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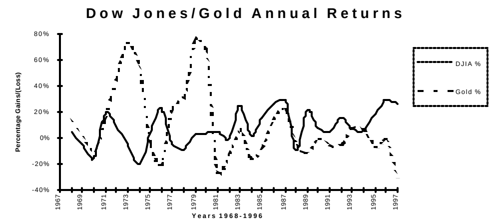
# Gold




# & Technology Stocks

**Volume 24 No. 2** ***(Now in our 23rd Year)*** **Feb 10, 2005**

# Why You Should Own Gold & Dollars
## Market Historian & Analyst Bob Hoye Explains

***Bob Hoye, Institutional Advisors***

Bob Hoye is chief investment strategist for Institutional Advisors, a firm he founded and which provides research to financial institutions, mining, and petroleum companies in a number of countries. The basic model integrates the behavior of the stock markets, credit spreads, the yield curve, and industrial commodities through what Bob considers as yet another new financial era, its usual dramatic climax, and consequent contraction.

The approach used by Bob and his associates anticipated the significant trend changes—usually with enough time to determine and implement policy. The models used by Mr. Hoye are supplemented by proprietary technical analysis that is used by stock, bond, and metal trading desks that pay a healthy fee for this group's unique vision of world markets and uncanny market forecasts.

Given the success of Institutional Advisors in making some very key market calls over the past two or three decades, the original conclusion that Bob's thorough research would provide a most reliable guide for market participants through new financial eras has been confirmed. For that reason alone, you need to listen to what Mr. Hoye has to say. But I have been attracted to Bob's work because of his unique deflationary research, which covered all significant inflations and consequent deflations. While his approach to markets is from a very different angle than the approach taken by Ian Gordon, who is frequently mentioned in these pages, and different from other deflationist thinkers that I revere, like Professor Emeritus–Memorial University of Newfoundland and of course former central banker, John Exter, I am struck by the fact that the unique views of these men are highly compatible with one another. Next month we expect to explore the views of another deflationist, namely Robert Prechter, who will provide yet another vision of an impending depression-induced return to monetary reality.

But for now, we present the very unique and "spot-on" views of Bob Hoye. He along with Professor Fekete was quite instrumental in your editor's February 5 decision to turn bullish on the Lehman Brothers 20+ U.S. Treasury Year ETF (symbol TLT). While in Vancouver a few weeks ago for the Cambridge House Resource Conference, I had the pleasure of dining with Bob. It was a most enjoyable 2+ hours of time as he covered a vast expanse of economic history. By the way, for a "Dining with Bob" experience of your own, let me suggest you click on the following link: http://www.institutionaladvisors.com/media-11-18-00.htm. Here "Financial Post" columnist William Hanley describes a lunchtime conversation with Mr. Hoye. The title of that article is: "Market in an Awful Stew? At the Teahouse, Bob Hoye Sees Red for Danger." When I visited with Bob in Vancouver, he insisted that an accurate study of history can only lead to the conclusion that major bubbles like the one we are now in the process of working our way out of, are always concluded with deflation, not inflation. It is deflation, not inflation, that leads to the loss of control by the ruling elite when the mathematics of an exponential rise in debt simply overwhelm the ability of central bankers to inflate any further. I found Bob's insights to be very valuable, and I trust you will, too. After you finish reading my interview with Bob, click on the link above for more on his remarkable track record.

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**TAYLOR**: Bob, I know that you provide a service for institutional clients that is quite expensive. Do you serve retail investors as well or only the professional investor?

**HOYE**: We got our start in the 1970s when the metals' side of the research was retained by two big mining companies. With the prospect of yet another "New Financial Era," in January 1982 we started an advisory letter for certified investment officers (CIOs) as well as equity and fixed income portfolio managers. Due to growing inquiry in 2000, we initiated a service for high-net-worth individuals. Beyond subscribers with a long-term view, our research is used by stock, bond, and metal trading desks.

**TAYLOR**: Tell us more about your background and how you got started with mining and oil companies.

**HOYE**: Originally, I took a degree in geophysics, which got me into mining exploration work. When I graduated, I began working on what turned out to be the hot mining play of the day. I didn't have much money, but I bought some stock at $1.18. When it went up to $5.25 I got out. Eventually it became quite a darling in Canada, as it soared to $7.50.

**TAYLOR**: Which discovery was that?

**HOYE**: Western Mines, and it was a producer for 25 years. But the big mistake is to make money on your first stock. You think, "This is easy." But then I started with the premier investment dealer in Canada—on the trading desk and in research as an assistant mining analyst. Eventually I got into institutional stock and bond sales. Then in 1974, I went off on my own and did all of the historical research on markets. At the time it was quite original, and it led to our forecasting models.

**TAYLOR**: I note that you very accurately called the stock market bottom in 2002. What prompted you to make that call?

**HOYE**: That was really in the hands of colleague Ross Clark who writes the "ChartWorks" letter. At the end of 1999 when the stock market was really building up to a frenzy, he came up with what we call the "Post Euphoria Model." We looked back at previous examples of great excitement, such as the stock market in 1929, gold in 1980, and the Nikkei in 1989. There were certain similarities to those as they peaked and as they broke and then as they collapsed. So that is what we started using. Now using that model, we ended up with an important low about 30-some-odd months later. That worked out to October 2002. Beginning in August, our "ChartWorks" page started to emphasize that we were looking for stocks and corporate bonds to bottom out by late in the year. And then in late September, Ross started to get what we call capitulation readings in his proprietary model. You never know whether one of those is going to last one or two weeks, but in early October 2002, we got the buy.

