

Directions Report - 1976 All Over Again

Years from now, when we survey the precious metal bull market of the early 21st century in its entirety, it's safe to say that the second quarter of 2013 will not be remembered fondly by precious metal bulls.

The period between March and June of 2013 was one of maximum volatility, price falls and despair, leading to many gold bulls throwing in the towel, including institutional investors, who thought that the launch of QE3 back in September of 2012 would be the rocket booster that would send gold prices to the stratosphere instantly.

Whilst in the long run, we will likely look back on the launch of QE3 as a game-changer for gold (and indeed the global economy), the short-term has proved particularly painful.

After trading in range between the high USD \$1800s and low \$1500s for a period between September of 2011 and March of 2013, most long investors were hoping that gold's next decisive move would be to the upside, with predictions of a USD \$2000 gold price by the end of 2013 abounding.

Alas, it was not to be! After suffering a precipitous 2-day fall in early April 2013, which took gold down over USD \$200 to the \$1320 range (which we covered extensively in a [special Directions report](#) at the time) gold prices initially rallied, almost all the way back to the USD \$1500.

This rally sparked considerable hope in the precious metal community that the seven-sigma correction that occurred beginning Friday April 12th 2013 was the end of this cyclical bear market in precious metals.

Again though, precious metal bulls were disappointed, and gold fell back into the USD \$1300s, where it oscillated right up until Federal Reserve (the Fed) chairman Ben Bernanke spoke on Wednesday the 19th June 2013, giving his now famous Monetary Policy statement, which markets interpreted as 'proof' of an upcoming Fed taper of quantitative easing and the end of the free money era that has characterised the 'post-GFC' world.

The result? Chaos.

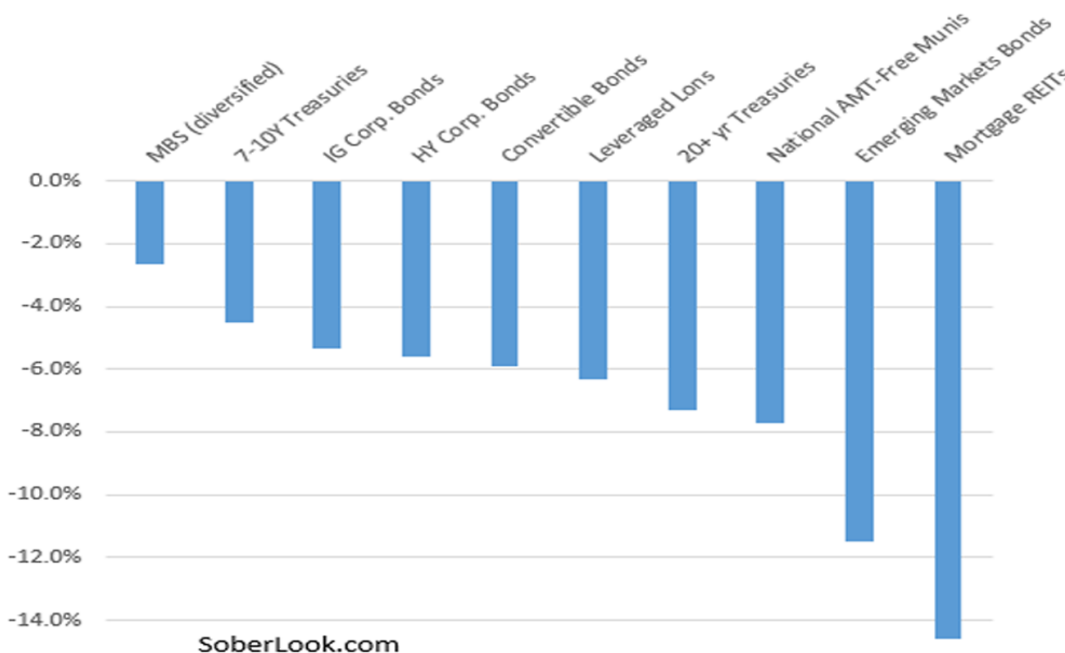
Gold prices ultimately plunged over another USD \$150, to below USD \$1200 at one point, whilst equity and commodity prices got slammed across the globe, at least initially.

Domestic investors in overseas assets, including gold, were protected somewhat, as the Australian dollar also sold off sharply. Indeed, whilst USD gold holders are waking up to daily lows in the metal price, Australian dollar investors are more or less in the same spot they were back in early April.

Most worryingly though for those who are believers that there is a genuine economic recovery underway, the Fed statement sparked a huge spike in bond yields (borrowing costs), which has affected fixed income markets across the globe, and represents a continuation of the weakness that has been evident in this section of the market for the past couple of months.

The chart below, which captures the loss in a variety of fixed income markets over the past month, highlights the losses associated with rising yields neatly.

