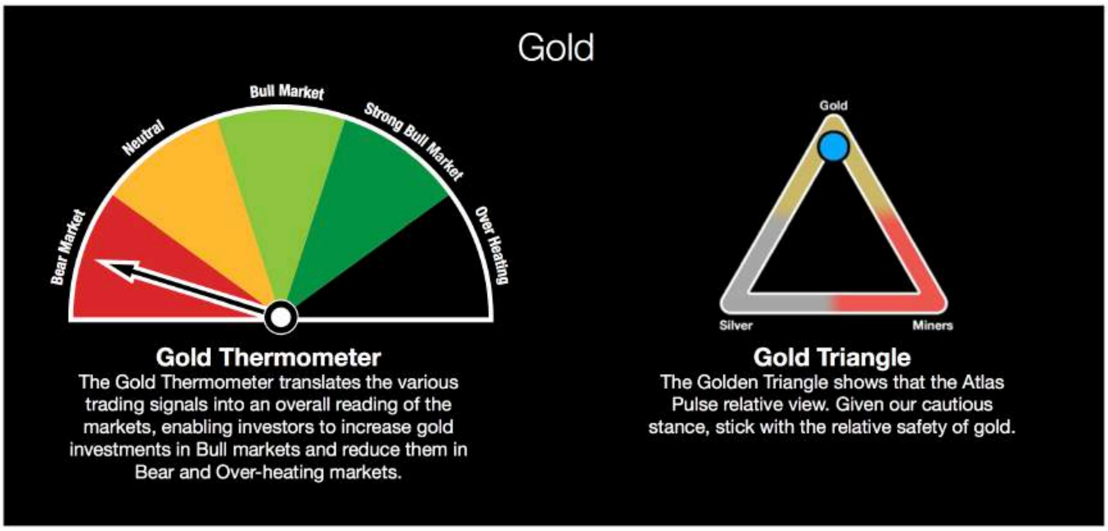
No.34 – May 2015

Atlas Pulse Gold Investor Report

See the facts, trade the action and ignore the noise



Gold Thermometer
The Gold Thermometer translates the various trading signals into an overall reading of the markets, enabling investors to increase gold investments in Bull markets and reduce them in Bear and Over-heating markets.

Gold Triangle
The Golden Triangle shows that the Atlas Pulse relative view. Given our cautious stance, stick with the relative safety of gold.

Recent recommendations:

Gold:

Jan 2013	downgrade to bull market at $1,675
Feb 2013	downgrade to neutral at $1,663
May 2013	downgrade to bear market at $1,476
July 2013	bear market rally with range $1,180 to $1,400
Nov 2013	expect new lows into 2014
Sep 2014	silver smash down from $20.45
Dec 2014	bear market rally, $1,350 is possible
Feb 2015	bear rally complete, $1,233

Crypto:

Dec 2013	initiating bitcoin coverage. Price to fall between 65% to 85% ($1050)
Mar 2014	buy bitcoin ($550)
Sep 2014	bear trend resumes ($450)
Mar 2015	bear market complete ($256)

Summary

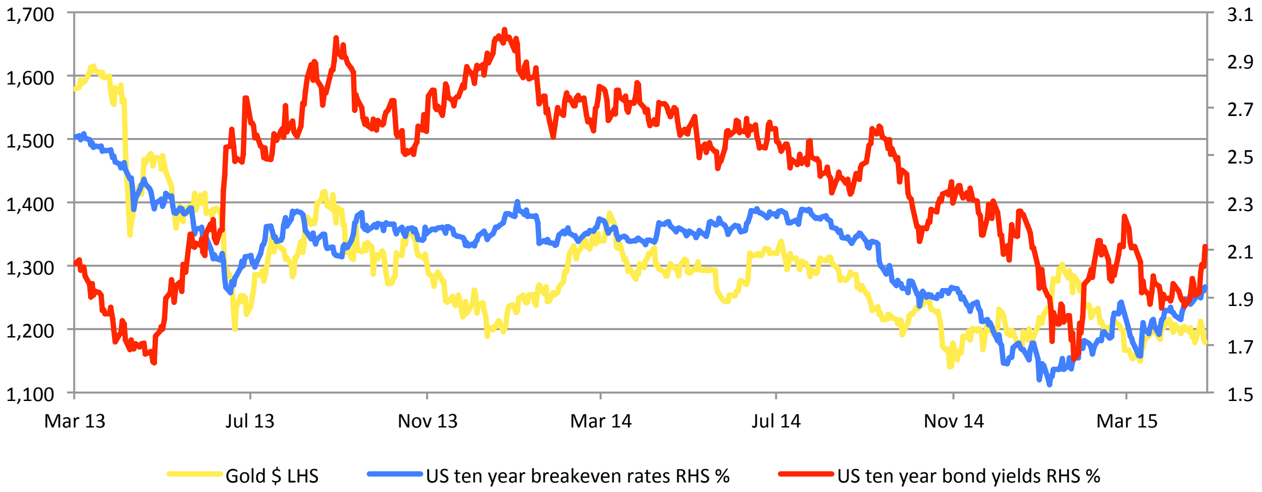
- Rate spike
- Inflation and oil
- The Core Models
- US leadership
- An opportunity in Greece
- Short-term technicals
- COT, flows and 3x sentiment
- Bitcoin joins the stock market

