Gold And Trend Exhaustion

The Market Has Stopped Rising On Good News

Actress and proto-celebrity Mae West once proclaimed, "Too much of a good thing can be wonderful." Maybe; one of my 398 Most Sacred Rules of trading is when a market stops responding to the same news that has driven it either higher or lower, the trend is exhausted.

When I entitled a March 2010 column Gold Needs More Irresponsibility, it was a setup of the first order: I was talking about the need for more monetary irresponsibility to drive the yellow metal higher, and the chances of central banks in general and our own beloved Federal Reserve in particular not coming through were slender. Bullion tacked on more than $800 per ounce by November 2011. As the printing presses are continuing to roll and as competitive devaluation amongst currencies remains the order of the day, why are prices $250 ounce below their peaks?

And, while we are at it, why have gold stocks taking it on the proverbial chin and elsewhere since last September? The NYSE-Arca Gold Bugs index (HUI) has underperformed the broad market by more than 37% since that time; the Philadelphia Gold & Silver index (XAU) has underperformed by 35% or so. The Dow Jones-UBS sub-index for gold has lost a "mere" 12% over the same period.

Closing The Gap

The questions then become whether gold stocks are leading the metal lower and whether the performance gap will close with the stocks rising or with gold falling. At the risk of getting the usual assortment of hate mail I get whenever I say anything negative about gold, I have to go with gold falling to close the gap.

One of the problems faced by the miners is they are a margin operation, not a pass-through for gold prices. As is the case with all resource-related stocks, they can move early in a bull phase as capacity is slack, costs are low and price increases can flow directly and relatively unimpeded into the operating margin. After more than a decade, the supply chain for gold has captured much of the rent of higher prices in the form of higher labor, energy, land and machinery costs. This is not at all unique to gold mines and, no, there is no sinister government plot involved.

Here is a simple question: If you have not been a participant in higher gold prices over the past decade or so, what would induce you to start buying now? This really has to be the case of there are no potential late longs left to join the party; moreover, anyone who is short now is likely to be a strong short. All of the factors that propelled gold higher, that monetary irresponsibility, remain. Governments and central banks have been trying to repudiate their debts via higher inflation, but they have yet to achieve that inflation. In fact, one of the consequences of financial repression has been newly created money simply goes to feed the transfer-payment machine and does not stimulate the underlying economy. This is why velocity, the ratio of GDP to the money supply, remains at its post-Eisenhower administration low.

By the way, I still like Ike.

Just as the NASDAQ pulled off its last 2,000 points in the short time between December 1999 and March 2000, gold's run from $1,250 to $1,900 occurred over the September 2010-September 2011 period. Markets tend to revisit their breakout points; not too many saw the NASDAQ at 5,000 approaching 1,000 by October 2002, did they?