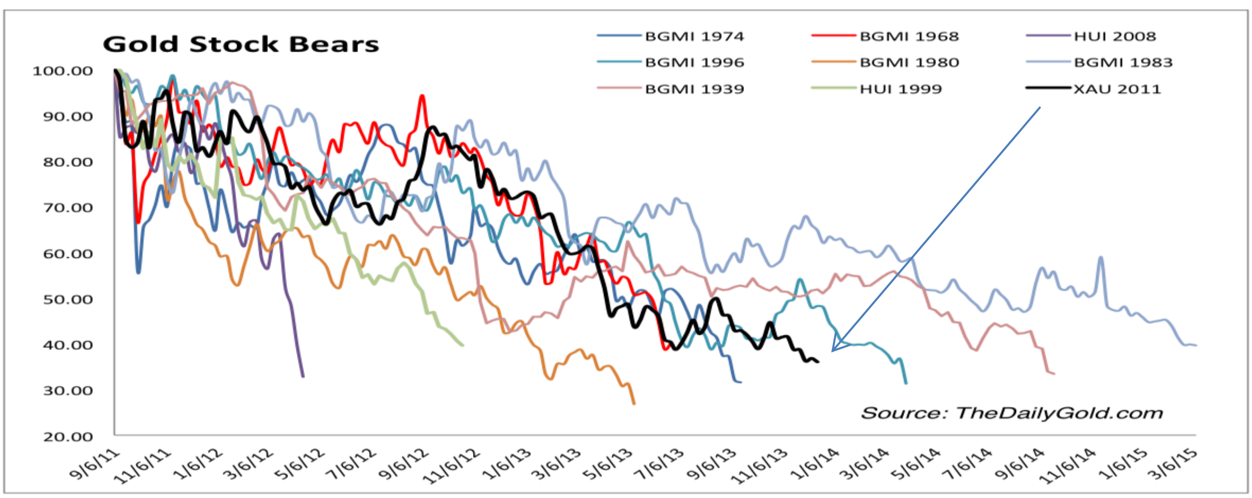
G O L D   I S   M O N E Y . . . EVERYTHING ELSE IS CREDIT **- J.P. Morgan**

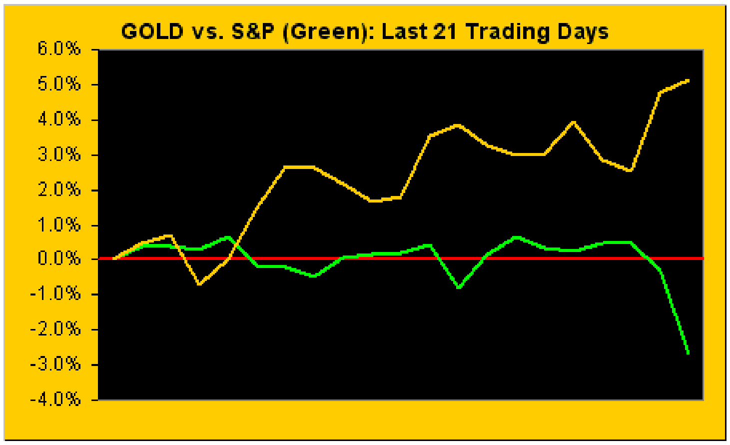
I will separately send out a detailed analysis of your portfolio. This letter is to give you a better understanding of the past year's performance (or lack thereof) and our ongoing strategy.

Since my strategy of owning mostly precious metal miners and some gold/silver bullion through closed-end funds is very unorthodox, I should tell you how this came to pass. **I have no love for gold or miners**; I would rather own a successful, growing business that can compound over time. Owning gold is like having money that can't be debased by fiat. The high price of most stocks forced me out of many of our franchise companies**. I will go into great detail about why the stock market will struggle because of unsustainably high profit margins.** Not only does the current market sport profit margins at almost double their historical norm, but the multiple on those profits is also high. Any regression to the mean will augur in low returns—probably over the next decade. My search for value led me to precious metals mining companies—the most hated asset class of the past two to three years'. As the famous investor John Templeton said, "Go where the outlook is bleakest, the outlook the worst to find values." A value investor needs to find distressed or forced selling. Believe me; investors were selling miners after three years of declining prices not because of certainty but because of pain of further loss. A video of John Templeton's investing philosophy which is similar to mine is here: http://wp.me/p2OaYY-2fN.

There is a catch. Since investing in miners means owning a cyclical asset, I must be contrarian—buying on sell-offs and selling on rallies—while being patient. The bottoming process has been almost 9 months, so if/when the miners turn, a new bull market will likely be for a few years unless prices rise rapidly and relentlessly. Think of how the businesses operate. It may take a year to close a mine or stop production. The 80% price decline of many junior miners sent a strong signal to investors and managements to change. Odds in terms of time and price favor the bottom being in as of Dec. 31, 2013 though in the markets as in life there is no absolute certainty.



In a nutshell, I think we are well-positioned being diversified (mostly) in—**by far—the cheapest asset class, precious metals miners that produce real money (gold and silver).** The general stock market of the NYSE, S&P 500 and NASDAQ has mostly fully-priced stocks of which I will give an example later. I sold out of general stocks mid-year 2013 and began accumulating depressed miners. The momentum continued to push up stocks and depress miners. But so far in 2014 there seems to be a reversal.



A short time period can just be noise or investors may be waking up to risks in corporate earnings, emerging markets currency crisis, and weakening/deflating economies.

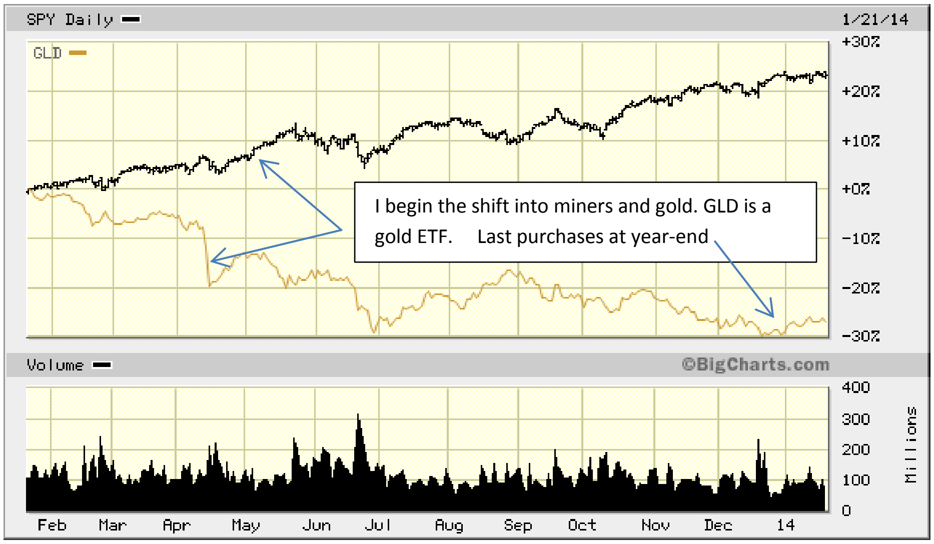
Since gold is money, it is a **store of value** and medium of exchange. Gold will maintain its historical exchange ratio for goods BOTH in high and rising inflation and with deflation or credit collapse.

Our miners would benefit the most in a credit crisis (input costs decline vs. gold).

You can see the long bottoming process after a sharp decline.

Your account (general client accounts) was down approximately 20% from the prior year while the S&P 500 scored one of its best years ever, up close to 32% with dividends. Ironically, the most over-indebted and heavily shorted stocks fared the best in a world awash in money printing by the Fed to purchase U.S. Treasury debt to suppress interest rates—central planning at work! I began selling our franchise-type companies back in April/May of 2013 to buy miners and other resource-based companies. **The relative underperformance was huge for that time period.** I would rather look like a fool during a boom than a bust.

Also, I believe the current calm belies massive problems festering in the US and Europe like growing debt burdens, weak growth and continued central bank money printing. This article sums up the situation I see today: http://www.acting-man.com/?p=28229. Set aside all the words, charts and graphs in this report and ask your common sense, "Does central planning work?" Note Eastern Europe, Communist Russia and Nazi Germany collapsing. Can money printing foster economic growth and solve our debt problem while maintaining the value of our currency? Has currency debasement and currency wars ever solved anything? If your answer to any question is no, then own some gold.



Just to show you **how one can paint the target wherever the arrow lands**, being down **20% in mining equities** was a vast improvement over the best performing gold mutual fund: **Tocqueville Gold Fund.**

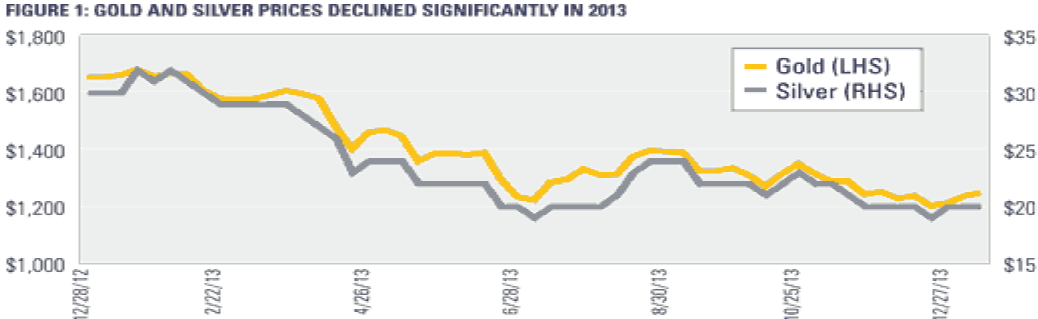
Named by Lipper as the Best Fund in the Precious Metals Category for the Past 3 Year and 5 Years ended 12/31/12.

Tocqueville Gold Fund Average Annual Returns as of 09/30/13

	3 Month	YTD	1YR	3YR	5YR	10YR
Tocqueville Fund*	8.54%	-40.04%	**-47.69%**	-19.64%	4.26%	7.11%
S&P 500 Index	5.24%	19.79%	19.34%	16.27%	10.02%	7.57%
Phil. Stk Ex. G/S I	16.95%	-42.54%	**-49.97%**	-20.58%	-5.24%	1.51%

But I am not trying to compare my investing to the S&P 500 or Tocqueville gold fund. **My goal is to protect our (I am invested right alongside you in many of the same positions) capital so the money invested will grow in real value—to buy more in goods and services than at the beginning of the investment period.** If the numbers were inverted and the S&P 500 was down 35% while your portfolio was down 20%, I wouldn't consider that 10% outperformance. You would be concerned about **permanent loss of capital.**

FIGURE 1: GOLD AND SILVER PRICES DECLINED SIGNIFICANTLY IN 2013



Source: Bloomberg

A Non-Conventional Strategy

The critical issue is what WILL the companies in your portfolio be worth in a few years? I will go into the reasons why I think the values will be much higher than today but first let me describe in more detail **what led me to this unorthodox strategy?**

The main reasons for my strategy:

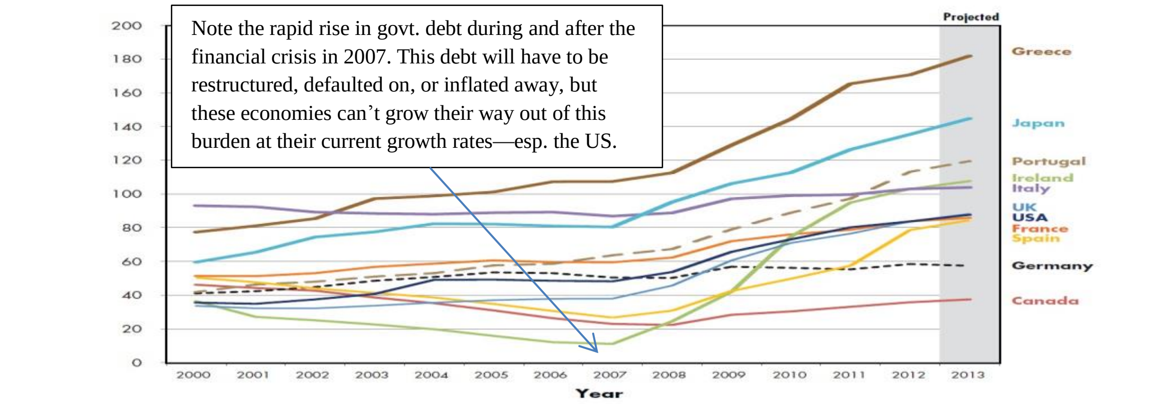
1. I **can't find traditional companies with a margin of safety based on today's valuations**. I see high risks or low future returns in the general stock market. See
   http://www.hussmanfunds.com/wmc/wmc140120.htm
   http://www.hussmanfunds.com/wmc/wmc140113.htm

2. I was forced to seek the **cheapest assets/companies--precious metals miners.**
3. **EVEN IF gold does not go up much or stays stable**. OUR MINERS could go up 50% or more because of extreme undervaluation.