One Month Fixed Income Performance by Asset Class



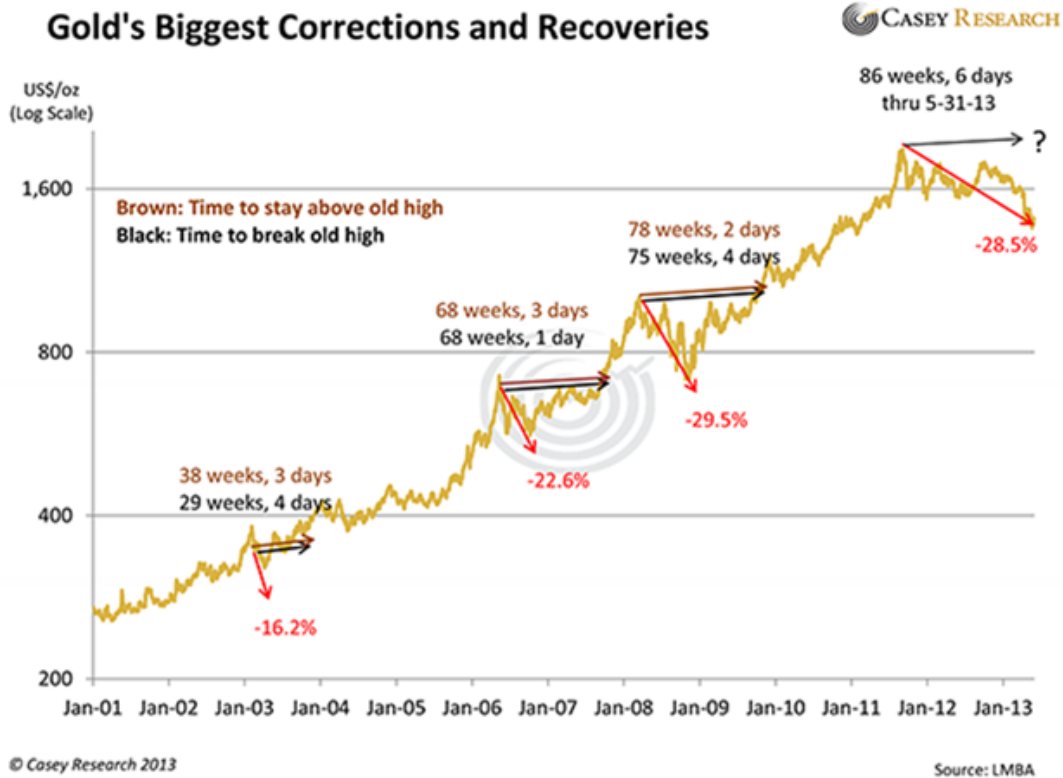
Source: Sober Look

Ultimately, the announcement by the Fed, which has led to the above-mentioned market chaos, represented a final nail in the coffin for the precious metal complex in the short term.

It also led to a series of further price downgrades from investment banks around the world, as well as continued outflows from gold exchange traded funds (ETFs) including GLD, which has seen holdings cut nearly 25% YTD.

All in all, the current correction, which is the fourth major correction in what we still believe is an ongoing secular bull market, has now seen gold lose just under 40% of its value in the past 18 months, making it the longest and the deepest correction in the decade long precious metal bull market.

The chart below (which only runs to the end of May and hence misses the latest leg down in precious metals) highlights these 4 major corrections clearly.



Source: [Casey Research](#)

So, what has been behind the relentless selling of gold this last quarter, and the latest, climatic gold sell off that characterised the final week of June 2013?

Our Directions report from April of this year, which dealt with the original correction down into the USD \$1300 range covered issues like investment bank downgrades for gold, technical trading and the volume of contracts traded on the COMEX, and the “Cyprus” issue, which demonstrated clearly that over-indebted Western governments will barely put a dent in their debt burdens by selling precious metals at these prices.

This quarter’s report will deal with a handful of other factors which have led to the extreme sell off in precious metals, and which has led to so many market analysts and mainstream economic commentators calling the end of the gold bull market.

The many factors behind the latest gold sell off

Whilst the talk of the Fed tapering its asset purchases (and a corresponding rally in the USD) has led to many market commentators claiming this is the end of the gold bull market, the reality is that this is but one factor that has helped push metal prices lower in the last two weeks leading into the 30th June.

Some of the other factors include;

- Heightened volatility in bond and short-term money markets

- Extreme levels of negative investor sentiment toward precious metals
- Continued outflows from gold ETFs
- A hike in futures margins on the Chicago Mercantile Exchange (CME)
- Restrictions on gold importing in India

Let's deal with each of these in turn, but before I do, let me stress that whilst all of these things are negatively impacting the precious metal complex in the short term, they don't in anyway change my firm belief that we are still in the middle of what will prove to be a roaring precious metal bull market.

This correction (which may last a little longer and see prices weaken further in the months ahead) is part and parcel of any secular bull market.

Remember the 1987 stock market crash? Prices dropped over 20% in a day, yet look at a chart of the secular bull market in stocks from the early 1980s up until the GFC and it's barely a blip on the graph.

There are a number of reasons why they're called bull markets in the first place, and one of them is because they're notoriously hard to ride!

