TECHNICAL SCOOP
CHART OF THE WEEK

Charts and commentary by David Chapman
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GOLD IN A RUT!

Charts created using Omega TradeStation 2000i. Chart data supplied by Dial Data

These are stressful days for those holding gold bullion and gold stocks. Sentiment in the gold sector has turned quite negative. Sentiment is at or close to the lows seen at the bottom of the market in 2008 and below the levels seen in seen in December 2011 and May 2012. To put things in some perspective since the depths of the 2008 financial crisis gold is up 132%, the TSX Gold Index is up 68%, the TSX Composite is up 70% and the S&P 500 is up 128%. However, if one goes back to 2000 and the top of the stock markets the S&P 500 is flat, the TSX Composite is down roughly 17%, gold is up 475% and the TSX Gold Index is up 150%. It all depends on where one is in time.

There is no doubt that sentiment is quite negative. The Hulbert Gold Newsletter Sentiment Index (HGNSI) has readings of -3.3% over the past four months. The Hulbert letter noted that one would have to go back to 1991 to find four consecutive months of negative sentiment at these levels. The Bloomberg sentiment readings are just as negative. Its readings are at 32% bulls. That was the kind of reading seen at the depths of the 2008 lows. Finally, the Daily Sentiment Index on gold is at 5% bulls, levels that have been associated with significant lows.

So what is going on? Interest rates have been ticking higher but thus far the increases in rates have been primarily at ten year notes and beyond. Gold prefers it when the real rate of interest is negative. Interest rates under ten years are all below the current rate of inflation. The monetary authorities in the US are not about to raise the official interest rate. That in turn should keep rates down especially those under ten years. Rates ten years and longer are market driven and not influenced to the same extent by the Fed rate at the lower end of the yield curve.

Ten year US Treasuries bottomed back in June 2012 at 1.47%. Since then they have gone up to 2.03%. Some analysts have cited rising interest rates as to why gold prices have fallen. But that argument loses some steam when one discovers that when 10 year Treasuries were at 1.47% gold was trading at $1,600 just above the current level.

Another argument is that the economy is improving and as a result, investors are shifting into the stock market as gold loses its safe haven status. If economic growth is a barometer, the recent Q4 US GDP numbers shows there is virtually no growth in the economy. The US housing market is off its bottom but is still down over 60% from its highs in terms of housing starts. Sales of new homes are falling not rising raising the spectre of further growth in unsold homes. Retail sales are essentially flat when one considers growth in the population. Both the Japanese and Euro Zone economies have slipped back into recession. While China has continued to show growth, they have slowed down. Given a stagnant to a low growth global economy a business boom does not appear to be on the horizon.

There is one intriguing argument that gold is suffering because of a loss of confidence in paper gold. Most gold markets are paper gold markets not physical gold markets. The market issuance of ETF's, gold certificates, futures, etc. far outweighs the actual size of the physical gold market. The question becomes how trustworthy are the counterparties? Unfortunately, one cannot separate the two, as there is only one gold market not a paper gold market and a physical gold market. There has been some evidence that there has been selling of paper gold to purchase physical gold in storage or fully allocated gold. However, until the paper gold is sold it could push gold prices lower until equilibrium is found. If that were the case, this is a temporary phenomenon, as the demand for physical gold would eventually overwhelm the actual supply.

The demand for gold is there. According to World Gold Council statistics, global gold demand in 2012 hit 4,405 metric tonnes including 534.6 metric tonnes for central banks the highest in 50 years. Mine production on the other hand was only 2,828 metric tonnes requiring 1,626 metric tonnes of recycled gold to make up the deficit. The 2012 demand was about 4% lower than the record 2011 demand.

Fed officials appear to be at odds with each other. The FOMC minutes of January 31, 2013 were released on February 20, 2012. The minutes indicated that while some Fed officials have warned about ending QE too soon others believe that the Fed should be prepared to vary the pace of QE because tapering the pace of asset purchase may become necessary as the economy improves. With the economy effectively stagnant and headline unemployment remaining high at 7.9% the odds of the Fed pulling QE is low to nil. The Fed's current round of QE (known as QE3) currently purchases $85 billion a month of US Treasuries

and mortgage backed securities (MBS). The current round of QE also wants to keep the rate of inflation at 2% or lower with an aim of lowering the unemployment rate to 6.5%.

QE is providing support to the economy but it is not having much in the way of impact. Since the financial crisis of 2008, the US monetary base has grown from around $900 billion to over $2.8 trillion more than a threefold increase. If gold is a barometer of the growth in the monetary base it has lagged badly. Gold is only up roughly 130%. Gold would have to be over $2,000 to match the growth in the US monetary base.

