Technical ideas: Gold

Downside bias with long tailed upside risk

23 March 2015

| GLOBAL | COMMODITIES| TECHNICAL ANALYSIS

- Macroeconomic drivers are net bearish – strengthening US dollar, rising US interest rates, and slowly improving global economy.
- Meaningful retracements and bottoming behavior will likely increase – Grexit deadline in June, gold price closer to break-even production costs, US dollar starting to be overstretched, and commercial gold hedging getting closer to bullish contrarian upper limit. In fact, a short term upcycle may have started, though it's hard to predict how long it will be.
- Under these conditions, our best recommendation is to adopt the right trading system instead of a plain vanilla buy or sell call
- What do you know? We have one available. We took the liberty of back-testing a straight forward trend following system and introduce it here. It returned a geometric average of 9.9% annually from 2005 to 2014 without leverage. Not too shabby.

Strategy: **2 Day High with 9 Day Low**

	Trading Results (Arith)	Long Gold Results yoy (Arith)	Number of Trades	Average ATR	SD of Daily Returns	No.of Gaps	No.of Traded Gaps
2005	+ 7.80%	+ 17.15%	31	0.429	0.008	133	23
2006	+ 31.30%	+ 23.22%	24	1.096	0.015	122	16
2007	+ 14.76%	+ 28.15%	24	1.045	0.011	86	13
2008	+ 8.51%	+ 10.14%	32	2.061	0.021	122	21
2009	+ 9.02%	+ 23.69%	32	1.646	0.013	119	22
2010	+ 20.84%	+ 27.07%	22	1.614	0.010	116	16
2011	+ 7.60%	+ 11.23%	27	2.419	0.013	124	21
2012	- 12.73%	+ 7.53%	33	1.905	0.010	119	27
2013	+ 17.92%	- 30.95%	33	1.769	0.014	123	27
2014	+ 11.37%	- 1.10%	27	1.179	0.009	129	20
2015	+ 1.97%	+ 2.47%	6	1.408	0.011	20	5
Total	+ 160.38%	+ 156.92%	**Geometric gain**				
Annual	+ 9.90%	+ 9.75%	**Geometric gain**				

Commissions: 0.20%, Slippage: 0.05

Source: PSR

We backtested a money-making system …

What a rollercoaster gold price has been on. Since our 1st report on 12th Jan 2015 titled *"Technical Analysis: Gold, Has Gold reached an intermediate bottom? Soon, if not now",* we stuck out our necks to alert investors to an intermediate bottom when gold price was under \$1200 and when most media narratives on gold was bearish. Since topping near \$1300 on 22th Jan, gold price has grinded lower, closing at \$1166 on 18th Mar. We had warned investors to have "a slight bearish bias" and look to price ranges "between \$1000-\$1200" for accumulation in our report titled *"Technical Analysis: Gold, For uptrend to resume, price needs to recover back above 1250 soon"* dated 9th Feb 2015.

In this report, we discuss the present nuances of gold prices and short term outlook. In response to our medium term observations in the market, we took the initiative to introduce a back-tested, straight-forward trend-following strategy which is price direction agnostic and allows one to trade in either price direction. Call it the "Hanna Montana Syndrome": we want a simple way to get the best of both worlds.

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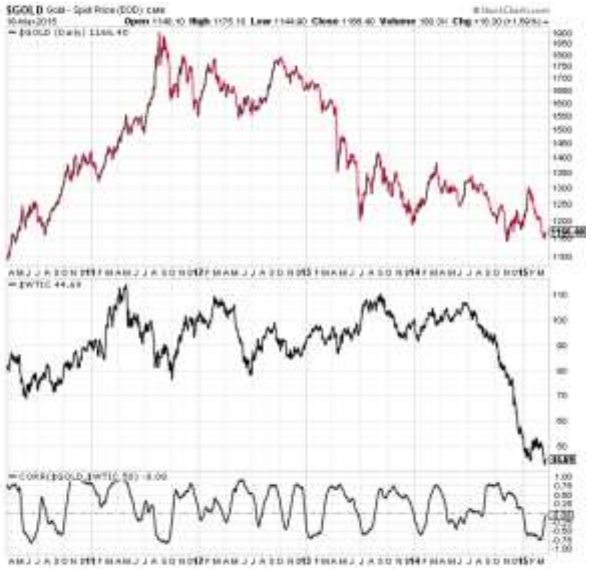
Gold - likely moderate cycles this year, with downside bias.