4. In a world where Japan, the US, Russia, China and Europe have large government debts and are in a currency war(s) then I want to own the MONEY (GOLD/Silver is a store of value and medium of exchange but it is not a currency) that **can't be debased** *(printed out of thin air).* All the conditions that drove gold higher since 2001 exist today. See a full research report here: http://www.incrementum.li/research-analysis/in-gold-we-trust-2013/

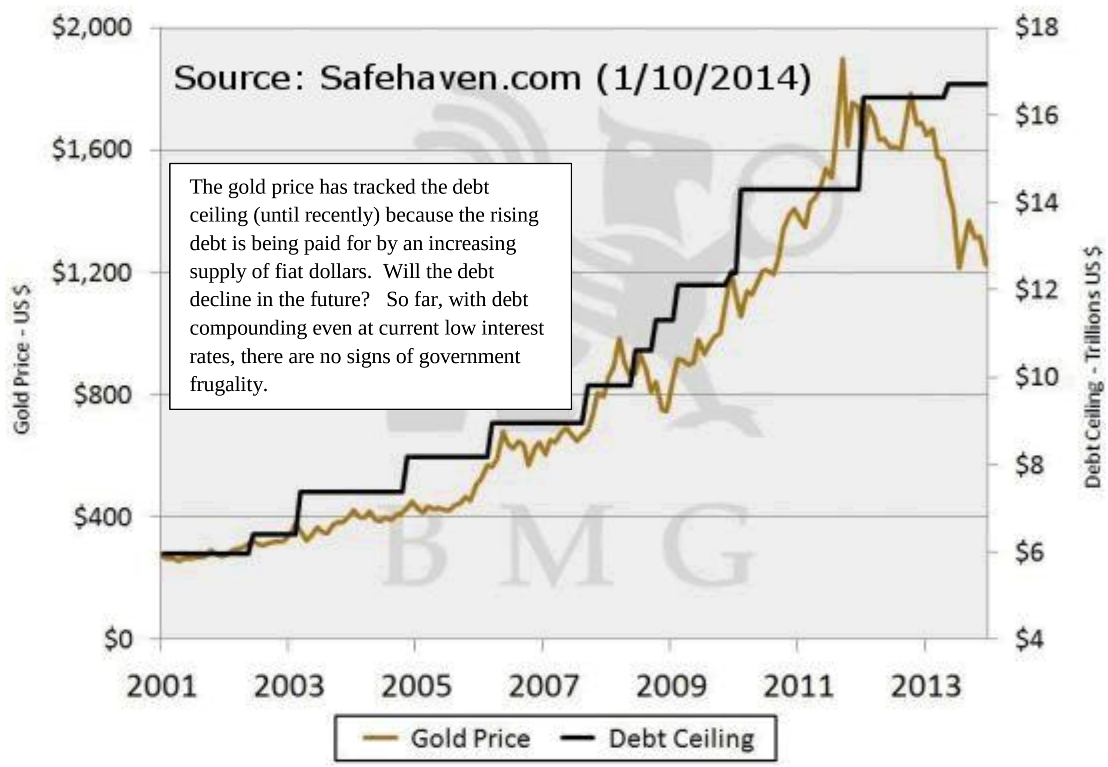
Many money managers seem to believe that the Federal Reserve can withdraw stimulus (QE) while the economy improves (reaches "escape velocity"). I believe that inevitably the failures of the Fed's central planning such as mal-investment and intervention to prevent prices (interest rates) from moving to their natural level will be revealed. Perhaps financial assets will reach "decent velocity." (A bad joke!)

GENERAL GOVERNMENT NET DEBT AS A PERCENTAGE OF GDP

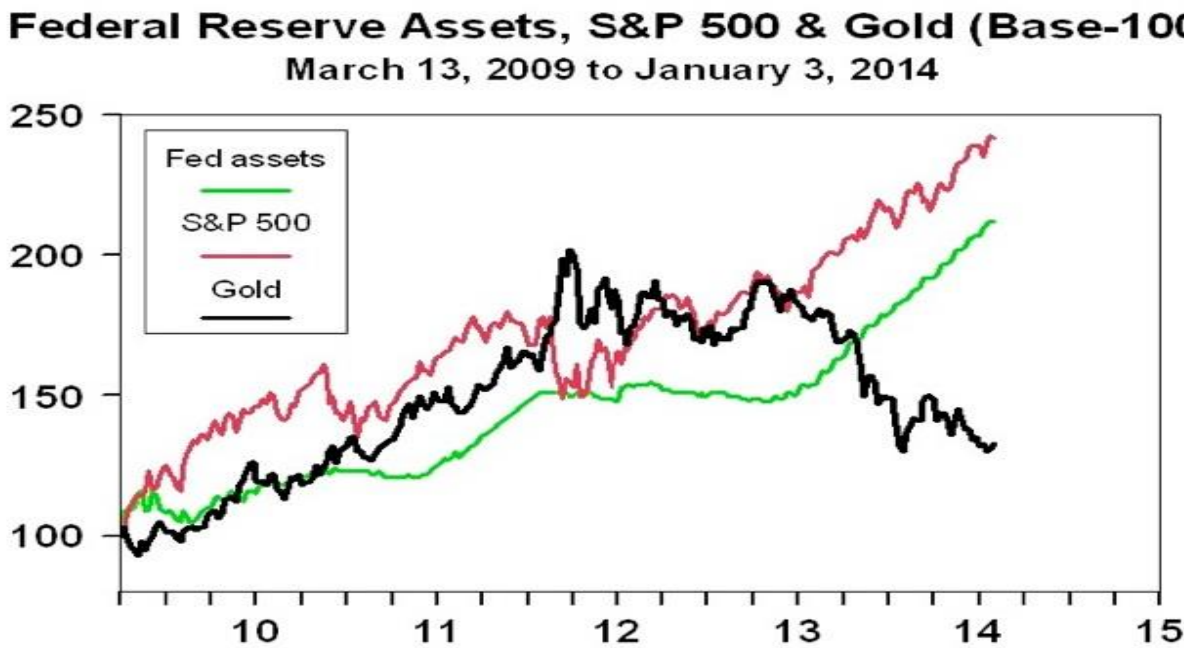


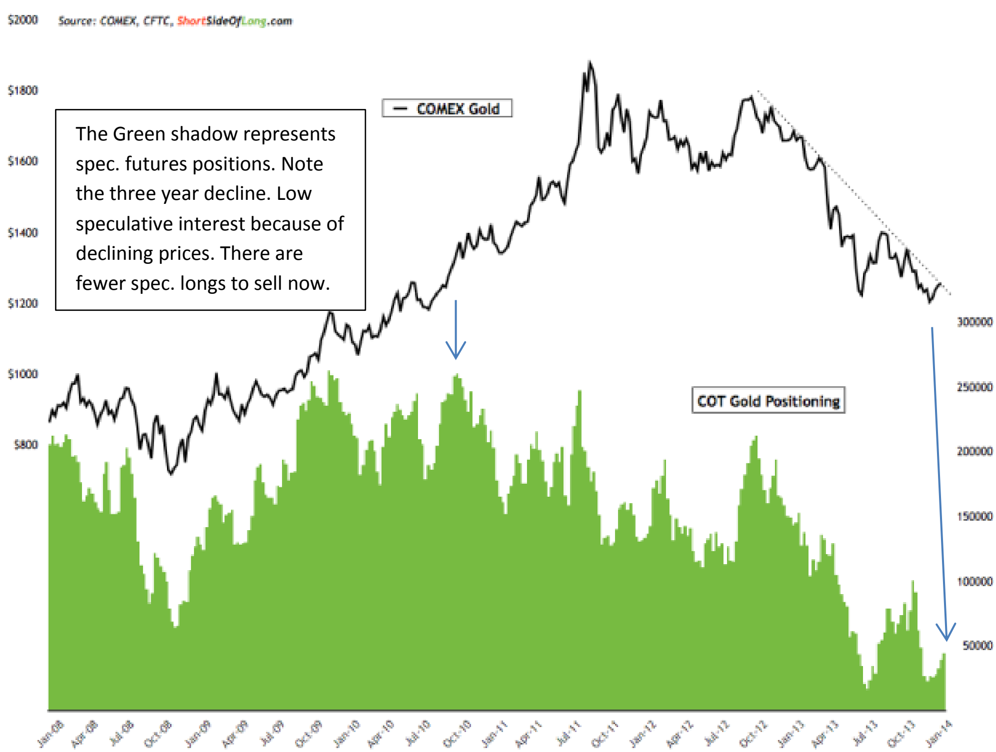
SOURCE: International Monetary Fund

5. The reasons for the rise in gold from $250 in 2001 to $1,920 in 2011 are still prevalent. Speculative investors who feared hyperinflation and a collapse in the Eurozone did not have their expectations met and may have migrated to the rising stock markets. There was a huge speculative swing from long to short in the West. Meanwhile, demand for physical gold is STRONG and growing stronger due to increasing wealth in the EAST. A 29% sell-off in gold is not unusual in a long bull market. A 50% decline occurred in 1976 when gold fell from $200 to $100 before rising to $850 in 1980.



What did happen? The S&P 500 has tracked the Fed's asset growth. Perhaps, banks are buying or lending to those who are buying stocks.


Federal Reserve Assets, S&P 500 & Gold (Base-100)
March 13, 2009 to January 3, 2014
250
200
150
100
Fed assets
S&P 500
Gold
10
11
12
13
14
15


Source: COMEX, CFTC, ShortSideOfLong.com
$2000
$1800
$1600
$1400
$1200
$1000
$800
COMEX Gold
The Green shadow represents spec. futures positions. Note the three year decline. Low speculative interest because of declining prices. There are fewer spec. longs to sell now.
COT Gold Positioning
300000
250000
200000
150000
100000
50000
Jan-08
Apr-08
Jul-08
Oct-08
Jan-09
Apr-09
Jul-09
Oct-09
Jan-10
Apr-10
Jul-10
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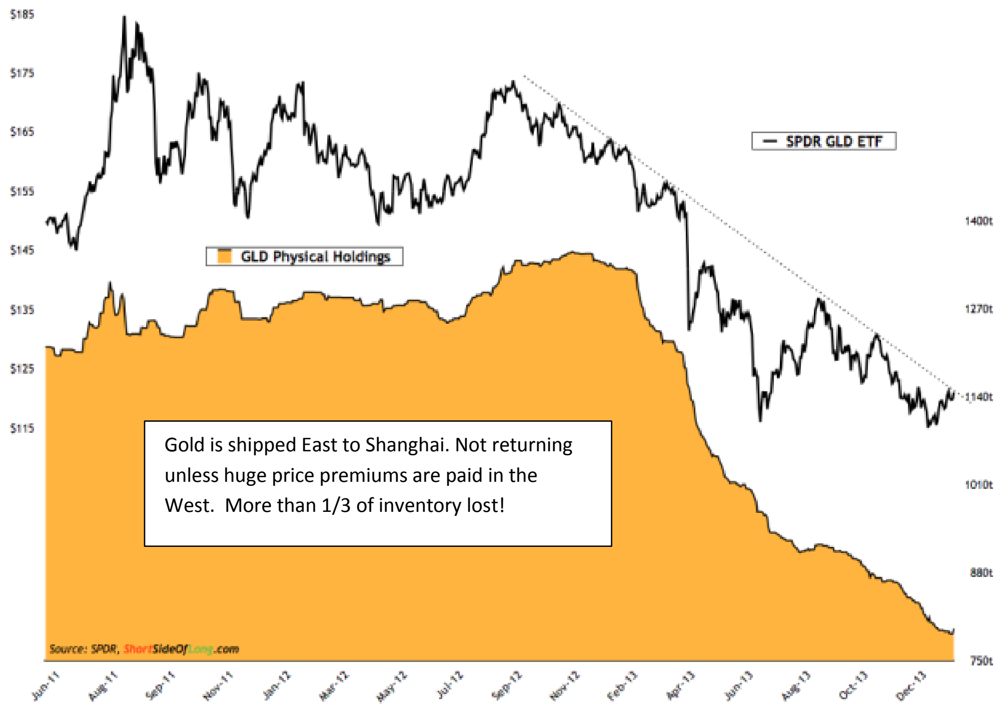


What the chart above shows is the huge swing of physical gold holdings. Gold moved out of speculative hands of ETF holders to the East as there were premiums as high as $35 per gold ounce in Shanghai to long term holders: Chinese citizens and the government.

Risks:

The massive "quantitative easing" or the printing of dollars electronically to purchase Treasury debt was helping companies expand their profit margins in the near-term but the growing debt beyond our ability to repay with taxes will eventually devastate the U.S. dollar. The underlying causes of our prior bubbles such as the Internet craze and the housing bubble are excess credit and manipulated interest rates by the Federal Reserve. See more here: http://youtu.be/Z0YTY5TWtmU

You wouldn't tell an alcoholic to cure his drinking problem by going on a bender. The government has chosen to heap more government spending and debt on top of higher taxes (Obama Care was the largest tax increase in U.S. history) and regulation. Rising interest rates will certainly hurt the U.S. dollar due to the heavy concentration of long-term debt on the Fed's balance sheet. The Fed's bond holding provides backing to the U.S. dollar besides its (reported but not audited) 8,111 tons of gold.

I do NOT want to own gold if the US government begins to reduce debts, deficits, taxes, and massive regulation, while supporting strong money with high real interest rates. Also, central planning of interest rates ceases. An example would be when Paul Volker received the political will to hike interest rates to 18% to quell the incipient hyper-inflation back during the early 1980s. Gold went into a 20 year bear market relative to the U.S. dollar. Wake me when that happens.

If there is a credit collapse, gold will be sold as well as the miners in the near-term for dollars, but the miners will recover because gold will hold its value as money vs. the miners input costs like oil, energy, steel, etc. The Fed can continue to increase QE and maintain the illusion of prosperity a bit longer, but the pressure on the dollar would probably support gold in the long-term. One can't predict the future but we can own the cheapest assets and avoid the most expensive (riskiest) ones.

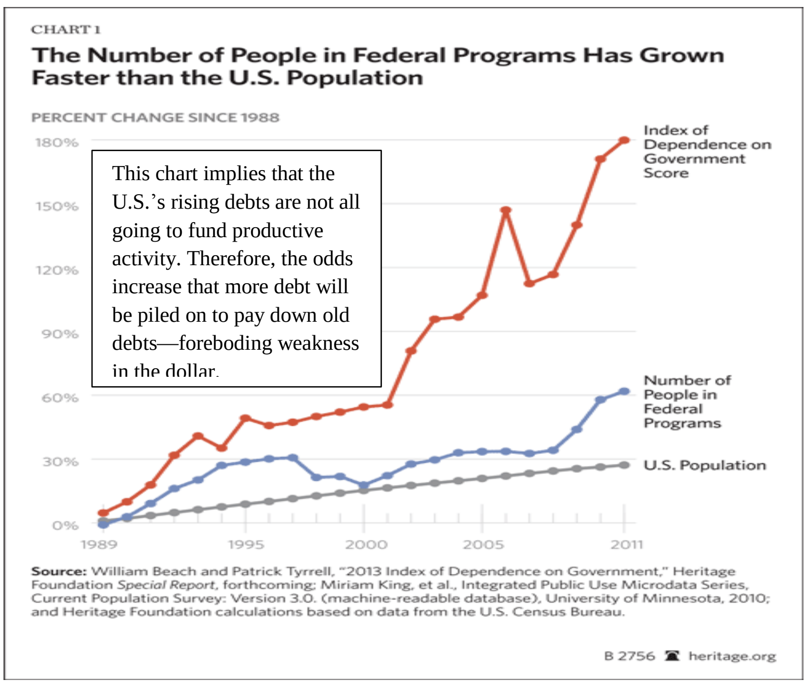
Definitions

Debt is a force for **deflation**. Encumbered firms' product to remain solvent. Heavily encumbered firms overproduce. Overproduction presses down prices. Easy access to debt prolongs the life of marginal firms. They don't go broke but, finding ready access to speculative-grade credit, carry on, thus adding to the physical volume of production and therefore to the overhead weight on prices. Debt is deflationary the more it drives production, or—in the case of governments and individuals—the more it constricts consumption.

Money printing is i**nflationary**. It lifts some prices like stocks and bond, but in the current cycle, not all of them. Banks have been impaired. Borrowers have been reluctant. The dollars that the Fed has conjured, most of them, take the shape of immobilized bank reserves. They are inert.