Reason Number 1: Federal Reserve 'tapering talk' and a strong rally in the USD

The US dollar has been incredibly strong over the last 18 months. After trading at around 75 in October of 2011, the US dollar index (which measures the strength of the USD vs. a basket of other major currencies – EUR, GBP, YEN for example) has rallied to over 84 as we speak.

This rally of nearly 10% has negatively impacted gold for the duration of this period, and the movements since Bernanke's speech on the 19th June 2013 only helped to exacerbate precious metal weakness.

Whilst USD has rallied strongly, it has not been due to any major (or sustainable) improvement in the US economy, or due to tight monetary policies by the Fed.

Indeed, over that period, the Fed has not only launched QE3, in September 2012 but expanded it in December last year. All the while, the US Government continues to run deficits of several hundred billion dollars per year.

In terms of the economic impact this has had, whilst the US economy is 'chugging along', we are hardly seeing strong growth rates, remembering that Q1 2013 GDP was sub 2% for the year.

The strength of USD over the past 18 months can be put down to the US economy, and the USD itself being the 'cleanest dirty shirt' in the closet. By that I mean that whilst the medium- and long-term outlook for the USD and US economy is extremely challenging at best, over the past 18 months, the US economy has looked stronger than either Europe, the UK or Japan's, which have either been in or on the cusp of recession.

This US 'strength' has also been the case when looking at their currencies, as the Japanese have launched 'Abenomics' and announced their intention to hit a 2% inflation target by doubling the Bank of Japan's balance sheet.

Meanwhile, over in Europe, Mario Draghi and his companions at the European Central Bank (ECB) have constantly assured markets that they stand ready to do 'whatever it takes' to preserve the euro.

On Threadneedle Street, incoming Bank of England president Mark Carney is likely to expand bond buying operations now that he has taken over the big chair on behalf of her Majesty's government.

Both of these central banks were only out last week with incredibly dovish speeches, which made it clear that interest rates will be low (and possibly lower) for a very long time, and that QE operations might be expanded upon. So much for 'normalising' monetary policy.

As a result of this elevated non-USD monetary uncertainty, gold has suffered, and continues to suffer off the back of USD strength. This has been exacerbated by the language used by the Fed over the past few months, convincing the market (and perhaps itself) that the US economy is approaching a self-sustaining recovery, and that a 'tapering' of QE is just around the corner.

Expectations that either the economy is genuinely improving, or that monetary policy will tighten (at least in a relative sense) are scaring investors away from gold for two reasons.

Those who believe the economic recovery story, see less need for gold as a hedge against falling equity, bond and property markets, whilst those who focus on the prospect for Fed tightening, fear that if this were to go ahead, then, if anything, we'll see deflation in the future, not the inflation that they had feared when various QE policies were launched over the last few years.

Whilst in the short-run, these forces could well see the gold markets fall further, in the medium- to long-term it will become increasingly obvious to the market that there is no genuine economic recovery in place, and that markets are totally reliant on perpetual QE to keep asset prices from collapsing.

Therefore, we expect that existing QE policies will not only be maintained, but will eventually be expanded upon in the months and years ahead, in line with what is happening and will continue to happen in Japan and the UK.

At times like this it pays to remember that less than 12 months ago, the Fed gave themselves the leeway to print unlimited amounts of money for an unlimited amount of time when they launched QE3 back in September 2012 for a good reason. They knew they'd need it.



Reason Number 2: Heightened volatility in bond and short-term money markets

The second reason behind the gold market sell off across Q2 2013 has been the flare up in bond yields around the globe, and increased volatility in short-term borrowing rates.

A rise in bond yields, coupled with generally lower inflation data around the developed world has actually led to positive real interest rates, at least for those investing in the longer maturing end of the bond market.

As negative real interest rates are one of the key drivers of precious metal prices, falling inflation, coupled with rising yields are definitely a negative for the gold price, and has contributed to the weakness we've seen in the past few months.

It's worth noting that the scale of the rise in bond yields has been quite significant, with the US 10-year bond yield (probably the most quoted government bond yield in the world) rising from around 1.86% at the end of 2012 to 2.50% today. That's a rise of 35%.

Rises like this have been matched around the world, and even in Australia we've seen the 10-year bond yield rise from circa 3% in the early part of Q2 2013 to around 3.82% (July 1st), a rise of over 25%.

