the sell-off in gold was orchestrated by the Fed. We have no evidence to suggest this, although they would be well within their rights to sell gold. Clearly, the sheer amount of gold sold on Monday, April 15th was not the work of any one individual.

No ordinary citizen can bear the risk of selling 400 tonnes of gold. That's $20 billion worth of gold. Further, as the chart below shows, over the span of minutes, a huge amount of selling was entered on the COMEX between 10:25 and 10:55 ET.



So we know the seller (or sellers) did not care about price. Somebody dumped a bunch of contracts seemingly with the purpose of driving the price lower. If the seller wanted to maximize profit, he or she would have done so in such a stealthy manner that nobody would be able to tell any selling was going on at all. That's what professional traders do. Instead, the seller left an obvious elephant-sized foot print on the market, assuring that he would get the worst possible pricing on his orders. Again, that seems as if it were the plan all along.

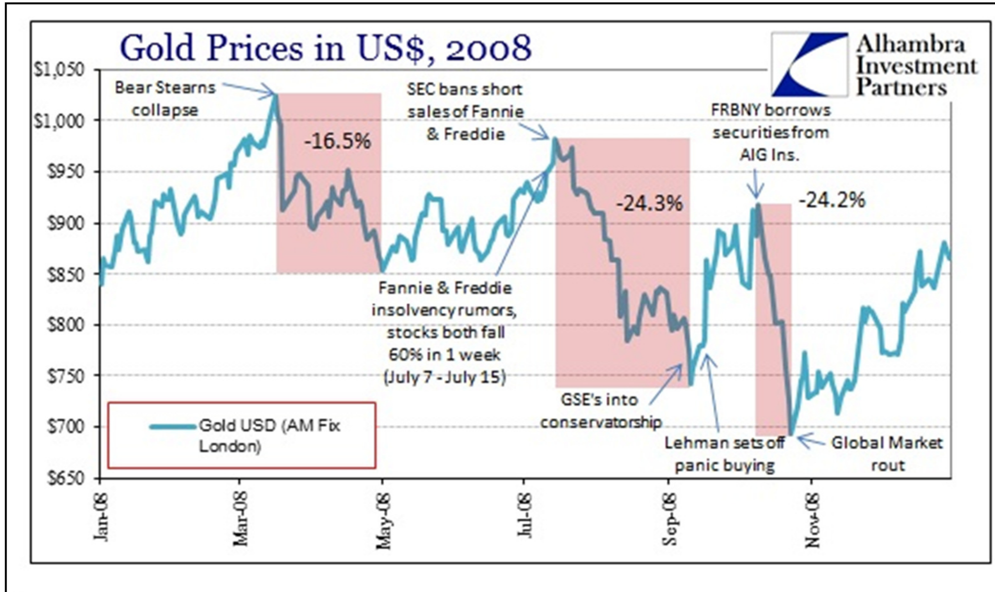


Chris Martenson has also proffered an opinion that some very deep pockets were at play as evidenced by the chart below taken from Sunday night the 14th.

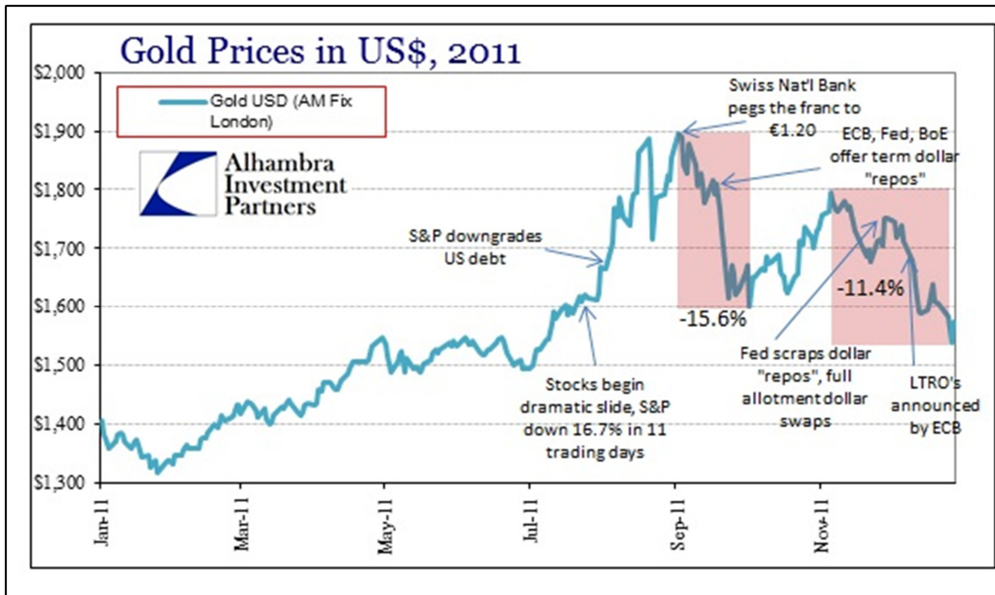
It looks like a classic High Frequency Trading (HFT) pattern, easily discernible from "human" trading. This set up the weakness in the market seen on Monday morning. Again, there is no proof, but it would not be shocking to find that a central bank somewhere had a role in the sell-off.