What we looked for then was a cyclical recovery in business and a cyclical bull market in stocks until it ran out. Well, it looks like it ran out late in 2004 and is in the process of topping now. As we all know, the market has been rather heavy since the first of the year. In the first week of December we started to look at the probability of a turn-of-the-year high. You had all those speculations, all against the weakening dollar. And you also had narrowing credit spreads, so we thought that would all culminate in the turn-of-the-year window. There has been a history of major speculations terminating at the turn of the year, such as gold and silver in 1980 and the Nikkei in 1989.

So that's how we got the '02 bottom and the '04 top.

**TAYLOR**: What do you think accounts for the end-of-the-year peaks? Do you have a theory?

**HOYE**: When the major patterns recur so regularly, there is little point in pondering the "whys."

**TAYLOR**: So what did you see here that said we are at a top? If I turn on CNBC I hear a constant drumbeat that the good times are just getting underway again. What was it that convinced you?

**HOYE**: Sentiment figures in December were at record highs on the stock market with an exceptional low at only 5% bulls on the dollar index. We had a capitulation reading on the dollar index in the beginning of November, and we hadn't had that since January of 2004 when a six-month recovery in the dollar followed. But all this came together in December, so it was a straightforward call.

**TAYLOR**: We still have quite a way to go to reach the old highs in equity prices that were set in the early days of 2000. So do you see this as a cyclical call within a long-term secular bear market?

**HOYE**: Yes, that was the call back in 2002. We said it would be a cyclical bull market within a secular bear. And that was important because the period following previous financial bubbles has always shown a long financial economic contraction until you get all the abuses in the credit and currency markets washed out of the system. The usual business cycle will prevail, but the recessions will likely be stronger than the recoveries. As in post-1989 Japan, some policy makers may become perplexed.

**TAYLOR**: So, Bob, you don't see a new high?

**HOYE**: We don't see the senior indexes going to new highs. Bullish sentiment for the stock market late in the year was actually at higher readings than it was before the highs in 2000, which was the real blow-off top. So in December, with the strongest sentiment figures, the best the markets could do was reach a lower high.

**TAYLOR**: You take a really long view; so when do you think the old 2000 highs will be taken out?

**HOYE**: Oh, for an index like the NASDAQ, I would say 20 years or so. It wasn't until 1955 that the Dow exceeded the 1929 high. A classic instruction on just how long it takes to fully recover from a tech-mania is provided by RCA. Radio Corporation of America was the big tech-darling, and it reported earnings of 3 dollars per share going into 1929, when the long-term rave was radio, gramophones, and talking pictures.

After reporting losses in the early 1930s, it took until 1957 for earnings to get back to 3. A good portion was due to the Elvis Presley contract, which was, of course, not seen by the long-term pundits in 1929.

**TAYLOR**: Richard Russell talks of a gigantic short position in the dollar, and if I'm not mistaken, this is a concept you have also spoken of. Perhaps Richard Russell acquired this concept from you.

**HOYE**: It could be, because I discuss that occasionally and published it early last year.

**TAYLOR**: Could you explain the concept?

**HOYE**: First, let's talk about bubbles. It means a new financial era, and each had the same setup. There was a huge blowout in inflation—that was the old era. Then you had the crash of commodities and tangible assets that then sets up the new financial era, and everyone thinks it is going to run forever. Then it crashes. The key elements of the pattern include a great boom in tangible assets, then a great boom in financial assets, and then a period of long contraction. It has been running for 300 years.

**TAYLOR**: So we had the boom in commodities in the 1970s.

**HOYE**: There were two booms—gold, silver, and crude oil in 1980. Then if you look at The Economist's commodity index, it had an important high in 1988. The way I ended up describing it was that the late 1980s' boom was the last business cycle of the old era inflation. That then set up the new era of financial asset inflation, which ran for nine years, which is typical. Then you get the first crash, and then you have the rebound. But the point is that after all those five previous stock bubbles, the feature of the contraction eventually was a relentlessly strong senior currency. It was strong, relative to most other currencies most of the time, and strong, relative to most commodities most of the time.

**TAYLOR**: Could this be next? Might the dollar fool everyone and get strong now?

**HOYE**: Quite likely. Back in previous bubbles, the financial capital was in London. Underwriters went around to places like Bolivia, Turkey, Chile, and Egyptian banks and everywhere else, because the demand for such paper seemed endless. So they floated a whole lot of "junk." Then, once the party is over, the debt becomes a burden.

**TAYLOR**: In the old days, their debt obligations were in sterling, which was the senior currency; whereas now, with New York being the financial center, the dollar is the senior currency?

**HOYE**: Yes. And all you need for this recipe to work is a bare majority of all the debt that is floated in the bubble to be contracted in U.S. dollars. Once the party is over, everyone then has to get their hands on U.S. dollars to service their obligations in New York.

**TAYLOR**: So that is the dollar short position—a short squeeze, if you will.

**HOYE**: It's going to be very interesting.

**TAYLOR**: You mentioned the South Sea Bubble. What were the others since then?

**HOYE**: The first one was in 1720. The next was in 1772. The third was 1825. The fourth was in 1873. Number 5 was 1929, and number 6 was 2000.

