

Ian A. Gordon
 Senior Investment Advisor
 & Vice-President
 Direct Line: (604) 643-0280
 Direct Fax: (604) 643-0152
 E-mail: ian_gordn@canaccord.com



Suite 1200 - 595 Burrard Street, Vancouver, BC V7X 1J1 Tel: (604) 688-0133



The Long Wave Analyst

‘An Opportune and Strategic Investment Approach’

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WRITTEN BY:
Ian A. Gordon
Canaccord Capital
Suite 1200
595 Burrard Street
Vancouver, BC
V7X 1J1

The Long Wave Analyst is published every two months and is an investment strategy based upon an historical analysis and interpretation of the “Kondratieff Cycle”. Fax interpretation available between publications on significant market developments.

Ian Gordon is a licensed Registered Representative and a Vice-President of Canaccord Capital, a Vancouver-based brokerage firm. He was educated at the Royal Military Academy, Sandhurst, U.K., and has a B.A. (History) from The University of Manitoba.

Ian Gordon

Investing During the Kondratieff Cycle

A major objective behind the writing of The Long Wave Analyst is to develop an appropriate investment strategy based upon the current position of the Long Wave itself. The following figure appeared in Volume 1, Issue 2 of this publication and I think it is of sufficient importance that I repeat it for new readers, and to re-acquaint existing subscribers. Of course, it is vital to determine our current position on the Wave, otherwise we are liable to make totally inappropriate investment decisions. It should be an easy task to recognize our position when one of the Long Wave seasons is in progress; but recognizing the move from one season to the next is a little more difficult. We have proposed in all our previous newsletters that the world is now approaching the winter season of the Long Wave, which is the deflationary/depression stage. Given the recent recovery in many of the stock markets around the world it is important to repeat our arguments in support of this hypothesis. In the first issue of the LongWave (February 1998) we wrote, “There seems to be little doubt that North America and Europe are at the end of the Plateau period of the Long Wave.” Volume 1, Issue 1, P.4. At that time, very little was being written or spoken about the possibility of deflation; whereas today there is far greater recognition that deflation is indeed a possibility facing much of the world. Deflation, like inflation, is a global phenomenon. No industrialized country escaped the inflationary ravages of the 1970s, and it is unlikely that any country will escape the deflationary / depression, which has already started in many countries, such as Japan and much of South-East Asia. In his writings, Kondratieff specifically recognized that the Long Wave was an international event.

We are confident that our location point on the Long Wave map is accurate. We know that the

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plateau period of the Long Wave is marked by an over-bullient speculation in stocks, bonds and real estate, which is due to a massive expansion of credit. At the peak of this speculative bubble many official pronouncements are made to justify the excessive speculation. The most common is "this time it's different." However, it never is any different. Excess builds upon excess to the point when speculation runs out of control. How could anyone justify the speculative excesses built up by Long Term Capital Management, which controlled assets worth \$125 billion (it has been said that this was closer to \$400 billion) on a capital base of only \$2.3 billion; or that major US banks have 243% of their capital exposed to speculation in derivatives. What is certain is that bubbles always burst, and the bursting of this bubble will be the catalyst for the commencement of the deflation/depression cycle in North America and Europe.

"We are apparently finished and done with economic cycles as we have known them."¹⁴

"We are apparently finished and done with economic cycles as we have known them." Edward H. Simmons, President NYSE, September 1929.

Signs of the Imminent End of the Plateau Period

- ?? US stock market is priced at record values.
- ?? Extreme speculation in stocks, bonds, real estate and derivatives.
- ?? Merger Mania.
- ?? Banks engaged in high risk loans and high risk investments.
- ?? Massive debt bubble encompassing governments, corporations and the public.
- ?? Deflationary/depression already affecting Japan, much of Asia & Russia and encroaching on the Middle East and Latin America.
- ?? Growing depression in agriculture.
- ?? Rapidly falling commodity prices.
- ?? Growing evidence of slowing economies in Western Europe and North America.

"Never will a man penetrate deeper into error than when he is continuing on a road that has led him to great success."
Frederick von Hayek.

