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Gold Update, Part One – A Plague of Experts

May 30, 2013 | Author *Pater Tenebrarum*

Suddenly, Everybody is an 'Expert'

As we have pointed out on previous occasions, there has been a 'full court press' in the financial media against gold. It is amazing that an alleged 'barbarous relic' of no particular importance (according to Fed chief Bernanke, the US treasury only hangs on to its gold due to a kind of misguided nostalgia, i.e., because it's a 'tradition') all of a sudden receives so much attention.

It is noteworthy in this context that it garnered far less attention while its price went up. Today we regularly hear people holding forth about gold we have never heard from before. They only popped up once it broke through technical support and suffered a mini crash. Evidently here was a nest of gold bears somewhere – and most of them appear woefully uninformed about the gold market. However, that hasn't kept the financial press from publishing their screeds. It should also be pointed out in this context that so far, the low established in the course of the mid April crash continues to hold. All the bearish forecasts published since then have yet to prove their worth.

As we have mentioned as well, it is certainly *possible* to construct a valid bearish argument for gold. It is possible with regard to *every* financial asset at any point in time to fashion *both* bullish and bearish arguments that have at least *theoretical* validity. One can then contrast the bullish and bearish arguments and try to figure out which of them are likely to gain the upper hand.

Even that exercise is fraught with many uncertainties, especially in the short to medium term (it is much easier to come to conclusions about longer term outcomes). This is because we cannot know in advance which issues market participants will focus on in the short term. For instance, stock markets have risen in bubble-like fashion to a level of overvaluation on a par with the valuations seen at previous historical peaks, in spite of a very weak economy and a notable decline in earnings growth rates. This mainly happened because investors chose to focus on the 'eternal' Bernanke put instead of on the rather bleak underlying reality.

Dubious Arguments

In any event, the point we want to make is that many of the arguments that have been forwarded in recent weeks by gold bears make no sense whatsoever. Let us look at a few recent examples that weren't produced by unknown scribblers, but by the gold analysts of major banking institutions. For instance, Barron's reports on a recent analysis by Commerzbank:

> "The steady exit from gold exchange-traded funds is as good a barometer as any for today's low investment appetite for the metal. ***But here's another way of looking at the outflows: Versus the size of central-banks' gold buying.***
>
> For some analysts, ETFs have grown so important that central banks' activities are now something of an afterthought.
>
> ***Commerzbank's strategists lay out the numbers this morning. Central banks bought about 30 tons of gold during April. So far in May, investors have pulled out***

the equivalent of 117 tons from ETFs like SPDR Gold Trust(GLD) and iShares Gold Trust (IAU). They've yanked more than 290 since the start of the quarter, according to the same figures.

'[T]he 30 tons or so of gold purchased by central banks in April – as we reported yesterday – thus appear to be but a drop in the ocean," write the firm's strategists in a morning note."

(emphasis added)

What is missing here is a mention that the '*290 tons yanked from ETFs*' are a '*drop in the ocean*' as well. As we have pointed out many times, **the buying and selling by central banks and gold ETFs is essentially immaterial to gold's price.** It is just as immaterial as variations in the mine supply are. It simply makes no sense at all to focus on these data when trying to analyze gold. The total supply of gold is an estimated **175,000 tons**. On the LBMA alone, as much gold is traded every three to four days as is supplied by mines in an entire year. Anyone who is looking at the paltry amounts ETF and central banks buy or sell in a period of three *months* is trying to analyze gold as if it were an industrial commodity. **However, gold is not an industrial commodity, it is first and foremost a monetary commodity.**

Gold must therefore akin to a currency and must be analyzed in a similar manner. Since the biggest component of gold demand is the reservation demand of current gold holders, one can only *indirectly* arrive at conclusions as to whether gold is more likely to rise or fall in the medium term (that its price will rise in the long term in terms of fiat confetti is a given, since the supply of the latter is *always* expanded at a far greater rate).