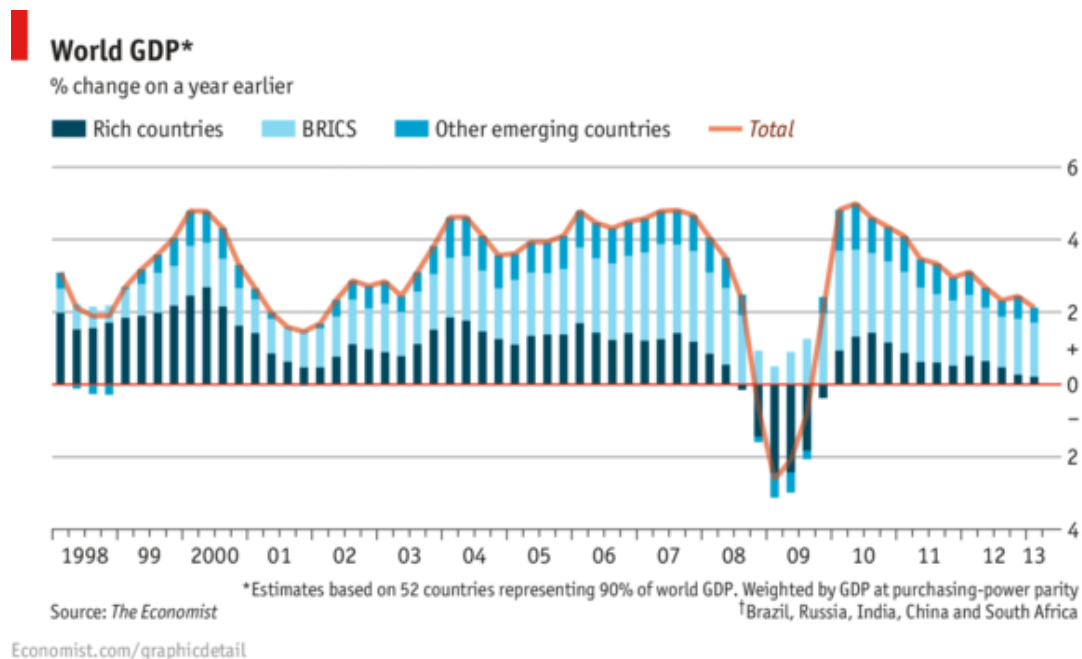
Of course, across the quarter, we also saw Japanese bond yields rise by the largest amount in decades, and we even saw the Japanese bond market shut down on a number of days, such was the volatility on display, a nasty side affect of the launch of 'Abenomics'.

It wasn't only bond yields that displayed heightened volatility in the past quarter. Overnight lending rates, particularly in China were particularly jumpy, especially in the last month, where Shibor (essentially the overnight lending rate in China) rates jumped substantially, from around 2% to nearly 10% at one point, highlighting the [lack of liquidity in Chinese credit markets](#).

Therefore, apart from the positive real interest rate story which affected gold, the volatility in the bond and short-term money markets hurt the precious metal complex to some extent too, as gold always has been and always will be a highly liquid asset which can be utilised when and if collateral is needed to cover other positions.

Again though, this is not something we expect to continue – central banks and governments the world over know that higher interest rates will bring to an end to global growth, and will keep the money spigots open to prevent either a freezing in the credit markets, or a blow out in bond yields.

Not only that, but even with the unprecedented QE currently being undertaken, growth is waning across the world (particularly in the developed world), as the chart below highlights.



Source: [The Economist](#)

It is clear that growth would suffer in a higher interest rate environment. In addition, central banks know full well it would also cause severe stress to sovereign balance sheets, which are burdened with unprecedented levels of government debt.

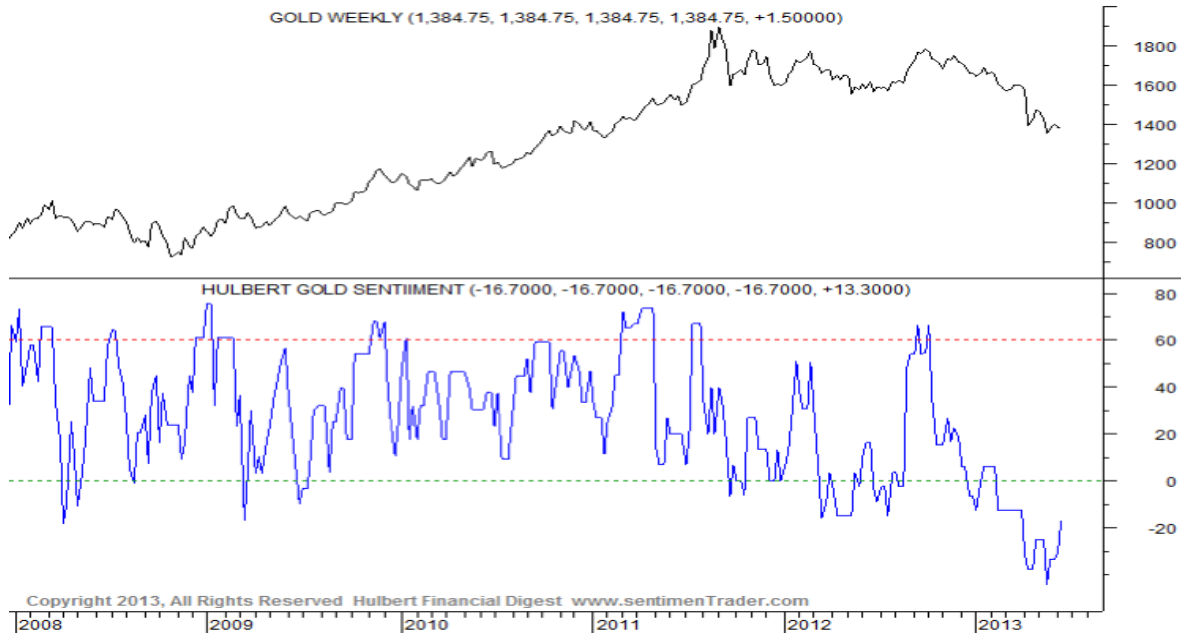
This would be a particular burden to both the Japanese, with their debt to GDP ratio of well over 200%, and the United States, where the Obama administration needs to rollover USD \$1 trillion or more in debt for each of the next few years, on top of the enormous annual deficits they plan to run going forward.