Rate spike

The taper tantrum of 2013 plays on investors' minds. Back then, the FED first uttered the phrase 'taper' whereby the rate of bond purchases would slow. The ten-year yield promptly rose from 1.7% to 3% whilst future inflation expectations (breakeven rates) fell from 2.6% to 2%. Gold collapsed because it faced a perfect storm.

At the time, many gold bugs cried foul, citing heavy intervention and manipulation. Atlas Pulse saw it differently; higher real interest rates in the future meant that gold would be worth less today.

Gold, the US ten year and breakeven rates - since 2013



Source: Bloomberg

Chart note: During the taper tantrum in April/June 2013, ten year yields (red) rose whilst future inflation expectations (blue) fell. This combination caused real rates to rise sharply and weighed heavily on the gold price. Currently, ten-year yields are rising again but, this time, inflation expectations are rising in parallel and so real rates are rising slowly. Is the current rise in inflation expectations justified or is something else going on?

Low growth assets don't respond well to rising real rates, but high growth assets are less sensitive. For example, a company on 50 times earnings today, would be on just 3.6 times earnings ten years from now, if it could grow at 30% per annum. There aren't too many of those, but that company's valuation is overwhelmed by its future growth and current interest rates will have little impact.

An ex-growth, 3% dividend payer, is more susceptible to rises in interest rates because its earnings in ten years won't be materially higher than today's. It therefore trades like a bond and if real rates went from 0% to 4%, it could reasonably be expected to lose approximately half of its value. This is like gold, except that it has zero growth, just inflation protection over the long-term.

This argument, to some extent, justifies the surge in growth stocks in the late 1990s. Of course it went too far, but the preference for future growth over steady income was initially rational. The implications for asset prices should not be underestimated as interest rates turn. In his recent report, the Janus bond fund manager, Bill Gross wrote:

"Funny how bonds were labelled 'certificates of confiscation' back in the early 1980's when yields were 14%. What should we call them now? Likewise, all other financial asset prices are inextricably linked to global yields which discount future cash flows, resulting in an Everest asset price peak which has been successfully scaled, but allows for little additional climbing."

Should the major stock markets hold up when real rates rise, we can expect to see the dividend payers lag whilst growth themes surge. Perhaps the normalisation of interest rates will continue to support the Nasdaq bubble 2.0 as funds sell the dividend payers and chase GAAP*. If that's too obvious to be repeated, the focus could easily move to China or elsewhere with an excitable story. Of course, the market could also fall.

* GAAP stands for 'Growth At Any Price'

Peak deflation

I wrote about 'peak deflation' two months ago, which proved to be timely. In January, most countries had a sharp reversal in future inflation expectations, which has coincided with the rally in oil. Recent correlations show that changes in the oil price now account for over 60% of future inflation expectations. This is, historically, a cyclical relationship, but is currently high and remains firm. As things stand, changes in the oil price are extremely important at the macro level.

With overwhelming news of deflation late last year, I am not surprised that expectations have risen, but their current levels versus their ten year averages remain above what one might expect to see. It's almost as if markets don't believe that there is a deflation crisis at all. I can accept that changes in inflation expectations are currently sensitive to changes in the oil price, but there must be another explanation for the generally elevated levels.

Future inflation expectations for ten-year government bonds

Country	Ten Year Inflation expectations	Ten Year Average Inflation expectations	Year to Date change
USA	2.0%	2.2%	0.4%
UK	2.6%	2.8%	0.2%
Italy	1.2%	1.6%	0.6%
Australia	2.3%	2.7%	0.1%
Canada	1.8%	2.0%	0.3%
Sweden	1.6%	1.7%	0.6%
France	1.5%	1.9%	0.7%
Japan	1.1%	0.4%	0.4%

Source: Bloomberg

Chart note: The difference between current levels and the ten-year average is extremely close in most countries. Bond markets may be correctly looking through these near-term deflationary forces and weighing what will happen when this era passes, or else the pension fund buying is structurally overstating reality. In any event, the increase in expectations this year strongly correlates with the change in oil prices.

Could the pension funds that, in many countries, are forced to buy long-term inflation protection by legislation, be skewing the market?

In the UK, pension funds continue to buy long-dated inflation-linked Gilts at a -0.8% annualised real return. That will ensure a 30 year investment will turn every £100 into 80p in real terms. That's not a retirement I'd look forward to.

