THE HIGH-TECH STRATEGIST

Issue #330 Published Monthly Since 1987 Editor: Fred Hickey

July 5, 2015 DJIA 17730.11 NASDAQ 5009.21 Gold 1170

The Return of Stagflation

Stagflation is a term used to describe an economy beset by stagnation and inflation at the same time. Austrian school economist Frank Shostak in 2006 described stagflation as "the result of money pumping which weakens the pace of economic growth and at the same time raises the rate of increases of the prices of goods and services." Shostak wrote that before the Fed, the Bank of England, the Bank of China, the Swiss National Bank, the European Central Bank, the Swedish Riksbank and other central banks began experimenting with money pumping on steroids (also known as QE – quantitative easing). Up until then, only the Bank of Japan had dabbled with QE, though for thousands of years prior, deadbeat, debt-laden governments had tried money printing (or coin shaving). They were typically acts of desperation and no good ever came from them.

The term "stagflation" was first used by United Kingdom Conservative spokesman Ian Macleod in 1965 when he warned the House of Commons of the dire situation the UK economy was in: "We now have the worst of both worlds – not just inflation on the one side or stagnation on the other, but both of them together. We have a sort of 'stagflation' situation. And history, in modern terms, is indeed being made." Stagflation would spread to the U.S. and several other countries in the 1970s.

Today, history is indeed again being made. In an attempt to fight off the forces of economic stagnation unleashed following the debt-driven global financial crisis in 2008, central banks around the world have engaged in every conceivable monetary pumping notion they can think of. In addition to the quantitative easing (money printing) programs, the Fed has quintupled its balance sheet to $4.44 trillion by buying U.S. Treasury securities and mortgage-backed securities with printed money, the ECB is in the midst of a $1.1 trillion bond buying binge and the Bank of Japan currently has an open-ended $65 billion per month QE program - buying bonds and stocks. Additionally, central banks globally have cut interest rates over 50 times this year and over 700 times since the beginning of 2008. China and India's central banks have each cut rates three times this year.

The interest rate cuts just keep on coming, despite the fact that many major industrialized central bank borrowing rates are already at zero percent, including the U.S Federal Reserve's. Some central banks (Switzerland, Denmark and Sweden) have cut rates below 0%. On Thursday the Swedish Riksbank, already with a negative (repo) interest rate (-.25%) cut it another 10 basis points to a record low (-.35%) and noted that it could cut rates again in the fourth quarter, if necessary. The Riksbank also increased its government bond buying program (QE) by an additional $5.4 billion.

Why are all these central banks taking such extraordinary steps? They're attempting (unsuccessfully) to fight the forces of economic stagnation caused by years (decades) of bad government policies that have led them to pile up historic amounts of debt and incredible entitlement liabilities (over $100 trillion in the U.S. alone). These massive debts have weighed down growth globally.

Last month the Organization for Economic Cooperation and Development (OECD), made up of 34 of the world's most developed countries, slashed its forecast for U.S. and global economic growth. The OECD now expects the U.S. economy will slow this year to 2% growth, down from 2.4% last year. In March, the OECD's forecast called for an acceleration to 3.1% growth. Even that 2% figure will be difficult to attain given that U.S. GDP growth in Q1 was slightly negative and the estimate for first half growth is around 1%. The U.S. economy in 2015 is almost certain to finish another year with sub-par growth, as it has every year during this worst economic recovery in modern day history.

The OECD expects just 1.4% growth in the eurozone in 2015. China's economy is slowing rapidly (and the 25%, $3.2 trillion collapse in Chinese stock prices over the past 13 trading days certainly won't help matters). Russia is in recession. Brazil's economy (largest in Latin America) is sinking and close to recession. Japan is still trying to end its long-running depression with "Abenomics" (accelerated money printing), even though Japan was the first country to begin "quantitative easing" in March 2001. That's fourteen years ago and they still haven't learned what Austrian school economists already know: Money printing doesn't

work – and it has never worked all the times it's been tried over a period of thousands of years.

What money printing DOES create is inflation – the second half of the stagflation problem. The stagnation is evident. The recent OECD report noted that the world economy has suffered from stubbornly weak growth throughout the recovery from 2009's "Great Recession." The OECD observed that this "has had very real costs in terms of foregone employment, stagnant living standards in advanced economies, less vigorous development in some emerging economies, and rising inequality nearly everywhere." Despite trillions of dollars in money printing globally, (over $10 trillion) and a massive increase in government fiscal spending and debts (debts up over 40% to $200 trillion globally since the beginning of 2008 through Q2 2014 per the McKinsey Institute) the OECD had to again cut its forecast for 2015 growth for developed countries' economies to below 2% (1.9%). The OECD report put its finger on the basic problem (besides the negative unintended consequences from money printing) by noting that "weak investment" is partly to blame for the slack recovery.