Reason Number 3: Extreme negative investor sentiment toward precious metals

Whilst negative sentiment has abounded for some time now toward the precious metal complex, it really has plumbed the depths in the last couple of weeks. On the last trading day of the 2012/2013 financial year, after gold went below USD \$1200, [an article appeared in The Age](#) with the headline; ‘Gold Plunges: “Nobody Wants It”’

That kind of thinking just about sums up both mainstream and institutional investor sentiment toward precious metals right now.

Another sentiment reading near enough all time lows can be seen in the below image, capturing the Hulbert Gold Newsletter Sentiment Index.

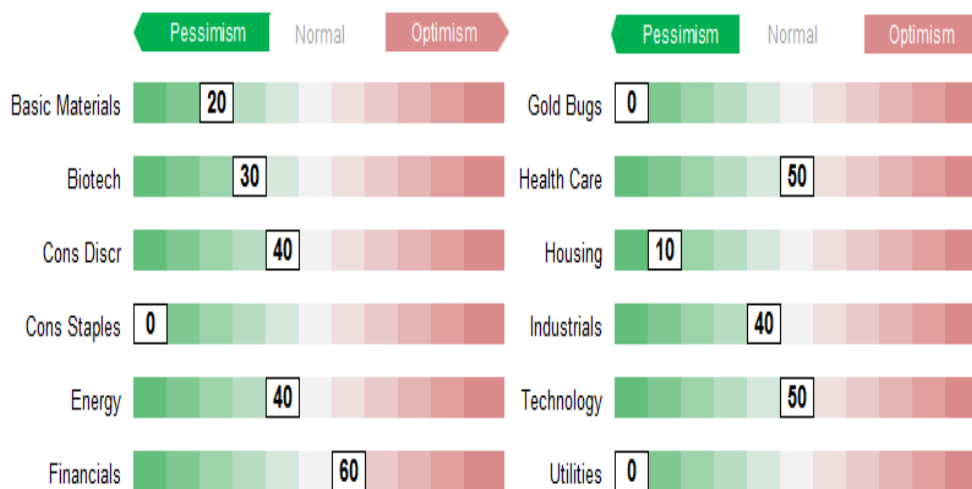


Source: Hulbert’s Gold Newsletter via in Gold We Trust 2013 Extended Report

As you can see from the blue line on the chart above, sentiment is at all time lows, even worse than where it was when gold was correcting by some 30% during the GFC.

This has also, not surprisingly, transferred over to gold stocks, which have lost well over 50% of their value in the last 12 months. As the below chart, which highlights stock and sector sentiment (as at June 21st) by investors, there is a bullish (or optimistic) sentiment toward gold of 0.00%!

Literally, no-one is bullish on gold right now.



Source: Sentiment Trader via in Gold We Trust 2013 Extended Report

From a contrarian point of view, this would tend to indicate that we are coming toward the end of this corrective cycle, as pessimism like this tends to come out at a point when there is no-one left to sell.

A recent example of this was Japanese equities, which over a year ago were institutional investors' least favourite asset class.

One year later, and despite the recent 20% correction we've just seen, the Japanese stock market has risen over 50% in the last 12 months (data point taken from Bloomberg on Friday 28th June).

Therefore, whilst in the short term the extreme levels of pessimism toward gold and all investments precious metal-related could portend continued weakness in the short-term, they are actually a very bullish contrarian signal for those with a longer time frame in mind.

Reason number 4: Continued outflows from gold ETFs including GLD

In the last decade, one of the key developments which has helped facilitate institutional (as well as retail) investment into precious metals has been the development of the gold exchange traded fund (ETF)/exchange traded product (ETP) market.

Whilst there has been some justifiable concern as to whether or not these products do house the gold they claim to own, or whether or not investors could actually redeem their investments for physical metal should they wish to (two great reasons to buy actual physical metal itself), there is no doubt the launch of these products has given many financial institutions a straight forward product to use, should they wish to gain exposure to precious metals.

And the inflows have been substantial – with nearly 85 million ounces of gold held in ETPs at their zenith in late 2012.