Perhaps the most difficult point of change to accept in the Kondratieff cycle is the impending move from Autumn (the plateau period) to Winter (deflation/depression). Sentiment is at its most bullish towards the end of the Plateau Period because so many people are making so much money on their investments. The vast majority of investors see no reason to exit the stock market. This was the case in 1929 and is certainly true today as investors believe that the returns that have experienced over the past sixteen years are likely to persist well into the future. These huge price gains have contributed to a lack of fear, unrealistic expectations for the future and an outrageous concept of value.

In 1929, it was the confirmed view of the general public, strongly supported by business leaders, Wall Street analysts, and academic economists that panics and depressions were a thing of the past. These people believed that the panics of the 1870s and 1890s were caused by an involuntary liquidation of credit, and that the relatively new Federal Reserve



Board would act vigorously and promptly to prevent any such liquidation in the future. The responsibility for the great economic boom of the 1920s was claimed by the Republican Party, which had just won the White House for Herbert Hoover, who in a radio speech to Americans announced that sophisticated financial management would “banish poverty from the face of the earth.” In spite of the apparent prosperity evidenced by the huge bull market, it was, in reality, an economic illusion. The American banking system was in a precarious state in 1929, having made generous but imprudent loans to farmers, land speculators, real estate developers, retail merchants and foreign governments. Consumer debt, mortgage debt and stock market debt all reached record levels at that time.

Then, as now, reality was almost completely overshadowed by the belief that the Federal Reserve Board and the Federal Government could and would resolve any and all economic problems to ensure perpetual prosperity. Today, that belief is enhanced by the strong rally in the stock market as a result of three recent administered interest rate cuts. Michael Belkin, president of his own advisory service, assessed investors’ interpretation of events in this way: “The worse things get, the more Greenspan will cut rates and the more bullish that will be for stocks. A catastrophic global depression is the most bullish thing imaginable-because the Fed will keep cutting rates and that is always bullish.”¹ The fact is that Mr. Greenspan is scared stiff by the bubble that he himself has helped inflate. The DJIA is more than 3000 points higher than it was two years ago when Mr. Greenspan was warning about ‘irrational exuberance’ in the stock market. Interestingly, he has shaved interest rates 1½% in three separate cuts over the past two and a half months. These cuts have taken irrational exuberance to new extremes, as evidenced by the astronomical values being placed on the new darlings of the investment community; the internet stocks.

In 1929, American bankers may have been guilty of making an excessive number of unwise loans, but this pales in comparison to their modern day counterparts, who have made speculative loans to many emerging countries far exceeding their capital bases. They have also made loans to consumers and corporations, which are fueling an unbridled speculation in the capital markets. Not content with overindulging in the traditional business of making loans, American banks have joined the general public in their search for instant riches through highly speculative investments in stocks and derivatives.

Reflect to late 1989, and recall if you can whether anyone believed that the ongoing bull market in Japanese stocks and real estate could ever come to an end. After all, the Japanese economy was the largest in the world. All ten of the largest banks in the world were Japanese and the country had become the world’s largest creditor nation. But the truth was that Japan was experiencing an enormous credit inflation; stocks were trading at 60 times earnings and land values were extreme; so much so, that the land area of the Emperor’s palace in Tokyo was worth more than the entire state of California. But the Japanese people themselves believed that the government, the business community and the investing public were all united in a determination to keep the Japanese economy prosperous and buoyant. The classic result of this credit inflation was the deflationary credit collapse.

And what of the so-called Asian tigers? Not much more than a year ago, the investing public was funneling money into their economies in the belief that nothing could hinder their incredible economic growth. Unfortunately, that story ended when the Asian credit bubble burst.

Europe and North America are living on borrowed time! The huge expansion of credit has built an enormous debt bubble and has inflated prices to unprecedented levels in the equity markets and expanded speculation in the derivatives markets.

Recently, it appeared that the shock waves from the Long-Term Capital Management debacle might be the pin that pricked the bubble; but Alan Greenspan engineered a rescue plan to augment that dangerous situation. Other situations are likely to arise, which the Federal

Reserve Board will be unable to rescue; thereby precipitating a panic in the stock markets.

Creating the credit bubble

During the expansion phase of the cycle, the economy experiences an enormous growth rate in capital projects. The burgeoning economy leads to inflationary excesses, which leads to higher interest rates. These high rates eventually stop the economy in its tracks and a primary recession follows, which signals the end of the expansion phase. Somewhat unnerved by the recession, the Federal Reserve moves to cut rates and inject liquidity into the economy. Rather than translate into a continued expansion of the real economy, these measures foster an increasing amount of investment in stocks, bonds and real estate. This is because the real economy is saturated with more than sufficient factories, mills and plants, built during the expansion phase to satisfy consumer requirements. Moreover, during the current plateau phase, economic expansion in Asia greatly added to an already overbuilt capital investment situation.