The notion that ETF sales are relevant to the gold price was also repeated in a bearish analysis released by Credit Suisse on Wednesday. Credit Suisse has the distinction of having turned bearish on gold before its recent swoon, but nevertheless several of its arguments demand rebuttal. All the talk about '450 tons of gold being sold here and absorbed there' can be safely ignored of course, as can the notion that gold was in a 'bubble' (we have already explained why gold is far from 'bubble territory'). We will therefore only look at the more nuanced arguments.

"The rationale behind the February call was Credit Suisse's sense that the most fear-inducing chapter of the post-2008 crash environment began to draw to a close after the European Central Bank's July 2012 decision to finally commit to being the lender of last resort to help the eurozone weather its debt crisis. The cornerstone for a slow recovery was finally in place, which undercut gold's fear-based allure."

To this we would note that it is true that a 'fear premium' that was embedded in gold's price has been taken away after the market's worst fears regarding the probability of euro area sovereign defaults receded. **To think that the central bank somehow put in place the 'cornerstone for a slow recovery' is however erroneous.** Central economic planning hasn't suddenly begun to 'work' as if by magic. Moreover, it is far from certain that the debt crisis is over. Let us not forget, the 'Draghi OMT put' has yet to be put to the test.

"Behind the latest call, published last week, is that the other major motivation for buying gold since the crisis—namely to hedge against inflation in the face of rapid expansion of central bank balance sheets, simply hasn't been necessary. In fact, it's been difficult to create any inflation at all, and a significant increase in the velocity of all the money sloshing around in the economy has not yet come to pass.

"Financial markets have decided that the remaining risks can be navigated in relative safety and so a growing number of ***investors think the opportunity cost of gold is too high a price to pay,"*** the report said."

(emphasis added)

The opportunity cost of holding gold remains actually a strongly *bullish* factor, **as real interest rates (nominal rates minus inflation expectations) remain deeply negative.** So this is a spurious argument. As to the idea that the 'need to hedge against inflation' as somehow disappeared, this is preposterous. The need has rarely been greater. The Fed has inflated the true US money supply by 80% since 2008 and continues to inflate it at a brisk rate. The fact that officially reported 'CPI' hasn't increased much is not relevant in this context. For one thing, CPI has been tame *throughout gold's bull market to date.* It seems highly likely that it will eventually rise strongly, but the time lag involved can be very large – very often many years, even decades can pass before a vast increase in the money supply brings about a notable rise in final goods prices.

With regards to 'velocity', this is simply an erroneous concept. It is far more accurate to speak about the demand for money. 'Velocity' is nothing but a fudge factor that is used in the tautological 'equation of exchange' of the Fisherian quantity theory of money. When this so-called 'velocity' is deemed to be low, what is really happening is that the **demand to hold cash balances is high.** However, a high demand for holding cash balances is not a bearish factor for the gold price, but a bullish one. **This is so because gold is a substitute for cash holdings. Anyone holding gold is essentially holding cash in form of another currency.** In short, what CS believes to be a bearish argument is really a bullish one.

The remainder of CS's argument concerns itself with deliberations about ETF selling, which as we have pointed out above is simply nonsensical from the outset.

If this is all the bears can come up with, you should buy gold with both hands. **As far as we are concerned, a bearish argument that may have some validity is that the rate of growth of the US budget deficit is declining.** However, as we have previously discussed, the current budget deficit estimates may prove to be overoptimistic, as there was a large one-off effect occasioned by people rushing to take capital gains and corporations distributing dividends prior to the tax hikes instituted earlier this year. Moreover, the budget is highly sensitive to 'bubble revenue'. If the stock market bubble should falter, a large source of revenue (capital gains tax) will disappear.