The developed world has been heading down the wrong path all these years by encouraging consumer spending, while at the same time discouraging investment. For while incentives to spur on consumer spending provide a short-term economic boost by pulling forward demand from the future, they come at a cost – less investment. Without investment (capital spending) there is little productivity growth and it is gains in productivity that ultimately increase the size of economies. Thus, we suffer year-after-year with sub-par economic growth and all the rosy forecasts at the beginning of the years (including the Federal Reserve's) end up being ratcheted down as the years progress. The economies never reach "escape velocity" and the central bank "exit strategies" never get implemented. Despite all the talk this year that June was going to be the start of the Fed interest rate hike campaign, the June Fed meeting has come and gone and many economists have (again) pushed their forecasts for the first interest rate hikes out to yet another year (2016).

Yet we never seem to learn. For fourteen years we've watched the Bank of Japan fail with their quantitative easing attempts and zero percent interest rate policies. In the U.S. we're in our 7th year of 0% rates. The Bank of England was supposed to begin hiking rates years ago (hasn't happened). It's the same in the U.S. The Bank for International Settlements (BIS - also known as "the central bank to the central banks") in a report released last month questioned the central bankers' approach. "It's hard to believe that interest rates that are so extraordinarily low are consistent with a fully rational allocation of resources," observed Claudio Borio, head of economic research at the BIS. The BIS report stated that the ultralow interest rates may be feeding the economic weakness, by destabilizing financial markets (causing bubbles and busts), pushing up debt and weakening growth. "In short, low rates beget lower rates," the BIS report concluded.

Historically, just holding rates too low for too long has led to inflation, but in addition, our current crop of global central bankers have resorted in some cases to negative interest rates (unprecedented) and to the greatest coordinated money printing campaign the world has ever seen. It has led to wild inflation – in stocks, bonds, art, and real estate in pockets of the country (and world) where the printed money flows first (financial centers, beneficiaries of the IPO booms, etc).

Inflation Becomes More Widespread

The Fed's "Flow of Funds" report for Q1 2015 (released last month) shows that U.S. household wealth has soared by more than $30 trillion to $84.9 trillion since the recent low in Q1 2009. That's asset INFLATION and it's directly the result of the Fed's three quantitative easing programs. That asset inflation primarily benefits those who already own the assets (mostly the so-called "one percent") and has caused the "rising inequality nearly everywhere" that the OECD warned of in its recent report.

It's no secret that the consumer price inflation (CPI) numbers that the U.S. government reports each month have been suppressed (some would say thoroughly cooked) by all sorts of adjustments to the calculations (hedonic deflating, stripping out items that spike, using an "imputed" owners' equivalent rent calculation instead of real rental rates or house price increases, grossly underweighting health care costs in the index etc.).

Last December the *Wall Street Journal* wrote a major story titled: "Basic Costs Squeeze Families." According to the *Journal,* "The American middle class has absorbed a steep increase in the cost of health care and other necessities as incomes have stagnated over the past half decade, a squeeze that has forced families to cut back spending on everything from clothing to restaurants." The "necessities" included "food eaten at home, rent, and education, as well as the soaring costs" of cellphone and home Internet service." Home Internet costs were up 81.3% over a six-year period.

Seen the price of beef or eggs lately? My lovely wife has been complaining about those soaring prices. All my insurance costs have jumped, led by our health insurance, which has been climbing at double-digit rates for our family for years. Obamacare insurers have asked for an average 12% rate hike in 2016 for health insurance premiums. Customers in HMO plans may be facing 20% average increases, according to a recent Healthpocket study. Healthpocket is a health plan comparison company.

For the past several years, my largest budget item has been college tuition costs which have also been rising rapidly. Thank goodness the youngest of my two sons (Ryan) just graduated in December! Both have good jobs, but Ryan experienced an inflation shock when he was trying to land an apartment in Boston recently. Friends of his who he had been planning to room with all dropped out due to price sticker shock (prices kept rising as they were looking). Finally, Ryan was able to land an apartment on the outskirts of Boston with a friend of a friend as a roommate, at a cost much higher than he had anticipated. The whole process was a traumatic experience for him.

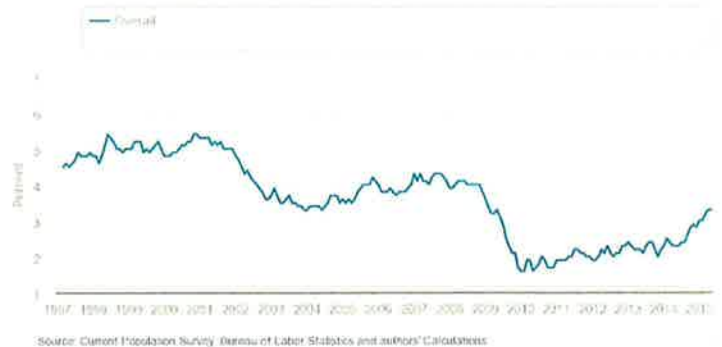
I guess he's lucky not to be living in California. Zillow recently reported that the new median rent in San Francisco is $4,225 per month (up 16% year-over-year), while median rents in Oakland are up 21.6%, San Jose rents are up 14% and rents in Berkeley have soared 30.9% year-over-year. Zillow also found rents climbing in pockets of the middle of the U.S, including Denver (up 10.2% year-over-year), Austin, Texas (up 7%) and Kansas City (up 8.5%). Zillow chief economist Stan Humphries stated, "Rental appreciation has been a freight train these past few years, chugging along without any appreciable slowdown." "Since 2000, rents have grown roughly twice as fast as wages, and you don't have to be an economist to understand why that is hugely problematic," Humphries added.