US ten year inflation expectations fell to 0.8% during the Asia crisis and 0.1% during the credit crisis, yet today, with overwhelming deflationary pressures, they have firmed to around 2%; close to the ten-year average. It's a baby bear number; neither too hot nor too cold. The impact has been to boost confidence and give the impression that things are normal.

Following past deflationary shocks, the bond market has turned out to be right, whilst CPI has lagged. During the Asia Crisis, inflation expectations led CPI by a year, and after the credit crisis, by eight months. If the current data is correct, the deflation storm is now passing and higher prices will be with us by the yearend. That idea could be supported by the very real pick up in bank lending in the USA and *moderately* buoyant wage data (I stress moderately).

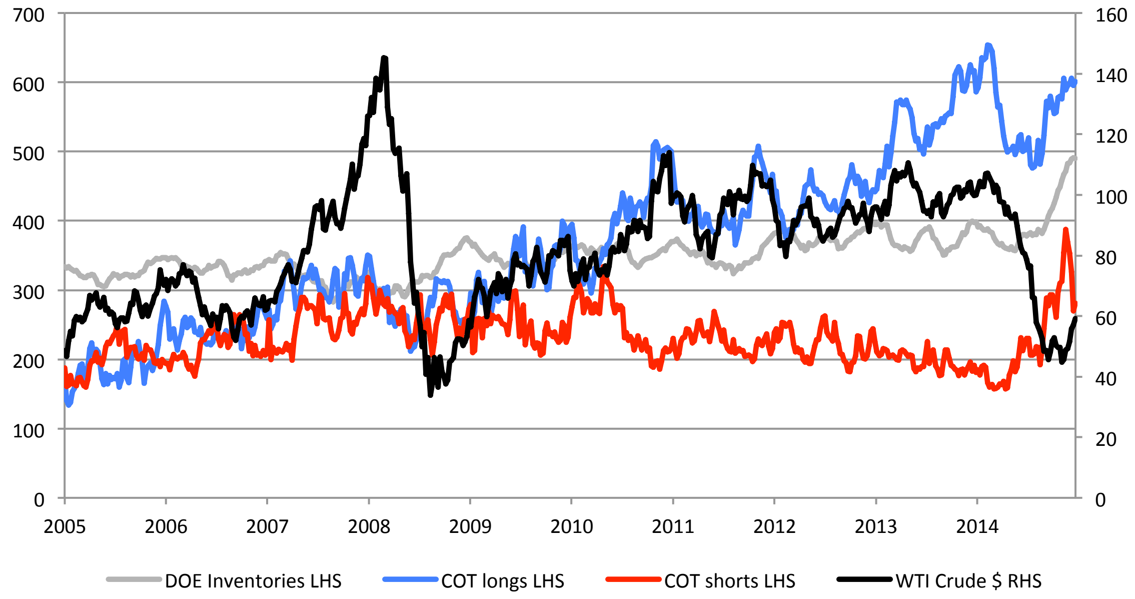
However, as I highlighted earlier, oil prices have a strong hand in the future outlook for inflation.

Inflation and oil

The Bloomberg High Yield Energy Bond Index comprises 390 constituents and less than 20% of them trade below $80; an indication of stress. The total value of the bonds is $240 billion and the yield to worst is just under 9%. If you are bullish on oil, look no further.

However, there may be reasons to remain cautious. With oil such an important factor at the present time, it is worth an update. Atlas Pulse made a bearish call back in October. From my perspective, the overwhelming number of bulls and absence of bears at that time, meant the price break from a four-year old squeeze pattern, would be unchallenged. Supply was firm and demand was slack, whilst the technical situation was extreme.

Oil, inventories and COT data – past ten years



Source: Bloomberg

Chart note: The longs (blue), shorts (red) and US inventories (grey) are shown on the left axis in million barrels. The WTI oil price is shown in USD on the right axis in million barrels. The shorts rose from low levels in September 2014 whilst the longs eased back from exuberant levels. In the mean time, US inventories have risen to all time highs at 500 million barrels. The short covering began in mid-March following the oil low at $42. The covering trade could continue for a while longer before the market settles down. Price resistance is strong between $65 and $70.

Looking further ahead, the Energy Intelligence data shows both OPEC and non-OPEC countries increasing production whilst global demand has fallen. The current surplus is 4.4 million barrels per day. In the short-term, financial markets have the upper hand, but once they settle down, it'll be the geology and the geopolitics that sets the price.