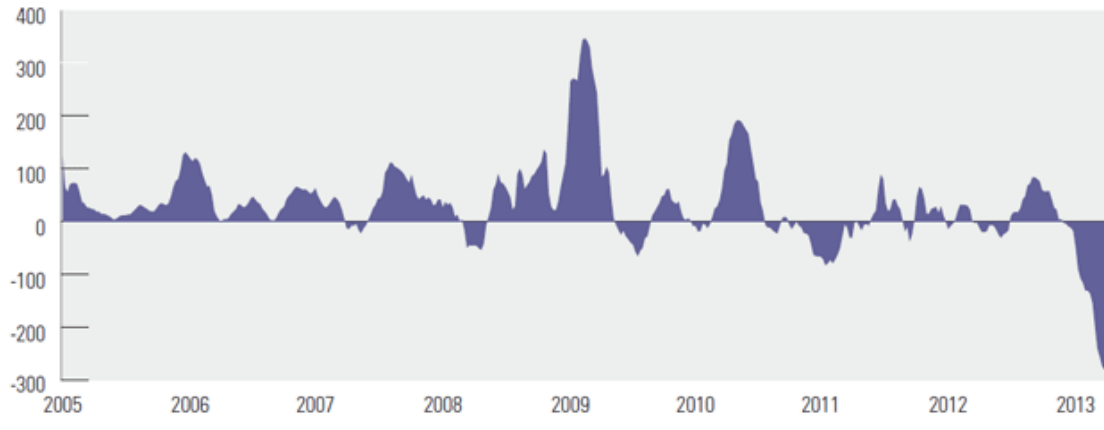
Since then though, mirroring the decline in the price of gold, outflows have been both substantial and accelerating, with the better part of 20 million ounces pouring out of gold ETFs in the first 6 months of 2013.

This has largely been a result of institutional investors (many of whom are not long-term gold bulls at this point), losing faith in gold as an investment, and rotating into seemingly more profitable sectors of the market, including equities, which despite their poor end to the financial year, were up well circa 10-20% or better for the year in almost all markets across the globe.

Nowhere has this outflow been more pronounced than in the largest of the gold ETFs, GLD.

The chart below, which shows the rolling 3-month flows in GLD highlights that ETF outflows have been accelerating across the last 6 months, as institutional

investors have continued their rotation away from precious metals and into the equity markets.



Source: [Sprott Asset Management](#)

Again, whilst in the short-term continued outflows could equal a continued correction, we note that the outflows from GLD and other ETFs are being swallowed up (and then some) by a voracious appetite for actual physical metal, particularly in Asia.

This represents a flow of gold from weak to strong hands, as institutional investors, with a focus on quarterly returns and annual bonuses, are far less sticky money than those picking up the real metal and locking it away for years.

Reason number 5: A hike in futures margins on the Chicago Mercantile Exchange (CME)

Another factor that didn't help precious metal prices was the [increase in margins](#) on the Chicago Mercantile Exchange (CME), which came into play on the 20th June (the day after Bernanke's testimony).

Increasing margins by 25% makes it more expensive both to enter new futures positions, as well as maintain the ones you already have in place. Considering that a lot of investors who were long in gold futures contracts would have been sitting on losses, a hike in the cost of 'staying in the game' would have scared a few away, creating further downward pricing pressure in the short-term.

Indeed, whilst changing margins doesn't have any noticeable impact on precious metal prices in the medium- to long-term, the hike on the 20th June 2013 did exacerbate weakness on the day, according to MKS Senior Trader, Alex Thorndike, who I spoke to about the price action that day:

"With respect to the raising of margin requirements you usually see a knee jerk. That is what set the ball rolling for a break of the 16 April low pivot (USD \$1321.00), which is where a truckload of stops were sitting and caused us to breach USD \$1300 pretty easily. Longer term margin raising does not really have any significant or tangible effects - but it did cause a quick sell-off for sure."

Reason number 6: Additional government restrictions on gold buying in India

When one of the world's largest gold consumers tries to limit imports of the metal into the country, there is a good chance it will impact demand and prices, at least temporarily.

Alarmed at the size of their current account deficit, and the corresponding fall in the rupee, the Indian Government has grown increasingly draconian in their desire to reduce the amount of gold that India imports.

In many ways, this is not surprising, as gold imports into India were surging earlier this year, with over 300 tonnes of gold imported in April and May 2013 alone, which led Indian Finance Minister, P. Chidambaram to say *"I would once again appeal to everyone: please resist the temptation to buy gold"* in June. At least he is honest.

Across the course of this year, in an attempt to reduce gold demand in India, the Indian Government, and the Reserve Bank of India (RBI) have, amongst other things:

- Raised import duties on gold by 2% to 6% (January)
- Doubled duties on gold alloys (January)
- Proposed restriction on gold imports on a consignment basis to banks only to meet genuine needs of jewellery exporters (May)
- Announced that domestic jewellers can only buy gold on a cash basis (June)
- Raised import duties on gold by 2% to 8% (June)

Whilst all these efforts have added to the negative sentiment toward gold in particular, and precious metal markets in general, there have been a couple of unexpected developments.

The first of these is a surge in the numbers of Indians flying to the Middle-East (Dubai) to buy gold there. The second, and far more important story has been an explosion in demand for physical silver in India, with imports in April and May alone running at over 800 tonnes per month (near enough 40% of total global silver production for the corresponding period).