**TAYLOR**: So was it the pound sterling until 1929 or the dollar that was the senior currency in 1929?

**HOYE**: Well, 1929 was in the transition period. By the end of the war, the dollar was the senior currency.

**TAYLOR**: Yes, and the dollar did get stronger of course during the 1930s. At least, it did gain purchasing power in the 1930s.

**HOYE**: After the bear raid by Roosevelt in 1934. Remember, he confiscated privately-held gold and then raised the price from $20.67 to $35. FDR was a flake who fell for any concept touted by interventionist economists who still are nothing more than financial adventurers in public policy.

Beyond that, he was a hypocrite. Bill Middendorf, who is chairman of the CMRE, has an original and redeemed note whereby Roosevelt personally made a loan to be repaid ***"to the order of Franklin D. Roosevelt, the sum of Five thousand Dollars in gold coin of the United States of America of the standard weight and fineness existing on the date of this note, without interest."*** The date the loan was made was February 1, 1927, to the Warm Springs Foundation, Inc. and it was due February 1, 1937.

**TAYLOR**: Do you see that same thing happening again in America? Do you think our gold will be confiscated again?

**HOYE**: NO.

**TAYLOR**: Why?

**HOYE**: Normally, during the post-bubble contraction, the politics shift away from the centralized government and toward the sovereignty of the individual. The exception was Roosevelt's New Deal. So with more sobriety returning, everyone is going to run their own household on a budget, and they are going to look to their government and say, "Hey, you get on a budget, too." And then eventually they will figure out that the central planners were very much at fault in promoting the whole mania. And so the people will turn on the politicians and eventually will demand the protection of a gold standard. It has happened before and it will happen again.

**TAYLOR**: Alan Greenspan is revered almost as deity. He is given all the credit for all the wonderful times we have enjoyed and yet it should be obvious that the so called good times have been a result of the excessive creation of money.

**HOYE**: Yes. The first big reckless central banker was John Law in Paris during the bubble of 1720. He was celebrated so long as the financial party was on and the market didn't crash. But when it crashed, he then had to have a false passport and a disguise to escape France with his life.

**TAYLOR**: He may have lost his head.

**HOYE**: In more ways than one. For those who think a central banker can keep inflation going forever, Law had 8 printing presses going in Paris. And then when the mania collapsed, the public demanded to see the plates destroyed. England was on a gold standard and was not printing money, but with the carry trade running full blast and as asset prices soared, credit ballooned. Speculation is fungible, and it doesn't matter what the tout is, so long as it soars, it creates credit. Sterling was backed by gold, so London's bubble was accomplished with a huge expansion of credit. Paris enjoyed that plus a huge printing of currency. In the crash, agents of the boom suffered a devastating loss of esteem.

**TAYLOR**: Of course, now, Ben Bernanke has reminded us that with advanced technology, we have digital money and helicopter money. We are not limited, as was John Law, to just 8 printing presses!

**HOYE**: Well, I think the market will disappoint even the most ambitious of today's central bankers. And the thing to understand is that unless they go to a pure paper inflation—which would require them to chew through the whole credit market—that would provoke such an uproar that it would force them to quit it. So here we are: it's a credit inflation, which depends on margin. As long as the prices are going up, everything is fine and it doesn't matter that short rates are going up. The cost of money doesn't matter if you know you can double your money every six months. And once the contraction starts, I suggest that it overwhelms the ability of the Fed to pursue its portion of credit creation. I'm not saying that the Fed is going to suddenly tighten. No bloody way—not willingly! But the whole system is going to tighten as all the leveraged "liquidity" disappears.

**TAYLOR**: Because the private sector or the economics don't allow it to generate returns any longer. So, out of economic necessities, start to turn their non essential items into cash and repay debts?

**HOYE**: As prices start going down, it gives undeniable power to the margin clerks. And their job description is vastly different to that of your typical central banker.

**TAYLOR**: The margin clerks and I would guess it also will involve the fractional reserve banking system overall?

**HOYE**: Yes.

**TAYLOR**: Let me understand. As prices drop, the loan officers and margin clerks at brokerage houses and in banks begin to worry that their clients won't be able to repay their loans, so they ask for more and more margin—which then triggers further liquidation because people have to sell non essential items to raise cash to meet margin requirements. That then results in a collapse in the value of less liquid assets relative to cash and the ultimate liquidity, namely gold?

**HOYE**: That's happened many times but, at the top, the street ardently believes that "this time it's different."

**TAYLOR**: But the argument is that the Fed can **always** expand the money supply, as Ben Bernanke suggested when he said if need be, the Fed could use its magnificent digital technology to create as much money as was needed to escape deflation. He even said we could drop money from helicopters if need be!

**HOYE**: That's credit, not money. It's a misnomer to call M-1, M-2, and M-3 money. And so once the prices of the assets being speculated turn down, then the margin clerk takes over.

**TAYLOR**: One of the economic dynamics I talk frequently about in my letter, but which is almost never talked about in the mainstream press, is the almost exponential growth in debt compared to income, as measured by GDP and that in fact economic returns are simp ly not sufficient to generate enough cash to service the debt. And when the debt can't be paid the loans are called by as you say, the margin clerks and then the debt repudiation process gets underway.

**HOYE**: That is what happened in every bubble. Credit is taken on because of soaring asset prices. As the prices stop going up, you are left with the debt. That kills the ability to promote any story. As we have seen in so many promotions, so long as the trend is up the street will believe the most preposterous of touts.

