

## Notes From the Rabbit Hole



Peter Newell's illustration of Alice surrounded by the characters of Wonderland. (1890)

In Lewis Carroll's *Alice's Adventures in Wonderland*, Alice follows a mysterious white rabbit into a rabbit hole to enter 'Wonderland', an absurd and improbable world inhabited by many strange characters.

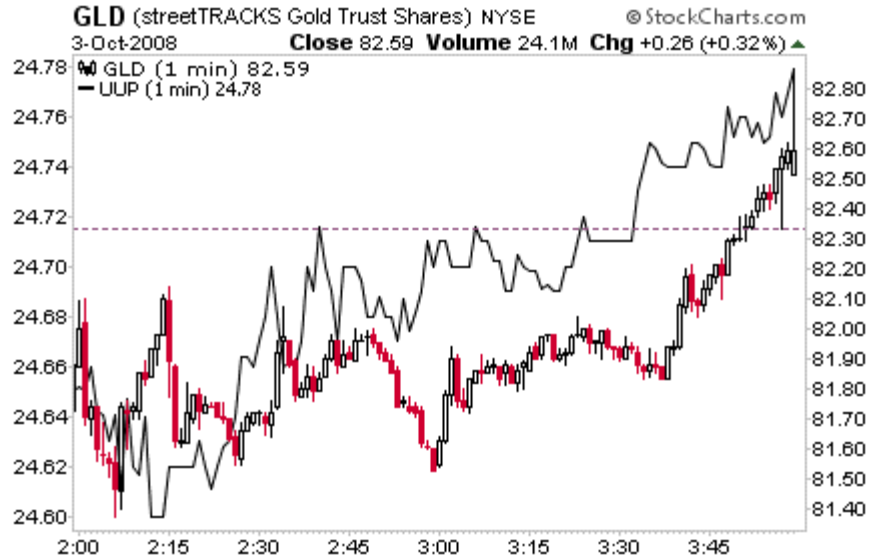
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### Tune Out the Noise and Get Safe

Congress made official what was probably already in the bag from the beginning in passing the pork filled bail out of those entities that took on outrageous moral hazard at the expense of those who didn't. But it is done and it was politically expedient, although not to the tax paying public. Banks and financial companies however, received the first installment on what is a costly and ill-fated welfare package.

But there is a bigger issue at play and that is panic. This week we observed what could well have been official panic at the highest levels of government and its finance distribution arm, Wall Street. In other words, it is very likely that they did not just run a scam of the taxpayer to capitalize on or 'screw' the little guy. They panicked because the system is falling apart and all they know is the system. The system has created Washington's ability to do business with varied powerful interests and if the system crumbles, so too does policy makers' ability to do 'business'.

Why do I think this tragic bill is born of genuine official panic? Here are two charts that show just how bad things are getting.



On a one minute chart of the EFT proxies GLD for gold and UUP for the US Dollar, we note that the rush toward liquidity was on again yesterday (10/3) and that meant the continued scramble for Dollars (official money) and gold (store of value trading as money) as the policy band aid failed to inspire confidence. The Dollar/gold correlation, while I don't necessarily expect the two to trade in tandem consistently, does illustrate that the Euro mania was nothing more than just another hot game for hopped up players like hedge funds and FOREX jocks. The next macro chart is of real concern.



Above we see the 1 month Libor chart as it correlates to the 3 month T-bill rate (IRX) since the 2001 recession. What is wrong with this picture? I will tell you what is wrong with it; in previous cycles such as the 2001 recession, as the IRX has dropped to re-liquify the system, the LIBOR or London Interbank Offered Rate has dutifully risen, which meant rates got more accommodative. Likewise, as the Fed underwent its most recent pretense toward tightening, the LIBOR declined as it was ‘supposed’ to. Even in the latest cycle LIBOR was in alignment as liquidity was needed – until the chop and hard down of 2008 when it did not respond favorably to the mechanics that would normally increase liquidity. LIBOR went the other way. The Dollar and gold spend some time in alignment. This is panic in a broken system.