Another bearish argument that deserves consideration is the fact that gold has stopped reacting positively to what should, on the surface at least, be bullish news. **However, this can probably be explained by the fact that the perceptions regarding declining risk of sovereign defaults in the euro area have removed some of the 'risk premium' that was previously embedded in gold's price. Now that this premium is gone, the market is once again free to take other factors into account.**

Conclusion:

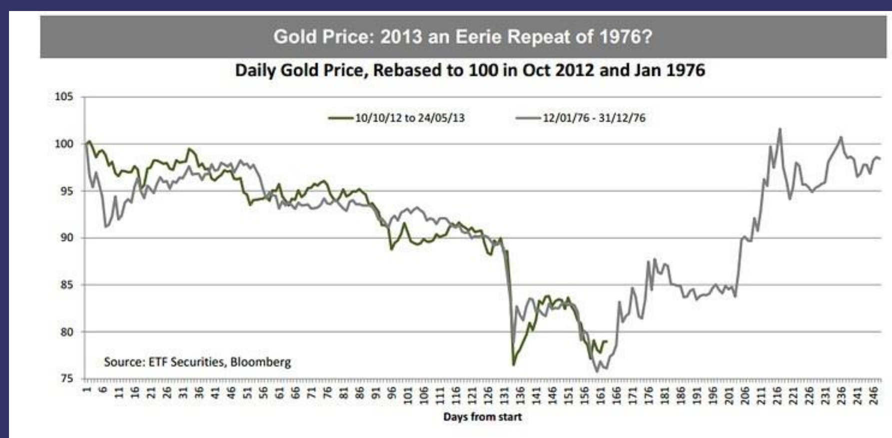
The gold bears should really think of a few better reasons if they want to make a bearish case for gold that stands up to scrutiny.

Several of the most important drivers of the gold price remain very bullish, among them negative real interest rates, a brisk expansion of the money supply and the piling up of ever greater risks in the debt and other 'risk asset' markets.

To be sure, there are a few bearish arguments that deserve consideration, but in our opinion they hold less water than the bullish arguments at this stage. This is further buttressed by recent developments on the technical front, which are discussed in Part Two of our gold update.

Addendum: Gold in 2013 versus Gold In 1976

Ironically, the Commerzbank analysis included a comparison of the 1976 correction pattern with the 2013 correction pattern which according to the analysts should best be ignored. We will reproduce it anyway:



Gold's 1976 correction pattern compared to the 2013 pattern. As Barron's notes: *"The firm isn't reading much into it and makes a point of calling it "not something to trade on."* To this we say: we shall see. Via Commerzbank – click to enlarge.

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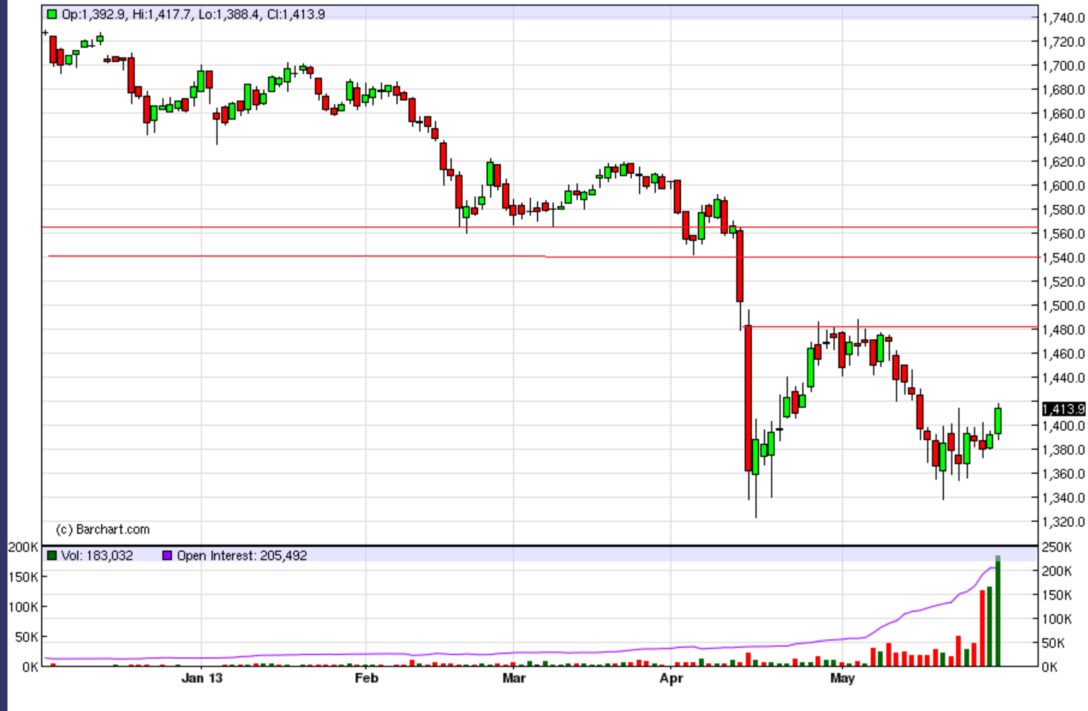
Gold Update, Part Two – Technical Conditions and Sentiment