**TAYLOR**: In the recent interview in "Barron's," you talked about how speculation has been rampant in stocks, bonds, energy, and industrial commodities. Would you also including housing in that list of speculative items?

**HOYE**: Oh yes, exclamation mark! It's been part of the party!

**TAYLOR**: So when this thing unwinds, the housing market is likely to go with it?

**HOYE**: Real estate indexes were hard to find. But one was farmland values in England. Theirs is an annually posted index. From 1873 through 1895, it went down every year—for 22 years—without relief. And according to other measures, that marked the bottom of that depression. We don't have a similar index in the United States, but at the top of the bubble in 1873, "The New York Herald," which was then the leading newspaper, editorialized that because the U.S. did not have a central bank, the Secretary of the Treasury could inflate any amount of currency and credit, and there would never be any problem. The 1873 to 1895 contraction was widely described as "The Great Depression." Leading economists were still analyzing it as such until 1940.

**TAYLOR**: Mrs. Taylor and I sold our two-family house in Queens, New York, in September 2002, thinking we were near a top in the market. All we have seen is the value of our house go up about 40% since then. While you may be right about the housing market going down with the upcoming deflation, we have been pulling our hair out because clearly with 20/20 hindsight our move to sell was not a good one. How long do you think we might have to wait before it looks like a good move—or will it ever?

**HOYE**: This has been associated with the speculation in corporate credit spreads. Coming out of the tragedy of 9-11, it seems as though everyone has been aggressively buying grand cars and the median home. That was helped by the decline in short rates. Using Treasury bills, rates went from 6.4% down eventually to less than 1%. The only time there has been that kind of a drop in short rates is in the post-bubble period. But in previous post-bubble contractions, such as what followed 1929, people were not inclined to aggressively buy cars and homes. This time around, it was used to inspire a consumption spree.

As with any boom, it will be vulnerable to an important change in the credit markets, which is typically indicated by widening of credit spreads and a steepening yield curve. Corporate spreads have widened a little since late December, but the curve is still flattening.

**TAYLOR**: Do you think we are going to continue to see a flattening of the yield curve here?

**HOYE**: The trend is on until it reverses.

**TAYLOR**: Don't we usually have recessions after the inversion?

**HOYE**: Yes. We have the yield curve back to 1858. And the rule of thumb is that whenever the curve inverts, a recession follows.

**TAYLOR**: And then you see a steepening before the recession comes on. Or does the steepening occur as a result of the recession?

**HOYE**: The inversion is part of the speculation. Once it reverses to steeping, it suggests that the contraction is underway. And in some cases it didn't have to get the curve fully inverted. All it needed to do was to approach inversion and then reverse.

**TAYLOR**: So the short end of the yield curve comes up because of the speculative demand for money?

**HOYE**: Yes. And England actually experienced an inverted yield curve in December. And now the chart is attempting to reverse trend.

**TAYLOR**: In the 1970s, we had very high consumer inflation as measured by the CPI, but not now. Why do you think inflation is being seen in equities, commodities, and housing, but not in consumer items?

**HOYE**: It goes back to the ancient pattern, which starts with the “old” era of inflation when the prices of all hard assets head up, including labor prices which resulted in a huge increase in the CPI. Everyone gets fully positioned for that and then that mania crashes, and out of those ashes a great financial boom arises and then you get the stock bubble. Then everyone speculates in financial assets and to a lesser degree in tangible assets. Some CPI inflation is seen, but it is ignored during the raptures of a financial bubble.

**TAYLOR**: The dollar index has held at the all-important 80 support level. Do you see that as being safe for now or for quite awhile to come?

**HOYE**: Yes. When it bottomed in December at 80.5, that was in conjunction with our capitulation reading. The last time when we had that was in January one year ago, at which time the dollar rallied from 84.5 to 92. This one has rallied from 80.5 to 84.5. Our next target is 87 this month. Then the telling moment will be when the next correction comes in. But I think that we are probably at the start of a very long increase in the U.S. dollar for the reasons that I gave earlier. The dollar is still the world’s senior currency. The next decline could be a huge test of the 80 level again. So we will see how that works.

**TAYLOR**: Any prediction as to when that test might come?

**HOYE**: Originally we targeted 90 by February, but now we are looking at 87 by late this month.

**TAYLOR**: Of course, conventional wisdom then suggests our favorite metal—gold—isn’t going to do very well if the dollar is on the rise.

**HOYE**: I should respond with a line that got “Barron’s” attention in late November: “The world is long inflation and short the dollar.” Massive depreciation was in the market. It was no secret that the Fed was leading a bear raid on the dollar. It’s worth noting that the official and continuing bear raid on gold has left a number of unrequited shorts.

The “ChartWorks” did a study a couple of weeks ago, showing the number of times the dollar rallied at the same time gold turned up. This seems possible now. To understand this you need to realize that in every post-bubble period, the senior currency eventually became chronically strong. But also in every post-bubble period, gold also became chronically strong. By contrast, during every financial bubble, the real price of gold went down; and in every long contraction that followed, the real price of gold went up.

**TAYLOR**: So by real price you mean a CPI-adjusted price, or what?

**HOYE**: It can be deflated against the CPI or the wholesale price index, but as both calculations of inflation are suspect, we use the price of gold divided by the commodity index, which gives us a more true reading. That index had a multi-year low in March a year ago at 183, and then it rallied up to 244 in December, at which point it has been correcting now to about 212. Gold has been outperforming most commodities for almost a year now. And it could go on for some time.