3) We think the most likely explanation is that a bank (or more than one) was experiencing a collateral shortage. In the past, when funding for collateral between banks has reached crisis levels, gold has sold off in the exchange market, but has actually nothing to do with the investment attractiveness of the metal. This is because when some bank needs gold, it is leased to them by someone who already owns it. This appears as gold selling. Analyst Jeffrey

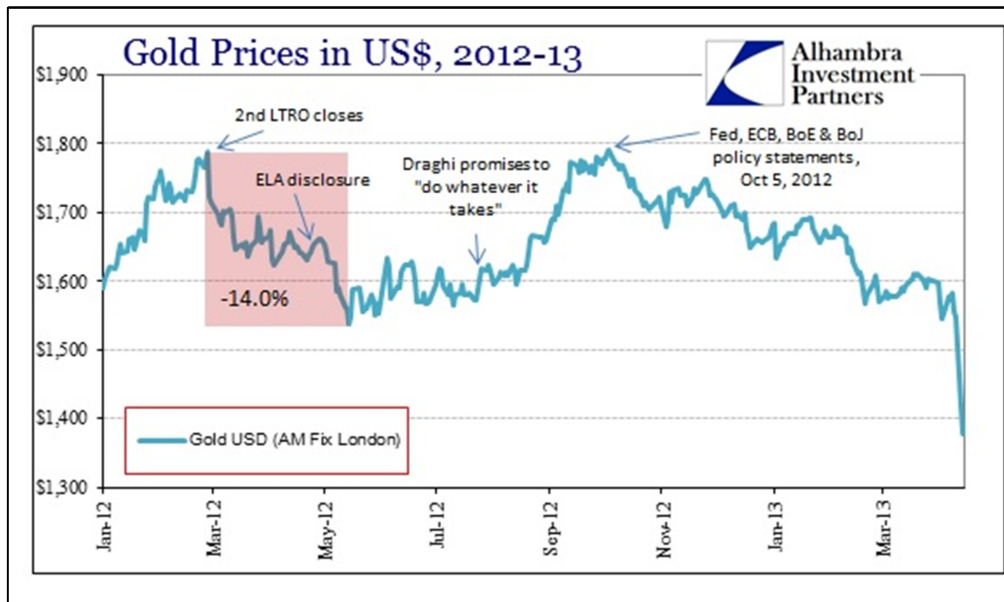
P. Snider makes a very compelling case showing that every time there was a collateral run in the 2008 crisis, gold appeared to sell off. Once the crisis was contained, the gold price recovered. We should point out that Treasuries are the most popular form of interbank collateral. But with the aggressive quantitative easing program of the Fed, Treasuries are being removed from the system. This leads to periodic crises in collateral chains, and as has happened over the last five years, it forces banks to use gold as collateral more often than it once did. Gold's response to these collateral crises can first be seen in the heart of the financial crisis in 2008:



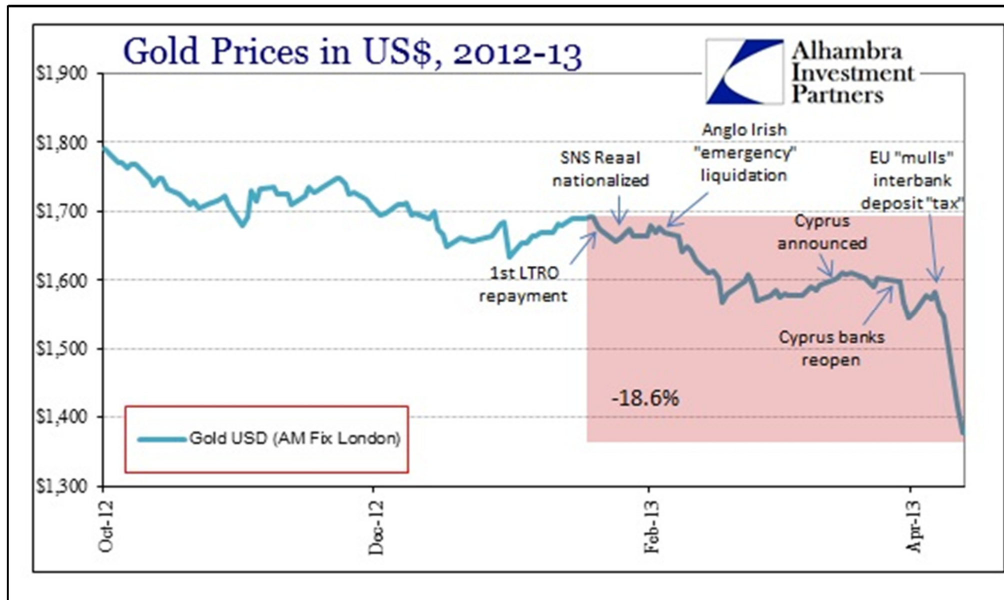
It happened again in 2011:



And again in 2012:



And, not coincidentally, it appears to have happened again in 2013:



We may never know if an interbank collateral crisis was occurring in mid-April, but certainly the EU "mulling" an interbank deposit tax may have sent some banks scrambling for cover. Whether the sell-off was concerted central bank-led monetary policy or an interbank collateral "event," what we do know is that the market is being periodically attacked by heavy paper selling (gold ETFs and futures) in a brief period of time, often with no particularly bearish news.

But make no mistake about it - outside these concentrated selling attacks on the price of gold, the mood is still bearish in professional and institutional investment camps. They do honestly believe that there is nothing particularly weak about the current economic recovery and expect US stocks to perform well - not because of excessive Fed intervention - but because US companies have exceedingly bright growth prospects. We wonder if those folks know that as of the end of the day May 6, 414 of the 500 stocks

I think this is a Typo

that comprise the S&P 500 had reported first quarter 2013 results. 72% had beaten their already downwardly revised profit estimates. But only 47% had beaten their revenue estimates. Revenues at S&P 500 firms have grown at a rate of -1.5% over first quarter 2012. That's a negative revenue growth rate. People are buying less stuff. But firms can still generate profits by cutting costs. That usually means labor. And if we continue to cut labor, or simply refuse to hire additional labor, who is going to buy all of the stuff that these companies are selling?