May 30, 2013 | Author *Pater Tenebrarum*

Gold and Gold Stocks – Technical Conditions

There have been a number of noteworthy technical developments in gold, none of which are bearish. Although it is still not possible to sound the 'all clear', there are now a number of signs that the April crash low may in fact have been an important medium-to-long-term low.

Let us first look at gold itself. As the daily chart of the August contract shows, gold has begun to rise on expanding volume after the successful test of the crash low. It is a good bet that recently added short positions are now being covered due to the contract's failure to break to new lows. At the same time we can see that a number of strong resistance levels are still overhead. These will have to be overcome in order to adopt an unequivocally bullish stance from a purely technical perspective.



Gold, August contract daily – a strong rise on expanding trading volume following the successful retest of the crash low. The red lines indicate overhead resistance levels.

Zooming in a bit on the shorter time frames, we can see that an attempt to sell gold down again after the initial rise to the $1,400 level has been negated by the most recent price action. Newly established shorts are being covered, and there are probably also new long positions being established, as indicated by the recent action in gold stocks (more on that further below). Note that when we talk here about short covering and the establishment of new long positions we refer exclusively to the activities of speculators.

What's more, the recent advance does appear to be an impulse wave.

Gold, August contract, 30 minute candles. On May 28 an initial foray to the $1,400 level was rebuffed – the subsequent break through this level has seen an expansion in trading volume, indicating that newly established short positions are covered again. The advance moreover has an 'impulsive' look to it.

However, what really constitutes very good news in our judgment is the recent action in gold stocks. As we have frequently pointed out, since the gold stocks have led gold to the downside, it is very important that the ratio of gold stocks to gold turn up and that they begin to lead to the upside in order to be able to be confident of a trend change.

Tentative evidence of a change in character has arrived on Wednesday already and Thursday's action has cemented it further. On Wednesday gold stocks rose strongly from a higher low, even while gold only advanced hesitantly. On Thursday, they opened with an upside gap, leaving a large 'island' behind. It is possible that we have witnessed a genuine island reversal (unless the gap is soon closed again). If so, this would be excellent news indeed. Island reversals are very powerful technical patterns: they indicate that the market's assessment has shifted by 180 degrees.

Note also that the technical divergences between prices and momentum oscillators we have previously pointed out seem to have 'worked' this time. In terms of the HUI, the next major resistance level is the gap between approximately 290 and 300 points. If the index overcomes the 300 level, it will further buttress the notion that a major trend reversal has occurred.

The HUI puts in an island reversal. Note that the island comprises almost two weeks of trading activity, which makes this an especially noteworthy event. The gap between 290 and 300 is the next major resistance level that the index needs to overcome.