So I wasn't surprised to see this week's *Wall Street Journal* story titled: "Rents Continue Their Steep Climb" or the findings from the recently released "State of the Nation's Housing Report" from the Center for Housing Studies at Harvard that showed that in 2013 there were a record-high number of cost-burdened renting households (20.7 million, 49% of all renting households) in the U.S. The definition of "cost burdened" are those households paying more than 30% of their incomes for housing. Worse yet, more than a quarter of all renting households (11.2 million), had "severe cost burdens, paying more than half of income for housing."

For those able to buy a house (and they'd better hurry as mortgage rates are jumping), the story is no better. According to the National Association of Realtors, the median price of a previously owned, existing, single-family home in the U.S. was up 7.4% year-over-year in the first quarter (up 7.9% year-over-year in May) and 51 of the 171 metro regions recorded double-digit gains in price year-over-year. That's over twice as many as in the fourth quarter of 2014 (24). Prices rose year-over-year in 85% of the metro regions and the double-digit gains were widespread, from up 11% in Columbus, Ohio to a 13% jump in Raleigh-Cary, NC.

On the other hand, the "owners' equivalent rent" concoction used by the Bureau of Labor Statistics (BLS) in the calculation of CPI came in at just 3% year-over-year growth in May. Owners' equivalent rent is determined by asking a sample size of households the following question: "If someone were to rent your home today, how much do you think it would rent for monthly, unfurnished and without utilities?" I wouldn't have a clue, and I doubt many others would either. Shelter (approximately 42% of "core" CPI) is the largest component in the CPI calculation (by far). Owners' equivalent rent accounts for nearly three-quarters of the Shelter component. If the BLS had used real rents or housing prices or if the BLS didn't make all the other adjustments (hedonic deflating etc.), the CPI numbers would be much higher than they've reported. According to the government, "core" CPI (excluding food and energy) is currently rising just 1.7% - under the Fed's 2% "target." A more realistic figure would be problematic for the Fed's continued 0% interest rates (also known by some as stealing from the savers to give to the banks and debtors).

In addition to the low official inflation numbers, the Fed also cites the country's low wage growth as justification for its extremely easy money policy. Wage growth had been relatively low following the "Great Recession" and the slow economic rebound, but that is now changing and a new monthly Wage Growth Tracker report from the Federal Reserve of Atlanta is clearly signaling the change (see chart below sourced from the Atlanta Fed). John Robertson, senior policy advisor at the Atlanta Fed acknowledged, "We are seeing signs of wage pressure."



This trend change in wage inflation is an important development. As you can see from the chart, median wage growth for the twelve months through May has more than doubled from a low of 1.6% in January 2010 to 3.3% currently. I submit it's not because companies can pay more due to improved productivity. Productivity has been a no-show in this recovery. In Q1 U.S productivity fell at a seasonally-adjusted annual rate of 3.1%. It's **wage inflation** caused by demands from workers.

One problem is that there are a lot of jobs available (a record 5.4 million per the BLS's latest JOLTS report) and not enough willing or skilled available workers. For example, the American Trucking Association estimates the industry is short 50,000 drivers currently. And the shortages are worsening, forcing trucking companies to raise wages to attract drivers. Fifty-five percent of truck drivers are over 45 years old and just 5% are under 25 years old. One would think that with a labor force participation rate in June (62.6%) at the lowest rate since October 1977 and a record 93.6 million working-age Americans not in the workforce, that finding takers for these 5.4 million unfilled jobs wouldn't be a problem. However, with all the government assistance programs and the rising average payouts in recent years, the U.S. has created a structural employment problem. The number of available workers looking for a full-time job (6.5 million in June) is only slightly higher than the number that were looking before the Great Recession began. The "slack" isn't there.

The Big Squeeze

Those who are working have been suffering from falling real incomes for years as their basic costs of living

have risen far faster than their wages. Increasing numbers are no longer willing (or able?) to tolerate such an inequity while massive wealth gains ($30 trillion!) have accrued to the already-rich as the result of the asset inflation resulting from the Fed's money pumping actions.

So activists around the country organize marches against McDonalds demanding $15 an hour "living wages" and politicians such as President Obama, Hillary Clinton, Elizabeth Warren and others rail about the unfairness of the country's growing wealth inequality. This demagoguery is effective as the wealth inequality and sinking real incomes are genuine, even if no one seems to understand the true underlying causes.