Every plateau period of the long wave is characterized by an expansion of credit, used to finance speculation in stocks, bonds and real estate. This speculation feeds upon itself. As the markets rise in value more money and more investors participate. Each wave of new money coming into the markets leads to higher prices and to a belief that the investment markets are a perpetual source of capital gains. Why wouldn't investors believe this when the US stock market has made average gains of 19% per annum since 1982?

Unfortunately, these exceptional gains are not sufficient for many investors, who seek higher and higher returns through more risky, speculative ventures. Eventually, greed overtakes reason.

“The future is but a repetition of the past”²

So it was during the last plateau period, that the Federal Reserve Board created the credit bubble which fueled the great bullmarket, and culminated in the disastrous crash of October 1929. In his book, *The Age of the Great Depression*, Dixon Wecter wrote, “The overexpansion of credit was a prime cause of the disasters that followed 1929. The First World War began a process which reckless financing continued to accelerate. In the background loomed the huge structure of long term debt in the United States -- a public debt, federal, state and municipal, of thirty-three billion dollars and corporate and individual debts of one hundred billion, which demanded expanding markets and world prosperity for successfully carrying. A relatively small reduction in buying power, or backsliding in prices, could send tremors along the whole length of this mountain chain. The grand operations of credit, a new force of such power that one economist likened it to the prime movers of physics, were still imperfectly understood and recklessly abused. The average American in 1929 had little notion of credit on the imperial scale, such as the growth of international financing dependent on a constant transfusion of credit from have to have not nations.”

The credit expansion of the twenties is a microcosm of what has been occurring in the United States during the 1990s.

The Federal Reserve has recently cut interest rates three times, in a bid to forestall a stock market crash. Alan Greenspan almost admitted as much when he brokered the bailout of Long-Term Capital Management. “Had the failure of LTCM triggered the seizing up of markets, substantial damage could have been inflicted on many market participants, including some not directly involved with the firm and could have potentially impaired the economies of many nations, including our own.” This is a frightening statement and emphasizes the highly dangerous degree of speculation currently inherent in US investment

markets. The trouble with these rate cuts is that they have emboldened investors into believing that the Federal Reserve will act to ensure that nothing impedes a rising stock market.

Not only is the Federal Reserve Board cutting interest rates but it is also adding exponentially to the money supply. Earlier this month it announced that money supply is currently growing at an incredible annualized rate of 25%. In normal circumstances this extravagant growth in the money supply would translate into inflation, but these are not normal times. Instead, this monetary growth has fueled price inflation in the financial markets, which is a typical result during the plateau period.



The Economist, 8 Aug 98, p. 78

“Dangerously, as the economy slips into recession, stock prices surge due to too much money. This is a textbook case of a massive credit and asset bubble that will end in disaster”.³

Encouraged by the benevolent Federal Reserve, US banks are on a lending spree. In the four weeks ending October 26th consumer credit rose 28.3% on an annualized basis and commercial and industrial credit increased 43.4%. “I would argue that these figures indicate not a credit crunch, but a credit craze.”⁴

Share price gains and easy credit have given American consumers the confidence to spend. Not only are they spending, but they are also saving less and borrowing more. In September total household savings turned negative for the first time in 60 years. Corporations have also been big borrowers. This has resulted in the combined private savings rate (the difference between total private income and saving) falling to record lows. (See Box below). US debt is now in excess of 260% of GDP, which is a record exceeding even the debt levels of 1929.

Gregg Myles, an analyst interviewed on CNBC on November 25th, said, “A major reason for this declining savings rate is that people save by putting money in the stock market.” Speculation in the stock markets is not saving.

Invariably, the expansion of credit reaches a critical mass and becomes very unstable due to the excessive speculation it finances. Eventually the credit bubble bursts, usually as a result of an external shock. In 1929 this shock was caused by interest rate increases and foreign withdrawal of credit for the US stock market. In 1987, it was weakness in the dollar and Germany’s refusal to support the greenback which were the primary causes of the stock market crash. It is precisely this reversal of credit that caused the market crash in much of Asia and even today continues to unwind the enormous Japanese monetary excesses of the 1980s.