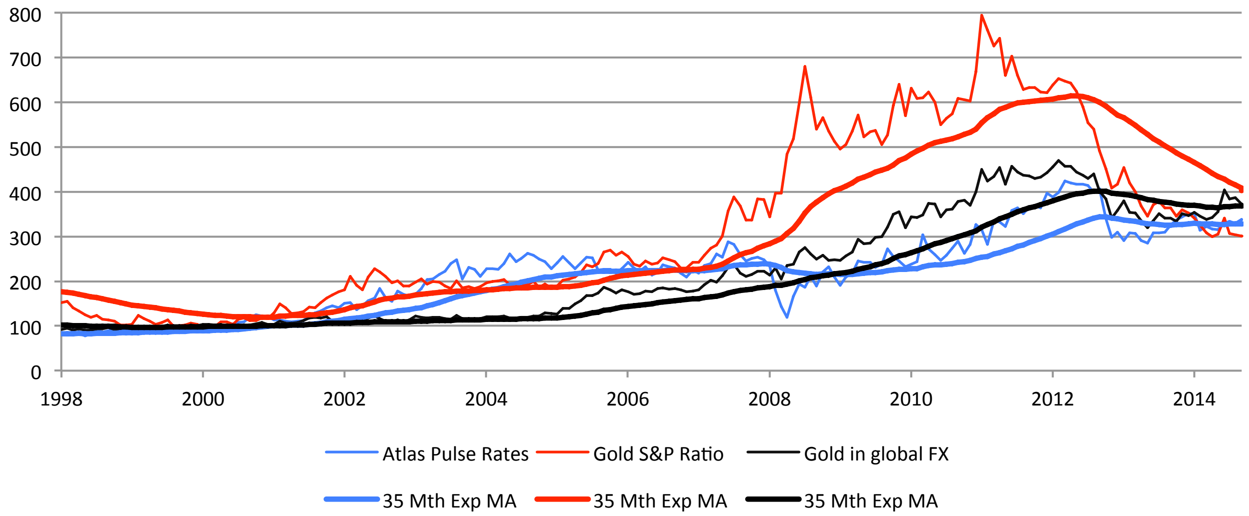
The 'peak oil' thesis is taking a break. New extraction techniques, combined with a need for funds from producing countries, has caused supply to overshoot. On the demand side, there is sluggish growth and new efficiencies. Elon Musk wants us all to have a battery in our house and Audi have made diesel, literally, from thin air. And there's LEDs, which virtually eliminate your electricity bill compared to the incandescent bulbs that produced more heat than light.

When this bear oil rally comes to a halt, which I believe it will, that could wake up the bond market. If long-term bond yields rise, in the absence of inflation, that will start to look like the taper tantrum all over again. The bottom line is that if oil falls, expect gold to follow.

The Core Models

Putting all of this together, what does it mean for gold? Atlas Pulse has three core models that assess the state of the market. These override everything.

The Atlas Pulse Core Gold Models – since 1998



Source: Bloomberg

Chart note: The thick 35 month trend lines matter much more than the thinner signal lines. The rates model (blue) is flat. The Global FX model (black) is marginally positive. The Gold S&P model (red) is still decisively negative. Three uptrends makes a bull market, two signifies neutral and anything less is a bear. Global FX has turned up slightly and if rates confirm, I will upgrade the Atlas Pulse model to neutral which is why rates are so important at the moment. Gold vs equities has been flat for six months which is progress, but the long-term trend is still negative. Apologies for the spaghetti.

US leadership

Many intellectuals are US equity bears. They see a bubble that will collapse and I can't disagree that they'll eventually be right, but here are a few reasons why it may not happen imminently:

1. The bond market may be right. The yield curve could be normalising due to a stronger US economy.
2. NYSE margin debt has just made a new all time high. This invalidates the previous sell signal.
3. US equities have taken a breather since November whilst the world has caught up.
4. If the dollar has peaked (stress if), then US upgrades will follow.
5. US bank lending is accelerating.
6. Financial stocks look ready to lead the market.
7. The Citi US Surprise Index is turning up from low levels.
8. Market breadth remains strong.

Speaking of breadth, whilst the US market is in rude health, China, Japan and Europe are turning down following strong rallies. The S&P 500 and the Russell 2000, on the other hand, are turning up using the same data.

The US financials story is a good one, as bank lending is now growing faster than nominal GDP. That means the intellectuals are absolutely right to be US bears and credit crisis 2.0 will eventually come. In the mean time, have a look at the banks, and don't be too surprised if US stocks resume their leadership over the world. That's assuming they can shrug off the perils of the bond market.