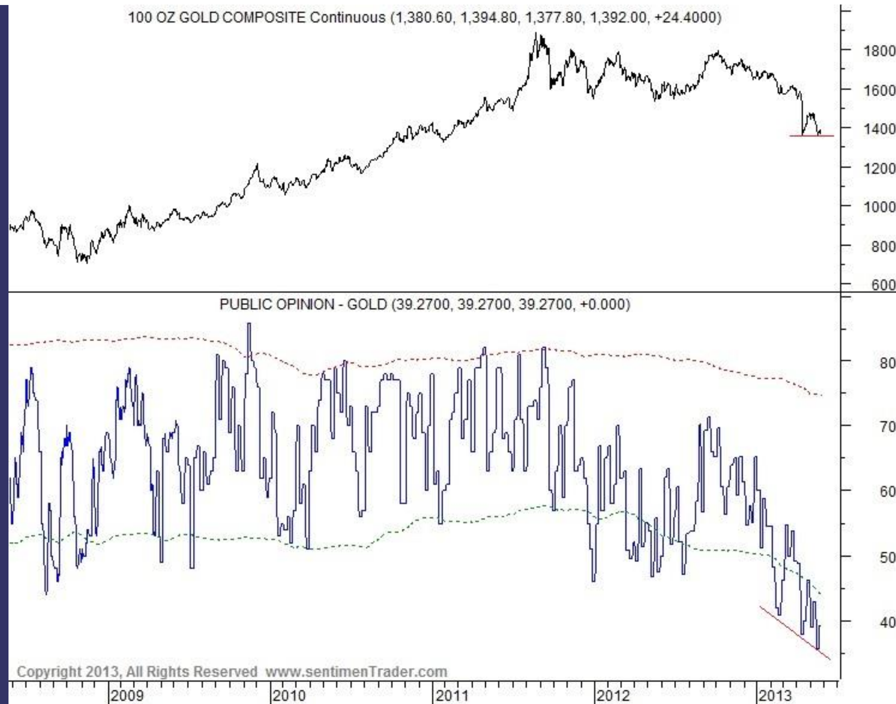
The HUI-gold ratio begins to rise from a higher low. Note that the preceding decline has lost momentum since mid April.

Sentiment Update

There have also been a number of interesting developments on the sentiment front. It is well known that on an anecdotal basis, **sentiment is in the gutter.** The financial media, mainstream analysis as well as internet discussion forums are brimming with bearish forecasts. This is reflected in quantifiable sentiment data as well. What makes recent developments so interesting is that the sentiment data have begun to diverge from the price action, something that is frequently seen prior to trend reversals.

In this context, **note also that the Hulbert Gold Newsletter Sentiment Index(HGNSI) has put in a new *all time low*.** On average, newsletter writers recommend a 44% net short allocation to gold. This unprecedented level of bearishness is belied by the price action, as gold has so far failed to break to new lows.

The same can be seen in sentimentrader's 'public opinion' index, which merges a number of popular sentiment surveys.



The 'public opinion' index on gold diverges markedly from gold's price action.

The HGNSI makes a new all time low of nearly minus 44% – this means that gold timers recommend a 44% net short exposure to gold *on average.*

Conclusion:

Gold bulls are not out of the woods yet. There are strong technical resistance levels that it will need to be overcome before one can turn unequivocally bullish. However, there are now strong signs that the mid April crash low may indeed have been a major medium to long term low. What argues in favor of this idea is *inter alia* the fact that the **April low was put in amid panic volume and was later successfully retested on lighter volume** (according to Tim Ord's technical method, this is a very strong bullish signal).

Moreover, the action in gold stocks is beginning to look quite constructive. They previously led to the downside and may now finally be in the process of beginning to lead to the upside. The main caveat is that the reversal is still young and therefore not yet definitive. In short, many things can still go wrong. Nevertheless, we do now at last have a number of signals in place that have in the past often indicated that a major trend reversal was at hand.