This brings us to the gold bugs—if it were not for the demented interventionist economists, there wouldn’t be any gold bugs. They really think the only way you can make money in gold is to have the U.S. dollar crashing. Let’s reverse that around and say the only way you can make money in gold is if all the major currencies rally. What happens if you are mining in South Africa or Canada or anywhere else? One example is Placer where they had some disappointing quarters, which were attributed to currency moves. At the time, the gold bugs thought they had the best of all worlds when the dollar was being trashed against a soaring gold price. But, naturally, there was no increase in gold’s price in stronger currencies. The gold bugs’ nirvana of a collapsing dollar had finally arrived, but it wasn't universally successful.

Conventional wisdom seems to assume that the consequent rally for gold prices is isolated and does not wonder if other price-items may rally faster than gold. In which case, increasing mining costs will eat into operating margins, just in U.S. terms. This is why we use the real price. It is a proxy for profitability, and it is universal in time and place.

**TAYLOR**: Well, the gold mining sector did quite well during the inflationary 1970s, though, didn’t it?

**HOYE**: Yes, that was an extraordinary bull market for gold in real as well as nominal terms in the senior currency.

**TAYLOR**: Before gold took off in the 1970s you had a suppressed gold price until Nixon detached gold from the dollar in 1971. It was fixed at $35 back then. So then as it began to freely trade, you had a gold price that was rising faster than costs.

**HOYE**: During certain inflationary periods of time, you can make money in gold. When gold went to $850, it certainly went up faster than costs. But the point is that when you are in a stock bubble, the real price of gold goes down; and after the bubble, the real price of gold goes up. And then you start to see improved operating results for producers, and that ultimately enhances the value of the stock. One of the ways Mother Nature works is that during the post-bubble credit contraction, there is a huge vacuum where real liquidity is needed. And the only way Mother Nature increases that liquidity is through an increase in the real price of gold so that people go out and find more of it and produce more of it. Despite this, the gold establishment, during the last 20 years, predicted the gold price would go up because mine production was going down. Another point was that gold should have increased with falling real interest rates. But such rates always decline with gold during a financial bubble. Then, to continue the confusion to orthodoxy is that following a bubble, real long rates and gold have increased together.

If the past continues to guide, we are in ***Year 5*** of a 20-year bull market for gold. On the near term, the "ChartWorks" (on February 8) notes that the conditions of the "isolated" low pattern have been met and gold's price in dollar terms is a "buy" now for an intermediate rally.

**TAYLOR:** You pay a lot of attention to the Baltic Freight rates, while Richard Russell and others pay a lot of attention to the Dow Transports. Can you tell our readers why you prefer looking at the Baltic Freight rates?

**HOYE**: It's a really good proxy on global business trends. The Transports indicate U.S. business conditions and of course, it is a component of the Dow theory.

**TAYLOR**: Stephen Roach recently worried about illiquidity that could come into the US. markets from a diminished U.S. dollar carry trade, now that interest rates are rising in the U.S. Certainly we have seen short-term rates rise more than long-term rates. So based on our discussion so far here, I assume you share this concern with Mr. Roach?

**HOYE**: Oh yes. January's sharp drop in the stock market and widening credit spreads suggests a sudden loss of liquidity. The concept of liquidity is badly abused. For example, in the summer of 2000, the street was fully bullish because there was so much liquidity to buy the stock market. They didn't grasp the importance that it was stock prices rising that permitted all speculators to leverage up their positions. But that is borrowed money. That isn't liquidity. While an asset price is going up it gives the appearance of liquidity and then when that asset price heads down, all of a sudden liquidity disappears. So that is what we are dealing with now. I think Stephen Roach is a good critic of the financial excesses, particularly since he sits at such a high place at Morgan.

**TAYLOR**: No doubt he is. Certainly the U.S. dollar carry trade is hurt by a flattening of the yield curve, but we still see the Japanese carry trade being alive and well. They can borrow in yen at very low prices at about 1% and buy our Treasuries at 4%. Is that something that can continue for some time?

**HOYE**: The carry trade has been around since at least 1720. It is usually described as borrowing short and lending long (I call it the BSLL factor). And there is a compulsion in any speculative boom to borrow short and lend out long. Either to buy junk bonds or the stock market or whatever. The symptom of that is the flattening yield curve. And the game is over when the yield curve reverses to steepening.

**TAYLOR:** But with the Japanese being able to borrow so cheaply in their own currency and then buy higher-yielding dollar assets, and with the dollar getting stronger, wouldn't there be an inclination for them to keep doing that for awhile?

**HOYE**: That is best answered by looking at the yield curve itself. This is how the post-bubble scenario goes. The lower grade bonds are already selling off. But at some point they will sell off further, and there will be no liquidity in them, and then you get credit downgrading because weakening commodities suggest weakening earnings; weakening earnings suggest inability to service debt, and then you get into the credit rating problem. Following a bubble, this process can get so bad that it even pulls down the prices of long Treasuries. So once the mania ends, short rates will come down, long rates will go up.

**TAYLOR**: This is exactly John Exter's inverted liquidity pyramid. As people look for liquidity they sell longer-term, less liquid assets, and go to the most liquid assets so that people panic into liquid assets?