The Fed is egging on inflation with one hand but suppressing it with the other. It materializes the dollars that drive some (right now financial assets like stocks/bonds) prices higher. It fosters the debt formation that presses certain other prices lower. What it refuses to do is let markets clear.

So, I view our current situation as **highly risky and unstable**. Inflation or deflation? I don't know but gold is a store of value which protects return OF capital. Mining shares are the cheapest proxy for gold and silver. The belief that central planners (the Fed) can guide the economy, interest rates and the stock market is absurd and will come to tears. A fatal conceit. Imagine if your never-do-well brother-in-law who is bankrupt with massive credit card debt asks you for help. Would you just give him a higher credit limit? **More debt will not solve indebtedness especially as the debt is going towards unproductive uses**—see chart 1 below**.** If printing fiat money (quantitative easing) by the worlds' central banks solved problems, then Zimbabwe would be the richest country in the world. Money and credit does not magically create capital.



Almost half the U.S. population is on some form of public assistance.

http://cnsnews.com/news/article/terence-p-jeffrey/census-49-americans-get-gov-t-benefits-82m-households-medicaid

Off-balance sheet U.S. government liabilities estimated above $200 Trillion. Unpayable at the current value of the dollar.

http://usawatchdog.com/america-in-worse-fiscal-shape-than-detroit-professor-laurence-kotlikoff/

Sobering!

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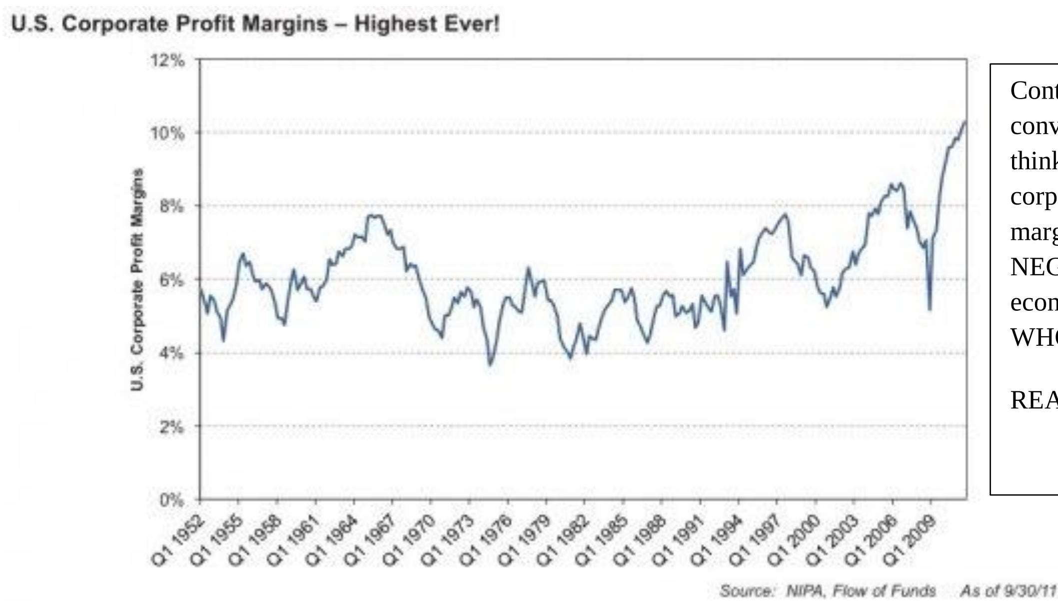
The only way I see to preserve capital in the long run is to **buy the most undervalued assets or franchises on an absolute basis and avoid over-valued assets and franchises.** Ideally, I would like to own profitable franchise[1] companies like the ones we owned back in 2009 through early 2013 such as IBM, Coach, WMT, MMM, Colgate, etc. at fair prices to return 15% per year compounded over time. As prices rose to and beyond my targets, I began to

[1] A franchise is defined as a company with a structural competitive advantage that can grow profitably. Example: Coke with economies of scale coupled with customer captivity.

sell and then try to reinvest those funds into other quality companies at the right prices. However, going on five years of money printing by the Federal Reserve to suppress interest rates to near zero had forced almost all stocks into full value in my estimation. **I could find no margin of safety.** Plus, **profit margins had risen to all-time highs** as managements deferred growth capex due to uncertainty of future high tax rates and massive, smothering regulation and ObamaCare. Managements are taking on debt to return excess cash to shareholders mostly through buybacks. **This is fine in the short-term but what about five years from now? What will fuel profitable growth?**

<u>U.S equities are overvalued if corporate profits are mean-reverting:</u>

Here you can see that profits presently exceed 10% of America's GDP.

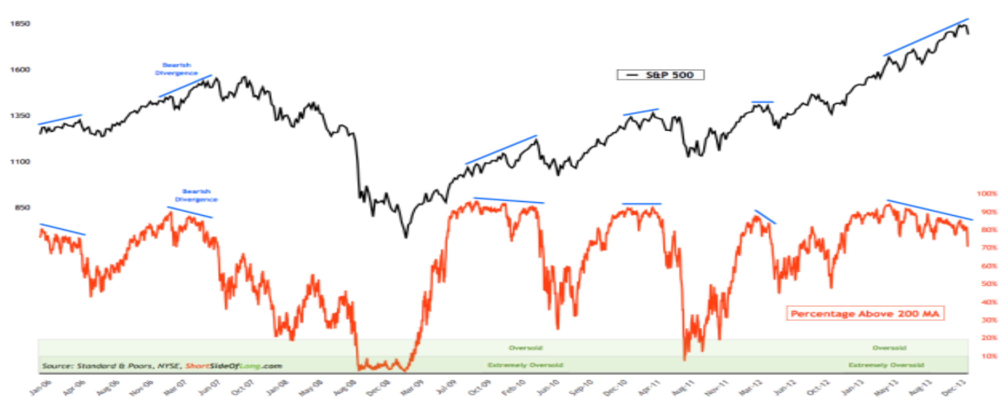


Contrary to conventional thinking, high corporate profit margins are NEGATIVE for the economy AS A WHOLE.

READ ON.

IF and when those profits revert, then stock prices are in for low to negative returns over the NEXT DECADE from today's prices.

"In the many years I've been surveying experts for their predictions for the coming year (2014)," writes New York Times' columnist James B. Stewart, **"I cannot recall another time when optimism about the stock market, the economy and corporate profits was so widespread.** As is pessimism about the bond market."



What is driving the record profitability? CEOs have high time preference. They are deferring growth capital expenditures to build up cash or return cash to shareholders via buy backs. In other words, rising net consumption is driving profits. Capitalists' revenue minus their productive expenditure equals their net consumption, which equals aggregate profit.

One of the hallmarks of today's economy is the gap between the gains accrued to shareholders and the gains made by workers in the recovery.

This gap has manifested itself in record corporate margins and massive piles of cash.

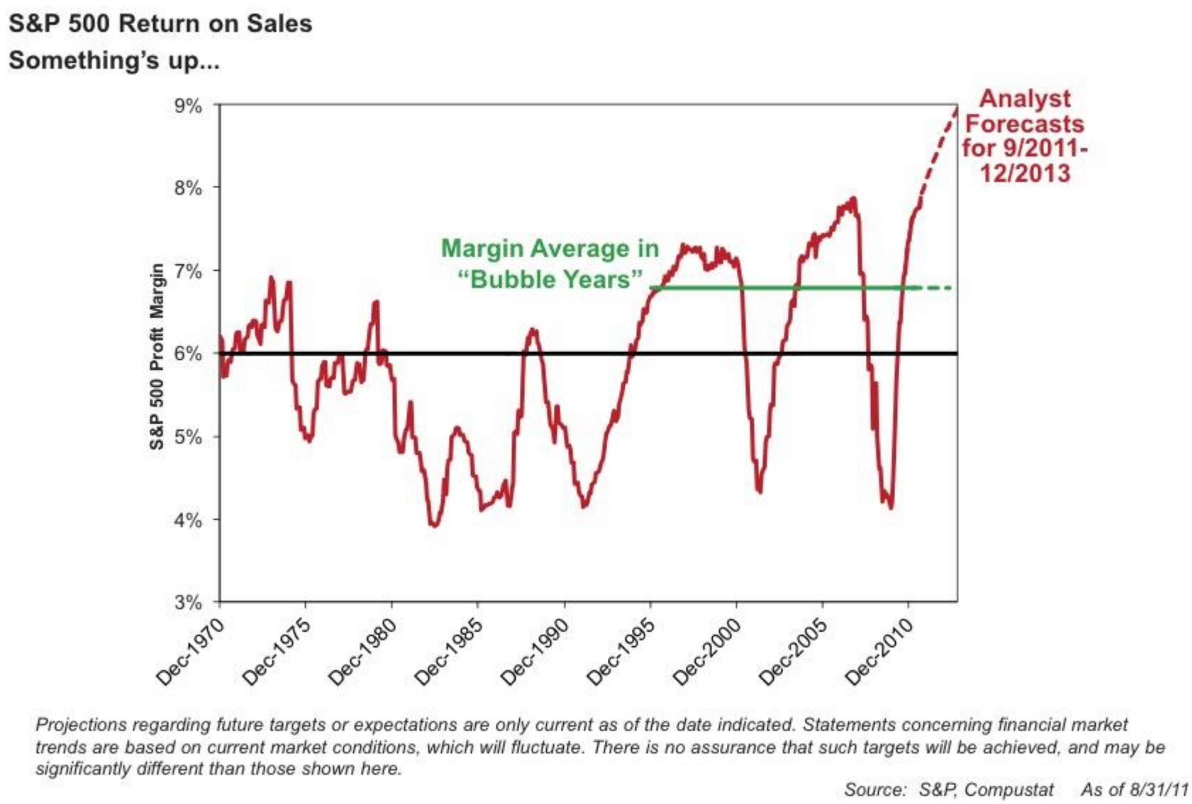
So what gives?

In a new-must read, GMO portfolio strategist James Montier delves into the origin of this issue.

Today I find myself once again digging through this toolkit, searching for a way to understand the development of profit margins. Currently, U.S. profit margins are at record highs according to the NIPA data. More freakish still is that **these record high profit margins are coming during the weakest economic recovery in post-war history.** Here's a look at said margins.

GMO LLC

What's crucial here, from the perspective of investors, isn't just that margins are above previous highs, but that **current earnings projections assume they'll go even higher** (At least as of late last year)!



GMO LLC

So what's the source of these incredibly high margins, and can they really persist?

Here Montier gets into the basics of the flow of funds and the national accounts, and he bases his work on the economist Michael Kalecki, who identified this simple equation:

Income = Expenditure

That seems obvious, but it's a good starting point to recognize that every dollar spent represents income for someone else.

Montier then notes that income equals profits and wages and that expenditures are divided into investment and consumption, so the above equation actually turns into...
Profits = Investment + Consumption – Wages

That gets permuted some through a few more steps, so that ultimately the equation for profits turns out to be:

Profits = Investment – Household Savings – Government Savings – Foreign Savings + Dividends

And with that equation we can finally start figuring out the source of those monster profits.

This is how things looked like in 2011:

Driver	% of GDP
+ Investment	+3.2%
– Household Savings	-3.4%
– Government Savings	--7.6%
– Foreign Savings	-2.7%
+ Dividends	+5.5%
= Profits	10.2%

See the big source of profits? It was the government's negative savings. Or to put it another way, it was the huge deficit equaling 7.6% of GDP that really boosted corporate profits.

Now what you have here is the justification for huge government deficits. Following the crisis, the private sector balance sheets were badly damaged, and **government deficits have done wonders towards boosting GDP and corporations.** The question being is how long we can continue our profligacy without dollar devastation?

The title of Montier's piece is: **What Goes Up Must Come Down!**

Read here:
http://www.zerohedge.com/sites/default/files/images/user5/imageroot/2012/02/Montier%20-%20What%20goes%20up%20must%20come%20down.pdf

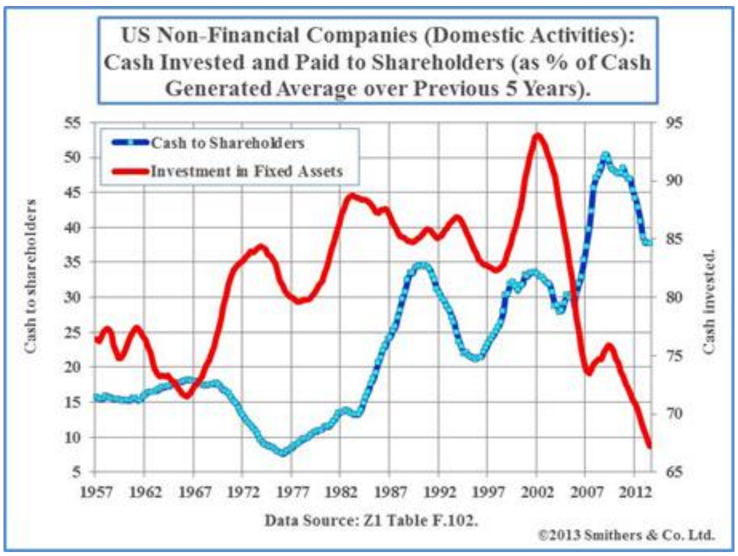
If you think that the deficit will inevitably shrink, then to maintain profits, something else has to change. Can consumers afford to save less? Can we shrink our trade deficit? Will there be a reason for investment to jump? If not, then the boom is over.

Since understanding why the current high profit margins are both unusual and unsustainable will be critical to understanding how high the risks are in the stock market, let me simplify.

High time preference determines the proportions in which people devote their income and wealth to present consumption (more) versus provision for the future (less) due to financial repression, higher taxes, and regulation. But you may ask, "How can fear of the future lead to high profits?" Imagine if you were a primitive native who fishes with his hands. Each day you catch two fish so your net consumption is high; you live in the present. Your profit is two fish! You could take half a day off to make a spear but your net consumption would fall to one fish but your capital (the spear) could be made. That day you spend a half day making your spear your "profit" or two fish drops 50% to one fish, but your investment in capital goods increases to one spear. Hopefully, your future production will increase your catch to three or more fish each day. Your productivity to kill/catch fish would rise with the use of your new spear. You are willing to defer consumption to save/invest for the future if you have confidence in the return on your investment.

When the Fed increases fiat money then capitalists increase their amount of investment, i.e., capitalists' demand for productive goods virtually always exceeds the cost of investment. As a result, net investment will comprise a semi-permanent component of aggregate profit. An increase of the quantity of money causes aggregate profit to rise. Today's increase in the quantity of money causes today's prices--but not yesterday's costs--to rise. The cost of investment (depreciation) reflects the past purchases of capital goods, which were made at the lower prices prevailing in the past. The Fed's increase in fiat money creates the illusion of true profits.

