Gold And ETF Trading: Do Not Confuse Cause And Effect

Fantasy football has nothing on fantasy machine-creation; witness Mattel's (MAT) 1985 creation of the Bashasaurus or Woody Allen's 1973 Orgasmatron in *Sleeper*. I shall follow in their spiritual footsteps with my virtual Sarcasmatic, a device conceived to address the assertion gold prices were driven lower by the redemption of exchange-traded funds. Yes; and wet sidewalks cause rain. I addressed this last April for gold and last May in a separate analysis for silver; let's update the one for gold right now.

Never A Natural Death

When dealing with any downward draft in gold, one must take to heart Sergeant Bowren's admonition to Major Reisman in *The Dirty Dozen*: "You see, the first thing one learns in prison, everybody is innocent." Gold never dies a natural death; it is poisoned by others in manners so foul as to prevent discussion in polite society. The old tried-and-true, that there was some sort of high-level international conspiracy whose goal was to prevent gold from rising back over $400 had to be abandoned when the alleged conspirators started ramping up the printing presses after the dotcom bust and then went into warp-speed money-creation after the 2008 financial crisis. Gold dutifully sailed north of $1900 by September 2011 but then stopped for reasons last discussed in December.

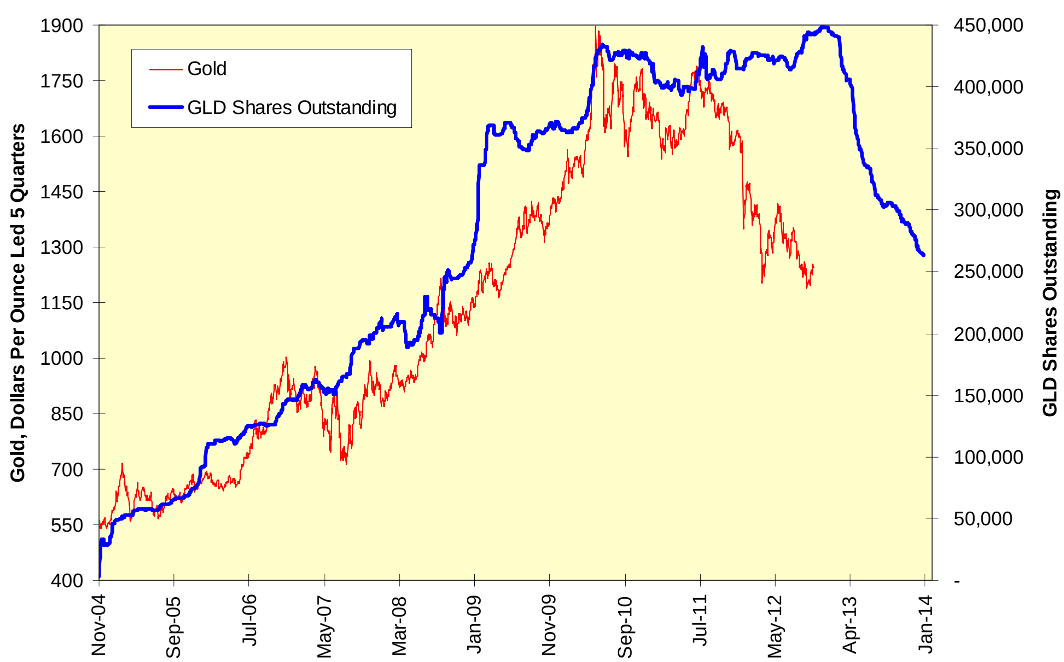
However, a general-purpose villain was found in the form of gold ETF redemptions; the shares outstanding for all gold ETFs in general and the SPRD Gold Trust (GLD) in particular peaked in December 2012. The argument went these redemptions, the sale of gold from one party to another, caused the downturn in gold prices that began in September 2011. How about that; they spend billions of dollars on particle accelerators and you can time-travel while staring at your quote screen. Never mind the simple fact those very same ETF holdings rose while gold prices fell during much of 2012.

A much simpler argument would be declining gold prices induced ETF redemptions and the transfer of gold ownership from rational investors to central banks and other less profit-sensitive buyers, but as that argument did not involve assigning blame it was rejected immediately.

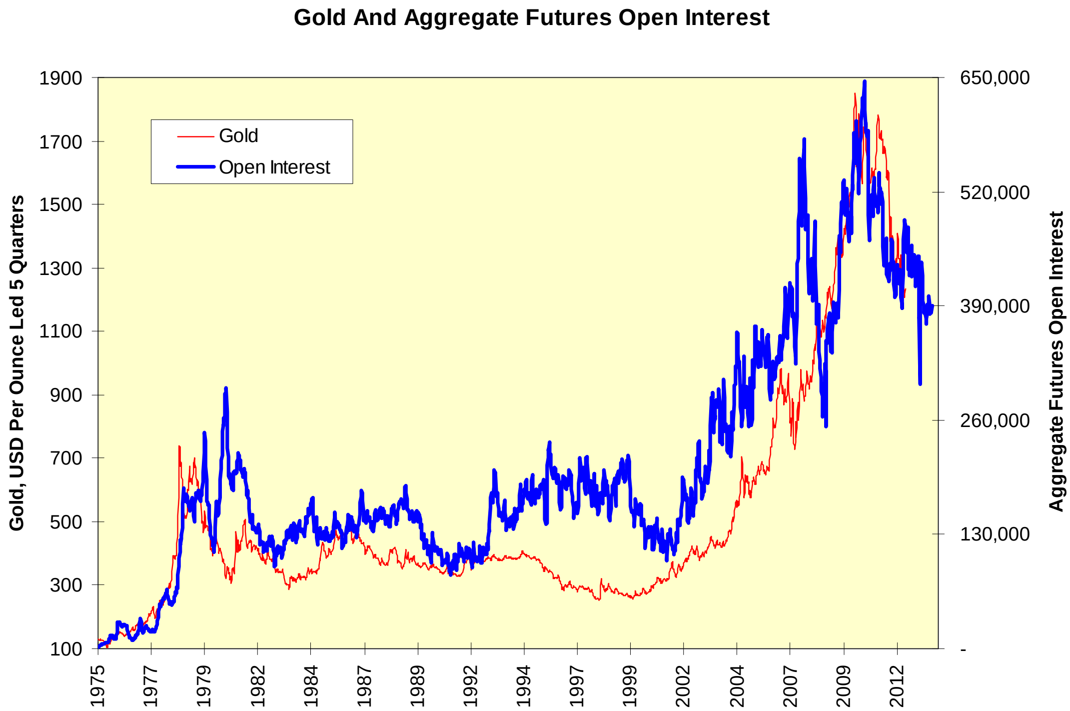
Leads And Lags

Worse – that is if you thought matters could not get worse – the SPDR Gold Trust's shares outstanding lead gold prices by almost five calendar quarters and they do it with an r^2, or percentage of variance explained, of 0.891. I noted last year this relationship implied weak gold prices into the first quarter of 2014; we now can extend that forecast into the first quarter of 2015.

Gold And SPDR Gold Trust Shares Outstanding



We get very similar results with a similar lead-time for gold futures' aggregate open interest, a measure available from December 1974.



Now here's the punch-line. If we model gold prices against the SPDR Gold Trust's shares outstanding with the lag noted above, we are aligned in time with October 2012. According to that relationship, gold should be about $360 higher than its present level. Restated, if the ETF redemption argument had any validity, the worst for gold is yet to come as prices will be affected by the post-December 2012 wave of redemptions.

If gold slides and ETF redemption reverses into creation, the excuse-makers will have to find someone new to blame. My faith therein is boundless.