We think the majority of macroeconomic factors are headwinds to gold price appreciation. Hence, we think there is a downside bias. We think the price should drift down slowly instead of sharp collapses. We argue that some of the factors that impact gold price are getting closer, but are not yet giving extreme indications towards bullish sentiment. This superposition of factors imply a slow downside bias for gold with moderate upcycles in between.

Key drivers to gold price indicate net downside bias

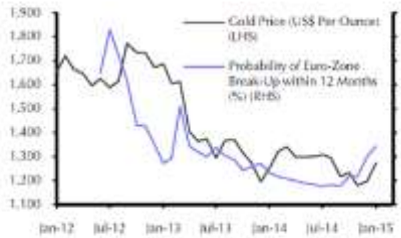


Gold has a long term correlation to US inflation, but **negatively impacted by rising US interest rate**s due to the underlying economic theorem that opportunity cost of holding gold will increase. **Gold is also inversely correlated to US dollar,** because gold is denominated in US dollars, a strengthening US dollar makes gold relatively more expensive for other nations and demand drops. On the longer term, **gold price and oil price also tend to trend in the same direction** as indicated by 50 day correlation of gold price and WTI crude prices tending to be positive majority of the time (chart right, bottom section).

Although we think oil is in a bottoming process, rising interest rates, a continued US dollar strength on the back of a healthy US economy and US inflation under 2% should continue to cast headwinds of gold price.

… but there are some long tailed upside risk possibilities

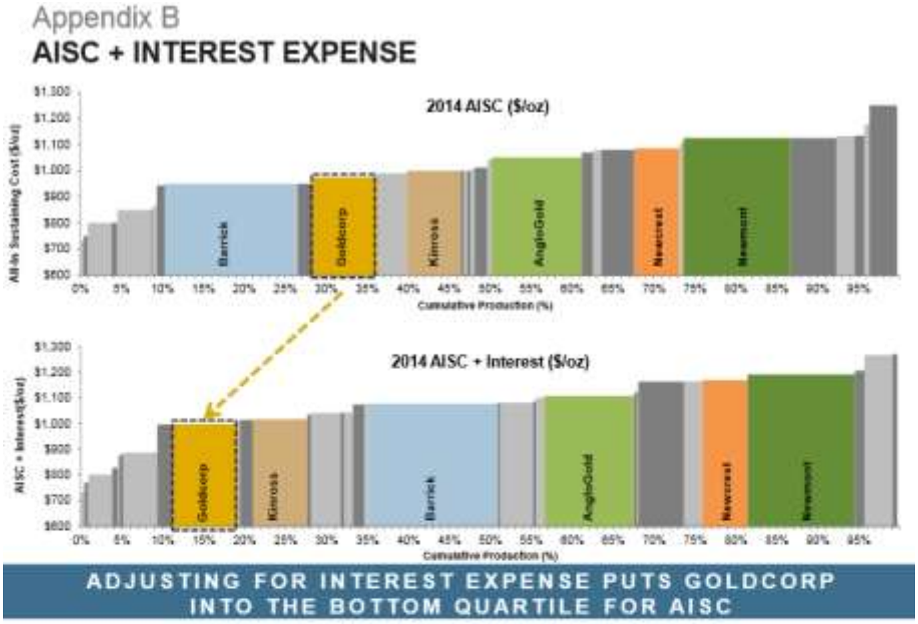
Things to look out for:



Sources: Sentix, Bloomberg

More Grexit news in June? Gold has been viewed also as a crisis hedge currency, according to a survey by Sentix, recent gold prices have correlated well with investor sentiment on the probability of a Euro-Zone breakup which is tethered with the risk of another financial crisis. [Greece's Eurozone lifeline has been extended until the end of June](), only 3 months away, and if we get closer to this deadline with no satisfactory resolution, crisis fears will raise its head again, causing a pop in gold price depending on the magnitude of said fear.

Gold miners on borrowed time. The below chart is the gold miners' "all-in sustaining costs" after taking net debt into consideration. The $1050-$1200 price zone for gold is a significant zone for gold miners: if gold price falls below this zone, 90% of the gold industry becomes unprofitable. When assets are trading close to such levels, we have to be mindful on upside risks based on sentiment, even if macro-trends are generally bearish. During these periods, intermediate cycles can be significant and last longer than usual.