Here is a chart that illustrates the above concept of low investment:



Perhaps American businesses require less capital investment in fixed assets or our future productivity to pay down our debt/obligations is being compromised by underinvestment.

The drop in investment is dramatic – especially juxtaposed against the rising portion of cash that companies are returning to shareholders. This shouldn't be the case when earnings and profit margins are at peak levels and the economy has been expanding for four years. And there is growing evidence that the way executives are paid is playing a role in their investment decisions. Research published this year from Alexander Ljungqvist, a research associate at the NBER, and two other colleagues, found that non-publicly traded companies have been investing at twice the rates of those of publicly traded companies. Private companies invest 6.8 percent of total assets while publicly traded companies **invest just 3.7 percent.** Also interesting, the researchers found that when a company goes public, they change their investment behavior, investing at a lower rate. That is, newly publicly traded companies slow the rate of their investments and begin to invest at the rate of the typical publicly traded company.

As the recovery continues to age, the standard explanations for low corporate investment rates become less compelling. Investment hurdle rates aren't very high with market interest rates so low. Record earnings and profit margins should have already kick-started an investment boom. That fact that it hasn't should have investors asking questions about when that may change and what the long-term implications for such low corporate investment rates will mean for the long-term growth rate of stocks and the economy.

A detailed discussion of the coming collapse of profit margins—unless QE is expanded greatly (negative for the dollar, in my opinion) **http://www.leithner.com.au/newsletter/feb13_newsletter.pdf**

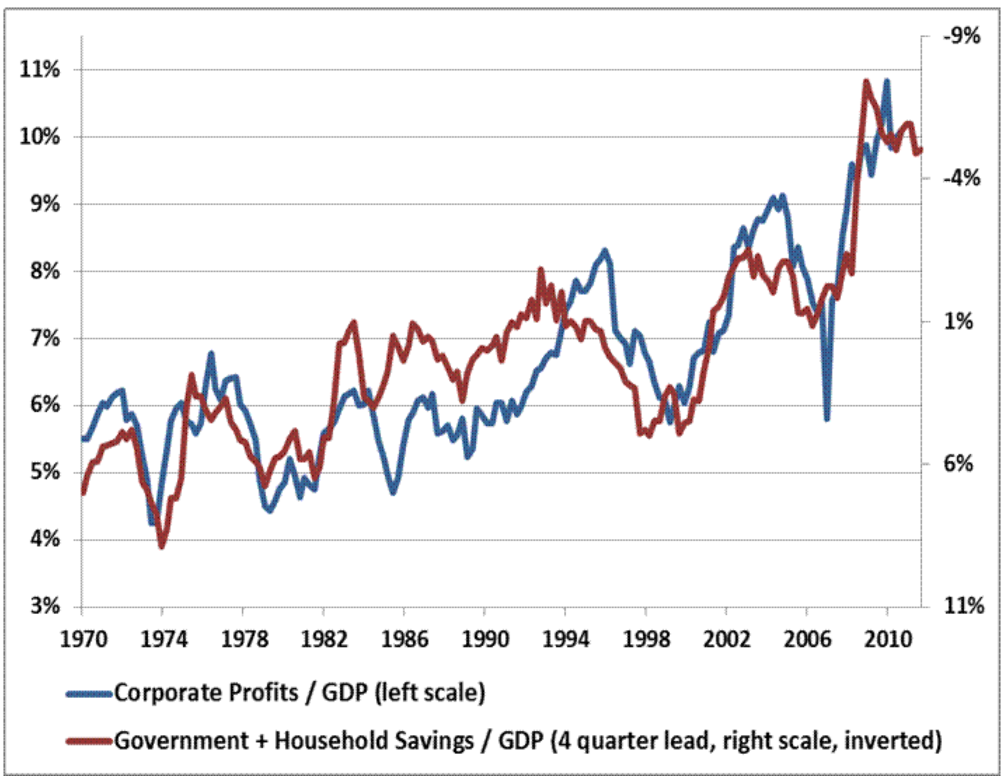
For more detail on the nonsustainability of corporate profits click here:
http://www.hussmanfunds.com/rsi/cape.htm and Profits are mean-reverting:
http://www.kingworldnews.com/kingworldnews/Broadcast/Entries/2014/1/15_Rob_Arnott.html

Finally, government deficits are another driver of corporate profits:

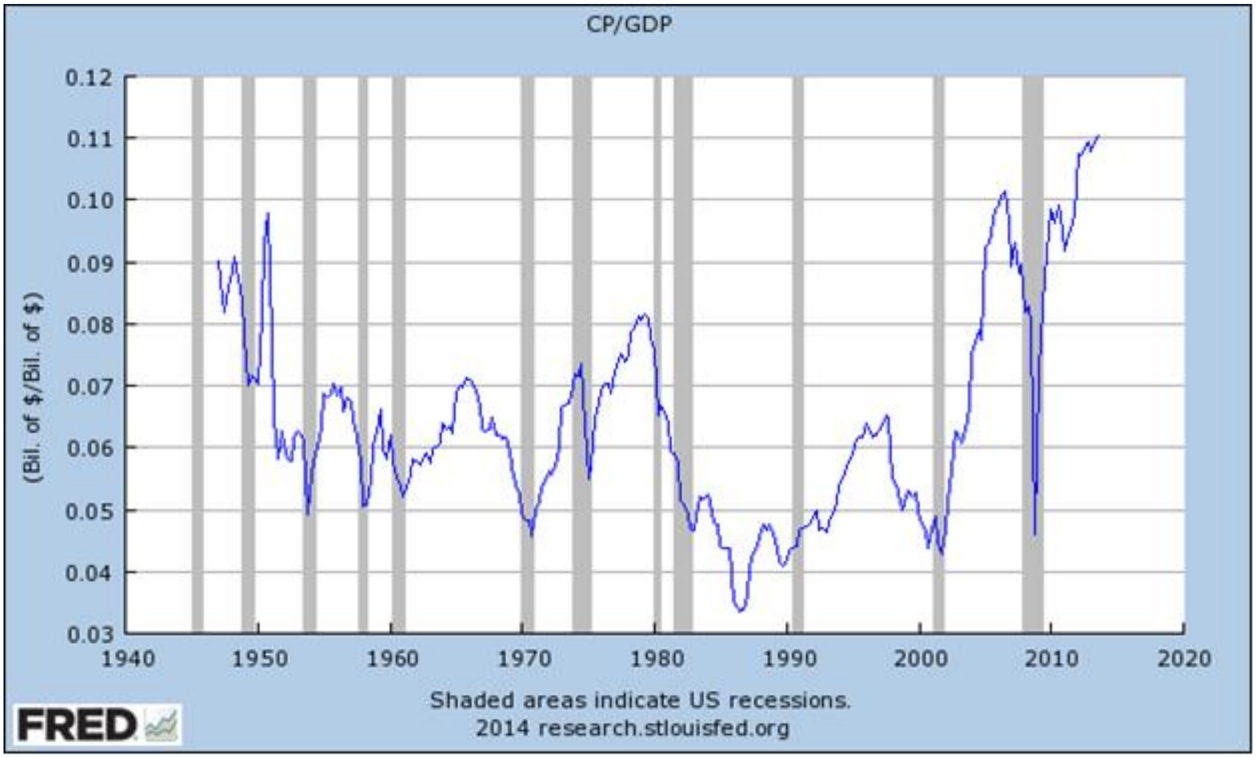
"The deficit of one sector must be the surplus of another.

This is not a theory. It's actually an accounting identity. But the effect of that identity is beyond question. Elevated corporate profits can be directly traced to the massive government deficit and depressed household savings that we presently observe.

I should note that this result is the outcome of hundreds of millions of individual transactions, so it's tempting to focus on those transactions as if they are alternate explanations. For example, one might argue that corporate profits are high because people are unemployed, many workers have been outsourced, and government transfer payments are allowing corporations to maintain revenues from consumers despite low wage payments. That's a perfectly reasonable of saying the same thing – but the transaction detail does not change the basic equilibrium that profits are elevated because government and household savings are dismal. One will not be permanent without the other being permanent. To see this, ***notice that corporate profit margins have always moved <u>inversely</u> to the sum of government and household savings"***

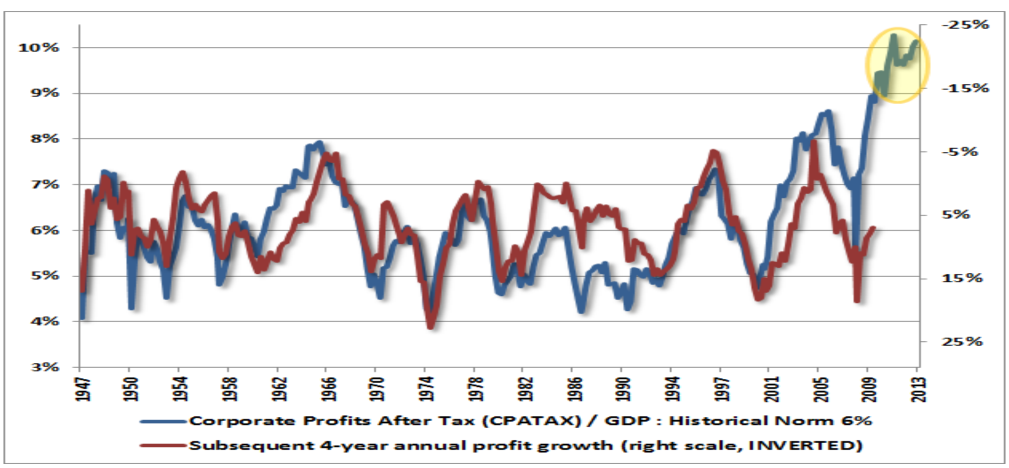


That's a pretty important chart above. What it's essentially showing is that government deficits have been a big driver of corporate profits.



Currently profits are coming in at 11% of GDP, a level that is around 60% higher than the average of around 6% that has been seen since 1952. It is even significantly higher than the average of the past 10 years - a period during which low interest rates pushed up financial ratios past their traditional levels. To return to a more normalized ratio either GDP would have to expand rapidly or profits would have to diminish. Given our view of the current economic prospects, we believe the latter outcome is more likely.

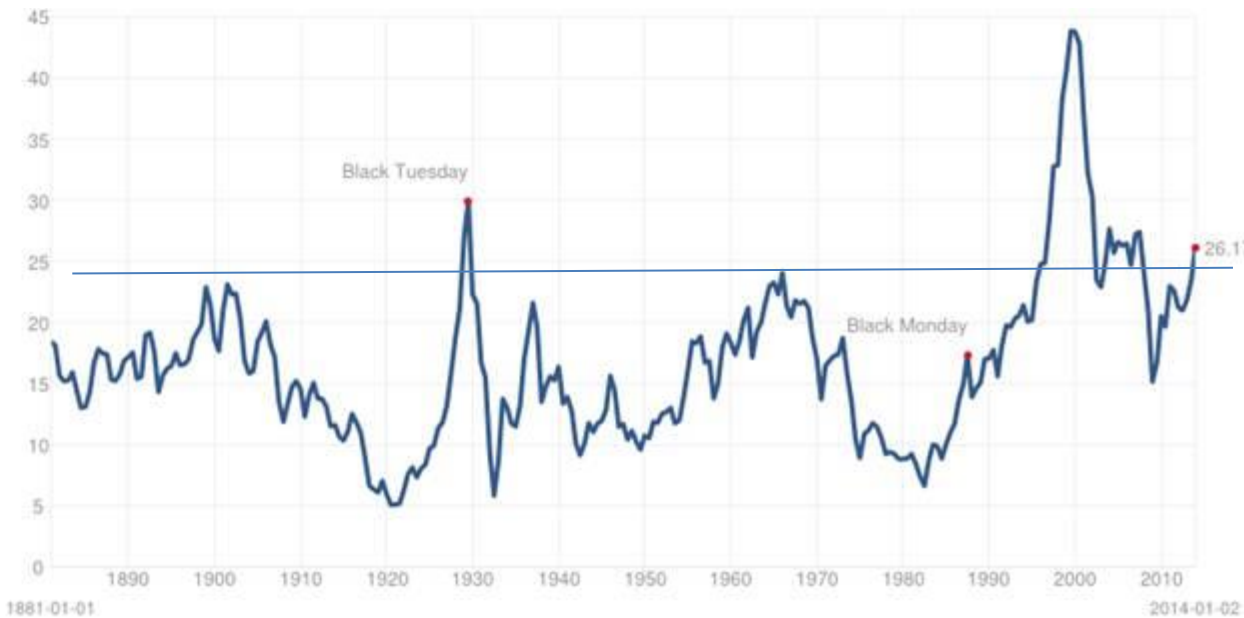
If the US government can keep inflating its balance sheet for a while, then margins can remain high. A bubble requires increasing credit.



The chart above shows corporate profits as a share of GDP, with a reminder of how elevated levels relate to subsequent profit growth. I can't emphasize enough that the issue is *not* what happens to profits over just the next 4 years, however. The issue is whether current profit margins are *representative* of what investors should expect for the next *50 years*.

