06/20/2021: A Precious Inflection...

Precious metals have been anything but precious this past week.

Gold is down roughly 8% from its June highs, spurred on by the recent FOMC meeting.

It's never fun to see this type of action in one of your big portfolio positions, especially when it happens so quickly. But... it's also an *inevitable* part of trying to position for a larger trend, especially the start of a new commodity bull.

There are really three things we need to ask ourselves when this happens:

1. **Is the fundamental thesis still valid?**
2. **At what price level would the technicals invalidate the trade and force us out?**
3. **If the fundamentals and technicals hold, then when should we add to the position?**

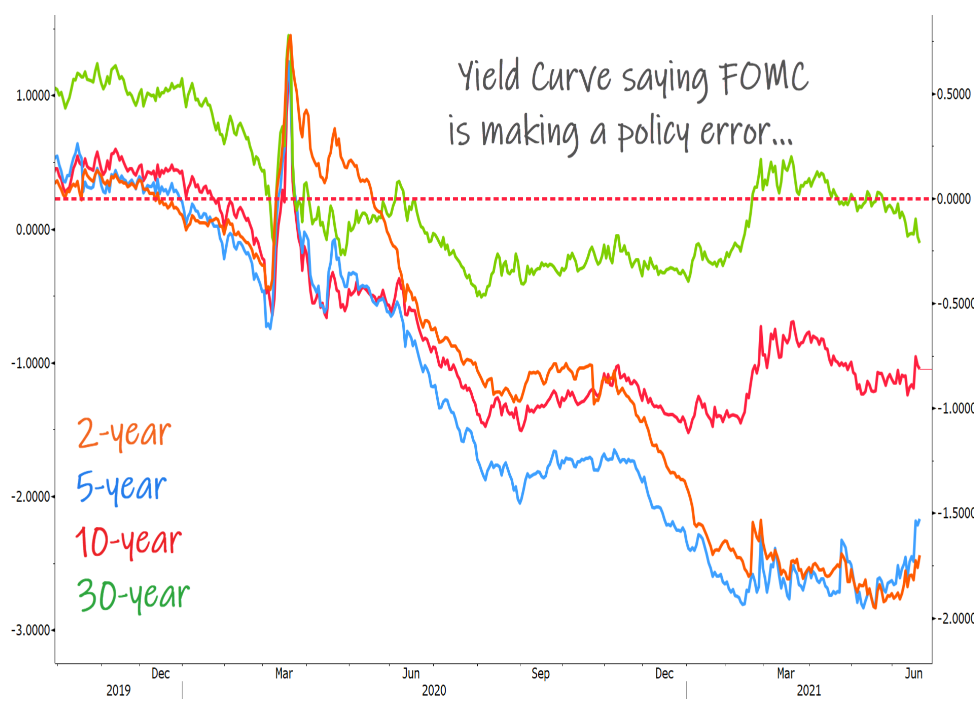
Let's start with numero uno and work our way down the list. First, we know that over the long-term precious metal returns are driven by two things (link to our PM Framework):

1. The price of gold will approximate the total amount of money in circulation divided by the size of the gold stock
2. It's not inflation or deflation that is the principal driver of gold but the **expected real return** from other long-term financial assets, particular equities.

Wednesday's FOMC doesn't adversely affect either of the above.

The yield curve is flattening though. Which is a signal that the FOMC made, if not a mistake in policy, then a major error in communication.

The chart on the right shows that real yields from the front end to the belly jumped while the long end moved lower — the Fed wants a steepenign curve, indicating higher growth and inflation expectations.



The FOMC's communication fumble stems from the fact that they spent the last year trying to convince the market of their structural shift in policy to flexible adjusted inflation targeting (FAIT) (which I outlined here). And then after the first signs of inflation running above target, they spook and shift their guidance on rate hikes.

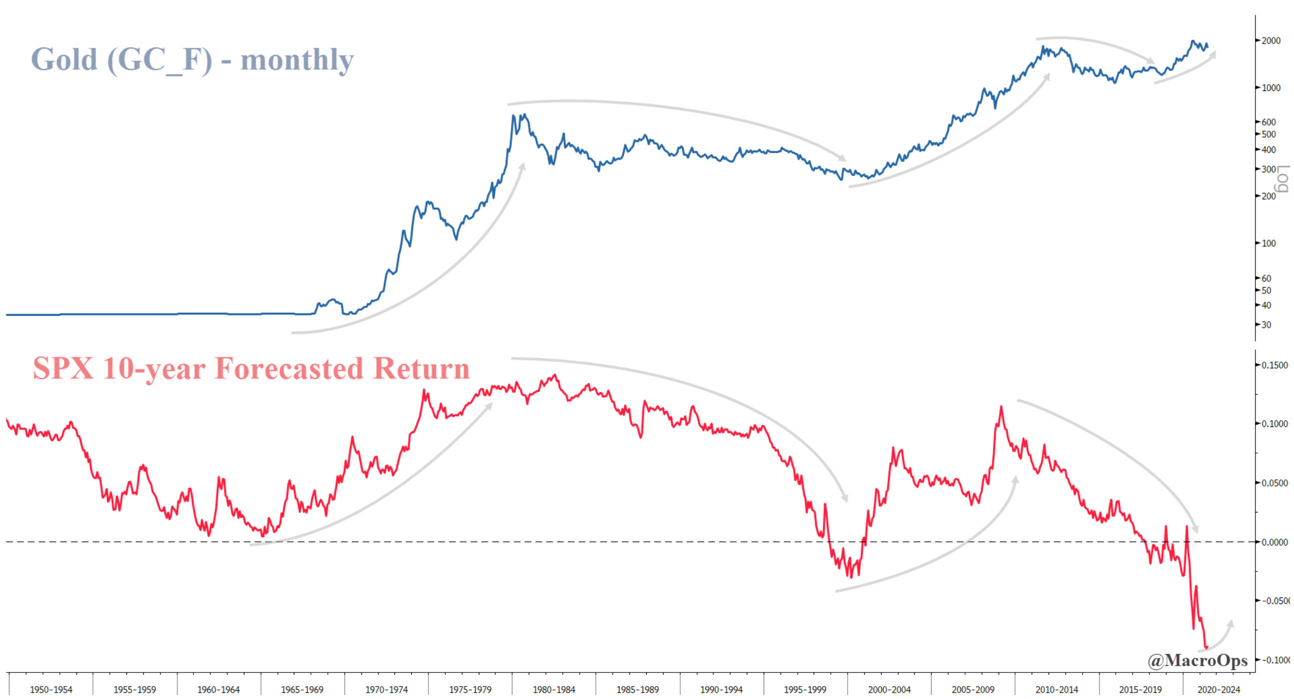
I've changed my thinking a bit from Thursday's FOMC note. It's quite possible last week's FOMC ends up as a more serious communication blunder, as it detracts from their credibility in guiding easy policy in the face of improving economic growth… Investors now have reason to question their faith in the FAIT…

We'll have to wait another week or so to see how the market ultimately digests this change in Fed tone (ie, what's being driven by a reset in positioning and what will be a sustained change in trend due to the Fed).

Anyways, this error doesn't change the fact that the expected returns for equities — US equities in particular — are low. If anything it helps bring forward the resetting of these stretched negative expected returns, which is all quite bullish for precious metals.

The below chart shows what we're talking about. The red line is the 10-year expected real returns for the SPX, which are currently at their lowest levels in history. And then we have gold in blue (gold is flat for the first couple decades because it was pegged to the dollar).

Low expected equity returns coincide with secular bottoms in gold. High expected returns that are trending lower tend to coincide with tops.



This fact means *everything* for precious metals long-term return potential (ie, next 1-10 years). But means squat when trying to figure out where gold will trade in the coming days and weeks.

For that we need to turn to the technicals…

Starting with the monthly.

Gold is still clearly in a solid uptrend on the monthly. The chart shows that the yellow metal has a historical tendency to test and respect its monthly Bollinger Band midline (20-month moving average).

In the previous 2001-2011 secular bull market, gold tested this level 8 times and only *briefly* violated it once, during the 08'-09' financial crisis.

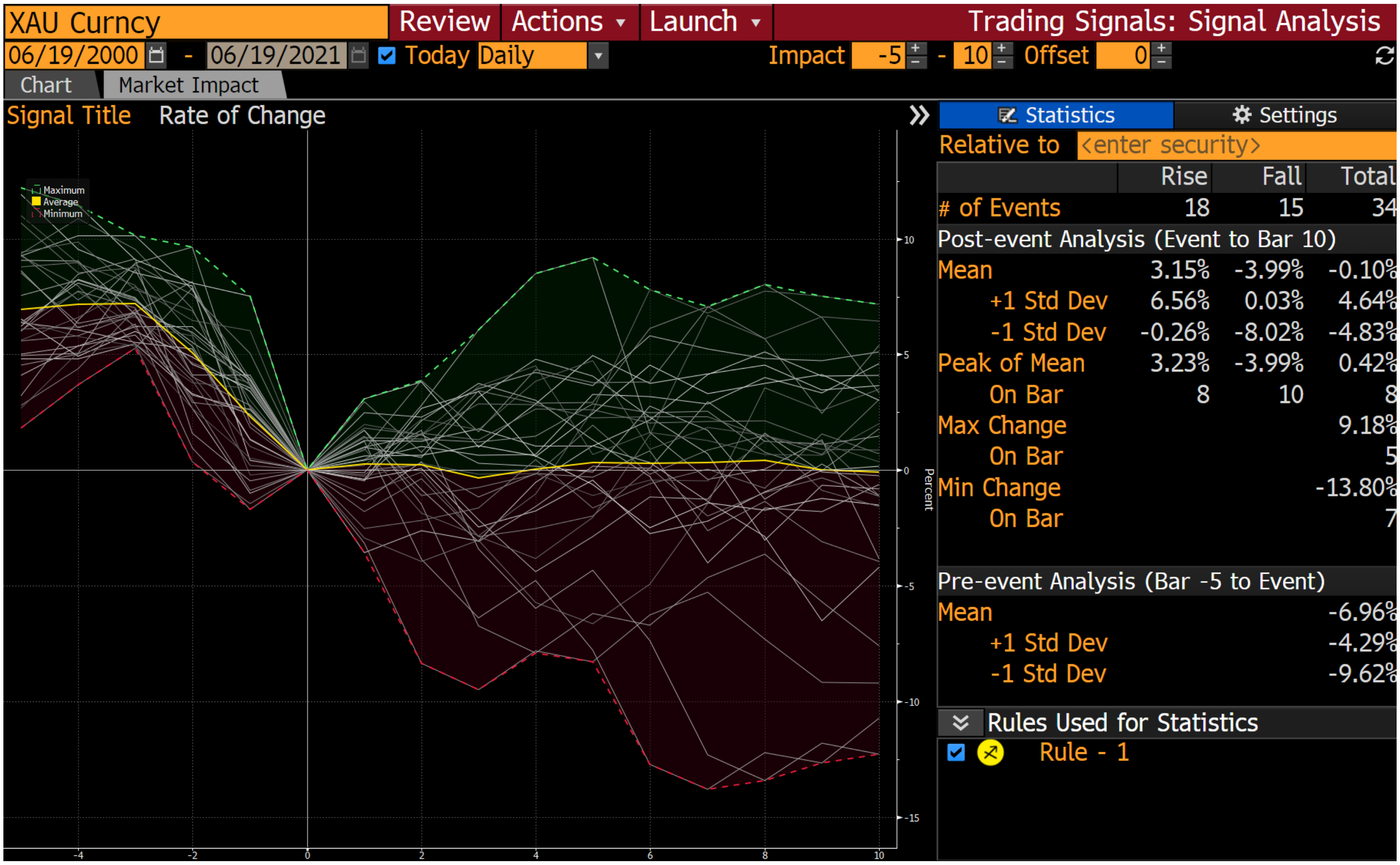
Gold is on this midline now. A monthly close well below this level would not bode well for gold's prospects over the short-term.

On a weekly basis, gold is retesting the upper part of its 9-month bull channel that it recently broke out of. Similar to the monthly, a weekly close back into this channel would signify a bull trap and likely indicate further sideways-to-down chop ahead.

The daily shows another significant level at play. Ideally, we'd want to see a washout reversal below this line in the coming days followed by a quick snapback close above it.

I ran a screen to mark every time gold has experienced a similarly sharp 3-day decline while in a larger uptrend. The yellow dots mark past instances. There's been 34 such cases over the past 20+ years.

The graphs below show the forward returns for each instance. The first one shows that results are mixed over the first 2-weeks. But the second shows a stronger tendency to <u>rise</u> over the follow on 2-months (yellow line is the average follow on return).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Review
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Launch
Trading Signals: Signal Analysis
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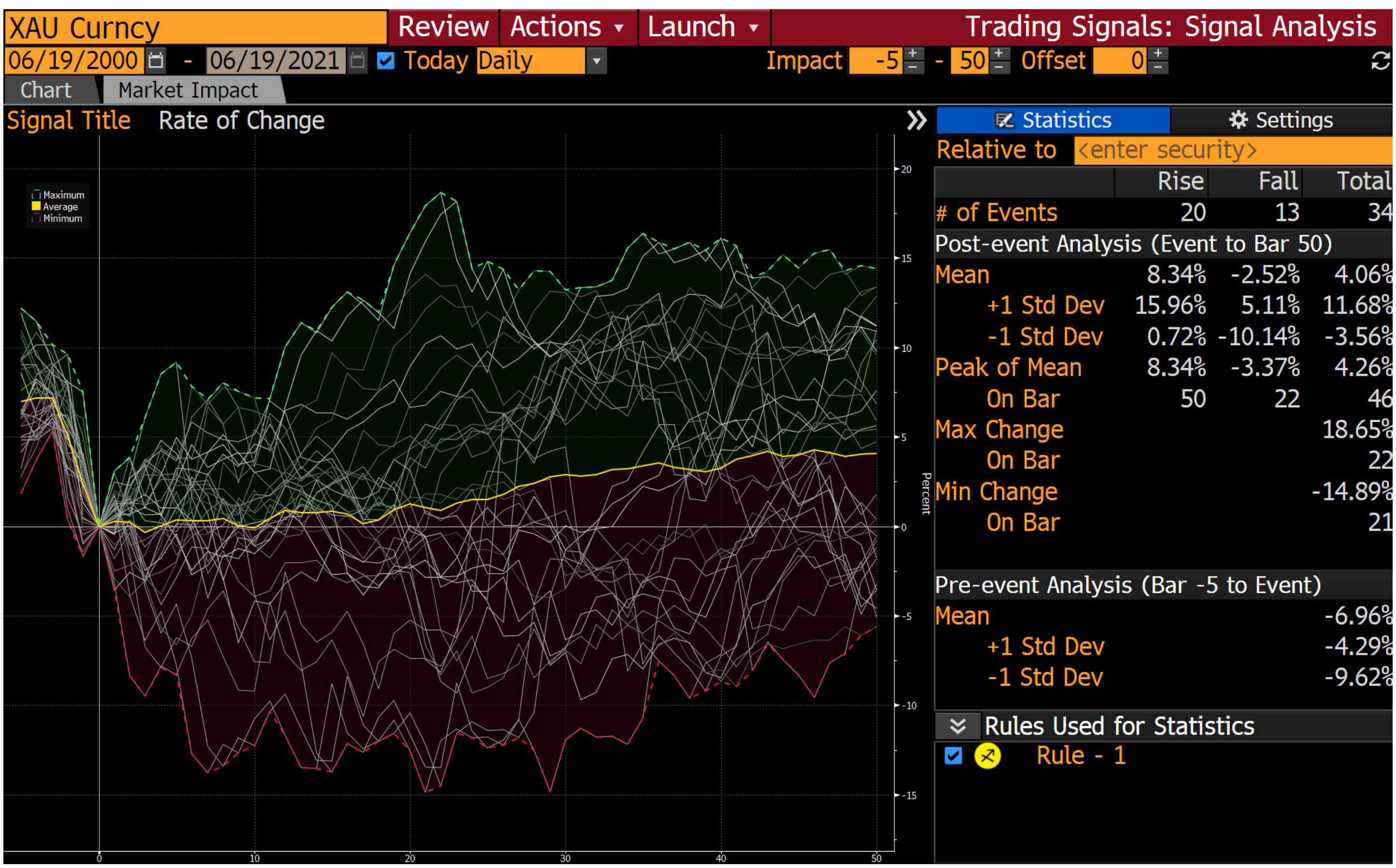
# of Events 18 15 34
Post-event Analysis (Event to Bar 10)
Mean 3.15% -3.99% -0.10%
+1 Std Dev 6.56% 0.03% 4.64%
-1 Std Dev -0.26% -8.02% -4.83%
Peak of Mean 3.23% -3.99% 0.42%
On Bar 8 10 8
Max Change 9.18%
On Bar 5
Min Change -13.80%
On Bar 7
Pre-event Analysis (Bar -5 to Event)
Mean -6.96%
+1 Std Dev -4.29%
-1 Std Dev -9.62%
Rules Used for Statistics
Rule - 1


XAU Curncy
Review
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Trading Signals: Signal Analysis
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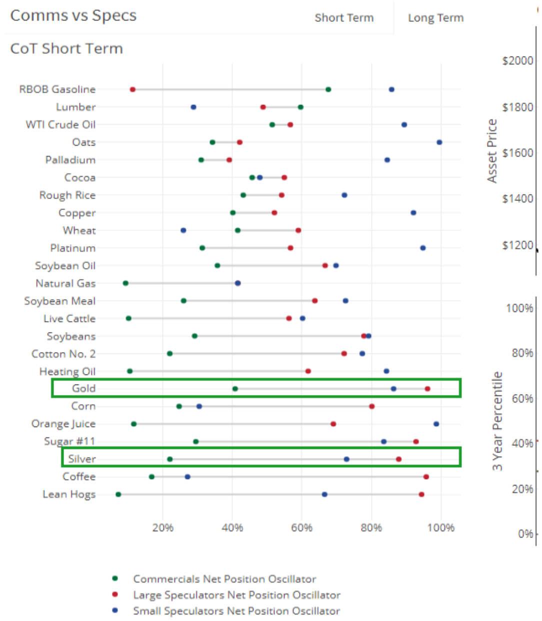
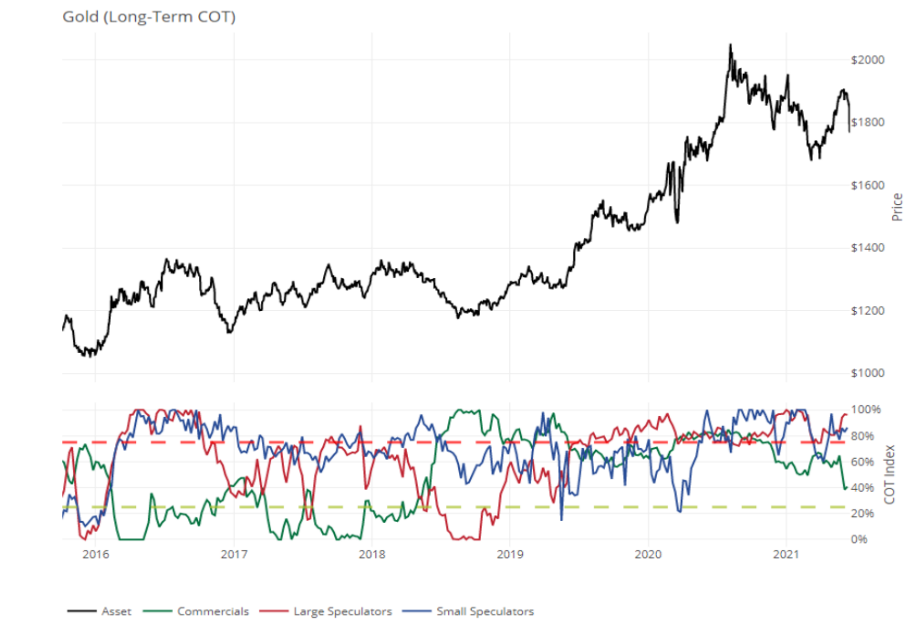
# of Events 20 13 34
Post-event Analysis (Event to Bar 50)
Mean 8.34% -2.52% 4.06%
+1 Std Dev 15.96% 5.11% 11.68%
-1 Std Dev 0.72% -10.14% -3.56%
Peak of Mean 8.34% -3.37% 4.26%
On Bar 50 22 46
Max Change 18.65%
On Bar 22
Min Change -14.89%
On Bar 21
Pre-event Analysis (Bar -5 to Event)
Mean -6.96%
+1 Std Dev -4.29%
-1 Std Dev -9.62%
Rules Used for Statistics
Rule - 1

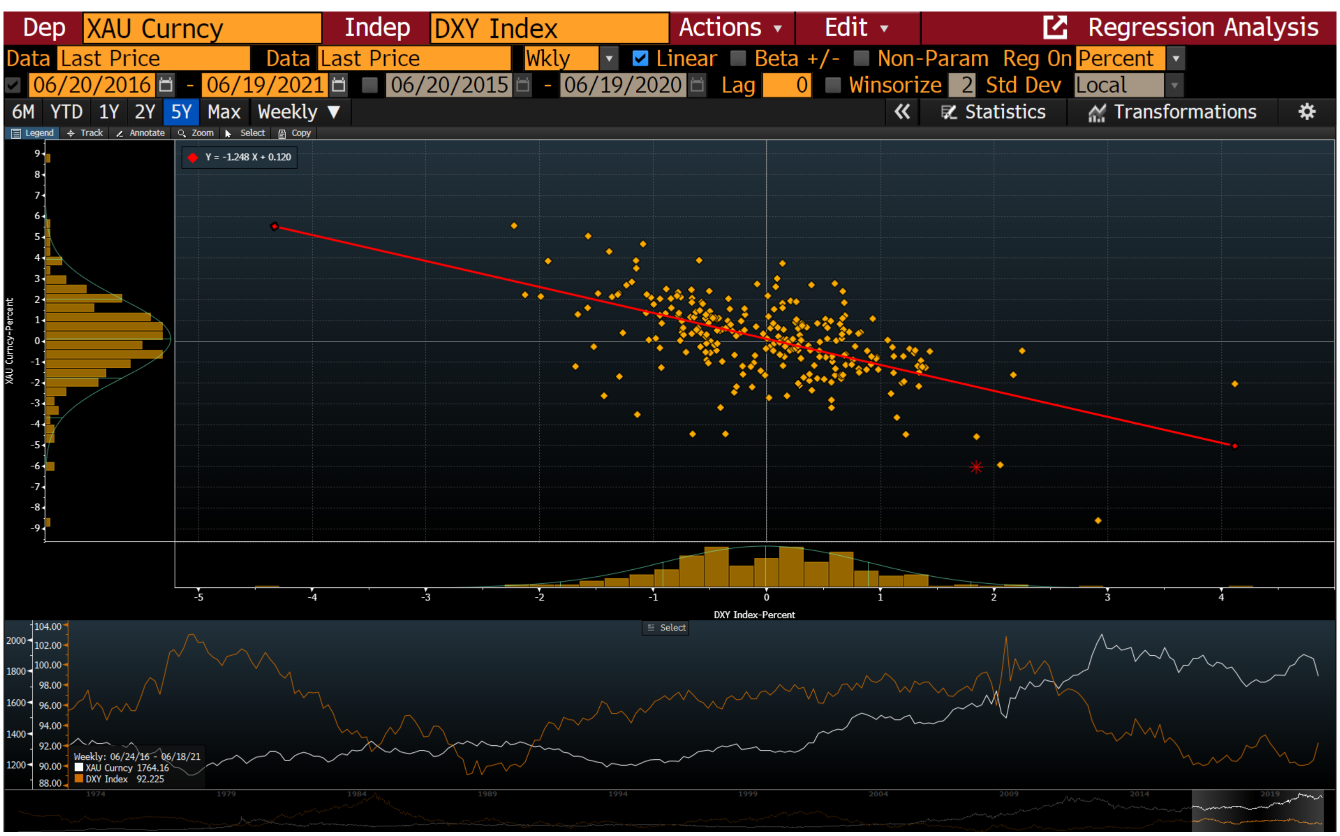
My base case is that this move is part of **broader knee-jerk washout of weakhands across assets**.

Speculative positioning in precious metals had gotten a bit crowded over the last couple weeks, with gold specs in the 96th %tile and silver in the 88th (link to our dashboard here).



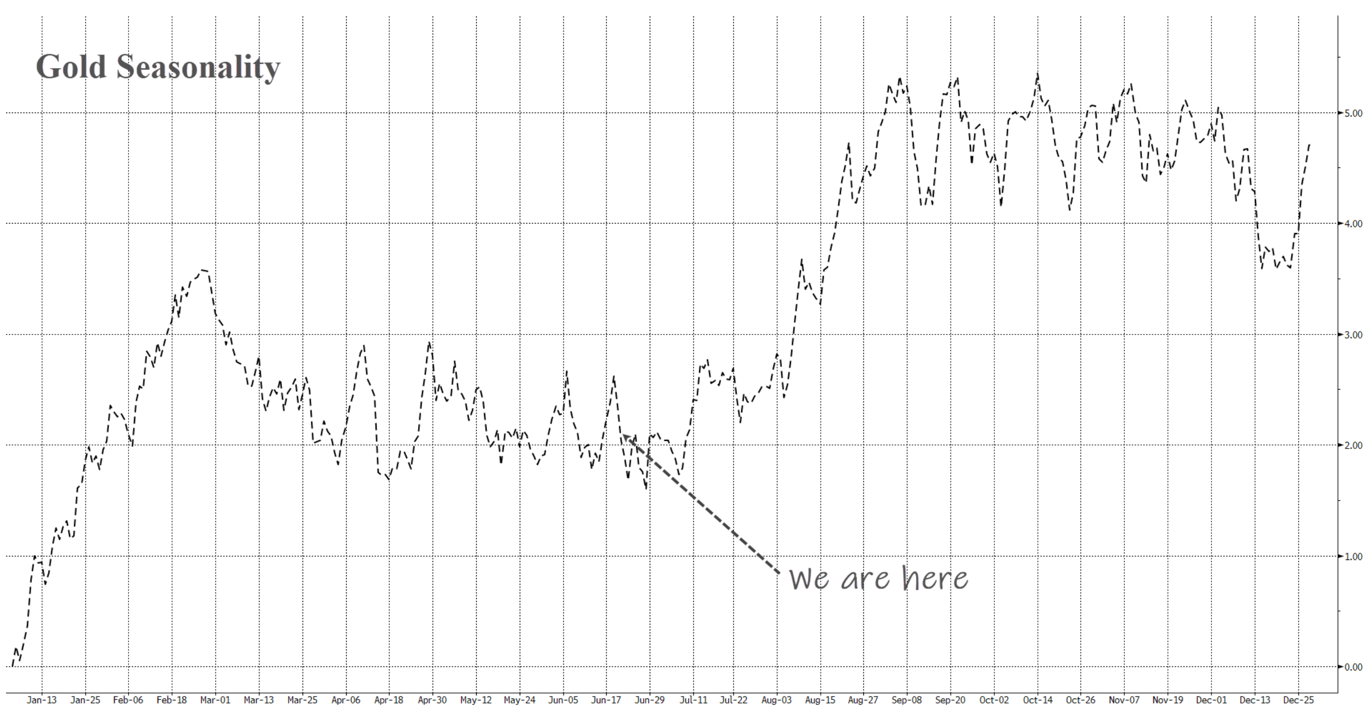


And there's little doubt that this dip has been exacerbated by the spike retrace in the US dollar, where short positioning had reached extremes. This graph shows the strong inverse correlation of the Gold/USD over the last 18-months.



Luckily, we have signs that gold is nearing a washout bottom. Breadth (% > 200dma) in miners is nearing 20% (green zone). **A level that tends to coincide with major bearish sentiment driven bottoms.**

And we're less than 2-weeks away from gold entering one of its strong periods of seasonality that lasts until September.



The long-term bull case still very much stands. In fact, the outlook for precious metals has hardly been better.

My gut tells me that what we're seeing is a large positioning driven shakeout in a number of correlated markets where weak hands had built up. The US dollar being front and center of that.

The FOMC's communication misstep being the catalyst here, causing the unusually fast unwind of these trades.

This unwind likely plays out for a few more days. With that said, gold is near a major technical infleciton point across multiple timeframes. It <u>needs</u> to stay above the 1,730 level and end next week on a strong note, or else the long precious metals trade is likely headed for another couple months of chop and vol basing action.

Should we get a technical reversal and see a reduction in spec longs in next week's CoT for PMs. Then we'll look to use this shakeout as a great opportunity to add to our positioning. If gold trades below 1,730. We'll cut our long for a small profit and go back to the sidelines to wait for the tape to shape back up.

Stay safe and keep your head on a swivel!

Your Macro Operator,

Alex