

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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NFTRH7

A Request

I have been extremely happy with the percentage level of re-subscriptions, which tells me that readers perceive value or at the least realize NFTRH is heading in the right direction toward better times ahead. But one subscriber who did cancel was kind enough to give this feedback when requested: *"I've cancelled my subscription. Not because there was anything wrong with NFTRH, but only because I'm not a financial analyst and found alot of the material went over my head. I've not had any formal financial education. I have BSc in Information Systems, but that's it."*

So my request to you is that if you have any comments on the subject matter, format or even the way I write, please do not hesitate to drop me a line. In essence, the letter is what it is and I cannot change who and what I am, but the former subscriber's comment helps because it confirms what I have been told in private life; that much of what I say and write may as well be in Swahili. I will try to write like a human being as opposed to an economist because I am the former and I am *not* the latter. I am sure there are other tweaks that can be made along the way to improve NFTRH.

DEFLATION or INFLATION?

I would like to call your attention to an email exchange I once had with Rick Ackerman regarding a provocative article written by Rick on the subject that is now foremost in the financial and economic community's consciousness. Talk of deflation is everywhere now, but in this little corner of the internet it was going on 3-1/2 years ago: <http://tinyurl.com/6fbfg4>.

The reason I dug this up is that all too often, subjects like inflation and deflation are batted around and discussed in abstract, almost cartoon-like fashion. Inflation and deflation are buzz words in a system that creates money out of thin air in ever less successful attempts to stimulate economic growth and prosperity. It is also relevant now because if I am known for something other than a generally negative attitude toward the Ponzinomic edifice that so many have taken for granted as a financial system, it is my current bullishness on the gold miners, a sector that most people would not associate positively with deflation.

This is my most direct point from the Ackerman exchange and indeed its premise is being tested today: *"In my view, the inflation game is played against the deflationary impulse or need to correct. It is the Fed and other forces pushing on a string, and one day they will find the string simply goes limp and all the inflated chickens will then come home to roost."*

Cluck cluck... they reside at the national doorstep. Having been lectured recently about deflation by a gentleman commenting on a recent article and having noticed legions of 'deflationists' appear on the scene after the market began eating credit for breakfast, lunch *and* dinner, I think it is time to at least look into the subject a little more closely now that the lonely few, led by [Robert Prechter](#), have gotten reinforcements en mass.

Don't get me wrong, people concerned about deflation are some of the smartest I know of; thoughtful people who understand the components of what an unsound economy is built on. The great post-9/11, post-recession inflation bull market in commodities and to a lesser extent, stocks, was actually the result of successful inflation policy from the preceding crisis. The actual inflation occurred during the depths of the economic downturn early in the decade. The effects of the inflation were apparent for years after, with the punctuation taking the form of oil at \$147 a barrel back in those relatively carefree days of summer, 2008.

Things are indeed more dicey this time around and global central banks are pushing on that string as hard as they can. The deflation argument holds that their attempts will fail as the gaping maw of many \$Trillions in liabilities just yawns wider with each attempt and says 'gimme more'. The inflation argument however – at least the proper inflation argument - holds that it is the *act* of money creation that will lead to higher prices one day and the associated rising inflation fears that will crest into the next cycle.

But first of course, there is the current and very brutal cycle to deal with. Which is why we watch things like what deflationists call 'the velocity of money' in an attempt to

gauge how well our official would-be inflators are doing. This week our often watched M2 and MZM have each hitched down a notch. On the other side of the mixed bag, the 1 and 3 month LIBOR rates have plummeted to new depths implying that somebody gave a big official cattle prod to the banks to 'get it in gear'. All we can do is to keep watching these and other indicators closely in trying to determine whether policy is successful (success defined as a new inflation cycle).

No matter whether or not official policy ultimately proves 'successful', the global economy is likely to experience a prolonged downturn as authorities feed the beast at one end and then deal with the – how can I put this... *by-product* at the other. At the moment systems are breaking down and inflation effects, if policy makers are 'successful', will likely have to wait quite a while before taking root.