Price/Earnings Ratios

Currently market bulls will tell you that current price to earnings ratios are well within their historic range. What P/E ratios are based on are **expected earnings for the coming year**. But those earnings won't be known in full until well into 2015. And like many forward-looking forecasts, **they may be overly optimistic.** More sophisticated investors tend to rely on the *Shiller S&P 500 P/E Ratio* which compares U.S. stock prices to average inflation-adjusted earnings actually delivered over the past 10 years. This takes a lot of the guess work out of the equation and compares current U.S. stock prices to the historical *long-term earnings power*. Today the Shiller S&P 500 PE Ratio is at 26.4. But going back 100+ years, the historic mean of the index is 16.5. This means the current ratio is **61% higher than its long term average.**

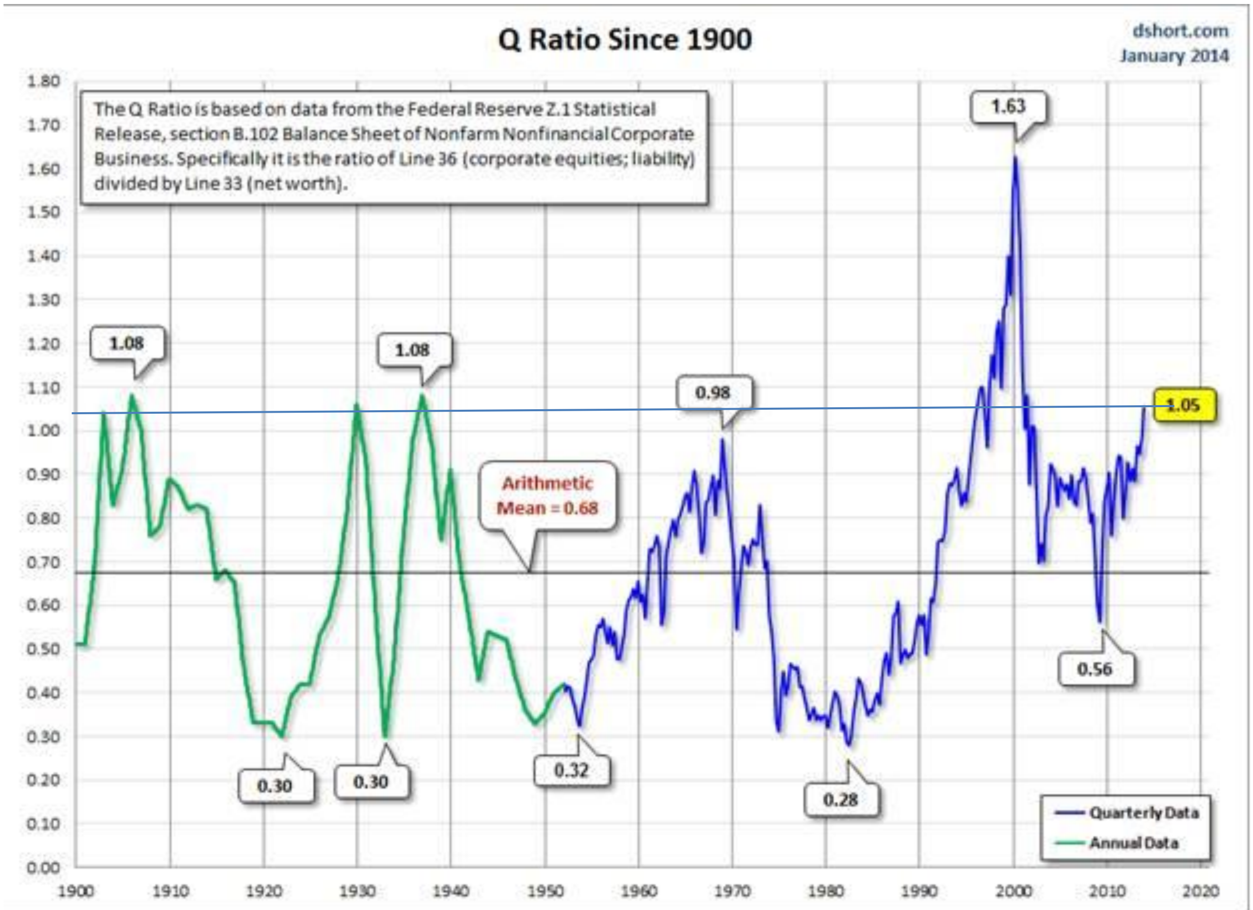


Shiller (1/2/2014)

U.S. STOCK PRICES VS. CORPORATE ASSETS: TOBIN'S Q RATIO

But maybe earnings just aren't as important as they used to be. In order to try to justify current prices, I looked at U.S. stock prices vs. corporate assets. Tobin's Q Ratio is a popular measure that compares the market value of a company (which is a function of share price) to the amount it would cost to replace the company's assets.

So if a company owned a factory, and the market capitalization of the company was $1 million, but the factory would cost $2 million to build today, Tobin's Q Ratio would be 0.5. The lower the ratio, the less the investor is theoretically paying for the company's assets.



Past performance does not guarantee future results.

At greater than 1, **Tobin's Q Ratio implies that stocks are overvalued.** From the chart above, you can see that the Tobin's Q Ratio for the **U.S corporate sector is at 1.05**, which is approaching the level associated with past market declines. The historic mean over more than 100 years for the ratio is just .68 and there are only a few occasions over that time when the ratio passed 1.0. When it did, declines typically followed. The late 1990's was the only instance in which the ratio passed 1.1. At that time it shot up to 1.63, before eventually plunging. But should we really hold up the dotcom mania as a benchmark for sound valuations?

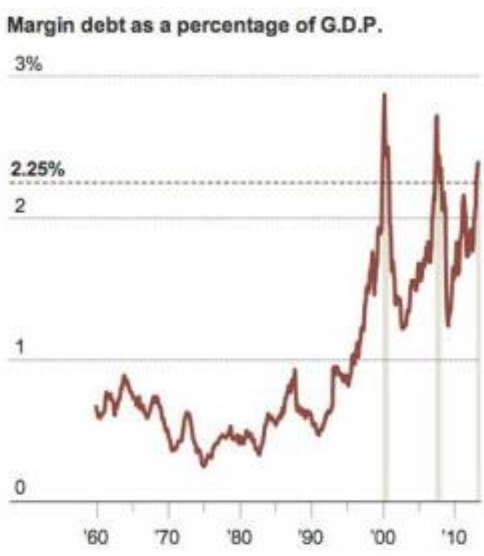
However, in the mining sector, an investor would find cheaper ounces in the ground through buying a company rather than exploring. View this expert mining panel: http://youtu.be/Og6j9U7TDsU

U.S. STOCK PRICES VS. GDP

Let's compare U.S. stock prices to GDP, which is the widest measure of domestic economic activity. On that front there was little encouragement to be found. The chart below compares the total market capitalization of all publicly traded U.S. companies with U.S. GDP.

U.S. STOCK PRICES VS. MARGIN DEBT

Just as it's possible to buy houses with debt (mortgages), people can buy stocks with debt (it's called margin). As stocks go higher, an increased number of investors may become tempted to tap into available margin in order to buy appreciating assets. This is particularly true when low interest rates push down the cost of borrowing. Not surprisingly, the chart below from the New York Times shows that stock margin debt as a percentage of GDP is approaching the higher end of its historic range:



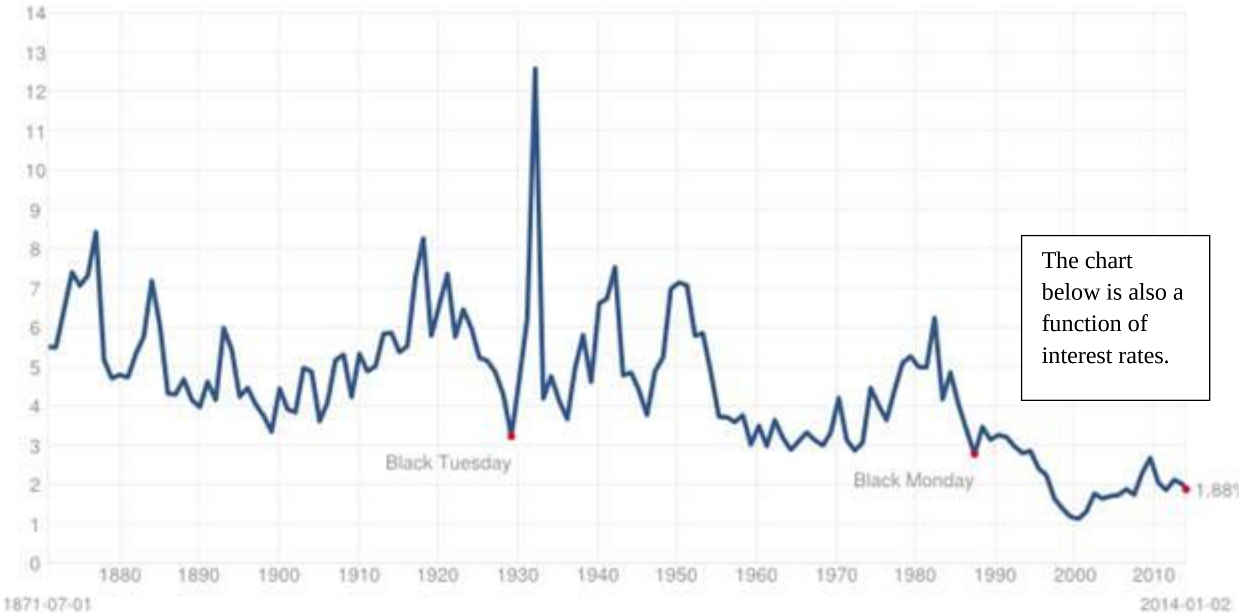
Growth of margin debt can drive share prices higher but drive prices lower if prices decline. Leverage works both ways. High leverage equals higher risk.

New York Times (5/31/2014)

U.S. STOCK PRICES VS. DIVIDEND YIELD

Of all the ways to measure stock valuations, dividend yield may be the most tangible. Evaluating dividends doesn't require projections or assumptions, just straight math. Dividends are what investors are paid directly to own stocks.

Yields (which are calculated by dividing dividend payments by share price) give us a fairly good barometer of relative value. By that metric, U.S. stocks are looking historically expensive.



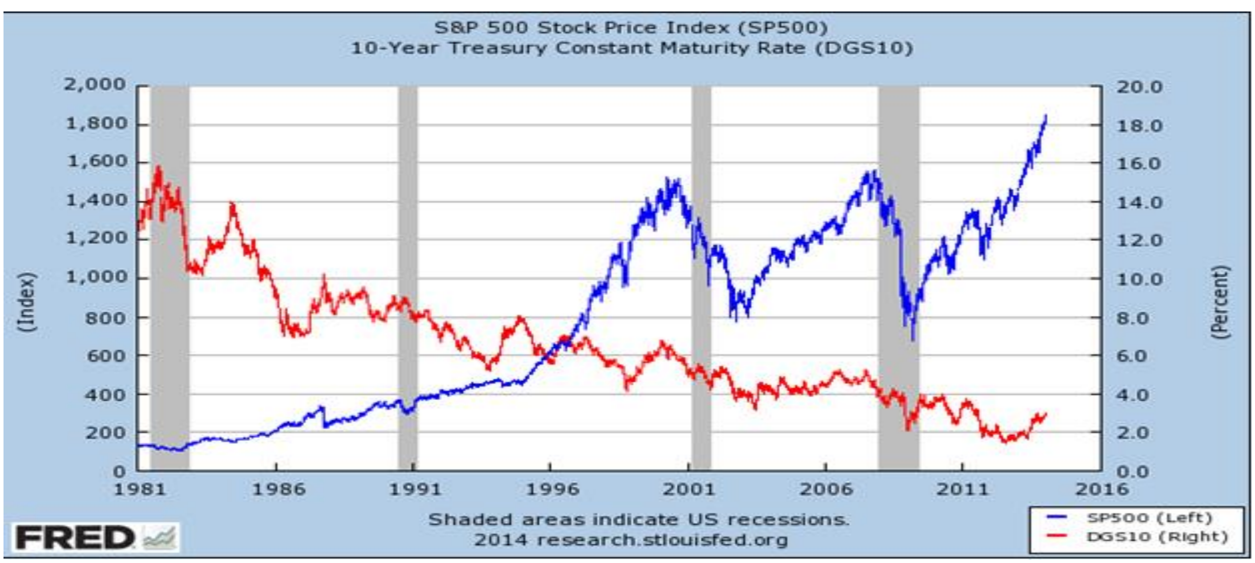
The chart below is also a function of interest rates.

Multpl.com (1/2/2014)

As you can see in the chart above, the dividend yield on the S&P 500 is the lowest it's ever been (with the exception of the period around 1999 - there's that year again).

U.S. STOCK PRICES VS. INTEREST RATES

Ah, the Holy Grail of stock market bulls: interest rates. By definition, the present value of stocks is valued higher by investors when interest rates are anticipated to be lower in the future (Meaning that investors are willing to pay more for well-established income streams today in anticipation of lower rates making it more difficult to find yield in the future).



As seen in the chart above, during the 30+ years from the early 1980s to 2013, yields on the 10-year Treasury bond were cut in half between 1981 and 1989, from 16%. They were halved again by 2002, and again by 2011. From there they decline another 25% before bottoming in May 2013, at 1.5%. These historic declines helped fuel an historic rally in stocks.

Low interest rates also tend to keep corporate costs down and profits up (low rates are one of the main factors in the current profit boom), and make stocks more attractive relative to bonds. They tend to be a further positive catalyst for stocks. As a result of the Fed's current commitment to keep interest rates near zero for the foreseeable future, many investors have adopted the "Don't Fight the Fed" rallying cry. (A new variant on this maxim is "As long as it's Yellen, don't think of sellin.")

But here's the problem**...interest rates remain in historically low territory and have been trending upward slowly for the past year and a half.** It's unreasonable to expect this trend to reverse and interest rates to fall once again into record low territory. Instead, it would be more likely that rates would rise from current levels, especially if the Fed goes through with its tapering campaign and diminishes the amount of Treasury bonds it buys on a monthly basis (purchases that have helped keep rates low).

In the first weeks of 2014, yields on 10-year Treasuries flirted with three percent for the first time since July 2011, a time in which the Dow Jones Industrial Average was about 23% below current levels. We could argue that the recent increase in yields, and the likelihood that it continues, has yet to be factored into stock prices. Instead, **investors appear to be expecting permanently low rates.**

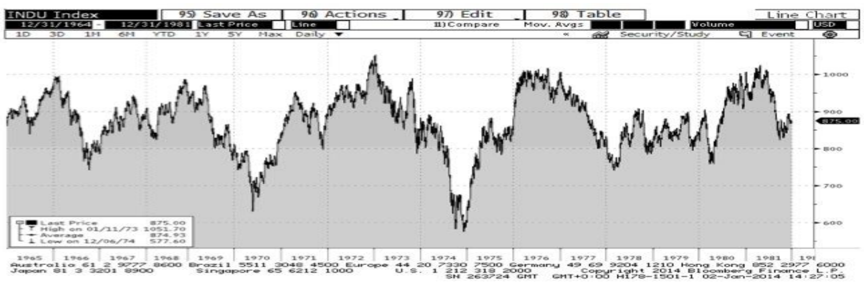
IN CONCLUSION

While the above analysis is in no way exhaustive, I believe that the above metrics make a fairly solid case that **U.S. stocks are likely overvalued.** I believe that the current optimism is based solely on confidence in monetary policy and the belief that the **U.S. has embarked on a period of sustained expansion.** However, as Peter Schiff has explained many times (see videos: **http://youtu.be/Z0YTY5TWtmU** on 2000 and 2008 busts**)**, the economy now shows many of the over-leveraged and delusional characteristics that existed before the recessions of 2000 and 2008. Perhaps that helps to explain why today's markets so closely resemble those periods. View comments about today’s conditions: http://youtu.be/zkbhq36oxEE

Could the U.S. stock market go up from here? Of course it can. Irrational increases often go on longer than level-headed people expect. But the longer it goes on, the more worrisome it becomes. The greater will be the misallocation of capital. Booms require ever increasing doses of credit/easy money. Who knows how the markets will react if the Fed has to reverse and INCREASE quantitative easing ("QE"). The game will be over? If QE is eliminated (I'm doubtful) then the boom is over. **There is no way the current situation can remain stablefa.**

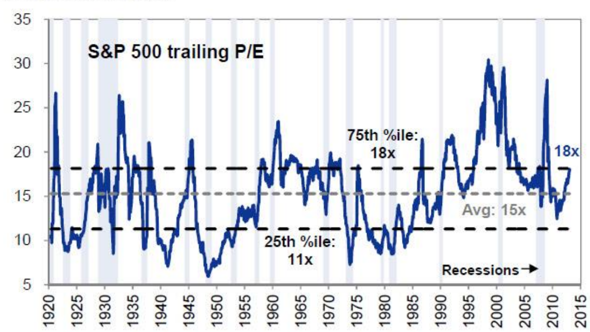
But while the mainstream media on Wall Street continues to paint pretty pictures, other facets of the financial establishment are following a different script. According to a recent report from a Bank of America Merrill Lynch analyst, while private buying of stocks has increased briskly in the past year, institutional players (the so-called "smart money") have accelerated their sales.