An opportunity brewing in Greece

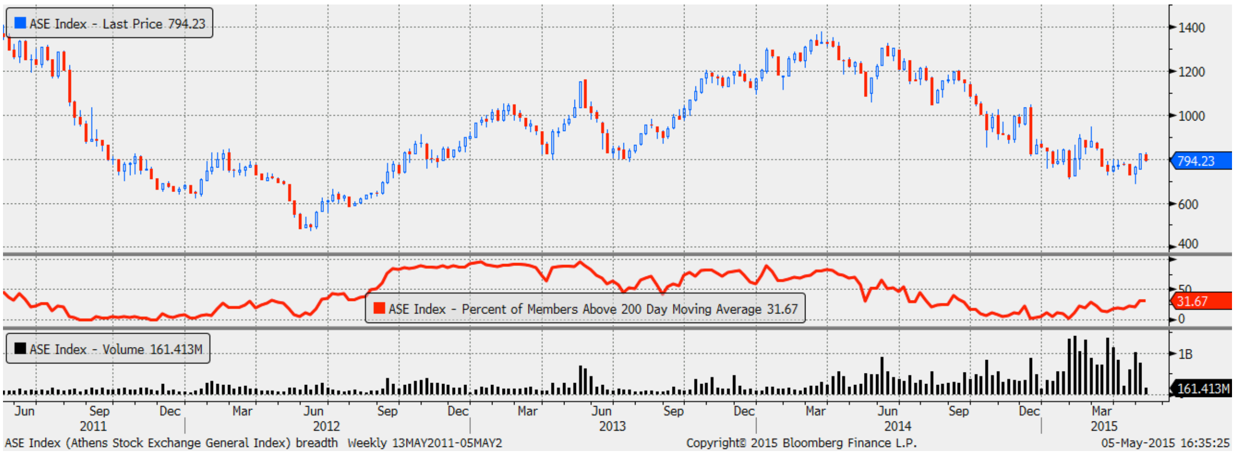
Looking around for forgotten themes, I stumbled across Greece. The market is cheap on most measures. For example it trades below 0.8 times book and the index is worth just Eur 12 billion. However, what struck me was the CDS spread has fallen from 35% to 26% over the past fortnight. That means, for whatever reason, bond traders are less concerned about default than they were. Don't get me wrong, 26% per year to insure your bonds is still extremely high. It's still terrible, just less so.

Looking at the economic releases, unemployment has fallen from a devastating 28% to 25% and industrial production is rising. That's also pretty ghastly, but an improvement.

Looking at the market, breadth is starting to rise and the Athens Stock Exchange Index may well be locking in a higher low above 600. Recent volume has been huge which can often signal a turn as the last bears have thrown in the towel.

I'm not saying Greek equities are a sure thing, but certainly worth some attention for value investors. The asymmetry seems to be on side. By now, the downside must be fairly limited in the event of Grexit or default, whilst the upside is potentially significant. After all, the Greek market knows how to rise when the going is good, just as it did during the late 1990s.

Athens Stock Exchange – since 2011 with breadth



Source: Bloomberg

Chart note: The Athens Stock Exchange could potentially be forming a base. The breadth chart (red line) is rising from low levels whilst the index has recently fallen on significantly higher volume than normal. Greek stocks are cheap and many commentators have lost interest. Be greedy when others are fearful.

If you agree that Greece is a buy, do yourself a favour and take small steps. After all, the political storm is very real and the news is terrible. That sounds like a buy signal to me.