Ludwig von Mises wrote, “there is no way to avoid the collapse of a boom brought on by credit expansion. The alternative is only whether the crisis should come sooner as a result of a voluntary abandonment of further credit expansion, or later as a total catastrophe of the currency involved.” As we shall see it appears that the US federal reserve has opted for the latter policy.

“It’s Déjà vu all over again.”

Yogi Berra

Ultimately, everything returns to fair value, but when values are at one extreme they tend to swing wildly to the opposite extreme. The US stock market today is

“I will tell you what caused the business cycle recession of 1930 to escalate into the terrible collapse of 1931-1933. It can be summed up in one word,

the most overvalued that it has ever been. Contributing in the Magazine of Wall Street in 1928, Loring Dana wrote, "the characteristic of the new doctrine is the utter abandonment of any of the old-time conventional yardsticks to measure 'intrinsic values.'"⁶ Dana claimed that traditional standards such as price earnings ratios, market to book ratios and the notion that capital should earn a fair return, had all been cast aside. A few analysts are making similar observations with respect to current market values, but their cautionary views are being smothered by the bullish views of the vast majority.

Nathan M. Rothschild has been credited with saying "the best time to buy is when blood is running in the streets." Mr. Rothschild might have added, 'the worst time to buy is when champagne is flowing in the streets.' In 1982, blood was not running in the streets, but the US stock market was just completing a two-year bear market and values were cheap, offering investors a relatively low risk buying opportunity.

Conversely, as we approach the end of the plateau period bull market which has added more than 1100% to those 1982 lows, values are the most expensive that they have ever been, and yet the public continues to buy as it enjoys the champagne. Anyone who believes that the recent rebound in stock prices is the start of a new bull market should understand that no bull market has ever started from these extreme high value levels. In this table we present the two value extremes.

We have warned in all our previous issues that bubbles of this magnitude always end in tears, regardless of how events elsewhere in the world may appear to have improved. The current overvaluation of the US stock market is as dangerous a condition as any prevalent in those international markets prior to their collapse this year. We think the words of Garet Garrett written in his book, *A Bubble That Broke the World*, published in 1932, are as appropriate to today's stock market mania as they were to the mania that ended in the crash of 1929. "A delirious stock-exchange speculation such as the one that went crash in 1929 is a pyramid of that character. Its stones are avarice, mass delusion and mania, its tokens are bits of printed paper representing fragments and fictions of title to profits that have not yet been earned and never will be. All impond down pyramid, doomed in its own velocity. Yet it devours credit in an uncontrollable manner, more and more to the very end; credit feeds its velocity."⁷

There is more than enough evidence to convince the open-minded that the US market is an overvalued mania of historical proportions. Current stock market values are for the most part at record levels. These values are somehow justified by market analysts, who propagate the myth that the US economy will continue its expansion into the foreseeable future. The height of insanity is reflected in the prices being accorded to the internet

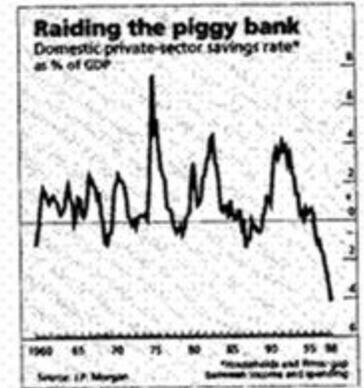
Saving disgrace

THRIFT went out of fashion years ago in America, but never quite like this. In September the personal saving rate turned negative for the first time since the 1930s—ie, in total, people spent more than they earned net of tax. The sharp fall in saving since 1993, when households squirreled away 5% of their income, has largely been due to big gains in share prices, which have made consumers feel wealthier and encouraged them to spend more money.

Corporate America has also been on a borrowing binge, as investment has far outstripped profits. Add the savings by companies and households together and J.P. Morgan, an American bank, calculates that the total private-sector saving rate has fallen to its lowest level ever. In the second quarter of this year, investment and consumption by the private sector exceeded income by more than 4% of GDP. In previous economic cycles dur-

ing the past 40 years the gap has never been greater than 1.4% of GDP.

This clearly cannot go on: another reason for worrying that, sooner or later, the boom is likely to end in a bust.