Stock prices may not plummet but a repeat of the 1970's stagflation market may occur. Sideways and volatile.



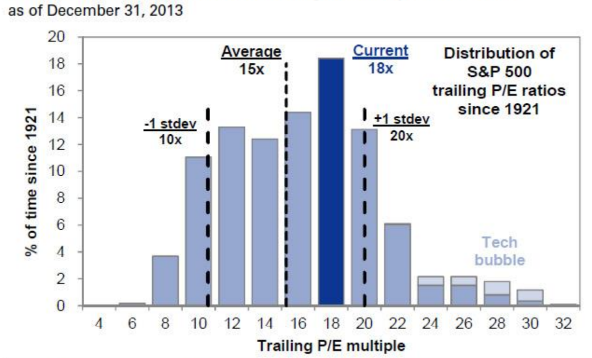
The market's valuation: http://www.hussmanfunds.com/wmc/wmc140120.htm

Exhibit 1: S&P 500 trailing P/E since 1921
as of December 31, 2013



Source: Robert Shiller, Standard & Poor's, Compustat, and Goldman Sachs Global Investment Research.

Exhibit 2: Distribution of S&P 500 trailing P/E multiples since 1921
as of December 31, 2013



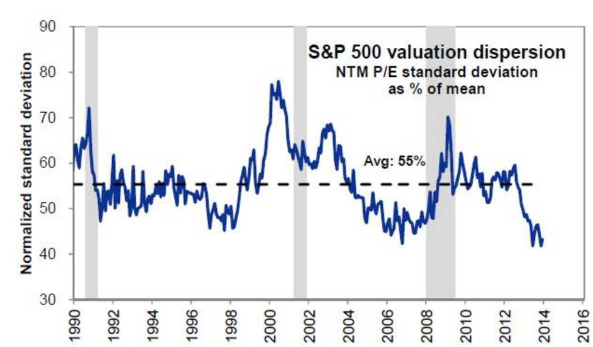
Source: Robert Shiller, Standard & Poor's, Compustat, and Goldman Sachs Global Investment Research.

Exhibit 3: S&P 500 P/E multiples in various interest rate environments
as of December 31, 2013

Nominal yield	Average P/E Trailing (since 1921)	Average P/E Forward (since 1976)	Real yield	Average P/E Trailing (since 1921)	Average P/E Forward (since 1976)
≤2%	15.0x	12.5x	≤0%	16.4x	12.8x
2% - 3%	12.7	12.8	**0% - 2%**	**19.6**	**14.3**
3% - 4%	**16.7**	**14.3**	2% - 3%	13.3	14.7
4% - 6%	20.8	17.3	3% - 4%	15.6	13.1
6% - 8%	17.3	12.9	4% - 6%	21.1	18.6
>8%	11.5	8.2	6% - 8%	17.2	12.9
Average	**15.9x**	**12.6x**		**15.9x**	**12.6x**
Current	**19.6**	**16.0**		**19.6**	**16.0**

Source: Robert Shiller, S&P, Compustat, I/B/E/S, FRB, Global Financial Data, and GS Investment Research.

Exhibit 4: Distribution of S&P 500 P/E multiples remains historically tight
as of December 31, 2013

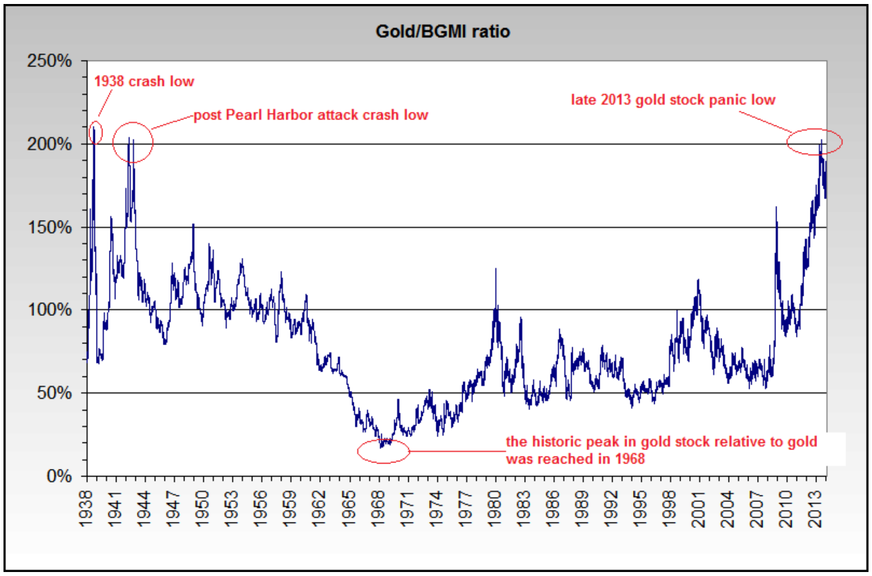


Source: Compustat, I/B/E/S, Goldman Sachs Global Investment Research.

I hope you realize how risky the *market in general* has become. Not all stocks are over-priced; I am speaking in terms of the averages. On top of the stock market, there are other dangers/bubbles lurking, real estate implosion: http://www.oftwominds.com/blogjan14/CRE-deadwood1-14.html

Of artificial profits and inflated stock markets: http://www.leithner.com.au/newsletter/feb13_newsletter.pdf

A Search for Cheapness: Precious Metals Miners at all-time lows.



The rising blue line indicates that gold prices are going up more or down less than the Barrons Gold Mining Index (BGMI). Prices recently touched the third lowest price (miners in terms of gold and silver prices) in over 90 years. Veteran observers say the miners have been in the worst bear market in 35 years!

Or this could be a once in a generation opportunity to buy cheaply.

In my search for cheap companies, I came across precious metal mining companies. It was a hated asset class because of declining gold and silver prices plus mining companies had underperformed the rise in metals' prices due to poor acquisitions, dilutive share issuance, overexpansion, etc. As I dug further, I saw that declining prices were forcing management changes to focus on returns on capital and not just growth for growth's sake. And gold, as money that can't be debased, is the best store of value in a currency war, credit crisis or hyper inflationary event.

No matter what metrics you use, miners are at historically low prices. Let's Get Physical: gold bullion and Bitcoin | Tocqueville and **Gold Monitor** *(please click through).*

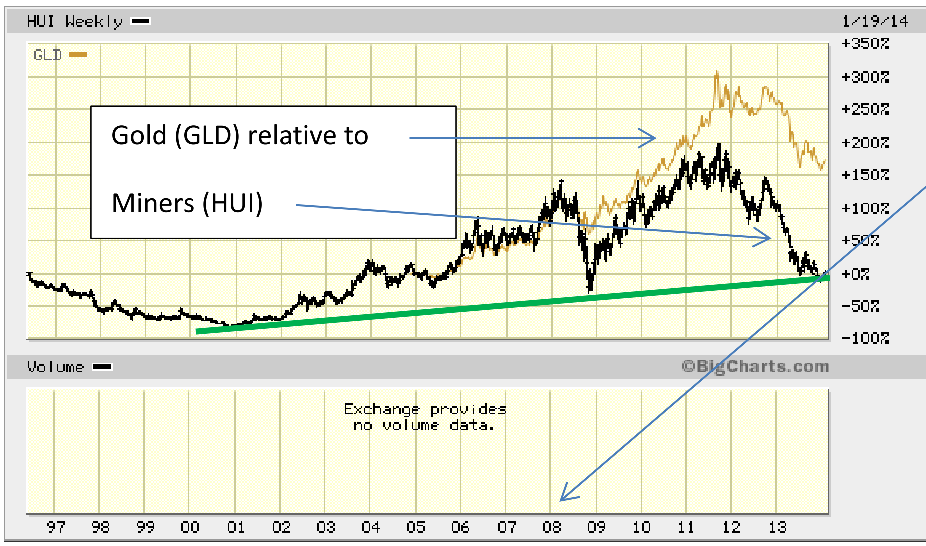
Empirical Evidence of Cheapness/Undervaluation

Recently Goldcorp made a hostile bid for a high cost miner, Osisko, at a price premium that would give certain companies in our portfolios a 100% higher price. http://business.financialpost.com/2014/01/20/osisko-board-rejects-goldcorp-hostile-bid/. This is the beginning of empirical evidence that our assets are too cheap relative to their future cash flows and properties. I expect that over the next eighteen months we will see many more takeovers as the industry consolidates. Meanwhile, weak companies will fold. All that helps our portfolio since we own well-capitalized producers and projects.

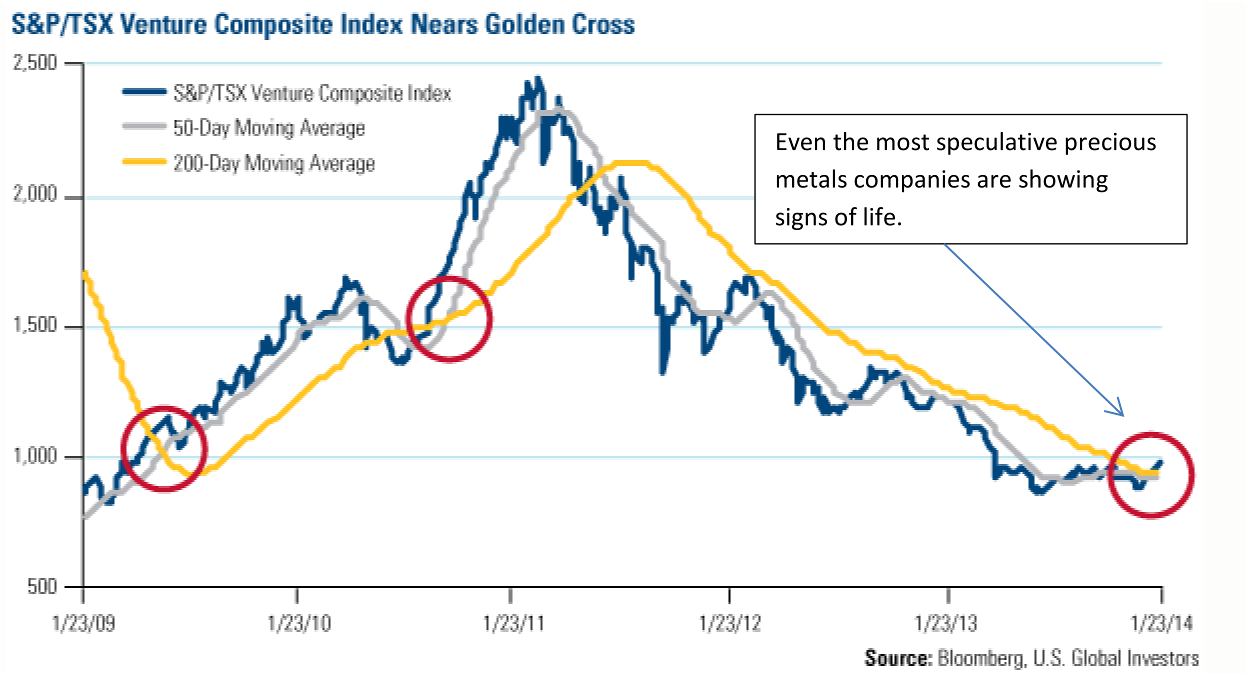
The **Hui Gold Mining Index d**aily chart of a nine month bottom.

The cure for low prices is low prices. The laws of economics grind slowly.

The day to day volatility has been huge, but Mr. Market is a voting machine not a weighing machine. If you are not a contrarian , you are a victim.



Note that miners underperformed the gold price after 2008. Miners sought growth without considering return on capital. That thinking has changed as 70% of all management CEOs at major miners have been changed.