For a more detailed read on the Indian silver story, please [click here](#) to read a short article by Sprott Asset Management on the subject.

Summarising the correction

When looking at the reasons for the correction we've witnessed in the past few months, from the ones we covered in detail back in April, to the ones we've gone through in this report, there isn't anything which would make one question the long-term fundamentals underpinning the precious metal bull market.

How low will gold go in this correction?

By the time this article is published, we could well be at the end of the gold correction, and the dip down below USD \$1180 may have been the nadir. Having said that, the potential for further downside should not be ruled out, as the path of least resistance is still clearly to the downside, and in a proper capitulation-type selling environment, prices can gap down by large amounts quite quickly.

Therefore, whilst we don't put a lot of weight on technical analysis when it comes to determining the secular trend in any asset class, we think it has definite value as a short-term predictor of where prices might be headed.

With that in mind, [research published by UBS in late June](#) highlighted that the low for gold should be at USD \$1155.00, which would represent a 61.8% retracement of the previous bull market advance to USD \$1891, which ended back in 2011.

Should that fail to hold, then the level below that could be around the USD \$1000 mark.

This is not necessarily where I think prices will correct too, but it highlights that even if we did see prices come down to around the USD \$1000 level, the gold price would still be in a typical corrective cycle for what would still be a secular bull market.

So the gold bull market is still alive and well?

In my opinion, and the opinion of many a long-term gold bull, the answer is an overwhelming 'yes'. Economic weakness and instability, low interest rates, excessive government debt, the need for emerging market central banks to diversify their reserves, and central bank money printing are all still features of our economic landscape today, and will be with us for many years, if not decades to come.

Even though these factors haven't prevented the current steep and painful correction in metals prices that we're witnessing, ultimately, all are bullish for precious metal prices. And in the long run, the fundamentals will win the day.

As a result, I'd encourage investors to cast their mind back to 1976.



Acting like it's 1976

Whilst I wasn't around in 1976 (I was born 5 months before the peak in the last gold bull market) some of our subscribers and clients might get a little nostalgic reminiscing about life in the 1976, including listening to Rod Stewart's "Tonight's The Night", "Rock'n Me" by the Steve Miller Band, or even "If You Leave Me Now" by Chicago (the last 3 number one songs that year according to Billboard Magazine's Hot 100).

But when we talk about acting like it's 1976, it's the gold price chart that gets us excited, due to the incredible buying opportunity the 18-month correction leading into August 1976 proved to be.

The 'Great Gold Correction' of the 1970s gold market

When one looks back across the great gold bull market of the 1970s in its entirety, where prices recorded an increase of over 20 times their value, it might not be immediately obvious just how serious the great gold correction of 1974-1976 really was.

Investors might be forgiven for thinking that the gold bull market was a one-way climb and that gold bulls enjoyed a relatively smooth sailing and highly profitable ride from top to bottom.



Source: [Wyatt Research](#)

The reality couldn't be further from the truth. As the chart above shows, there was in fact a hair-raising 45% correction in the gold price between 1974 and 1976, which shook out many investors and caused many more to question the sense of investing in gold.

And just like today, all the media headlines were screaming the 'gold bull is dead', encouraging investors to liquidate their positions and get out of gold. Some of the headlines in 1976 were as follows

"Meanwhile, the economic conditions that triggered the gold boom of 1973 through 1974, have largely disappeared. The dollar is steady, world inflation rates have come down, and the general panic set off by the oil crisis has abated. All those trends reduce the distrust of paper money that moves many speculators to put their funds in gold."

Time Magazine, August 2, 1976

"There is simply nothing in the economic picture today to cause a rush into gold. The technical damage caused by the decline is enormous and it cannot be erased quickly. Avoid gold and gold stocks."

New York Times, August 19, 1976

"Gold was an inflation hedge in the early 1970s,' the Citibank letter says. 'But money is now a gold-price hedge."