The Economist, November 14, 1998, p 80

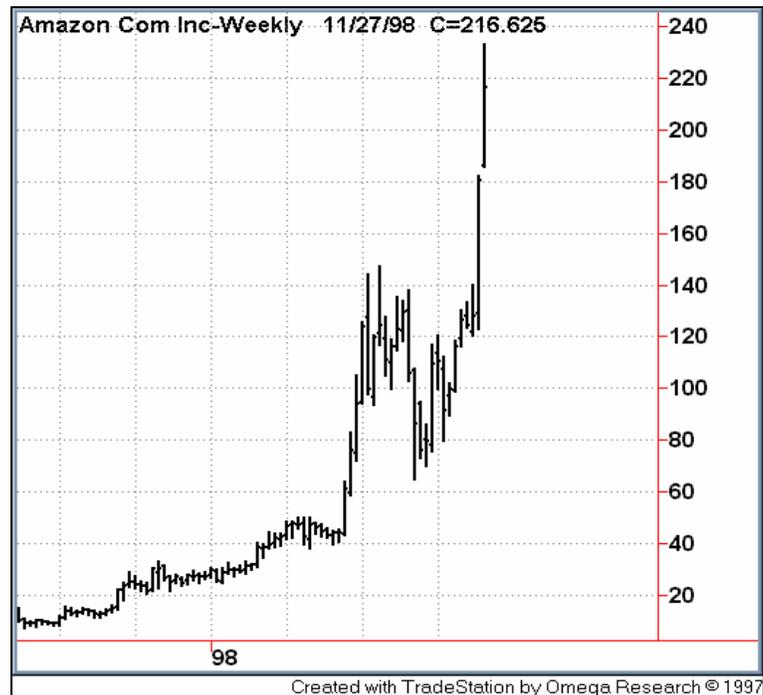
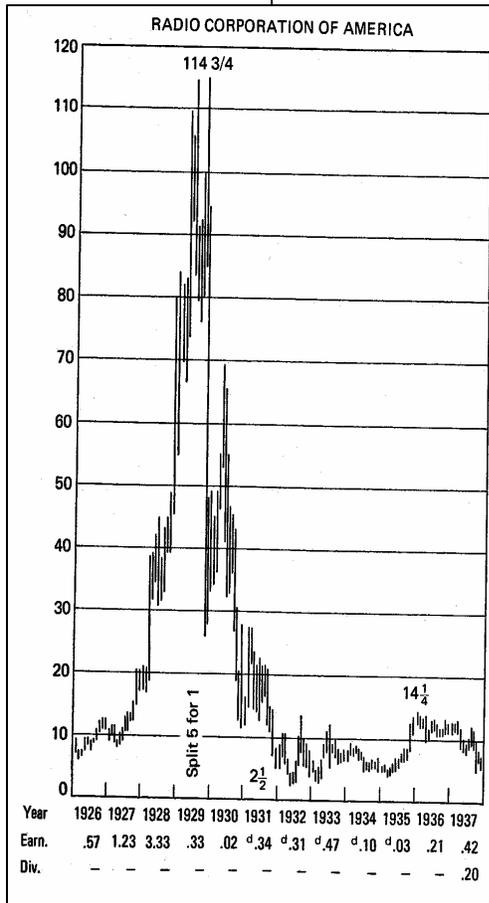
VITAL & FATAL SIGNS	1982	1998
Dividend Yield	6.3%	1.4%
Price/Book	1.1	6.2
Price /earnings	7	30
Value of NYSE/GDP	0.3	1.2
Dow Jones Ind. Av./new homes	0.012	0.060
Dow Jones Ind. Av/wages	105	700
Dow Jones Ind. Av/gold	2	31
Dow Jones Ind. Av/commodities	3	47
No. of Equity Mutual Funds	320	2,500
No. of Investment clubs	4,000	32,000
Consumer debt as a % of financial assets	21%	21%
Consumer debt as a % of disposable personal income	65%	95%

Source Barrons, October 12th, 1998.

stocks.

On November 13th, Theglobe came to the market in what turned out to be the most successful initial public offering in US history. The offering price was US \$9 and the stock rocketed to US \$87 per share at the market opening for an idiotic gain of 866%. The previous record for a first day price move was also held by an internet stock, Broadcast.com, which gained 248% on July 17th. Earth Web, which came to the market on November 11th almost equaled Broadcast.com's gain, but three days later was up 500%.