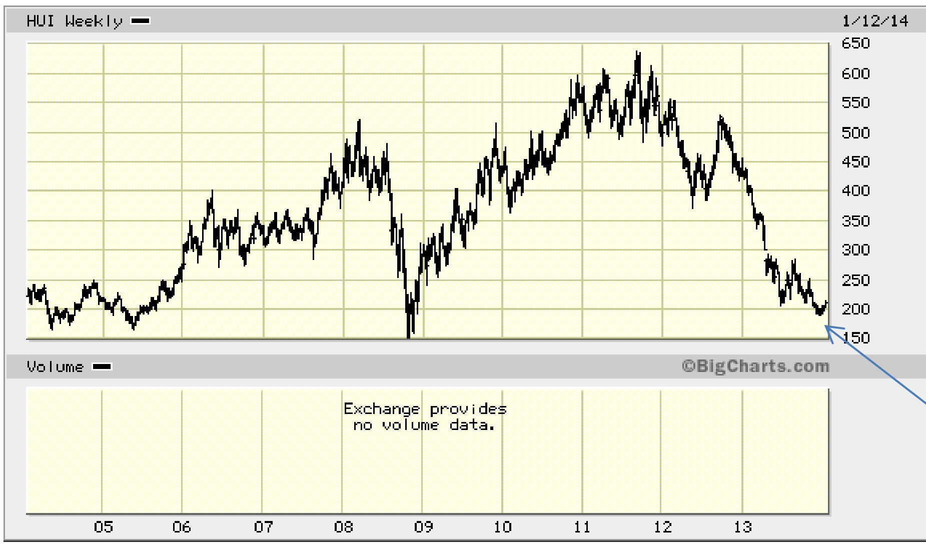


Why gold stocks lead gold: http://news.goldseek.com/GoldSeek/1390572900.php

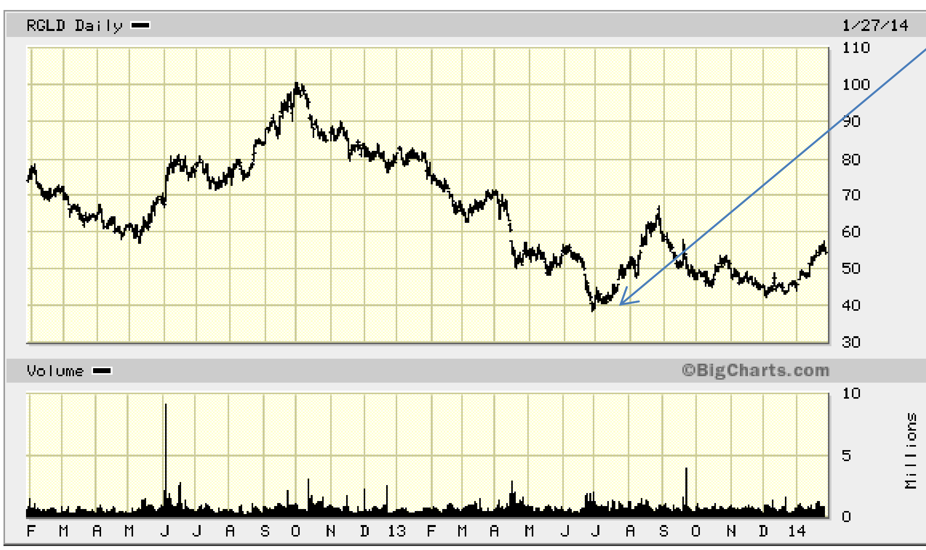
Among the reasons why we believe the secular bull market in gold is not over yet is also the fact that gold mining stocks have not yet entered the kind of bubble phase that could be observed in 1974, 1979 and especially 1980. While in 2011, gold and silver stocks refused to confirm the new highs in the metals <u>by significantly</u>

underperfoming in the latter stages of the rally, something qualitatively slightly different happened at the end of the 1970s bull market. While the shares of mining companies also underperformed during the rally that peaked in January 1980, they subsequently rose to higher highs concurrently with gold and silver putting in secondary lower peaks in September of 1980. In short, there was a great deal of enthusiasm for the sector shortly after the bull market had actually ended. **This is the polar opposite of what could recently be observed – in fact, gold stocks haven't declined this much relative to the price of gold in more than seven decades:**

However, as the picture above shows, mining is very capital intensive and cyclical. Note the huge swings in price in the long-term HUI chart. I believe we have bottomed.



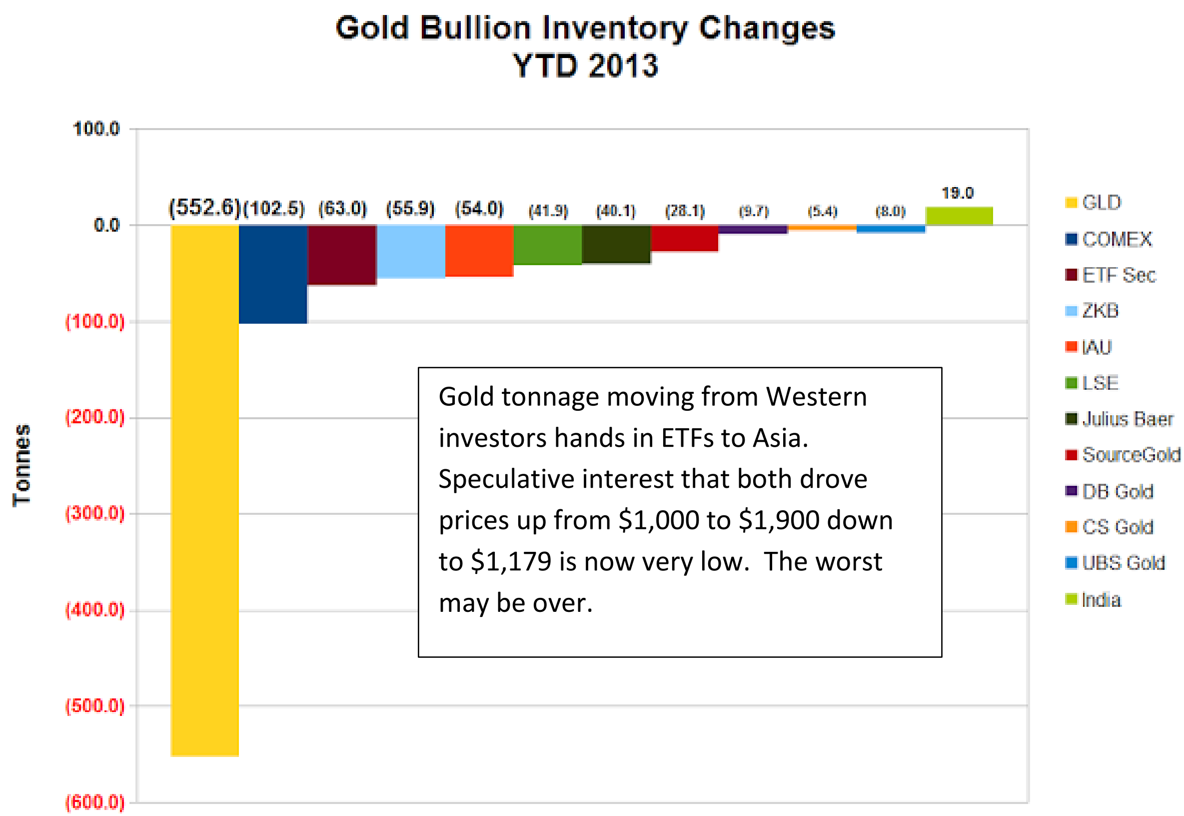
Note that a few of our companies like Royal Gold (Royalty company) bottomed in late June 2013 versus Dec. 30 for the index of miners



The important point is that the market is bifurcating between strong companies versus weaker companies. My strategy is to be well diversified within the mining sector. A 5,000 year industry can't be eliminated, but individual companies can.

GOLD's Fundamentals Are Strong

Gold is moving into strong hands.



Here are briefly the factors which we believe to be the **main drivers of the cyclical bear market from the early September 2011 high. First of all, at the 2011 high, there was a large premium embedded in the gold price as a result of the euro area debt crisis.** This combined sovereign debt/banking system crisis was likely a very important factor driving the rally from about **$1,200 to $1,900.** This **'crisis premium'** was subsequently lost, something that was also mirrored in 'safe haven currencies' like the Swiss franc and the yen **(it is interesting in this**

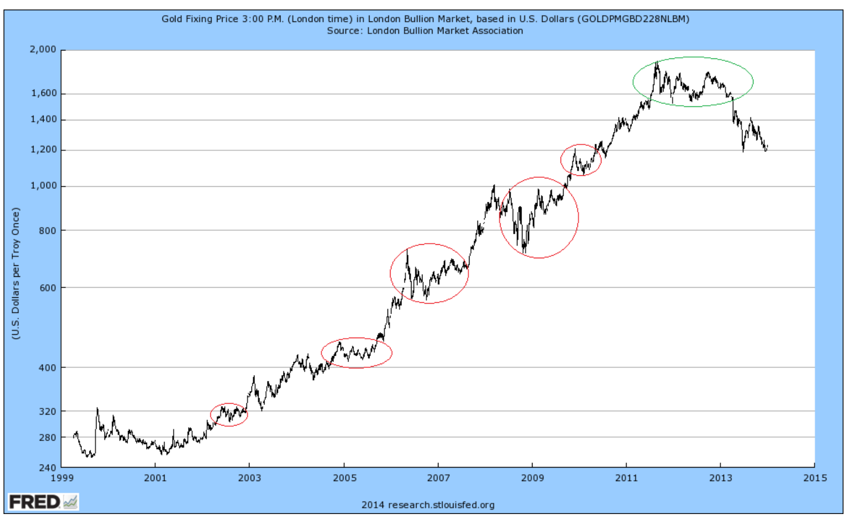
context that the interim peaks in gold in 2012 all coincided with major central bank announcements aimed at getting both real and imagined crisis situations under control).

Secondly, the US federal deficit has <u>begun to decline</u> from its previous record highs *(However, the total debt continues to compound and grow).* This has received very little attention, but we tend to believe that it is one of the factors playing a role in determining gold's price trend (it is fairly easy to figure out why: **the larger the deficit, the greater the probability that it will be financed by central bank monetization, notwithstanding official protestations to the contrary).**

Thirdly, inflation expectations have incongruously declined quite sharply in 2013, but without entering the 'deflation scare' zone. Such an environment of declining expectations regarding future CPI rates of change tends to be bearish for gold. We are not saying that these expectations will turn out to be correct – we merely note that this is what could be observed.

And finally, expectations regarding the state of the economy have become as distorted as the economy itself. There is now an almost unanimous consensus among economists, Wall Street strategists and in the financial press that we are on the cusp of what could be termed 'business as usual', i.e., a **'normal' economic expansion.** This consensus is even more deeply entrenched than the bearish consensus on gold, and it seems highly likely that it will turn out to be quite misguided. This won't necessarily happen immediately, but it will as soon as 'tapering' leads to a distinct slowdown in money supply growth.

To us it is just amazing that people seriously believe that following the biggest financial crisis since the 1930s and right after the biggest money supply and debt expansion since the end of WW2 (which was accompanied by the weakest 'recovery' of the entire post WW2 era to boot), we are about to return to something resembling 'normalcy'. **That strikes us as a case of wishful thinking (the image that suggest itself is that of a herd of buffalo in the African plains that thinks the pride of lions that was stalking it is gone because it has temporarily ducked behind a copse of trees).**



Gold from 1999 to 2014 – once again, many triangles have formed on the way up, followed by a large triangle preceding the recent cyclical bear market – we believe the last triangle and the bear market since then is a somewhat expanded 1975-1976 analog – click to enlarge.

Possible Future Developments

Considering all of the above factors, we have formed an opinion as to what is likely going to happen over the next few years. Of course **you should take this opinion with a grain of salt** – we may well turn out to be wrong. First of all, given that gold declined during 'QE3/4', it is reasonable to assume that it *inter alia* **discounted a coming slowdown in money supply expansion well in advance.** This makes us think that it will begin to discount the next expansion phase with a large lead time as well. Moreover, we do not think that the problems that are currently widely regarded as solved, such as the **debt crisis in Europe**, are really gone for good. After all, since it was first recognized that there might be a sovereign debt problem, said **debt has done nothing but grow** further, at what are in many cases astonishing rates of change (see "The End Game Approaches", where the rates of change in sovereign debt in the euro area as of late September are shown. Most people are unaware of these data, mainly because there was no market trouble lately).

Intra-European current account deficits have largely been 'fixed' as a side effect of the deep recessions in the periphery. Banks have at the same time used the ECB's liquidity provisions to support the debt of financially shaky sovereigns by gorging themselves on sovereign paper (especially in Spain and Italy), in return for receiving numerous 'guarantees' **(for instance, Italy's government made it possible for Italian banks to pawn all sorts of securities with the ECB by guaranteeing them). Not one of these maneuvers is really a durable solution of the underlying problems.** In fact if one considers the interaction between Italy's government and Italian banks, it is almost as if Enron were bailing out Worldcom. Let us also not forget that there may be a political storm brewing in Europe unless there is significant improvement in the economic situation of the worst stricken peripherals.

Meanwhile, the relatively better performing (but ex inventories really still quite lame) US economy cannot withstand a large slowdown in money supply growth in our opinion – it is what keeps numerous bubble activities going and likely also still keeps much of the malinvested capital of the last boom period propped up (**see this chart of the ratio of capital vs. consumer goods production (click through) as an indicator of the growing imbalances in the economy).**

Japan's government and central bank are in the middle of an experiment that is nothing but a bigger version of what has already been tried countless times since the bubble peak in late 1989. The problem as we see it is that some sort of resolution is probably on its way, which is to say, it will sooner or later be discovered that **it is actually *not* possible to expand the government's debtberg to ever higher levels without suffering large negative consequences.** *(Source: www.acting-man.com)*

Gold as money

Gold, quite simply, is money but NOT AN INVESTMENT because it throws off no cash flows unless you lease it. Its primary defining characteristic is that it is **stable in value**, which is why it remains a form of money today. Owning gold bullion is a lot like owning a coffee can of $20 bills. We *assume* that $20 bills will be stable in value, because that is the purpose money is supposed to serve. This is often a bad assumption. We also *assume* that gold will remain stable in value -- and, I would assert, that gold has done exactly this for over 5000 years. You might disagree after seeing gold decline rapidly in 2013, but gold is just the reciprocal of the U.S. dollar.