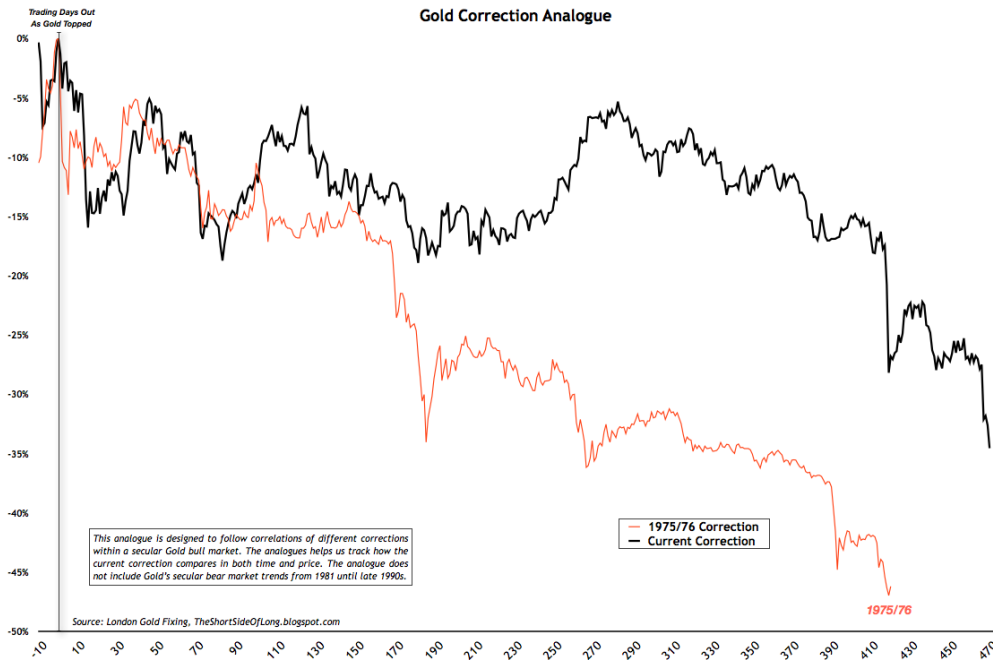
New York Times, August 29, 1976

"Our own predictions are that gold will go below \$100, with some hesitation possible at the \$100 level."

New York Times, August 19, 1976

For a couple of great reads on the 1976 correction, including a more comprehensive list of mainstream media headlines back in the day, please view these reports by [Casey Research](#) or [Peter Schiff](#).

This is relevant to today's gold investor because that correction in the middle of the 1970s bull market bears a lot of similarities to the one we're witnessing today, as the chart below shows.



Source: [Tiho Brkan – Investing.com](http://Tiho Brkan - Investing.com)

Whilst in the short-term it's causing some squeamishness amongst investors, this actually should be hugely encouraging either for people looking to buy precious metals for the first time, or those looking to top up their accounts, as the very significant gold correction of 1974-1976 proved to be the **last great buying opportunity** of that precious metal bull market. In the 4 and half years that followed, gold prices did not sink as the mainstream finance analysts were predicting, but rather rallied by some 800% before the bull market actually did come to an end, comfortably outperforming all other asset classes on the way.

For those not yet exposed to precious metals, that period provided the perfect opportunity for investors looking to diversify their portfolios and remove some of the concentration to uncertain equity and bond markets, by adding precious metal exposure to their portfolio.

Should something similar happen with gold this time around, we could expect this current correction to end with prices somewhere between USD \$1000-\$1300 (i.e. right where we are now), before a resumption in gold's bull market cycle which will take the price well north of USD \$5000 (and potentially closer to USD \$10,000) by the latter part of this decade.

Should this happen, undoubtedly we'd see a corresponding move in silver, which will likely outperform the gold price as the primary bull market re-asserts itself, and the gold/silver ratio narrows towards its historical average in the high teens, a long way below the roughly 62.5 it is today with gold and silver at around USD \$1250 and USD \$20 respectively.

Indeed, assuming we got a narrowing of the gold/silver ratio to even 25:1, and a gold price of USD \$5000, we'd see silver at USD \$200 an ounce, a return of 10 times your money from here.

Indeed, [the following article](#), which appeared in King Worlds News highlights the potential for a bullish move like this to occur in the next few years.

Whilst there can be no guarantees that this will happen, history certainly has a habit of rhyming, if not repeating, and all of the fundamentals underpinning such a move are well and truly in place (and getting stronger).

With that in mind, I'm confident that years from now, intelligent investors who took a definitive position in either gold or silver will look back on the first half of 2013, and Q2 in particular, as the darkest hour of what was otherwise an incredibly profitable bull market in precious metals.

Remember that no-one rings a bell at market bottoms or tops, it takes patience, discipline and a bit of courage to buy into falling markets, but it's where the highest reward is, provided your outlook on the future is accurate.

We are, in all likelihood, exceptionally close to a bottom in precious metals, and from here on, a potential return of well over five-times our money on our gold investments could be in the offing. Even if there is some further short-term weakness ahead, any of us focusing on the long-term would be justifiably thrilled should the next 10 years be as rewarding to gold investors as the last 10 have been, and returns like that are definitely something to get excited about.

As a result, like a lot of ABC Bullion clients who are treating this correction in gold as a buying opportunity, I've recently topped up both my personal precious metal holdings of gold and silver, as well as those in my self-managed super fund.

I'm confident, it's a decision I'll not regret.

Until next time,



Jordan Eliseo
CHIEF ECONOMIST

ABC Bullion

Disclaimer: this publication is strictly for education purposes only. It contains general information and advice only and does not consider any particular persons investment objectives, financial situation or needs. Accordingly no recommendation (expressed or implied) or other information should be acted on without the appropriateness of that information having regard to those factors. You should assess whether the information and advice is appropriate to your individual financial circumstances before making an investment decision. You can assess the information yourself or seek a qualified financial planner. Performance is historical & may vary, past performance is not necessarily indicative of future performance.