**HOYE**: Yes, so that gets back to the real definition of liquidity, which typically has been found in gold and short-term bills in the senior currency. We've advised bond traders not to even think about whether the Japanese are going to stop buying the long bond or not. If they stop buying the long bond, will that drive the dollar down? No, because when the curve reverses, where they may have been buying the long bond, they will stop doing that and they will begin buying the short end of the curve. And that is why I am not concerned about any further downside in the U.S. dollar. The dollar crisis will occur when it becomes too strong.

**TAYLOR**: Corporations have had great profits in 2004, and they are building up a huge amount of cash or they are buying their own shares. But they don't seem to be borrowing much or using the cash they have to invest in plant and equipment. That, along with the fact that corporate insiders have been selling their own shares en masse, suggests to me that the folks who manage corporate America are not overly optimistic about U.S. business prospects, even though profits have been so high. Would you agree and do you see any long-term significance of the cash buildup of American corporations?

**HOYE**: Cash is at a 35-year high. You have had a huge buildup of plant and equipment during the '90s boom. One of the features of past post-bubble contractions is that corporations with cash keep it because they get concerned about their AA or even AAA credit rating. And then at the same time, banks will only lend to AAA accounts. So corporations stop spending, and banks stop lending. It's classic.

**TAYLOR**: So the Fed can't expand the money supply when that happens?

**HOYE**: Yes. Central banks can increase reserves but if corporations don't borrow, that's it, game over. That's why Keynes and all that bunch just went crazy about people hoarding money in the 1930s. Keynes said that if you saved a schilling, you put a man out of work. So now in the U.S. and Canada where we have adopted the Keynesian model, we are now down to virtually a zero savings rate. So if Keynes was right we should have 100% employment. He was a flaming idiot.

**TAYLOR**: He was a flaming bunch of things, but . . . I'd like to get back to the topic of commodities. Jimmy Rogers, who we interviewed on a couple of occasions in this letter, is extremely bullish on commodities. He told me that lead would outperform gold and so far, I think he has been right. What would you tell Jim Rogers if he challenged you with that statement?

**HOYE**: The debate would likely be his opinion versus financial history.

**TAYLOR**: He sometimes reads this letter, so that statement might make some sparks fly!

**HOYE**: Well, he is a perma-bull on commodities. And financial history suggests that no one sector is good forever. Our gold/commodities index includes crude oil, copper, lead, zinc, aluminum, nickel, as well as the grains, and gold has been outperforming commodities for almost a year now. I concluded the research by about 1980 and said that once that commodity blow-off was over, a long bull market could start. When taking this concept to institutions in 1981 and 1982, the standard response was "no," the Fed will keep printing and there will continue to be inflation. They had been dismayed by their returns on stocks and bonds during the "old" era of inflation. So I came up with the line that, "no matter how much the Fed prints, stocks will outperform commodities." And that baffled the street for some time. Some are still unclear about the reality of inflation in financial assets.

The only reason I could come up with that line was because in every new financial era, stocks outperformed commodities. So then the next difficult part—it is really difficult—is that no matter how hard the Fed tries to print, you still get a contraction. And that I think we should know more about that by October. But I would enjoy having a drink and discussion with Jimmy Rogers.

**TAYLOR**: Perhaps that could be arranged when you come to New York to speak at the next CMRE?

**HOYE**: Sure.

**TAYLOR**: Part of Jim Rogers' argument hinges on China. He thinks, as do most people, that economic growth in China will continue at a torrid pace for as far into the future as the eye can see. Do you have any thoughts on the influence of China in the post-bubble era? Might demand from China overwhelm normal post-bubble dynamics?

**HOYE**: First step is that in the 70s and 80s it was Japan that was the engine of growth and was buying industrial commodities. What's more, they had the most brilliant policy makers in history. But then tangible asset speculation collapsed so the world could enjoy another financial bubble.

But the best model is the U.S. after the 1873 stock bubble. There were huge migrations of people into the U.S. The U.S. was building railroads and canals. It was a very vibrant and innovative economy. But it was subject to its own domestic speculative excesses. It was also subject to the availability of credit from the world's financial capital in London. So until the global depression bottomed in 1895, the U.S. had bull markets and very sharp collapses, but nonetheless, England and Europe had a depression. The U.S. was within that envelope, and I believe China is going to be vulnerable to its own speculative excesses and vulnerable to the availability of credit in the world's financial capital.

It's nice to have them becoming more and more free, but we saw the same pitch in 1929 when the end of socialism in Europe was seen to be a great opportunity for the market and industry in the U.S. That came to play in the 1990s when another collapse of socialism was again seen to provide a great stock market. They were going to sell all kinds of BMWs to the people in East Germany. But if we should go back to an economist by the name of Say, Say's Law said if you must consume you must produce. The Chinese are in the anomaly of consuming immediately a lot of raw materials from elsewhere. At some point they will develop iron deposits, copper mines, and coal deposits on their own.

**TAYLOR**: I've noticed recently that the Chinese are cutting back on some plans to build nuclear power plants. Might this be the start of a contraction in China?

**HOYE**: It's possible that the authorities who are deciding on nuclear power may be concerned about running out of money. Let me quote from St Luke. *"Which of you intending to build a tower has not sat down first and counted the cost? Whether he has sufficient to finish it. Lest happily, if he has laid the foundation and is not able to finish it, all behold and begin to mock him."* (Luke 14:28-29).