The pressure from the activists and politicians are beginning to bear fruit. Wal-Mart, the largest private sector employer in the U.S. (1.4 million employees) in February said it would raise its hourly minimum wage to $9 in April and $10 in 2016, an increase of 38% over the Federal minimum hourly wage of $7.25. This change was estimated to affect half a million Wal-Mart employees, yet one can imagine that it would put upward pressure on other pay strata at Wal-Mart as well. A Wal-Mart worker group had been pushing for $15 an hour (and still is). One month later, Target (347,000 employees) said it too would raise its minimum hourly wage to at least $9 an hour. Panera Bread, TJX ($9 an hour starting in June and $10 next year) and other retailers followed. Remember that the U.S. is primarily a service-based economy.

Over the past several months more than a dozen states have raised minimum wage levels. Next year, the minimum hourly wage in California will rise from $9 an hour to $10 (an 11% increase). New York and Minnesota go to $9 an hour later this year. By 2018, at least six states will have minimum wage levels of $10 or more. In June, the Los Angeles City Council approved an increase in the minimum wage level from $9 an hour currently to $15 by 2020. Wages hikes will occur yearly in increments. Economists at the University of California, Berkeley estimated that 609,000 workers (41% of the city's total) will see their wages rise. Seattle and San Francisco have also passed $15 an hour minimum wage hike ordinances (over 3-5 years) and minimum wage proposals are being evaluated in several other cities across the country, from Portland, Maine to Olympia, Washington. The wage inflation genie is out of its bottle and there's no getting it back in. The trend of accelerating wage growth (as seen on the prior page's chart) has only just begun.

Last week President Obama, by executive order via a new Labor Department regulation, proposed nearly doubling the income level below which workers will receive time-and-a-half overtime pay (from those paid $455 per week - $23,660 per year and under, to $970 a week - $50,440 per year). Estimates of the number of U.S. workers affected range from 5 million to 15 million. The *Wall Street Journal* titled a story: "Free Raises for Everyone." Labor Secretary Thomas Perez estimates that companies will have to pay their U.S. workers up to $1.3 billion per year more in overtime wages once the rule is finalized. On January 1, 2016 midsized U.S. businesses (firms with 51 to 100 workers) will fall under the Affordable Care Act regulations (Obamacare), driving up healthcare costs for those companies. The U.S. Chamber of Commerce estimates that healthcare insurance premium increases of 18% will affect nearly two-thirds of the workers at those firms.

With central banks printing trillions of dollars and keeping interest rates at zero percent for many years, the end result was always going to be much higher inflation. That's what money pumping does and it's always been that way. It's nonsensical to think otherwise (even though most Wall Streeters have bought into such a fairy tale). Money printing is not cost-free, otherwise every government would have engaged in it through the ages. The cost is inflation and inflation is known to be "the cruelest tax" on the people. Up until recently, much of the current inflation was contained to asset prices (which most everyone loves). That often happens in the early (first) phase of inflation. Additionally, the official government calculations have hidden the true underlying rate of inflation. The Fed speaks of fighting "deflation" but nearly nothing my family purchases is deflating in price except electronics and gasoline (recently) – in fact it's just the opposite.

Nevertheless, the government and central banks are beginning to lose control and the pressures to raise wages, without any increases in productivity, will lead to further cost-push inflation. That means there will be even more air in the bags of chips, candy bars will be even smaller and Wal-Mart, for example, will have no choice but to raise prices unless its management doesn't mind watching its stock price continue to sink like a stone due to disappointing sales growth and building margin pressures– as it has all year long. Wal-Mart's stock has fallen steadily over the past six months and has now lost 21% of its value from its peak on January 8 (91 to 72).

History shows that once confidence in the ability of governments to contain inflation is lost, prices tend to accelerate very quickly. For example, during the 1970s (the era of Fed Chairman Arthur Burns' easy money polices and the previous great gold bull market) U.S. inflation soared from about 2.7% in mid-1972 to over 12% by the end of 1974. This was before the BLS discovered the magic of hedonic deflation and owners' equivalent rents. Inflation soared again (from just over 6% to nearly 15%) in mid-1978 through early 1980 until Fed chairman Paul Volcker's tough love (scorching high interest rates) began to bring inflation under control. Inflation also skyrocketed from 2% in early 1946 to nearly 20% by early 1947. This was also during a period when the U.S. government had been suppressing long-term interest rates.