Commentating on these and other similar stratospheric moves, Mr. Taulliof IPO Monitor said, "it's kind of like getting Vegas through your modem. On days like yesterday (Friday, November 13), a long term investment horizon is about five hours."⁸ During the past month or so there has been a huge influx of money into the aggressive mutual funds -- just another sign of how cavalier the public has become in spite of the ridiculous valuations attributable to these equities.



Brown, John; 101 Years on Wall Street, Prentice Hall, 1991, p 189

The mania in the internet stocks is reminiscent of the mania that was pervasive in another media stock in the late 1920s, RCA, which was listed in 1924 at \$25, rose to \$200 in 1928; and almost tripled again in 1929 reaching a high of \$570. The chart, post-split, is a dramatic visual presentation of a price bubble and what happens to price after the bubble bursts. We also show the current chart of Amazon.com, as a comparison.

The termination of the present credit cycle will likely occur as the result of a stock market crash in the US. This is what turned the cycle in 1929 and, in Japan, in 1990. Once the crash occurs it destroys wealth. Every 1000 point drop on the Dow Jones Industrial Average reduces the wealth of Americans involved in the stock markets by approximately \$1.75 trillion. In September, "tumbling share prices have wiped almost US \$4 trillion off the world's financial wealth over the past two months--the equivalent of Japan's GDP."⁹ By the time these markets had bottomed in October, the losses would have likely been closer to US \$6 trillion.

The Other Half of the World...

“One half the world cannot understand the pleasures of the other.” Jane Austen, Emma

Meanwhile, the other trouble spots covered in our previous letters are not improving. Indeed, in Japan, things are going from bad to worse. The government’s budget deficit has climbed to 10% of Japan’s GDP and the economy is expected to continue its decline. Once the North American and Western European economies begin their decline, Japan’s problems will escalate dramatically.

Hong Kong is now experiencing its worst recession since records began, posting a 7% contraction in GDP for the third quarter. Other historic lows in the economy were registered for retail sales, inflation, exports and unemployment.

Russia’s economy is almost non-existent and falling oil prices are adding to the pain. The country faces a massive starvation situation during the coming winter. Russia continues to renegotiate its outstanding debt with Western banks. It is unlikely that these banks will be repaid anything but a few cents on the dollar.

As for Brazil, the \$42 billion IMF bailout can only buy time. With interest rates above 40%, there is absolutely no way that the country can avoid a recession. This will only compound the country’s budget woes.

The fact that these worldwide problems are being dismissed as irrelevant by rising stock markets indicates a degree of complacency bordering on arrogance.

The twilight’s last gleaming

We have long maintained that the ultimate key to continued world prosperity rests with the US dollar. This currency has been adopted by the world to replace gold as the money of last resort. In our last letter we outlined several reasons that imperiled this worldwide confidence in a currency we contend has been seriously mismanaged. As evidence, the dollar has lost 90% of its purchasing power over this century and much of this loss has been experienced since Bretton Woods, when the US dollar was established as the world’s reserve currency and the worldwide medium used in the purchase and sale of all commodities. Since 1971 when President Nixon closed the gold window, establishing the US dollar as a purely fiat currency, successive US governments have undermined the notion that the dollar was as good as gold by a series of devaluations and profligate spending. The US has become the largest debtor nation in the world and must rely upon large creditor nations to help finance an enormous budget deficit.

It is difficult to understand how the world continues to tolerate such serious fiscal mismanagement by maintaining so much of their reserves in the dollar. Perhaps it is because the dollar is too big to fail. Any major move out of the dollar would seriously impair not only the value of a country’s dollar reserves but also its holdings in US debt instruments. This is particularly true for Japan and China, the two largest creditor nations. Interestingly, both these countries have recently ruminated about their excessive reliance upon the US dollar as a major part of their currency reserves and both have said that they will reduce their US dollar holdings in favour of the EMU.

On the 23rd of November, China’s Financial Times, published by the Chinese Central Bank, suggested that “If there were problems with the dollar, there will be an international catastrophe. Reducing reliance on the dollar and maintaining greater variety in foreign exchange reserves is the only way to reduce risk. As a result, an increase in our country’s gold reserves is necessary.” Commenting on this statement, USAGOLD wrote “This admission by the People’s Bank of China, the second largest holder of dollar reserves next to Japan, points up the growing concern in financial circles about the future of the dollar.”