But then again, perhaps the Sierra Club has opened a chapter in Beijing.

**TAYLOR**: It might be appropriate for the U.S. as well, no?

**HOYE:** Well, yes, for everyone who has become over-extended on the party.

**TAYLOR**: You have expressed the view that investors will seek gold as liquidity along with T-Bills. But do we have any evidence of investors doing that in recent times since policy makers have gotten rid of the barbaric notion of gold as money?

**HOYE**: Yes we do. At each of those bubble tops I mentioned earlier, from 1720 to recent, all participants including government agencies were caught up in the party. Nobody wanted prosperity to end. But it ends anyway.

I might mention this for your gold readers who have the notion that the club of central bankers can run gold down. The best argument against that is to go back to 1946, which was the secular low in interest rates. Then they started to rise, naturally. So when rates approached 3%, policy makers got concerned because it was very easy to figure out that this was going to increase the cost of servicing the debt. So then the Treasury started buying bonds off the market in order to keep rates from rising above 3%. Then in the 1960s when it was at 6%, they were still at it. And in fact they got all excited about their promotion to buy bonds and called it "Operation Twist," whereby they were going to drive long rates down. But eventually rates got up to 15%.

Now, the central bankers with the 1990s' bubble, had history on their side. The price of gold was going to go down anyway. So then it looked like they were doing it. But they have never been tested by a really big recovery in gold that you can get following a bubble. But this next bear market in stocks and corporate bonds will set up the conditions for a <u>real</u> move in gold that will test just how powerful the central bankers are. And I think they will be just as unsuccessful in keeping gold down as the U.S. policy makers were in keeping interest rates down through the 1960s and '70s.

**TAYLOR**: In your "ChartWorks" publication of January 25, you addressed the gold markets; you noted that the U.S. dollar and gold were poised for a joint advance. Could you tell our readers what prompted you to predict that and could you also provide some indication of what your target levels and time frame are for the advance in both the dollar and gold?

**HOYE**: At previous points in the last 10 years or so there have been a few times when gold and the dollar rallied together, and it looks like we are getting to that point again. This tandem move just appears to be in the charts. But then eventually, both gold and the senior currency become relentlessly strong, relative to everything else. That defines the contraction that has followed all previous financial bubbles.

**TAYLOR**: What is your best prediction in terms of timing for that to happen?

**HOYE:** We are not there yet, but it sure looks like we are going to get there. Once you get the bear, then it would be a natural that the first lows would be the lows of October 2002.

**TAYLOR**: In your "Pivotal Events" issue dated January 27, 2005, in referring to your gold/commodities index you talked about how the index surged from 183 in March 2004 to 244 in December 2004 before falling back a bit more recently to 212. Then you said the following: *"This not-widely-followed index is an indicator of gold mining profitability. Someday participants in gold will* *get over their fantasies about dollar depreciation and the intellectual nonsense about using macro economic modeling to forecast gold prices and look to the real price."* Were you referring here to the likes of supply siders like Larry Kudlow and Steve Forbes, who constantly suggest that when the price of gold rises, the Fed should tighten, and when the price of gold falls, the Fed should loosen monetary policy?

**HOYE**: The last sentence you spoke reveals one of the great blunders in public policy—and I remember watching Kudlow on TV in late 1999 and then through 2000. His line was that you just had to buy the stock market because there wasn't any inflation. He didn't understand that the huge inflation was in stock prices. And also "The Wall Street Journal" would have an op ed piece that would say that because the price of gold isn't going up, the Fed shouldn't be too tight. But it is so straightforward. The price of gold goes down during financial bubbles. I remember looking at that and seeing that the policy makers thought they could just keep on being "easy" so they were easy right through the biggest stock mania in history. Not only that but the Rubin/Summers Treasury was aggressively buying long bonds out of the market, which was aggressively putting cash into the system. It was like pouring gasoline onto the fire. Those were some of the most insane moments in the history of policy making.

**TAYLOR**: Well, I do hope the public will some day understand that, because right now Bob Rubin and Lawrence Summers are almost as revered as Alan Greenspan.

**HOYE**: Now the next part of your question above deals with using macro economic modeling to forecast gold prices. First they are forecasting the price in dollars, which, as pointed out above, doesn't mean too much unless the price of gold is going up relative to the cost of mining. Another point is that no matter how many other price series are used in the regression analysis, to come up with a forecast on gold it is necessary to have a "forecast" on the key elements that are supposed to then influence gold prices.

Some years ago, a big mining company spent a lot of money to solve the problem of forecasting the business cycle. In order to make sure the study was impartial, none of the researchers had had any courses in business or economics. The top macroeconomic models were then hired and, when tested, were found inadequate. While those inadequacies were acceptable within the macroeconomic fraternity, the modeling was considered impractical within such a cyclical industry as mining.

Much of this work was done before the stock bubble launched and one program was fascinating; this was the attempt to use 1920s data to forecast the monumental reversal of the economy in 1929. A number of macroeconomic models were tried, then modified with some breakthrough mathematics in geophysics, and one of the most important events in financial history couldn't be anticipated.

The group did put together an approach to the big financial events that has been reasonably successful. Within this were the conclusions that in the final stages of a great inflation in either tangible or financial assets, the growth curves become skewed. At the time, we tried to find proof that skewed curves were mathematically unsolvable, but it could not be found.