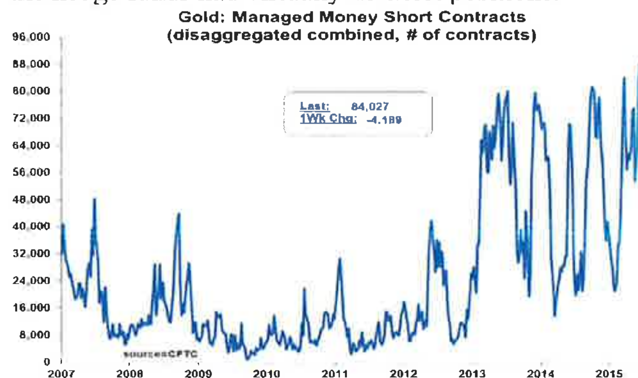
Precious Metals Set to Explode Higher

Recent newsletters have been wall-to-wall tech focused with very little written about the precious metals, my largest positions. But since we're in the third month of the quarter with very little in the way of tech earnings reports (that deluge begins later this month), I'm going to devote some space to gold and silver before I get to tech. Moreover, I think we're at an extremely exciting moment for the precious metals as I believe the secular bull market

that began almost a decade-and-a-half ago is ready to resume with explosive (upward) consequences for the gold and silver miners in particular. I believe we're on the cusp of one of the greatest money-making moments that I've ever experienced in the 36 years I've been an investor.

At the very least, in the short-term there's almost always a seasonal summer rally for precious metals starting around now (over 90% of the time over the past three decades). Gold prices typically begin to rise in anticipation of the strong demand that comes from the Indian festival and wedding seasons, Christmas and inventory building before the Chinese New Year.

Gold stock prices relative to the price of gold are incredibly low (historic levels) and there are currently record "Managed Money" (mostly hedge funds) futures short positions for gold and silver. Every time we've seen spikes in the shorts to these levels over the past two years, we've had significant (but so far unsustainable) rallies. See chart below of the gold short futures contracts sourced from Meridian Macro Research (212-679-0094, info@meridianmacro.com). The chart for silver is even more dramatic, with the current level of Managed Money short contracts 13% higher than the previous record (November 2014). Note also that as gold topped in 2011, the hedge funds had virtually no short positions.



As long-term readers know, in the early 2000s I began tilting my portfolio heavily towards the precious metals to participate in the expected secular bull market and to protect myself from the inflationary repercussions of the Fed's easy money policies. At the time, I never would have imagined that the Fed would have suppressed short-term interest rates at 0% for nearly seven years, nor would I have guessed that the Fed would have engaged in three rounds of QE, quintupled the size of its balance sheet or that the rest of the world's major central banks would follow the Fed's lead. It turned out to be a fortuitous choice as gold rose for 13 consecutive years, far outpacing stock returns (especially during the "Lost Decade" for stocks in the 2000s). However, secular bull markets do not go on without correction and just as in the 1970s bull market – there was a whopper beginning in September 2011.

In hindsight, of course, it would have been much better had I anticipated an extended cyclical bear market rather than the correction that I expected in late 2011 and in 2012. At the time I trimmed some miner positions, built some cash, bought the Costa Rica villa with the proceeds and shifted some money from the miners to gold & silver ETFs. However, since I believed that the secular gold bull market had not ended (I still believe that), that a final phase was still ahead, that the modern-day central bankers hadn't learned anything yet, and the risk of inflation was greater than ever, it was hard for me to do anything more than I did at the time. So I've been forced to wait.

Gold's decline in 1975-1976 was actually steeper (47%) than the 2011-2014 decline (just slightly over 40%). Gold stocks in 1975-76 plummeted 68%. The current bear market decline for gold stocks has been even more severe (down nearly 74%). The result is that precious metals and miners' stocks are hated – as always occurs at market bottoms.

Extreme Negativity

Currently, there's non-stop negativity on gold from the financial media with headlines such as: "There's Still No Hope for the Gold Market" (MarketWatch), "Will Gold Ever Top $1300 Again" (CNBC) and my favorite from CNN: "25% of All Physical Gold Buyers are Crazy." Harry Dent (an awful forecaster) is all over the internet heralding the coming "CRASH" of gold to $700. Seemingly all of the many negative stories have some version of this argument: Higher interest rates dent demand for gold and since gold is a non-interest-paying asset, the coming Fed rate hikes are negative for gold. First of all, globally, virtually no one's raising rates. They're cutting them. The second problem is that the conclusion isn't true. It's a total canard, a "Big Lie" repeated over and over again in all the negative gold stories.

The last Fed rate hike campaign began in June 2004 as the Fed raised its fed funds and discount rates in 17 "baby-step" 0.25% increments over a two-year period. Gold soared 55% from $395 an ounce on June 30, 2004 (the day of the first hike) to $612 by the end of June 2006 (the last Fed hike). In the great 1970s gold bull market, the Fed raised its discount rate from 4.75% in February 1971 (beginning of the gold bull market) all the way up to 13% by early 1980 (the top of the bull market). The fed funds rate went from 3.5% in February 1971 to as high as 20%. Truth is that gold rises when the Fed is "behind the curve" with its interest rate policy (as it was throughout the 1970s), which means inflation is a real threat as rates are too low. With the Fed at 0% for seven years, some central banks below 0%, the Fed's balance sheet bloated, money printing (QE) all the rage and the building wage and inflation pressures in the U.S. as I've described above – the Fed has NEVER been more "behind the curve" - which is wildly bullish for gold.