Thus, it is easy to see that gold is a "currency." It is undoubtedly a commodity. Since inflation is a decline in value of a currency, gold naturally "hedges" against inflationary events. It can be considered an asset class, in the same way that "cash" (i.e. short-term dollar-denominated loans) is often considered an asset class. **I note that "gold mining" is considered its own sector of the S&P 500**, while all other forms of mining are in a different sector.
It is not hard to see that the only situation in which gold is a superior asset is one in which the value of everything else declines. If there is no credit risk (as with government bills perhaps), then "cash" would be a superior alternative to gold if the currency itself is stable in value, as "cash" pays some interest. Since there are many currencies in which one can hold short-term "cash**," the only situation in which gold is a superior asset is one in which currencies around the world lose value, as expressed by their declining exchange value versus gold. (I put "cash" in quotes because these are really short-term, interest-paying loans, with counterparty and default risk. Real cash -- bundles of $20 bills -- does not pay interest.)**

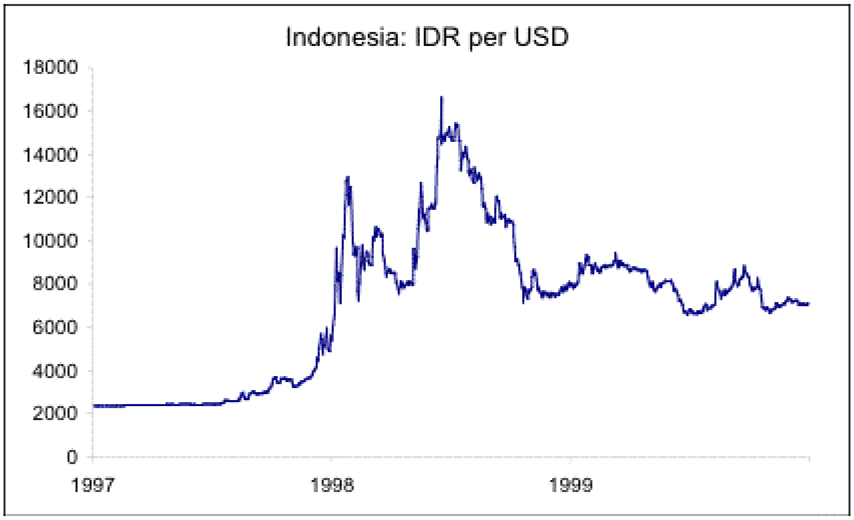
In practice, when the world's primary currency loses value significantly, it is all-but-impossible for other currencies not to follow it lower. This was true in the 1930s, when Britain began a worldwide cycle of devaluation, and it was true in the 1970s, when the US began a worldwide cycle of devaluation. **The reason for this is simply that other countries cannot bear the effects of exchange rate changes caused by these devaluations. Eventually, political pressure builds to keep exchange rates relatively stable. The yen was pegged to gold at 12,600/oz. of gold and ÔøΩ360/dollar in 1970, when the dollar was worth 1/35thounce of gold. In 1980, with the dollar at $850/oz., if the yen had remained pegged to gold, the yen/dollar exchange rate would have been 114.8/dollar. "Free trade" would not have been possible under such circumstances, as the Japanese economy would have been crushed by cheap imports and unfair competition.**

It may rankle many to consider that gold's value doesn't change significantly -- by more than perhaps 10% either way. Isn't it driven by a "wave of investor mania?" Doesn't it "decouple from currencies?" What about the incredibly short and sudden spike to $850/oz. back in 1980? **Certainly that was a case of a gold "bubble," no?**

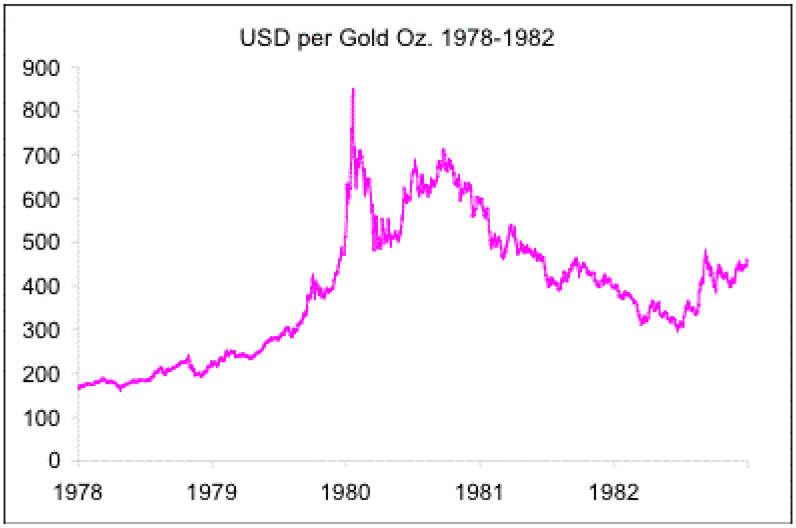
This is because you are *assuming* that $20 bills are stable in value, and gold is not. Which, as noted previously, is exactly the opposite of reality. Gold is stable money, and $20 bills are a floating currency.

However, if it is true that gold is a stable measure of value, **then when "gold goes up" it means that the value of the currency measured against gold goes down.** When a currency's value declines, markets will naturally adjust to this reality, and it will tend to take more dollars to buy all manner of goods and services. In other words, a) if gold "goes up" and there is no accompanying evidence of "inflation," that may be a sign of gold's value changing, but b) if "gold goes up" and there is accompanying evidence of "inflation," that is evidence that the currency's value has fallen while gold's value has remained essentially unchanged.

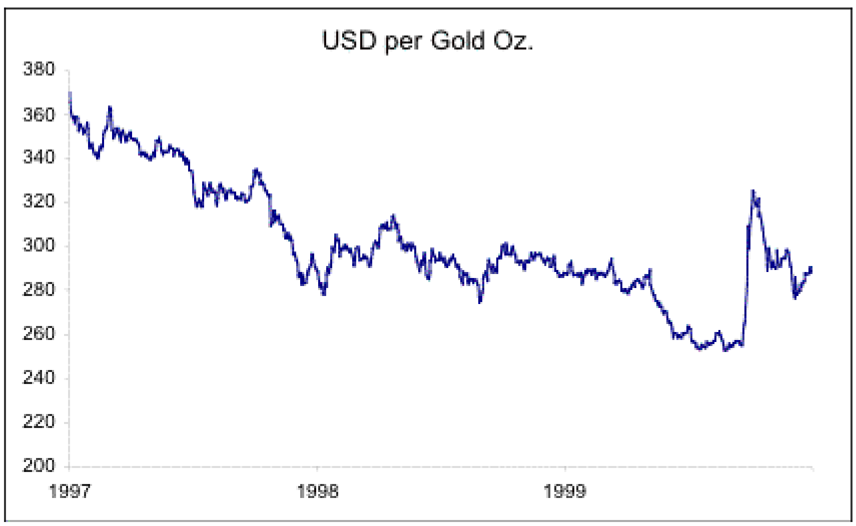
While the major currencies typically don't move much against each other in an average week, currencies are certainly capable of tremendous and sudden changes in value. Let's look at the Indonesian rupiah (IDR) during 1998-2000.



The great gold boom (dollar bust) of 1980 was also pretty wild, but ultimately not that much different than the rupiah bust of 1998.



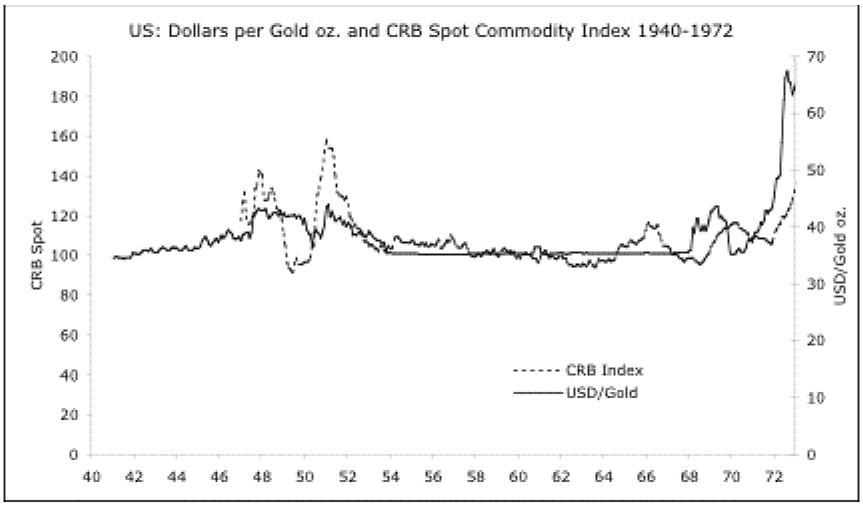
In 1998, the dollar had been rising against gold.



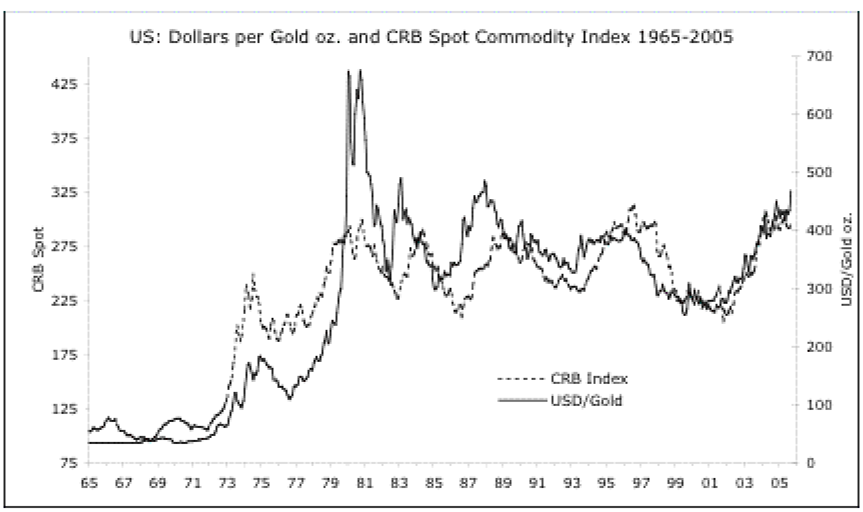
But, if you were an Indonesian, gold was soaring in 1998, its price more than quintupling!

In short, **I am proposing that the 1979-1980 "gold event" was really a *dollar panic*, very much like the *rupiah panic* of 1998.** They were resolved much the same way -- with Paul Volcker taking a hawkish, monetarist-tinged stance to support the currency in 1980, and the Indonesian central bank taking a hawkish, monetarist-tinged stance to support the currency in 1998. As you can see, they played out very similarly in a technical sense.

The remainder of this exercise would be to show that prices for all sorts of things, in dollar terms, were rising in or soon after 1980, showing that the "rise in gold" was indeed a decline in the dollar's value. We won't look at most of the usual suspects -- CPI, interest rates, PPI, crude prices, etc., etc., -- now, but be assured that "inflation," as popularly conceived, was a big deal at the time, and intensified greatly during this time. **In short, virtually everything you can point to reinforce the idea that *gold is stable* while the *dollar varies in value*.** At some point, we may look into this is more depth. To begin with, here is a comparison of the dollar's value vs. gold and the dollar's value versus a wide range of industrial commodities, represented by the CRB commodities index.



See how stable commodity prices are when the money is stable in value? Flat as a pancake for most of the Bretton Woods gold-standard era.



Do you see how the dollar's value vs. gold *leads* changes in the dollar's value versus other commodities? This is particularly apparent in the 1980-present period. In his book *The Golden Constant*, Roy Jastram found that this pattern holds for over 400 years. I suppose some would complain that commodities didn't actually rise much in the 1979-1980 period. This is likely because economies were rather depressed at the time, and also because the spike to $800+/oz. was so brief. Basic commodities tend to lag the dollar/gold ratio by a few months to a year or two. The commodities *futures* market shows a dramatic spike during this time.

Gold is "money." We call it "money" because it is stable in value, and that's the quality we want in our money. **Because gold is stable in value, we used gold as the foundation of monetary systems for hundreds of years, until 1971, and it worked just fine. Other than that, it's just a chunk of metal. Not an investment.**

There's no return on capital. **But, if you're interested in return OF capital, it is the King of Kings.** Gold is an interesting speculation at only one time: **when currencies are losing value.** And not only that: if one currency, like the Indonesian rupiah in 1998, is losing value, then you can go to a currency that is not losing value, like the US dollar in 1998. That would be more profitable than gold, as it pays some interest. **So, the only period in which gold is an attractive speculation is when all currencies are losing value, which typically takes place when the major international currencies lose value.** Thus, we need to look toward the currency managers, central banks, to manage our gold speculation effectively. Today, especially in the US, it appears that central banks are not only complacent regarding the worsening inflation, they are outright negligent. Ben Bernanke built his career on the notion that the Great Depression could have been averted by a brisk inflation in the early years of the 1930s. It's false, and Ben Bernanke is going to prove it today.

Eventually, people get it. The value of their currency is collapsing. It takes more and more ... dollars, marks, yen, whatever ... to buy an ounce of gold. **The only apparent way to preserve financial value is to own gold, or some foreign currency that is stable in value. When the entire world is inflating, as was the case in the late 1970s, and there are no foreign currencies that are reliable, then gold is the only option.** The "demand" for paper currency collapses, causing its value to collapse, and the "price of gold" soars.

Unlike most anything else out there that one could invest or speculate in, gold does not have a valuation. It is never expensive or cheap. It might be overbought or oversold, or some such thing, which is really a way of saying that a floating currency compared to gold is oversold or overbought. Gold is money. It is money because its value is stable.

Thus, there can never be a "bubble" in gold. A "bubble", at the very least, must be a period when people pay far more for an asset than it is worth. What's gold worth? One ounce of gold is worth....one ounce of gold. **It's money. It's also true that there are times when it is extremely beneficial to speculate in gold (1971-1980) and times when it is extremely unrewarding (1980-2002).** But you could say the same thing about dollar bills in a coffee can (a wonderful investment in 1929-1932, a terrible one in 1970-1980). That's really just the paper equivalent of stuffing gold in a vault in Zurich. In 1923, during the German hyperinflation, it is said that a hotel was purchased for one ounce of gold. The price of one ounce of gold, in Germany, reached about 84 trillion marks. Yet, in 1923 one ounce of gold was $20 in the US, as had been the case for the past 134 years. **Was there a bubble in Germany but not in the US, for the same easily transported, easily traded item?**

Most all investible assets can be valued on some cash flow basis. This is true of stocks and bonds, of course, and real estate, which constitute among them the vast majority of assets worldwide. Gold has no cash flow. Other commodities can be valued ultimately on their usefulness. This translates into a demand, which is balanced by a supply, which is closely related to production cost. Gold's value is ultimately related to production cost as well, but because annual production is a tiny fraction of available holdings (less than 2% these days), changes in production have little effect on gold. If all gold production ceased for the next ten years, nothing in particular would happen. There would never be a shortage of gold, because it is never "consumed." On the demand side, nobody needs to buy gold either, for industrial purposes. (A tiny amount is used in electronics.) Gold is useful, of course. It is useful as money. One of the *requirements* of money is that it is not useful (at least at its present value) for anything but money. You can see this is true of dollar bills as well. Nobody uses them as anything but money. *(Source: Nathan Lewis)*

Meanwhile, the cognoscenti of Wall Street opine that Gold will decline.

Dec. 31, 2013, 5:35 p.m. EST

Gold's prospects in 2014 look tarnished

Commentary: Gold prices fell 28% in 2013 and 2014 may be another year of loss

Gold in 2014: How low will it go?

BANK	TARGET ($ PER OZ.)	% DROP FROM AVG. PRICE OF $1,413 PER OZ.
Bank of America Merrill Lynch	$1,150	18.6%
Barclays	$1,205	14.7%
Deutsche Bank	$1,141	19.2%
HSBC	$1,292	8.6%
J.P. Morgan	$1,263	10.6%
UBS	$1,200	15.1%
Average	**$1,209**	**14.5%**

Source: The companies

Gold will average $1,209 an ounce this year, judging by recent forecasts from six big banks.

This is another good sign—**dour sentiment**. We have gold moving from West (speculative hands in the ETFs) to the East (China and India, the strong hands); government debt is growing, currency wars are raging as Japan destroys its currency, the stock market/real estate has high risks while a stable form of money, gold, is hated. Regardless of whether gold rallies, precious metals miners are set to improve their values due to their extreme undervaluation relative to their product prices. However, if the US government became serious about not intervening in free markets and tackled entitlements, debt and deficits, then my strategy would need to change quickly. Let's hope that day comes.

I have thrown many charts, graphs, and descriptions at you. **Please call with any questions**, especially where you disagree. Your individual reports will follow. END. --