Perhaps this proof may have been accomplished since, but the members of this research group have gone on to other endeavors. But I found no reason to think that macroeconomic modeling would be successful in our go-around with sensationally skewed growth curves. That is just a fancy way of describing the high volatility that has accompanied every bubble era.

**TAYLOR**: A big mining company was spending money and time to find a mathematical proof that skewed curves were unsolvable. Why?

**HOYE**: Glad you asked. So that we could be confident that the economic establishment would be unable to predict the top of the next great financial bubble. It seems that to the establishment it was unanticipated, had an unpredictable collapse and, as instructed by Alan Greenspan, et al., couldn't even be identified until it was over.

**TAYLOR**: You used to be involved in the gold share markets in Vancouver, so let me ask, why do you think the gold shares performed so badly in 2004 and what are their prospects for 2005?

**HOYE**: There was a really good party in small cap gold stocks going right up to last April. In retrospect, it was a bit of a blow-off. We had a good market. It blew out and then you ran into the problem that with the advance of gold up to $456 was gold, but it wasn't rising vis-à-vis other currencies. So then you were not having the same bull market in Canada and Australia that you were having in the U.S. So the two countries that generate gold stories were out of the play. So just look at it as a mini-bear market. That could be ending right now.

**TAYLOR**: You were able to record an excellent track record for 2004. Would you mind letting our readers know of your successes in 2004?

**HOYE**: On the big picture, it was identifying the series of big spikes as they occurred during the first quarter. The blowouts went from nickel to the Baltic to silver and then stocks and bonds. Then on July 27, we came up with the line that it was party time again and that would probably run until at least September; and then when we did the election stuff that got us out to November, and then by the end of the November we saw a turn-of-the-year top. I guess the one problem we had was that at the first of April we thought the party in the gold stocks would run for another month. And then two weeks later we realized that we made an error. Levente, with his "BondWorks," has been bullish on long treasuries since the April low.

**TAYLOR**: I certainly remember the mood in January 2004 when I was at the Cambridge House gold show. There certainly was a mini-euphoria at that time as I look back at it.

**HOYE**: It was a good one. But in the next leg up in the junior golds, one should think about 1997 in the high tech stocks. But I think the way to play this for most retail investors is to own a gold fund that knows the players in the exploration side. If you have that as a core position, this is a good time to accumulate more. Then you might want a small group of stocks that you own separately, so that come party time, you might want to blow them out and take some profits. Maybe Newmont or something like that. The main thing is to have a good position in the juniors, and I think one of the easiest ways to do that is to buy one of the good gold funds either here in Canada or the U.S.

**TAYLOR**: But the U.S. doesn't really have gold funds that get down to the more speculative junior exploration plays. Do you have some Canadian funds we might look at?

**HOYE**: John Embry, at Sprott Gold, is highly experienced and is well known. In the U.S., those who can play an exploration market would include Greg Orrell at Monterey Gold, as well as some of the bigger funds such as Van Eck and Tocqueville.

**TAYLOR**: Uranium has been all the rage among the junior mining companies in Vancouver. And now coal-mining firms are getting hot, too. Would you be a buyer of these hot issues now? If not now, when?

**HOYE**: Generally, most of the energies are subject to market forces, such as bull or bear. The next driver often is the seasonal moves for crude oil. We don't want to go into too much detail, but we were looking for an intermediate low around Christmas, with a recovery likely until around May. We advised in January that the overall action in the energies had become briefly overbought.

**TAYLOR**: But if your deflationary scenario unfolds, are not energy stocks likely to come under pressure?

**HOYE**: I would play it on an intermediate basis and take some money off the table on an intermediate high in May.

**TAYLOR**: Bob I believe I have hit the major topics I wanted to cover. Can you perhaps summarize our discussion by telling our subscribers where and how they might best invest their money, given the deflationary views you expressed above?

**HOYE**: Agreed, let's talk about an investor who is not a trader. He should be long a good suite of gold stocks. And on the fixed income side, in anticipation of the yield curve reversing to steepening, we should position on the 4 to 5 years in long Treasuries. The reason is that once the curve changes, short rates will go down, so if you are too short, you will lose on every roll over. And then the other irony is that as long rates go up, you get killed in price. So that takes care of term risk. So the other risk to look after is credit risk. And we would definitely avoid lower-grade bonds; even on high-grade bonds we would not be any longer than 4 or 5 years' maturity.

Then you have the huge new game in income trusts that people have been buying. And perhaps the oil patch group will be okay, but you are still dealing with something that is trading on a yield basis. So if long interest rates go up, the price of the trusts will go down. So we would be a little wary of income trusts.

**TAYLOR**: Where can people go to gain more information about your service if they wish to do so?

**HOYE**: Our Web site at www.institutionaladvisors.com includes some critical research studies, and it is open to all. Our subscription publications include the weekly "Pivotal Events," which covers key strategies in the investment markets and is published every Thursday. The "BondWorks," which says what it is, goes out each Monday, and senior fixed income specialist, Levente Mady, has been one of the very few who got the bond market right in 2004. Ross Clark's "ChartWorks" covers stock, bond, currency, and commodity markets—frequently and reliably.

**TAYLOR**: Well, thanks again for taking the time to share your insights with our readers.

**HOYE**: Anytime.

**TAYLOR**: Well, we might just take you up on that sometime down the line to see how your unique research is panning out.