The mentality was the same at the bottom of the cyclical bear in 1976 when *Time Magazine* printed a story titled: "The Great Gold Bust" which began as follows: "To hoarders and speculators, gold lately has had about as much luster as a rusty tin can." Of course, *Time* also opined that there was little hope for the "goldbugs." The *Wall Street Journal* at the exact low in August 1976 penned a story: "Gold's Potential Price Range on the Low Side Is Put at $75 to $100 as Metal Trades at $108.10" (down from $197.50 on December 30, 1974). The *Journal* story stated:

"Gold's rabid fans, their long faith in the metal seemingly justified by events, were talking then of gold climbing to $300 or $400 an ounce as more and more inflation-scarred investors joined their camp. The visions have long since evaporated." "The question for gold aficionados clearly has become how low the metal's price can go." The answer came quickly, although most didn't know it at the time. Gold was never to go lower, as gold began the final (parabolic) leg of the secular bull market that took it to $850 an ounce over the next four years.

As spectacular a move as that was, most of the more depressed gold miners' stocks did far better. Dome Mine's stock soared 12.3 times from its low. Western Deep went from 6 to 86. Kloof went from 3 to 57. These were some of the biggest gold miners in the world. Smaller ones did even better.

I date the end of this current cyclical bear market at November 5, 2014 as, at least for now, that was THE low (see chart below). Note also that the early November low occurred with massive selling volumes (capitulation). The most recent sell-off in June came on much lower trading volumes (selling pressure is ebbing). A chart of the GDX ETF (gold stocks) shows the same – massive sales volumes in early November. It's another reason why I think November 5 was the cyclical bear market low. The masses just don't know it yet.

Since that early November low, gold has bounced around, but not violated the November low. In fact, there have been two higher lows during selloffs this year, one in March and the current one. Technically, this is progress, but it's not yet conclusive. We'll likely need a major breakout above $1300 an ounce before some of the disbelievers begin to be converted to the bullish case (by then the miners will have doubled).

I know the secular bull market is not over as the inflation risks today are far, far higher than they were in the early 2000s. Stagflation is the perfect environment for precious metals price gains, just as it was in the 1970s. A so-called "Goldilocks" (just right) economy is not. This is no "Goldilocks" economy.

The price of gold is low relative to the amount of money that's been printed around the world. We also know that the price of gold is too low because miners aren't willing to look for gold at current prices (they've slashed exploration expenditures in recent years) resulting in forecasts for falling year-over-year global production beginning in 2016. Meanwhile, demand from the major global buyers (China, India, Russia etc) remains enormous (and growing). The World Gold Council last month predicted that gold demand from China would surge after the Chinese stock bubble broke and that's exactly what happened, as trading volumes on the Shanghai Gold Exchange recently exploded to a record daily high.

The chart below from Meridian Macro Research graphically shows just how low gold stocks (HUI index of miners) have sunk relative to the price of gold (all time lows). The ratio is currently .127%, almost one-third of normal levels. In other words, for this ratio to revert to the historical average (0.36%) gold stocks would have to nearly triple – assuming the price of gold did not climb from current levels.

Note that this ratio is even lower than what was seen at the bottom of the 20-year bear market for gold in 2000-2001. The latest *Grant's Interest Rate Observer* (a wonderful publication) has an interview with Pierre Lassonde, chairman of Franco Nevada, board member of New Gold and considered to be one of the gold market's greatest investors of all time. Lassonde described the current sentiment for gold miners: "It's the worst I've ever seen in 30 years." "I've never seen gold equities trading at such a low valuation in 30 years. Even in the worst of 1980, 1986, 1991 – even in 2000, the valuations were better than this." If Lassonde was a bit older, he could have said he'd never seen worse sentiment and lower valuations for 70 years. The oldest running gold stock index, the Barron's Gold Mining Index (BGMI) recently reached its lowest level relative to gold in more than 70 years.

Gold Stock Leverage

Gold stocks are almost always more volatile than gold. Their bottom lines are levered to the price of gold. When the price of gold rises sharply, most of the increased revenues fall directly to the bottom line. When gold declines, the opposite occurs. The pressure from the sharply lower gold prices over the past few years has been enormous, forcing gold miner managements to take all sorts of aggressive actions to cut costs: limiting exploration, closing down less profitable mines, delaying startups, laying off employees, demanding supplier concessions, etc. The end result is that most are lean and mean and any significant move up in the price of gold (and silver) should lead to explosively higher earnings.

So I continue to build my gold miner positions with eager anticipation. Last month I added to positions in Agnico-Eagle, GoldCorp and New Gold. Soon (maybe this week) I plan to sell some of my precious metal ETFs and shift the money to the gold miners, the opposite of what I had done in 2011 and 2012. The upside is greater with the miners.