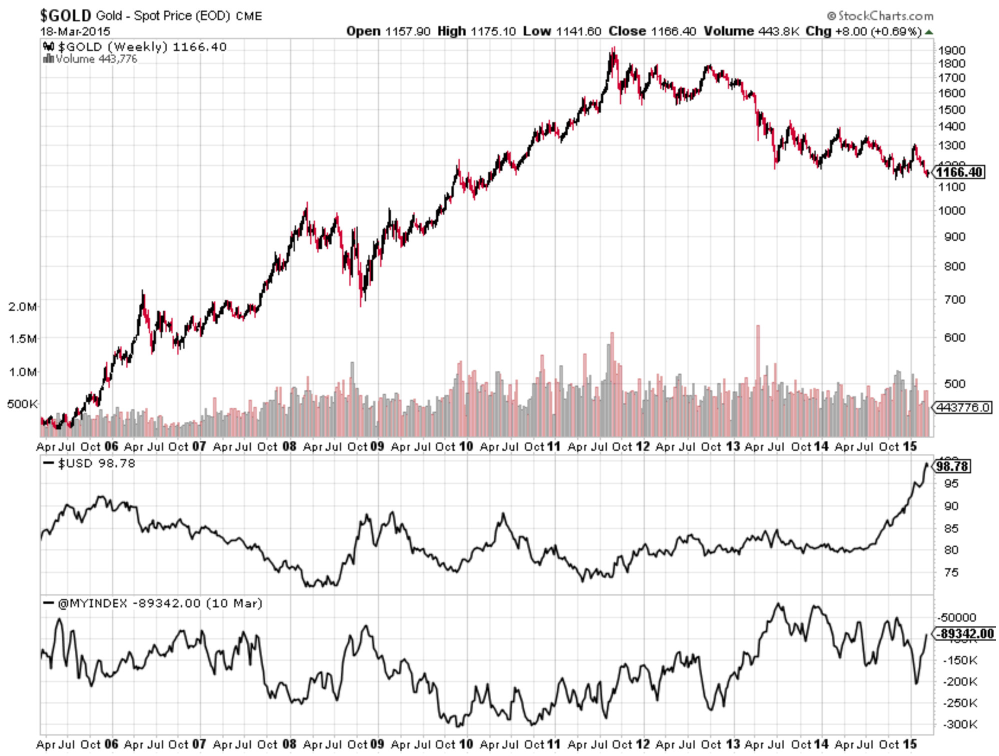
Source: Goldcorp presentation dated November 20, 2014

Technical contrarian sentiment signals are not at bullish extremes yet, but its getting there. In the following gold price chart, the 1st indicator section shows how **the US dollar price is extended**, and any pullback could last for weeks, not days. The 2nd indicator window is the net hedging levels of gold commercials as compiled by the Commitment of Traders report.

We observe 2 things:

i) We are getting closer to the commercials' hedging recent multi-year upper limit, as defined by the high in Jul 2013. These usually correspond to intermediate bottoms that can last for weeks

ii) The last two years of cycles in both hedging positions and price show swings (either upside or downside) that can weeks to months.



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Conclusions for gold price behavior going forward

We conclude that the US dollar strengthening and inevitable raising of US interest rates should cause a net bearish headwind on gold prices, likely causing gold prices to drift lower. But short/medium-term factors are getting closer to bullish extremes, such as gold prices being at lower limits of all-in sustaining costs for miners, oil prices that are getting closer to the bottom, gold commercials getting closer to upper hedging limits. These imply that there could be short-term long-tail upside risks. The recent run-up in gold price in January gives a precedence of the possible magnitude and timing of price escalation due to crisis fears.