The Fed's balance sheet has grown to over $3 trillion from just under $1 trillion in 2008. The Fed has become the prime buyer of US debt and is purchasing some 70-80% of debt issues. Some recent numbers suggest that the Fed has actually purchased more US debt since the start of 2013 then the US Treasury has issued http://cnsnews.com/news/article/fed-has-bought-more-us-gov-t-debt-year-treasury-has-issued

The Fed cannot pull back its support without causing a potential big jump in interest rates. Nor can the Fed liquidate its holdings of US Treasuries without causing a jump in interest rates. In addition, the Fed has taken on upwards of $1 trillion of MBS debt and other debt. The Fed's current program of QE is effectively continuing to bail out the banks that were at the heart of the 2008 financial crisis. A pullback in the QE program could cause another systemic bank crisis.

While there are Fed officials who are getting the "heebie jeebies" over the QE program because there does not appear to be an exit strategy the reality is the Fed cannot stop its QE program. The end of QE could cause a rise in interest rates, which in turn could kill whatever feeble economic recovery is underway. Finally, pulling QE would undermine the banks that caused the financial collapse in the first place. The large financial institutions need continued support in order to work their way out of their toxic holdings in MBS, derivatives and other questionable securities. This has been ongoing since the 2008 financial crisis.

Surprisingly all the talk of currency wars has not yet caused gold to rise. The Japanese Yen has been devalued by 18% since September 2012. The Euro zone has expressed concern about the rising Euro. All of this has put some upward pressure on the US$ as reflected by the US$ Index. As the US$ Index goes up gold tends to fall in price.

The drop in gold prices over the past month has shaken the confidence of many. Rumours had it that a large hedge fund (or funds) may have blown up and caused a selling spree in the commodity sector. There was an unexplained drop in oil prices of about $2 all at once on Wednesday at one point.

Above is a weekly chart of gold. On the chart, TC has drawn speed resistance lines off the low of the October 2008 at $681 to the high of September 2011 at $1,912. The theory is that speed lines will act as support/resistance for either a bull or a bear market. Note how a high in 2009 tried to break above the speed line only to fall back. The speed line was tested once again in 2011. Since then gold has been working sideways toward a lower speed line. The drop this past week has seen gold prices test this speed line. The line should act as support.

Note the extremes on the MACD indicator at the bottom in 2008 and again at the bottom in May 2012. The MACD turned up again before topping in September 2012. Since then the MACD has been pulled lower although so far it is making a higher low to the low of May 2012. We also put a 100-week exponential MA on the chart. Since the major lows of February 2001 gold has only broken below the 100 week MA in 2008 and again now. When gold broke below the 100 week exponential MA in 2008 it only stayed there for about six weeks before rising again. On the other hand, the S&P 500 spent the period

from November 2000 to August 2003 as well as the period from January 2008 until November 2009 under the 100 week exponential MA.

Could patterns repeat themselves? The 2008 collapse in gold fell in five waves with the fifth wave bottoming in October 2008. Gold broke over the five-wave decline trendline in January 2009. After peaking in February 2009 gold fell to test the breakout line. These waves have been labelled 1, 2, 3, 4 and 5 then waves 1 and 2 following the breakout. Similarly, the decline from the high of September 2012 fell in five waves with the fifth wave bottoming May 2012. The downtrend line of the five-wave decline broke in late August 2012. This appears as a test of the breakout line. Once again the waves were labelled 1, 2 3, 4 and 5 then 1 and 2 with a ? The market would confirm that a low is in when Gold closes over $1,695. In technical analysis, it is not unusual for patterns to repeat themselves.

There is extreme bearish sentiment for gold. Of late negative stories have been appearing almost daily. But the western economies remain mired in debt, high unemployment and stagnant growth. All the major economies including China are using QE in an attempt to bail themselves out. The longer QE goes on with little in the way of results the monetary powers become increasingly nervous. Currency wars are breaking out even as they are being denied. Austerity programs are common but it is really a spiral to the bottom as a round of austerity leads to lower revenues and more austerity. With no debt deals in the US, huge budget cuts loom. The Pentagon has threatened to furlough upwards of 800 thousand workers if the proposed budget cuts go through.

There is a solution out there and that is to restore at least a modicum of a gold standard and revalue gold upward to back at least a portion of the monetary base. Most countries would be unable to back their currencies with gold unless there was a huge rise in the price of gold or they were able to purchase more gold. The current bearishness in gold is overdone although one cannot say with certainty as to whether there might be some more downside. Once this correction is out of the way gold has objectives over $2,000 and possibly higher.

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