My five largest miner positions (including Detour Gold and Aurico Gold) all have the vast majority of their operations in the least politically risky parts of the world (a very important criterion) and have reasonably clean balance sheets – relatively low debts). All five have production growth profiles – in a sector where production is expected to fall globally in upcoming years. Agnico has been able to aggressively acquire gold mining companies or stakes in miners at distressed prices. They've also had great drill results at properties in Nunavut, Canada, near their Meadowbank mine. Agnico will likely be the institutional favorite as the bull market resumes.

GoldCorp has two major new mines ramping up this year that will increase production (revenues) and lower their average costs. Cash flow expenditures will be lessened going forward. There's good news coming in the second half. Unlike most gold miners, GoldCorp never cut its dividend during the gold price decline and continues to pay monthly dividends at an annual yield of 3.7%. New Gold has great properties to develop, most of them in Canada. It's a cheap option on a higher gold price. Detour and Aurico have been successfully ramping their flagship mines (in Canada), de-risking potential startup difficulties. Aurico is merging with Alamos Gold making the combined company stronger. Detour is a prime takeover target. There was insider open-market buying in June by officers/directors at Detour, New Gold and Yamana. Since they're awarded options, this type of insider buying is unusual.

Tech Stocks: Victims of the Economic Stagnation

In last month's letter I predicted that much of the expected damage to tech stocks from the coming poor Q2 results would likely occur in advance of the reports, beginning in June. That's exactly what happened as a number of the stocks where I had put options were clobbered last month. As a result, I sold a lot of my biggest put options positions (Micron - very poor results and outlook, DRAM prices continue to freefall, Seagate and Western Digital) with some hefty triple-digit gains. I also was able to sell enough puts on Intel, Qualcomm, Fairchild Semiconductor, Oracle (disappointing quarterly results, an 8% software licensing miss) and some of my Avago positions so that I could take my investment costs out – leaving me with "freebie" put options. I also sold the remainder of my Netgear freebies as the mid-June expiration date approached. Virtually all of the proceeds went back into the favored gold stocks.

The overall stock market (declining) provided a tailwind for my put options in June. Shortly after QE 3's termination late last year, the Dow Jones Industrial Average broke over 18000 for the first time. Seven months later and it's at 17730. Underneath the major averages the market continues to deteriorate. Market "breadth" is poor, as momentum investors herd into an ever smaller number of stocks that are still performing. The Dow Utilities and Dow Transports are down 9.2% and 11.1% year-to-date respectively. There looks to be a broad market top forming for stocks with fireworks potential in the typically volatile September/October period, if not sooner. Tops take time to form, just as bottoms do. Gold appears to be forming a broad bottom. This should not be a surprise as gold and stocks typically move in opposite directions. It happened throughout the 1970s (gold up, stocks down), the 1980s and 1990s (stocks up, gold down) and the 2000s decade (gold up, stocks in a "lost decade").

Though I have cut back on my Intel put option position, it's still significant as I expect bad news over the next couple of weeks. Internally, Intel had layoffs in mid-June and several executives, including Intel's president are heading out the door. Intel CEO Brian Krzanich unloaded millions of dollars of his Intel shares in early June. The forecasts for Intel's second half are nearly impossible to attain, so I expect a "come to Jesus" type of acknowledgement (guide-down) soon.

Even though industry types were holding out hope for a pickup in PC sales orders in June, it didn't happen. *Digitimes* last week reported that, "Notebook demand might not see as strong growth in the second half as originally expected and overall shipments are expected to decline to 160 million units in 2015, down 5% on year with some conservative players even forecasting the number to reach only 150 million units, down a double-digit percentage on year, according to sources from the upstream supply chain. After having a weak first half, the sources said that they are still seeing weak orders from brand vendors for the second half as depreciation of non-U.S. currencies and oil price drops have both caused overall consumer purchasing to stay weak." Wistron, a major Taiwanese notebook maker, told *Digitimes* that first half notebook shipments fell far short of expectations and that second half volumes won't grow more than 10% sequentially (big disappointment). So much for the second half PC rebound. Making matters worse, I just found out this (July 4th holiday) weekend that Microsoft is slowing the roll-out of Windows 10. There are issues.

In Q1 Intel hit the lowered bottom line EPS estimate with the help of stronger-than-expected "Datacenter" results, offsetting weaker PC numbers. While analysts expect this segment's strength to continue, I do not. In last month's letter I reported that one of the "Big Three" cloud capacity data center builders was slashing their capex forecasts after discovering that demand for such cloud capacity hadn't even come close to what they had been forecasting over the past few years, leaving a massive capacity overhang. I've been arguing that that is the case throughout the industry. What I wasn't sure about was when the cutbacks would start to hit the data center component makers (I provided a list of the exposed in last month's letter).

In June I got an inkling when semiconductor maker Methode Electronics (MEI), a high-flying momentum

stock, blew up. This surprised me, as two of the strongest end markets for semiconductors, autos and data center had been propelling MEI's recent quarterly results. Both segments were weaker than expected in the quarter ended in May, and MEI's stock immediately cratered by more than 30%. The big data center customer, which had been accelerating their purchases from MEI, surprisingly cut back orders and, as MEI's management stated on the conference call, "They have informed us they have sufficient capacity at the moment." I was able to confirm that their big data center customer was the same one I was referring to in last month's letter. This is BIG news.