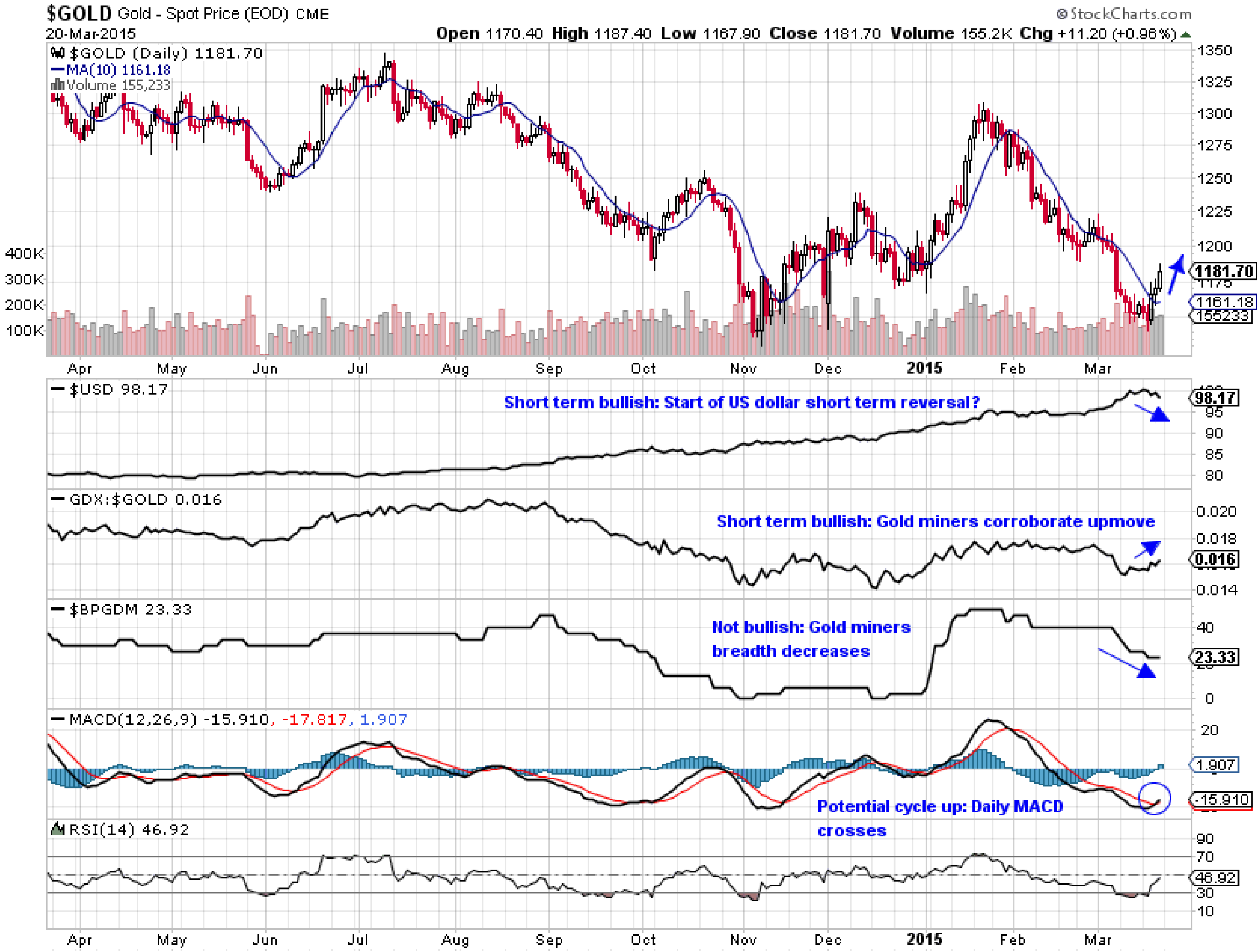
There is downside bias, yet gold is trying to find a bottom. Hence, it may be difficult to recommend a long term short recommendation. Yet at the same time, the bearish bias makes it difficult to suggest a long term buy recommendation. Hence, we call for investors to have a trading mentality at the present moment instead of marrying to a longer term fixed directional position. We investigated a trading system that can be profitable by reacting both ways. The N-day breakout, or Donchian Channel, strategy allows us to profit from medium and long term trends (in either direction) but take smaller losses due to whipsaws if trend are not meaningful enough. We believe it may be appropriate because:

1) The nature of gold price movement lends itself well to trend-following strategies in general.
2) Our previous discussion on possible gold movements this year increases the importance of having a reactive trading system to protect big capital losses.

Please find the report: *"QUANT ideas: Trend-following series -Optimizing an N-day breakout on the GLD"* dated 23rd March 2015.

As a bonus, we include a short term gold market technical outlook next.

Short Term Technicals: Short term cycle up



Gold looks to be cycling up within a bear-market trend.

The recent daily MACD cross was accompanied by an increase of relative strength of gold miners index price vs gold price. This signals a potential short term upcycle. The start of this cycle coincided with t**he dollar showing a small sign of weakness.** We need to keep an eye on the dollar. The length of this upcycle will likely be determined by the magnitude of the dollar weakness. We expect gold to hit $1200 as the first target, and a successful breakout of that level implies $1250 as the short term upper limit target.

Traders who want to trade this can go long. Convenient stop-loss levels can be the rolling 10 day MA for a tight stop (at 1161 at the moment), or the rolling 9 day low as prescribed in the N-day breakout model for a final stop - that is currently at 1141.

If gold price goes below the said stop loss levels, the bullish short term cycle thesis is negated.

As a point of interest, the recommended model would have captured the long signal at $1163 on 18th Mar 2015, with an immediate stop loss level of $1141.

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