Gold price – monthly since 2009

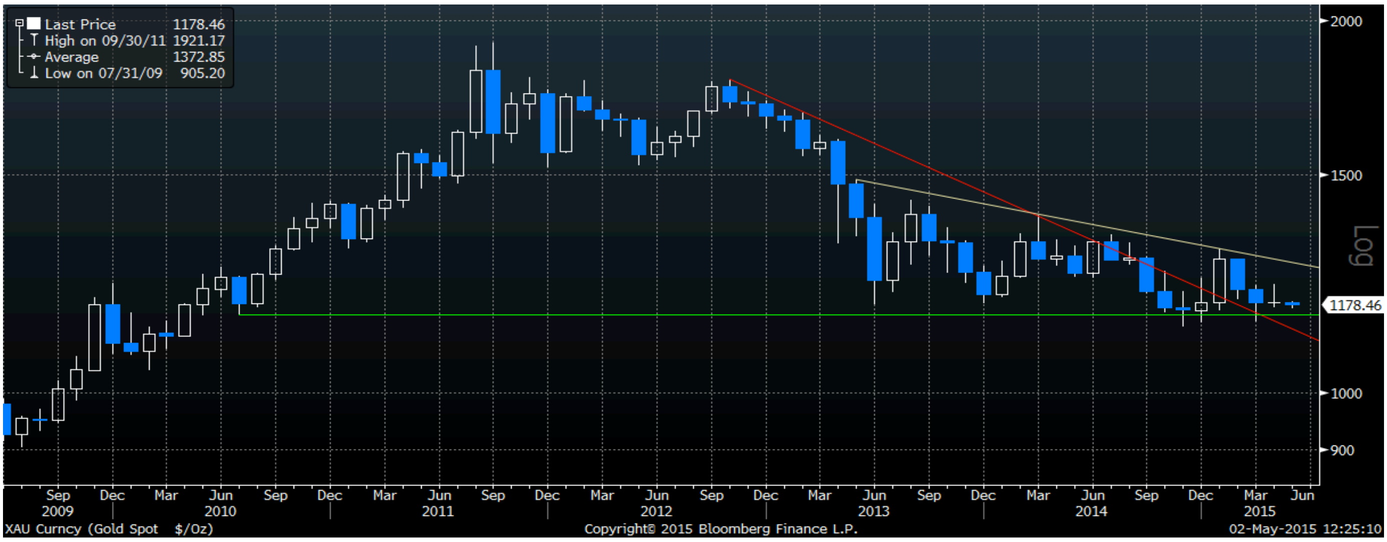


Chart note: Sometimes a short-term outlook can be better viewed via a long-term chart. The red trend line falls at -16% per annum. The price rose above it in late 2014 but has still failed to hake a higher, high. The white line falls at a more modest -7.5% with support around $1,164. A significant new low looked likely earlier this year but has been avoided. The range is now extremely tight. A closing low below $1164 would confirm the bear, whereas a break above (say) $1250 will indicate a continuation of this 1150/1350 range for a while yet. Fingers crossed; something interesting should happen soon.

Silver price – monthly since 2009

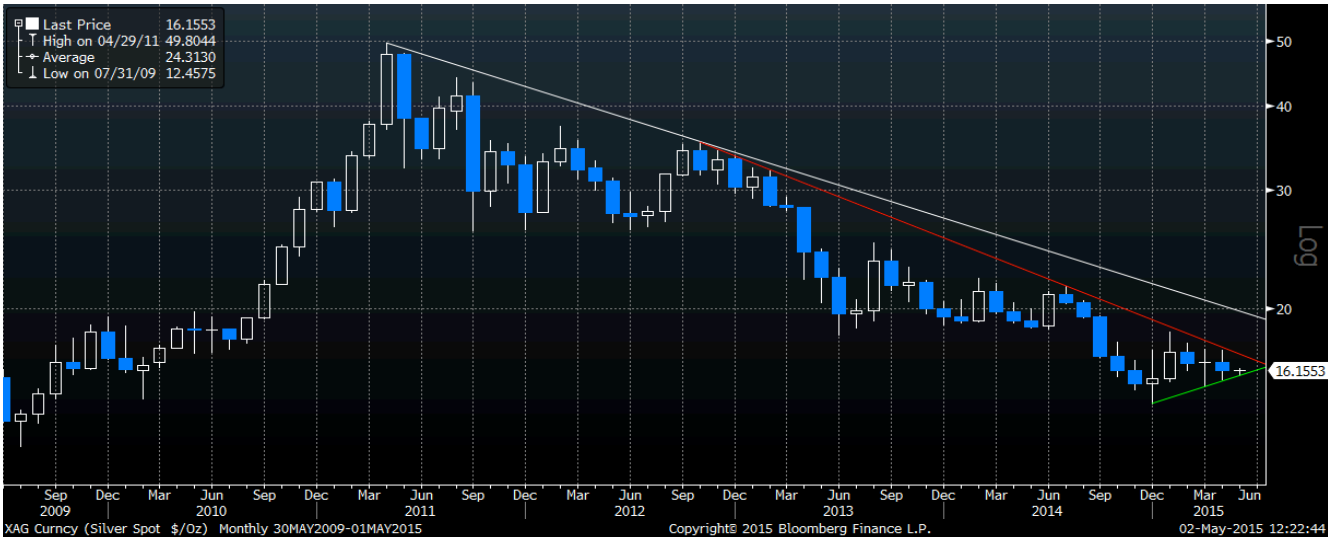


Chart note: The white trend line falls at -20% per annum whilst the more recent red line falls at -25%. The gold downtrend slowed down whilst the silver downtrend accelerated; hence the rise in the gold to silver ratio. The green support line is +30%. Once again, we have a pennant. The break out must happen by the summer.