Although I am a gold stock trader and more recently, a gold stock *investor* (for better and lately, worse), the purpose of this first segment of the official commercial launch of **Notes From the Rabbit Hole** – and let me insert a quick WELCOME and THANK YOU to subscribers – is as the title states, to implore readers who have not yet done so to get to safety *first*. Investment and/or speculation can come after you have buttoned down the basics. I will define these basics as being in cash and the safest cash alternatives - which you will see illustrated in the safety oriented capital preservation/investment portfolio below - and for protection against the global forces of inflation now being mainlined into the system, gold. Although I look forward to looking at other positive investment themes I expect we will talk a lot about safety for the foreseeable future because with the severe strain in *global* financial systems, this is not going to be a quick one and done process.

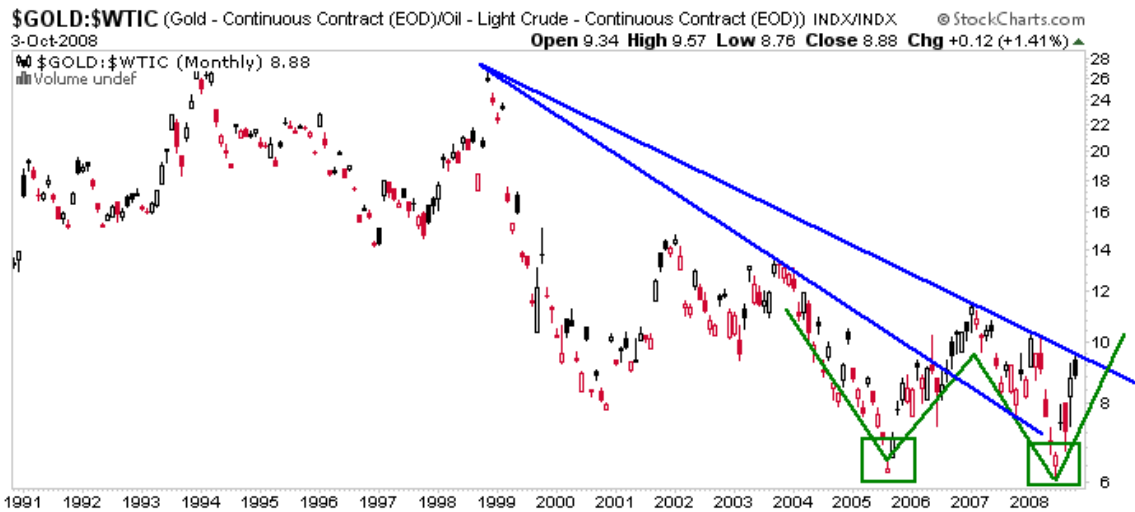
## Gold Sector

The pain was not limited to the broad stock market and in fact commodities and gold stocks were blown up this week. But since the summer of 2007 when yield curves began turning up, short term rates began to decline and credit began to tighten, I have been more investor than trader in the sector and I do miss those heady days of profiting on the gold miners through swing or short term trades, because it has not been easy *or* profitable in the recent past. But this is the ‘deflation scare’ that has been in the cards all along and it is certainly living up to its name. The Fed cannot increase money supply (that is of course inflation, not rising prices) with a backdrop of \$150 oil and such. It is almost a sick joke that the current system is stuck in a seemingly never-ending cycle of boom-bust-reflate-boom-bust... and you wonder why currencies lose so much value over time.

But here was the problem in the recent commodity boom; the gold stocks traded with the anti-dollar bubble for much of the middle part of the decade. [Blog](#) readers often saw me write about “raging commodity bulls”, the “go-go inflation trade”, the “Euro mania” and the “global casino”. What kind of talk was *this* for a gold stock trader? It was the kind of talk that a *reluctant* gold stock bull puts forth because I did not like seeing gold miners running with all sorts of things that I felt were bubbles with their stories rooted in the fallacy that the Dollar was the world’s lone debased currency. Hence, I traded and quite profitably at that.

But I feel the real profits will be made going forward through investing, not trading in and out. At least that is my tact. I would not try to turn a trader into a bag holder as is my current status ;-). I have traded around the edges of core holdings recently to mitigate some of the damage, but the tact continues to be to look for buying opportunities as the market throws out these ultimate *beneficiaries* of economic contraction - yes, *contraction* when authorities are forced to attempt to weaken their currencies - not inflationary growth. Therefore the miners running hard along with oil, copper and other commodities positively correlated to the economy, commodities that in some cases were negatives to the gold miners' bottoms lines, was a concern. That is now being relieved as gold outperforms most asset classes.