This is why I find it troubling as a gold stock trader/investor when this asset class moves in tandem with the widely touted 'resources' trade and even the stock market. Raging inflation bulls want you to protect yourself from a coming inflation but do not discriminate between the monetary (currency, bonds and sometimes gold) and the economically positively correlated (commodities, stock markets and sometimes gold).

As [blog](#) readers know, throughout the most recent inflation bull cycle, I awaited the contraction, which would be the time the gold miners become distinguished as a unique asset class. The title of this article should actually be Deflation AND Inflation because that is what we currently have; deflationary destruction of credit/liquidity and global authorities pushing on that string. We were never going to get active inflation policy until a well rooted deflation impulse took hold. It is here, it is monetary and gold is outperforming, which is all the gold miner investment stance needs.

US Dollar

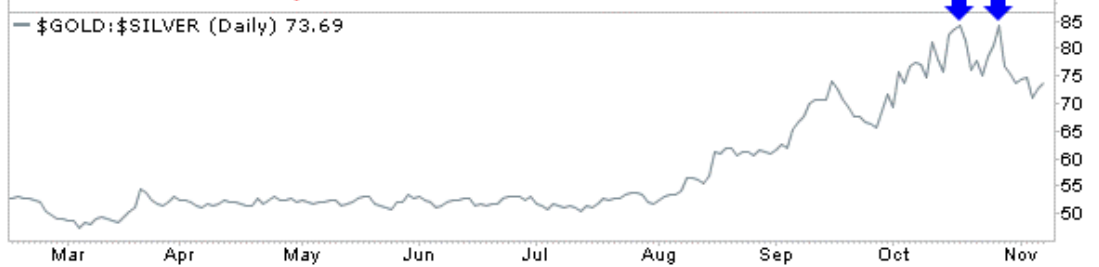
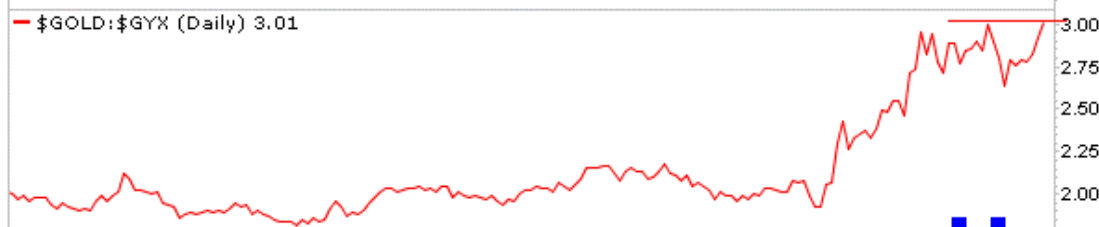
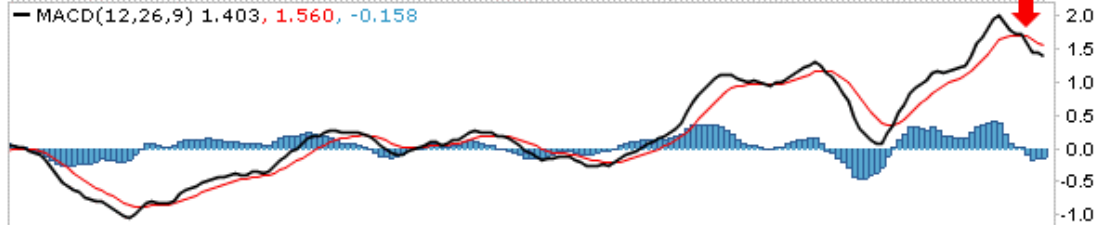
I thought I would get to Uncle Buck sooner, rather than later in today's report. That is because it is flashing an interesting conflict on the daily chart; a bullish looking symmetrical triangle at the same time MACD has triggered down from over bought. While I still expect a near term retrace down to the area of the 38% Fib, we cannot rule out the triangle being expressed upward, which would target the 92 area as noted in the weekly chart which is very over bought. If that were to happen, I would likely become quite bearish the Dollar over more than a short term time frame. Think about oil in July of 2008. In my view, it would be a similar setup.