Network equipment component maker Finisar also was clobbered after providing weak guidance last month. They also made an interesting comment on "hyperscale or Web 2.0 data center" on the conference call: "the challenge in that space is that there aren't hundreds of customers." "And they often are related to construction projects which have, at least historically, been pretty lumpy in terms of their stops or starts or unexpected delays." On Intel's last conference call in April, Intel management made a similar comment about the possibility of data center lumpiness.

As for MEI's auto business, while auto sales in June were still relatively strong in the U.S. (but not in China) at an annual sales rate above 17 million units, the year-over-year growth rate was only 1%. It is possible that the car dealers have hit the wall at these high levels after pulling in future demand by dramatically lowering credit standards and lengthening auto loans beyond six years. Some auto lenders have been giving out loans for more than the cars they've sold are worth. We'll see this month if other auto component makers see their businesses slow.

DisplaySearch, a market research house, said that most TV makers have reported slowing demand. "Some cut demand for June as well as their demand forecast for the third quarter to better control inventories," according to a recent *Digitimes* report. TV set sales are yet another end market that was strong in recent quarters.

Strategy/Positioning

As noted earlier, I reduced my tech put options positions last month after several of the stocks were hammered lower. I currently have put options on Intel, Qualcomm, Amazon (AMZN), Fairchild Semiconductor (FCS), ASM Holding (ASML), Lam Research (LRCX), Cirrus Logic (CRUS), Avago (AVGO), Skyworks, (SWKS), NXP Semiconductors (NXPI), F5 Networks (FFIV), Apple (AAPL), VMware (VMW), Maxim Integrated Products (MXIM), Oracle (ORCL), Red Hat (RHT), Ciena (CIEN) and Tesla (TSLA). Most of these remaining put options have longer-term expirations. I also have longer-term puts on the biotech ETF (IBB). In the semiconductor equipment area, Lam Research will probably report strong Q2 results – but their orders problem will come later in the year. I am considering a put options position on semiconductor maker Microchip Technology (MCHP).

My biggest positions are in the precious metals and gold and silver miners. I continue to hold substantial positions in the shares of the Sprott Physical Gold Trust ETF (PHYS) and the Central Fund of Canada (CEF), a closed end fund that holds gold and silver. I have smaller positions in the iShares Silver Trust ETF (SLV). I hold physical gold. I hold large numbers of long-term LEAP call options (expiring in 2016 and 2017) on the iShares Silver Trust ETF (SLV). I added more of those last month. My biggest gold mining stock positions are in Agnico Eagle Mines (AEM), New Gold (NGD), GoldCorp (GG), AuRico Gold (AUQ) and Detour Gold (DRGDF). I have smaller-sized positions in Yamana (AUY), Pretium Resources (PVG), Franco Nevada (FNV), and Primero Mining (PPP). I own the Market Vectors Junior Gold Miners ETF (GDXJ). I own a significant position in silver miner Hecla Mining (HL) and a much smaller position in First Majestic Silver (AG).

I hold a significant number of GoldCorp long-term call options and a smaller number of short-term Agnico-Eagle call options. I added to both last month. As has been the case for some time, I retain large cash reserves, mostly in near-zero interest paying bank accounts and money market funds. I moved some of that money last week into short-term New Zealand government bonds. The New Zealand currency (kiwi) is at five-year lows versus the U.S. dollar on the expectation (built in) of a number of rate hikes from the Fed (no chance!) and rate cuts in New Zealand. Although New Zealand has trade exposure to China, it is a fairly well run country (relatively small public debt, almost no budget deficit forecast for this year, #1 least corrupt country on the Transparency International list). Though primarily a currency play, they yield about 2.8%. I was successful with New Zealand bonds some years ago.

Here's hoping everyone (in the U.S.) had a great 4th of July holiday. Greeks to provide the fireworks next week?

Fred Hickey 603-888-3954

One year subscription US: Email only delivery $140, Mail delivery $150. Email and mail delivery $170. One year subscription (non-US): Email delivery $140, Mail delivery $185. Email and mail delivery $205. Send U.S. check or money order to: The High-Tech Strategist. Three month trial: $60(US). To subscribe, please send your name, address and check or money order to: The High-Tech Strategist, PO Box 3133, Nashua NH 03061-3133

We have set up a PayPal account as an alternative payment option for a $10 fee to cover costs. Upon request via thehightechstrategist@yahoo.com email address, we can electronically send an invoice through the PayPal system, or we can give our PayPal account email address in order to send us payment.

Information presented in this newsletter was obtained from sources believed to be reliable but accuracy and completeness and opinions based on this information are not guaranteed. Under no circumstances is this an offer to sell or a solicitation to buy securities suggested herein. The editor may have an interest in the companies mentioned. All data and information and opinions expressed, are subject to change without notice.