Meanwhile, recent action on the part of the Federal Reserve Board does nothing to enhance its reputation in support of a strong dollar. Three rate cuts and a reacceleration of the printing presses are not conducive to instilling investor confidence in the management of the world's reserve currency; a responsibility the Federal Reserve appears to be relinquishing.

In the past, whenever nations have accumulated debt burdens beyond their abilities to repay, they have destroyed their debt by destroying their currency. The ultimate crisis facing the dollar is when the United States can no longer count on foreign cash surpluses to purchase its debt securities. As the problems mount in Japan and China, the beginnings of this crisis might well be here.

Twelve Reasons For Owning Gold

- ? ? The plateau period of the Long Wave is close to an end. The deflationary/ depression stage which follows is the best period in the entire cycle for the purchase of gold and gold shares. (Refer to Issues 1 and 4 to see the enormous gains in value of Homestake shares from 1929 to 1936).
- ? ? Gold performs well in times of increasing financial, economic and political uncertainty. The world is facing a more uncertain financial and economic future than in almost 70 years. A long wave depression appears imminent.
- ? ? The future of the US dollar is in jeopardy, both as a currency in its own right and more importantly as the world's reserve currency.
- ? ? With any significant breakdown in the US dollar, the world monetary system is threatened. In the previous two long wave deflation/depression cycles the world monetary system has collapsed.
- ? ? If you are bearish on the US dollar, you must be bullish on gold.
- ? ? Gold is the only internationally recognized financial asset that is not someone else's liability. It is the historic shelter from financial chaos. For 4000 years gold has been viewed as the money of last resort.
- ? ? Deflation, which is already affecting much of South-East Asia, is anticipated to engulf the remainder of the world. Deflation is synonymous with financial chaos and failing banks. Gold responds very well in that environment.
- ? ? Gold, relative to the Dow Jones Industrial Averages, is at its most undervalued in more than 100 years. We urge you to buy low and sell high.
- ? ? Keeping gold or gold shares prevents that capital from being controlled by the existing financial establishment.
- ? ? There is a huge short position in gold, estimated to be as much as 8000 tons, which is more than three years mine supply. Any forced liquidation of these positions would create a tremendous buying surge.
- ? ? Technical indicators on long term charts, for both gold shares and the metal itself, have just initiated BUY signals. This is the first such signal in many years and

indicates at the very least, that this bullmarket in gold should last 2 to 3 years.

? ? Investment demand for gold is growing. Gold coin sales around the world are surging; even in the USA, where individual Americans are purchasing gold eagles at a record breaking pace.

Gold and Deflation

We are perturbed about the many analysts who fail to comprehend gold's monetary role during deflation. For instance, we recently read a comment from a highly respected economist, who shall be nameless, suggesting that given the fall in commodity prices, there was absolutely no reason to own gold; and in his view, gold shares should be shorted. Time and time again, we read and hear similar theories advanced by reputable analysts for lower gold prices. Unfortunately, these analysts have neither studied the last period of world-wide deflation, which was of course during the 1930s; nor have they viewed gold as a store of value, which unlike other commodities will appreciate in value during deflation. Need we write it again? Gold is money and has been money for more than 4000 years. "Gold money does better against paper money in deflation than in inflation, because in deflation the market runs from paper assets, including the dollar itself, that are falling in price or actually defaulting. Gold never defaults and, compared with paper, is unbelievably scarce. The price will soar."¹¹

To ascertain just how much the price of gold will soar in the coming period of deflation we turn to James Davidson and Lord William Rees-Mogg for the answer. "Five great credit cycles have come to an end over the past three centuries, the last in 1929. On average, the price of gold in real terms (adjusted for inflation) rose within four years of the end of the cycle to exceed its high of a decade earlier by 8.5% in real terms. This implies that the inflation-(or deflation-)adjusted price of gold would exceed \$925 in 1980 dollars. That comes to about \$1600 in December 1990 dollars."¹²

On the basis of this hypothesis, but using \$850 instead of \$925 per ounce for gold in 1980, the price of gold during this deflationary cycle should reach \$2000 per ounce within four years. Obviously, such a price extreme would only come to pass as a result of a major catastrophe in the world financial system. Major rifts are already evident.