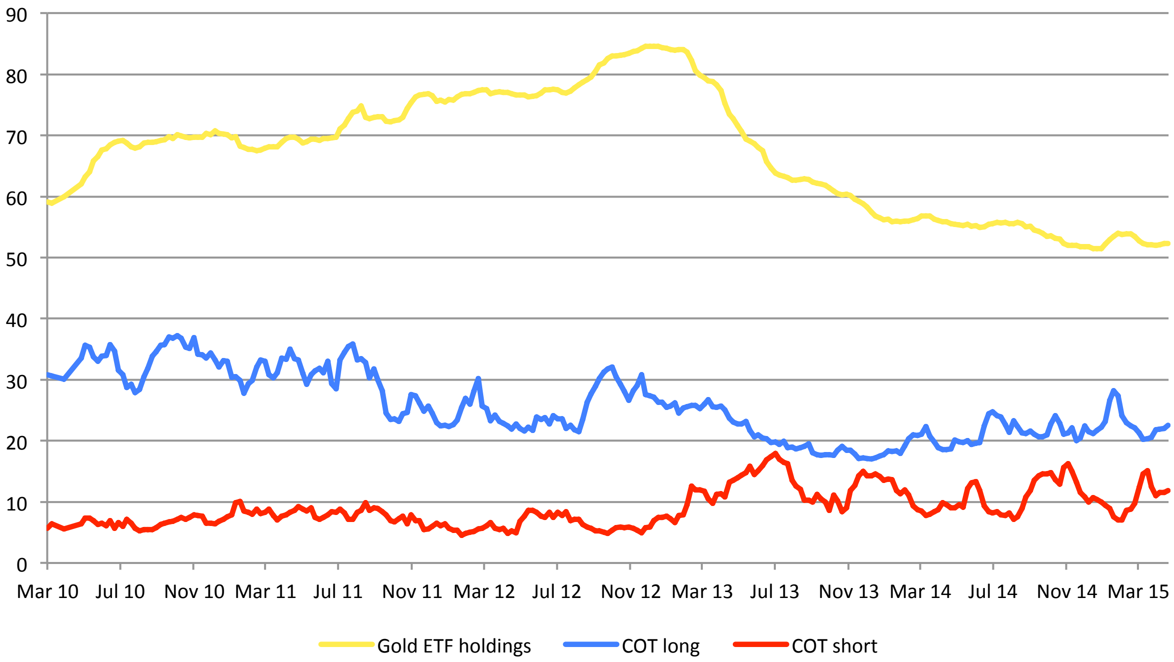
COT, flows, 3x and sentiment

COT stands for commitment of traders; it is the data series from the Chicago exchange that shows the positioning of speculative, as opposed to commercial, investors. Those are typically hedge funds.

ETF stands for exchange-traded fund. These hold physical gold and silver and are mainly traded by institutional and retail investors. The number of ounces of gold or silver that they hold is reported on a daily or weekly basis. All holdings are shown in million ounces (Moz) on a like for like basis. The ETF movements tend to be slow, the COT longs faster, whilst the COT shorts move very quickly.

3x refers to the leveraged exchange-traded notes that are used by investors to express a strong view. The daily returns are 3 times (hence 3x) the daily percentage move of the underlying asset either long or short. These funds are highly speculative but excellent trading vehicles when volatility is low. Use them when volatility is high at your peril.

Gold COT and ETF flows in million ounces (Moz) – past five years



Source: Bloomberg

Chart note: The holdings in the gold ETFs have made a higher low. Holders seem to be committed. The (red) shorts remain slightly elevated whilst the longs (blue) are following the ETFs, despite the weak price trend.