While it is easy to look at the very bullish short term charts of the gold v. oil ratio (GOR), I thought I would dial out to the monthly view which gives the biggest picture of gold's progress v. a gold mining cost driver, oil.



A potentially powerful 'W' bottom has formed in GOR. But it has not broken the remaining trend line as of yet. Given the economic backdrop I expect it to do so on this cycle. Friday's post bailout market reaction notwithstanding, the GOR can pull back first (along with the gold v. silver ratio) if there is a sudden surge in optimism related to the government's attempts to keep things afloat.

## US Dollar

The following monthly (big picture) chart of the Dollar is quite interesting. Many observers, myself included, have expected the noted long term resistance to hold solid on any rebound. But that was before the sheer intensity of the macro panic expressed itself in full. The rush for cash, the rush for liquidity could very well propel the USD up and through this resistance zone as emotion on a grand scale does not care about some chartist's red lines. Consider this as the equivalent of a massive short covering rally as the global anti-dollar trade 'buys back' its shares and this thing could ultimately be heading to 90, the 38% retrace level of its entire bear market. But first, the noted resistance will be dealt with and it remains strong resistance until such time that it isn't.



## Wrap Up

The Dollar has proved its point and could take a break at any point, but Uncle Buck is measured against a world full of fiat basket cases and looks strong. The Dow, S&P 500 and Nasdaq have all broken down to new lows as have many commodities. Global markets are in tough shape as well. Fear is everywhere, the VIX is in nosebleed territory. The stage is set for a strong stock rally within the cyclical (at this point) bear market. The stage is set but the actors seem to have stage fright and have not yet made an appearance. They need to get it together.

Gold has had a healthy retrace from the panic inspired highs earlier in the week and could decide at any time to shake off the silliness and resume its role of policing the increasingly global chronic inflators disguised as monetary policy officials. The gold miners have resisted new lows thus far but short term new lows are not out of the question. A break of the September lows on HUI would target 220. Until HUI breaks below the September lows, its posture is that of 'testing' said lows. The true gold miner fundamentals are improving weekly for quality gold stocks. It is important to remember their bottom lines were hurt during the inflation fueled boom. The opposite will happen when their product outperforms their cost drivers. The market should catch up with this eventually.

## Portfolio Composition

*Note that the 'safety' portfolio (1) does not include what I consider the most important core safety asset, gold bullion. This is a personal decision for each individual with regard to portfolio percentage and type of holding. But suffice it to say, I favor this asset.*

*When my computer blew up on Thursday, the starting values to which this week's performance was to be compared were lost. Thursday was indeed a bad day and my holdings suffered accordingly, obviously disproportionately more in the speculative*

*portfolio, which was down on the order of 7% for the week but next week a new horse will ride in to town and I will hop on. Going forward this week's levels will be used as baseline.*

*As mentioned previously, I will highlight individual equities in the future but with the state of the markets, I think that takes a back seat to macro analysis in the short term. Otto will provide a monthly professional fundamental write up of the stock of my choice and I will of course do the technical analysis. As a heads up, they will not all be gold stocks as I expect - given anything short of the world ending - there to be some future bargains out there on quality companies across different sectors.*

*Portfolios omitted in NFTRH sample editions*

**Portfolio 1: Capital Preservation & Investment**


**Portfolio 2: Speculation & Investment**


In closing the first commercial edition of NFTRH, I want to again thank you for coming aboard and putting your trust in me. Many who have read [Biiwii.com](http://Biiwii.com) and the [blog](#) over the years know how I go about things – sometimes having fun, trading and happily producing charts and other times in deep concentration about the all important big picture and its implications. Right now I am in the latter mode. The letter will change over time, expand and contract and flow to and from different modes. I will not always be right because I was never issued a crystal ball. But I will always be right *on* the themes that are important in searching for an edge. Send questions, comments or suggestions to gt @ [biiwii.com](mailto:gt@biiwii.com).