Conclusion

As previously stated, our primary purpose in writing this letter is to determine our current position within the long wave cycle, and make appropriate investments to complement that position. We offer only probabilities not certainties, but we are amazed at how closely the current plateau period is following its predecessor. Knowing what happened then, we can anticipate how events should unfold now. As we see it, the critical factors facing the US now are almost exactly the same as those in 1929. The first is the enormous mountain of credit keeping the economy and the stock market afloat, and the second is the price bubble representing the stock market. If anything, these two problems are significantly larger than they were in 1929, and the US is monetarily in a much weaker position now to confront them. We do not see how US consumers can keep the rest of the world's separate economies afloat, particularly since they have eliminated their savings. Nor do we see how the Federal Reserve Board can continue to fuel this spending, for to do so will destroy the dollar.

All this suggests that, as in 1929, the US stock market will collapse, deflating the credit bubble and bringing about a collapse of the world financial system. In 1929, only two investments survived and were enhanced in this environment -- cash and gold.

Last Minute Notes

November 30, 1998

The Standard and Poors 500

In our last letter we warned that our bearish outlook would be negated by a move above 8700 on the Dow Jones Industrials. This target was breached and the DJI has since moved to form double top in the 9400 area. Based on our Elliott Wave analysis of the chart pattern, we are uncertain that this is the final top. Elliott, who formulated his technical system in the mid-1930s, maintained that the technical top of the DJI was reached in 1928, not in 1929. What followed was a corrective ABC pattern with the B wave taking the DJI to new highs in 1929. The C wave was the entire crash into 1932. Elliott argued that the C wave of an ABC pattern at the end of a market always results in a devastating crash. Our analysis of market price suggests a similar pattern is underway in the current market.

Thus, the real top on the S&P was completed on July 20th when the S&P reached a high of 1190.58. The A wave then bottomed on October 8th at 923.32. The B upwave may have completed its high at 1193.26 on November 27th. This top would be confirmed by an S&P closing below 1084 (DJI equivalent is 8650). If these prices were broken we would expect the start of a major bear market, signaling the end of the plateau period.

However, should the S&P correct to approximately 1140, turn up and then break above 1193 we would expect a move to new highs, still within the context of the B upwave, to 1280 (DJI equivalent 9720). These Highs would then be followed by the devastating C wave down.

For students of Dow Theory, the Transportation Index has failed to confirm the new high in the Dow Jones Industrials. Indeed, the Transportation Index still languishes 20% below its all-time high. This non-confirmation is a bearish signal and suggests that the Dow Jones

Footnotes and Credits

1 The Globe and Mail, Monday, November 13th, 1998, p.B11.

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Two roads diverged in a yellow wood,
 And sorry I could not travel both
 And be one traveler, long I stood
 And looked down one as far as I
 could
 To where it bent in the undergrowth;
 Then took the other, just as fair,
 And having perhaps the better claim,
 Because it was grassy and wanted
 wear;
 Though as for that the passing there
 Had worn them really about the
 same,
 And both that morning equally lay
 In leaves no step had trodden black.
 Oh, I kept the first for another day!
 Yet knowing how way leads on to
 way,
 I doubted if I should ever come
 back.
 I shall be telling this with a sigh
 Somewhere ages and ages hence:
 Two roads diverged in a wood, and I-
 I took the one less traveled by,
 And that has made all the
 difference.¹³

Industrials will soon turn back to the downside.

XAU Index (Gold Shares) Daily chart.

We are convinced that gold shares have recently started a long-term bullmarket, evidenced by the technical indicators on the monthly chart (not shown). Nevertheless, gold stocks are currently experiencing a short-term correction which could take the XAU back to the 65 range. We would not be overly concerned about a pullback to 64. A break below 63.50 would cause us grave concern. The charts suggest that for the short term the XAU is completing its C wave pattern down, and should be close to a bottom. The next move of consequence should be a major short-term move to the upside and could take the XAU to 100 or 110 points. This move should be completed by mid-January. Confirmation of the impending breakout would be a price move above 80.



All enquiries concerning investment accounts or junior gold mine financing may be directed to:

Ian Gordon

604-643-0280 Phone

604-643-0152 Fax

ian_gordon@canaccord.com

I will not accept account queries from US citizens. These may be directed to my colleague, Rick Langer