Silver COT and ETF flows in million ounces (Moz) – past five years

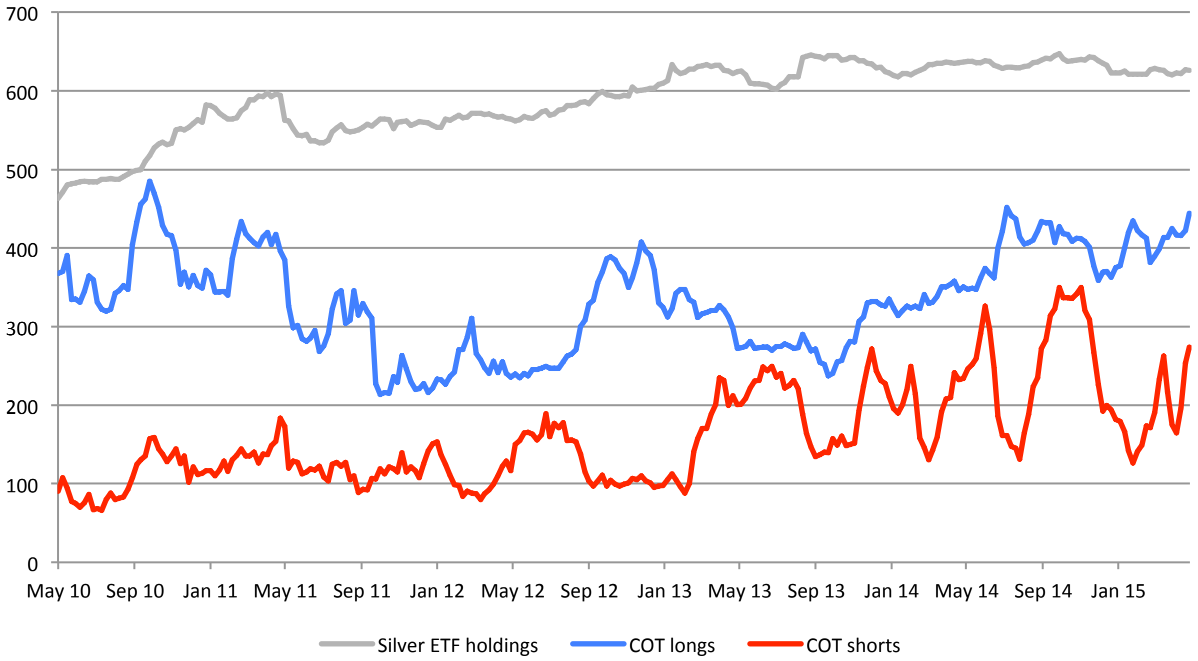


Chart note: Silver ETF investors still don't want to sell their bullion. I had always assumed that this line would drop during a bear market but it hasn't. Whilst it's not growing, the stability of this situation is impressive. The silver ETFs mop up the slack in the market and are therefore important. The (red) shorts have risen again, which is supportive over the short-term. The (blue) longs are near to the all time high. It's a mixed message with high commitment on the long side with a counter force coming from the sceptical shorts. The signal would be more bearish if the longs and the ETFs started to sell. There are no signs of that at this time.

Gold, silver and the miners - 3x positions - past year

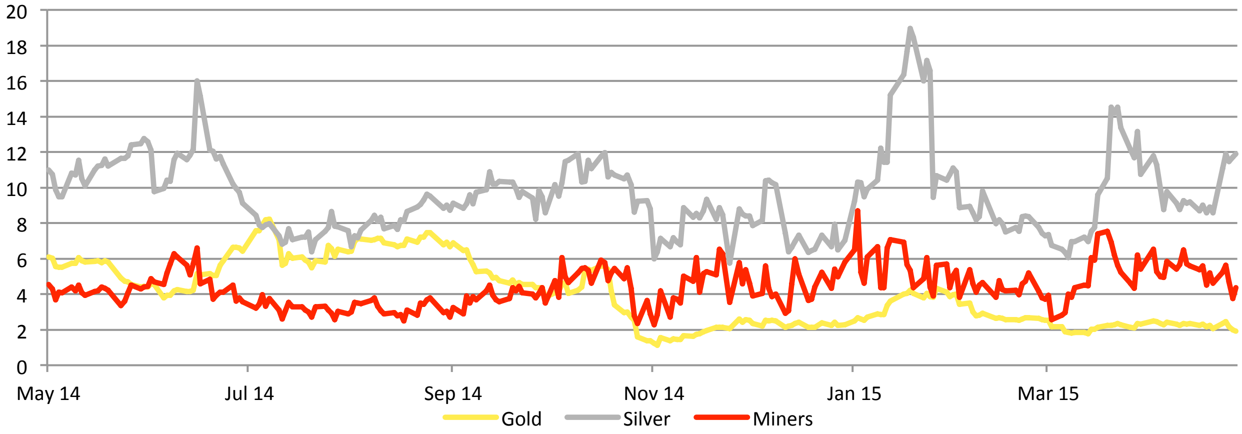


Chart note: Gold 3x speculators remain modestly positioned in gold and the miners but are still positively skewed in silver. This is the speculative play of choice for the bulls.

Bitcoin joins the stock market

Congratulations to Barry Silbert. He is the first man in history to get Bitcoin onto the stock market. The ticker is GBTC and it is listed on the OTCQX, an unregulated US market as of Monday 5th May 2015. It's hardly a credible listing but it's a step forward. He's beaten the Winklevoss twins to it, but at 2% per annum, it's expensive; especially considering the coins are uninsured against a hack attack. A Swedish product, called Bitcoin tracker One, is also coming to our screens soon. They will charge 2.5%. Wasn't Bitcoin supposed to eliminate financial frictions?

Remarkably, these launches haven't caused much of a stir. The world has lost interest but the price is still sitting comfortably above $200, but without direction.

Sir Richard Branson is doing his best to change that by inviting the great the good to Necker Island to discuss Bitcoin. Presumably they will have a party with lots of brightly coloured drinks. Let's hope, when they sober up, they'll have achieved something useful.

Where's my invitation?

Summary

The gold price is still in a consolidation pattern. The recent dollar weakness has been mildly supportive, but gold strength hasn't followed through in Pounds or Euros, so there's no great impact thus far. Seasonally, the second quarter is the weakest period of the year and there are still two months to go. A break higher in the S&P 500 would be moderately bad, whilst a reversal in inflation expectations and a spike in bond yields would be terrible.

Gold is in a bear market, but so much could change. The main driver will be the bond market, which will follow the next move in oil. Saudi Arabia and Texas have become the joint centre of the world.

Silver has not only seen the shorts rise, but also the longs. Gross exposure is huge and I continue to believe this market this market could yet collapse. It will only do so, however, if gold breaks downwards. If gold breaks upwards first, I suspect silver will lag until the interest cools. In any event, stick with gold and the high quality miners.

I am off on a walk from St Jean Pied de Port (France) to Santiago de Compostela (Spain). It's a 776 km pilgrimage in search of St James, known as 'The Way'. Forgive me if the June issue is a little late.

Twitter: @AtlasPulse

The gold thermometer remains in a bear market (decrypt the inflation machine).

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