Aside from that and pertaining to the gold miner investment stance, note the lower panel indicators, which show gold's performance in a deflation vs. positively correlated commodities as similar to that of the Dollar. In fact, the gold-silver ratio is actually mimicking (or is it leading?) the USD's MACD bearish downturn. Interesting.

\$USD (US Dollar Index (EOD)) INDX
7-Nov-2008

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Open 86.21 High 86.35 Low 85.34 Close 85.92 Chg -0.04 (-0.05%)





Gold Sector

A savage bounce in the Dollar would likely be accompanied by another leg higher in the gold-oil, gold-gyx and gold-silver ratios as well and the panic would be intense. But just as it would be bullish for the gold miners' bottom lines, it would likely be short term bearish for nominal gold stock prices as babies get tossed once again with the dirty water as the swamp is drained. These are the short-term gyrations that can happen while investing in times of amplified moral hazard. This is why the safest bet remains cash or predominantly cash for all but the most fundamentally engaged.

As such, portfolio updates at the end of the report reflect continued risk aversion in portfolio 1 and gold miner bullishness (with decent cash levels for future opportunities) in portfolio 2. In an email update, I mentioned I had sold out SLW and JAG. SLW remains on 'watch' and JAG was bought back yesterday, just in time to be highlighted in NFTRH. Attached along with this week's NFTRH will be a NOBS report (which I have not yet seen) by fundamental analyst extraordinaire, Otto. Meanwhile here is my brief overview and technical take on Jaguar Mining (JAG):

Jaguar Mining is a gold miner operating in Brazil. From 70,000 oz. produced in 2007, the company has plans to expand to 700,000 oz. within seven years. This is ambitious to say the least and keep in mind that a projection is simply that. When considering young mining companies, it is best to have an attitude that includes the question "what can go wrong?" because a lot can. Examples can be found in current and past holdings of mine including Minefinders, Gammon Gold and Metallica Resources (my entry point into New Gold). Metallica made me some really nice gains but there were many months of pain as 'locals' held up construction at Cerro San Pedro, Mexico. Minefinders has encountered something similar, albeit less severe.

Thus far, all Jaguar has been guilty of has been previous over-valuation at \$12/share and a few hitches to their projections. Here is a review of Jaguar's operations as we await Otto's full nuts and bolts report: <http://www.jaguarmining.com/s/Overview.asp>

Technically, JAG looks a lot like last week's spotlight, Aurizon (AZK) in that we have positive divergence and a steep decline from questionably valued to unquestionably undervalued given our usual gold-to-cost input parameters. I have tried to associate resistance areas with trading disciplines. For instance, a down and dirty trader seeing a buying opportunity at 3 might dump with extreme prejudice at 4. Further down the road, and once we are sure we have a bottoming process in the rear view mirror, I would expect JAG to have the potential to double to 6 in the intermediate term. Patience will of course be required and please note the green support line at 3 that was tested yesterday. Another sector downside event would vaporize this little support area for a test of the lows.

As for the gold sector in general, the HUI clings to the support zone around 200 noted on the chart sent with the email update Thursday afternoon. So, nothing has changed although in the short term, the grinding low volume action is certainly not inspiring for hopers. A near-term test of the October lows remains in play.

A final note on the gold sector, which is the only one I am fundamentally bullish about. For some reason, emotion tends to run deep among gold bugs. This can be very damaging to them as well as those of us that just want to invest in a good opportunity. I see opportunity in the confusion and hope that I am right about this. But the sector is full of pitchmen and pitchwomen. All one inflation fueled 'resources' trade and all. I am not going to name names, but there is one fellow, speaking with experienced authority, frequently calling a bottom and periodically insisting that you must protect yourself from the coming inflation by owning "resource stocks".

What you MUST do is think for yourself. Otto and I have exchanged thoughts about some of the people being led by gold gurus to the slaughter. It is apparently pervasive and it has literally ruined lives. Think for yourself in the final analysis. Now, without further delay, the JAG chart:



