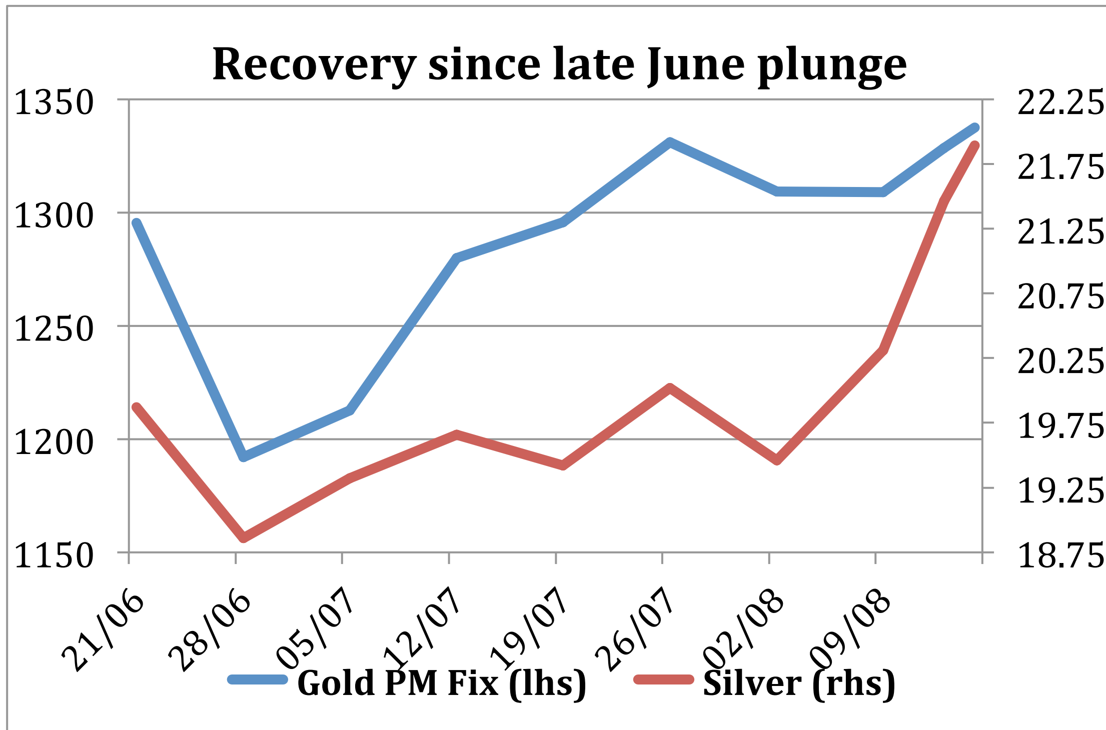
Gold rallies - they don't ring a bell at the bottom

It's been another interesting week in the precious metals complex. After closing out last week with a strong rally back above USD $1300 (USD $1309 on the PM fix), gold and silver prices shot up impressively on Monday, closing at USD $1341 and USD $20.83 respectively.

Whilst prices pulled back on Tuesday and Wednesday, not unexpectedly considering the rapid nature of their appreciation, gold and silver are now up 12% and 16%% respectively since their lows on the 28th June, and are currently trading at USD $1337.50 and USD $21.89.

The impressive bounce can be seen clearly on the chart below:



The recent strength in the precious metals complex has even led to some semi-positive coverage in the mainstream media, with this article appearing in Business Spectator.

One of the major reasons for the rally was the short covering which has occurred over the past week. As many of you will know, the violent correction in precious metals prices in Q2 2013 was accompanied by a record volume of short futures

positions, all of which put pressure on metals prices and helped them fall as sharply as they did.

In the past week however, we've seen futures traders unwind short positions to the tune of over 23,000 contracts, which represents over 2.3 million ounces of gold. This is the fastest pace of covering in over a decade, and has contributed strongly to the recent strength in the metals complex. We may well have seen more of this overnight, with over 800k ounces trading in the last few minutes on the December gold future, which took out buy stops and saw a sharp increase into the USD $1335 zone.

The short covering fits in with our thesis that the end of this cyclical bear market won't occur against a wildly bullish precious metals backdrop, or due to some new reason to be bullish on gold and silver. After all, the old reasons of economic uncertainty, sky-rocketing debt levels, money printing and ultra-low interest rates have been with us all throughout this correction.

Rather, the turning point, or the end of this cyclical correction will be marked by an absence of selling, or merely a reduction in bearishness towards precious metals.

A futures trader covering a short position in gold (or any asset) is not necessarily bullish on the asset, they're just no longer convinced it will fall, or that there's easy money to be made on the short side, and they're therefore no longer willing to have a leveraged position in that asset.

And whilst its nice to see the bounce in precious metals of late, as you'll see from the graph, it must be stated that the market is still predominantly bearish, with short positions still at an extremely elevated level.

This could mean further weakness is ahead, or that there is clearly the potential for a lot more short position unwinding to come, which would take prices even higher.

Either way, what we can say with some confidence is that for those investors who are waiting for the 'dust to settle' as it were, before adding to their precious metal positions, they'll have to be willing to forego 10-20% upside at a minimum.

They never ring a bell at the bottom, so it won't be until gold is back around the USD $1500 range that we'll be able to 'safely' say the cyclical bear market is over. That's a 25% rally from the June 28 low.

There's nothing wrong with waiting for a confirmed trend change to happen, and it is indeed safer to ensure the trend is back in your favour before investing in any asset, but by reducing risk you also reduce potential return.

The latest from China, India and Japan

Barely a month goes by where the Indian government or the Reserve Bank of India (RBI) doesn't come up with yet another piece of legislation aimed at ending or restricting the import of physical precious metals.

In the last few months they've passed restriction after restriction on how jewellers and gold exporters can do business, with the latest being a hike in import duties on both gold and silver, to 10% for both precious metals, up from 8% and 6% respectively.

This was added to overnight, with a senior official from the Indian finance ministry stating that all imports of gold will need a licence from the foreign trade office. Bureaucracy – a truly global phenomenon.

Whilst this will no doubt lead to ever more job losses in this sector in India, I don't think it will do anything to stem or curb India's demand for gold specifically, and precious metals in general, with Indian gold demand actually rising between June and July.

In fact, as I have often commented on to others, I feel it will be even less successful than America's attempt to prevent citizens during the Prohibition era, and will instead lead to an explosion in smuggling, or bootlegging bullion.

We're already seeing elevated signs of this, with gold now apparently replacing narcotics as the biggest smuggled item in India.

Meanwhile, according to data released by the China Gold Association, in the first half of 2013, consumption of the yellow metal rose to 706.36 tonnes, up over 50% in only 12 months.

This staggering number, which would annualise out at over 1,400 tonnes – represents 50% of annual gold production, and goes to show why China is on track to overtake India as the world's largest gold consumer.

Robust demand for precious metals from the world's two most populous nations is a sign of the market's health.

Elsewhere in Asia, Japanese GDP figures were released, recording one of the biggest misses to expectations in years, coming in at only 2.6% for the year – a full 1% below expectations, off the back of an incredibly weak Q2 figure.

Predictably, this has led to further calls for the Abe government, or the Bank of Japan to 'do more'. Considering that the Bank of Japan's existing QE programme is already proportionally much larger than the Fed's, and the Japanese government has by far the highest debt ratio in the world, we're not exactly sure what more there is to do – apart from simply admitting open-ended debt monetisation is the economic policy du jour, inflationary consequences be dammed.

A comment on the Australian election

Thankfully, there's only 3 weeks until the Federal election. Whilst the economy is obviously going to be talked about a lot, most of what we hear will be largely nonsensical and incredibly self-serving.

Therefore, rather than focus on what either Kevin or Tony are saying, I'd take a look at what Treasury included in the Pre-Election Fiscal Outlook (or PEFO for short)

Even though both parties are promising to cut taxes and or increase spending, the Treasury is somewhat laughably forecasting that spending growth will fall, whilst revenue growth will rise.

The Treasury is also predicting a 5% unemployment rate, even though it's already higher (and likely to rise). Obviously a projected unemployment rate of only 5% would lead to Treasury modelling, or forecasting higher tax revenue and lower government spending than what we are likely to witness in reality.

Whilst we've all come to expect the worst from both sides of politics, it is disappointing to see yet another lame effort by the Treasury when it comes to providing a balanced and fair assessment of the nation's finances.

They've been consistently wrong and consistently over-optimistic in their assessment of the Australian economy since the onset of the GFC, to the detriment of the Australian public who pay their wages.

This latest fiscal outlook must also be taken with a grain of salt.

Make no mistake about it, government debt is going up in the years ahead, and there will be no surplus in the foreseeable future.

Meanwhile in the USA

The major data point released in the United States this week was US retail sales. Whilst the headline figures printed at 0.2% (below expectations of 0.3%), the previous month's numbers were revised higher to 0.6%, and the ex-autos print came in at 0.5% for the month.

These numbers are neither here nor there, they don't show a consumer in crisis, but nor do they highlight a genuine economic recovery.

Overnight we saw the release of another week's mortgage applications results. This is a data point that the market judges as low priority, but I think it's worth paying particular attention to in light of the rise in US house prices of late and the fact the Fed points to them constantly as 'proof' of an economic recovery.

This week, we saw another fall, with mortgage applications falling 4.7%, a continuation of a trend that's been in place for the last few months, ever since yields (borrowing costs) started rising.

In fact, mortgage applications have now dropped for 12 out of the past 14 weeks, hardly a sign of robust demand. Heaven forbid they were to end QE and see interest rates normalise to 5% or higher.

Also in the news was Fed President Dennis Lockhart talking about US economy and potential changes to the Fed's QE programme.

Whilst Lockhart stated that he expected the economy to pick up later this year (hardly surprising), it was his comment that the first step to reduce QE should be 'cautious' that got the market's attention, as it was interpreted as being relatively dovish.

For me personally, the most intriguing comment from him was: "*I don't expect to have enough data to be sure of my outlook next month*". This is an incredible statement. Consider that via the St Louis Fed, any member of the public can access over 140,000 data series from over 50 sources, it seems odd that a Fed governor would claim they don't have enough data to make decisions.

And if they don't have enough data now, what led them to be so sure they needed to launch QE1, QE2 or QE3 – as well as help facilitate ZIRP, TARP, and the rest of the alphabet soup of 'rescue' plans that the Fed has launched since the onset of the GFC.

Fedspeak wasn't limited to Lockhart this week, with Fed President James Bullard also speaking, and adding to the market's confusion about what the Fed's next move will be.

Perhaps more importantly, a discussion from 2010 that Janet Yellen (one of the front-runners to replace Bernanke as Fed Chairman) had with the Financial Crisis Inquiry Commission (FCIC) is also now making the rounds.

Discussing some of the issues within lending and credit markets that were a feature of the GFC-era, Yellen stated: "*I did not see and did not appreciate what the risks were with securitization, the credit ratings agencies, the shadow banking system, the S.I.V.s — I didn't see any of that coming until it happened.*"

Hardly encouraging in terms of having a visionary at the wheel, and considering that the role brings with it the power to set the price of credit for the whole market, and print money, you'd hope someone with a better track record might be being looked at.

Whilst I do expect the Fed to taper at some point, if only to protect their 'credibility' I expect it will only be transitory and they'll end up expanding QE beyond a 'mere' $85bn a month by some point next year.

With that in mind, I think it's worth finishing this week's article by bringing readers' attention to this article, which recently appeared in The Telegraph in the UK, highlighting the level of investor exuberance towards the stock market presently.

As the article points out, investors have rarely been more levered than they are today, with margin debt above US $375 bn, higher than the levels it reached before Lehman Brothers and the onset of the GFC.

If it all goes pear-shaped from here, stock market investors will have been well warned. They might also want to take note of another fact highlighted toward the bottom of the article: since 2009 the US economy has grown by $1.3 trillion, whilst the value of the US stock market has increased by $12 trillion.

Whilst there are many who claim one can only see a bubble after it's popped (including the potentially-incoming Fed Chairperson it would seem), I think that in a situation where just one segment of the financial market grows at 10 times the speed of the economy underpinning it, alarm bells should be ringing.

Until next week,

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