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Gold Is Up 10%: Has A New Bull Market Begun?

By MARK HULBERT | MORE ARTICLES BY AUTHOR

Chart watchers see a positive pattern, but sentiment indicators are pointing the wrong way.

Is it premature to declare that gold's bear market is finally over?

It certainly looks that way to some chartists, who are making a big deal of gold's double-bottom at the end of last year just below $1,200. Since then, bullion has risen by $130 an ounce, or more than 10%.

Even if gold's bear market has ended, it was no slouch: From a September 2011 high of $1,925 an ounce the decline lasted for 27 months and took 38% off of bullion's price. Gold-mining stocks had a particularly rough time: The NYSE Arca Gold Miners Index fell 70% from September 2011 to its December 2013 low.

But a 10% rally does not automatically mean the bear market has ended, since that 27-month decline experienced several rallies of at least 10% — each of which eventually proved to be a head fake. How do we know that gold's recent rally will end any differently?

To help get insight, let's review a number of indicators that historically have been useful in identifying the direction of the major trend. They don't suggest that the bear market has ended.

Sudden Optimism

The first set of indicators are based on sentiment.

Consider the average recommended gold market exposure levels among a subset of short-term gold market timers tracked by the Hulbert Financial Digest (as represented by the Hulbert Gold Newsletter Sentiment Index, or HGNSI). That average currently stands at 30%; as recently as late January, it stood at minus 30%.

In other words, the average short-term gold timer has increased his recommended exposure level in gold-oriented portfolios by 60 percentage points in less than a month's time. That is a rapid retreat from the bearish camp. That is not what is typically seen at major bear-market bottoms, at least according to contrarian analysis.

Instead, the usual pattern is for the initial rise off the bear-market low to be met with widespread skepticism. That skepticism, of course, is the veritable Wall of Worry that bull markets like to climb. When rallies off of lows are quickly met with widespread

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enthusiasm, in contrast, contrarians bet that the rally is more likely to be a mere correction within the confines of a longer-term bear market.

That's what happened in the summer of 2013, by the way. That's when gold's rally from a similar low just below $1,200 to a high of near $1,400 was met with a big jump in the HGNSI. The bear market soon resumed in force.

If gold-market sentiment conforms to the usual contrarian pattern, the final bear-market low will be accompanied by such widespread despair and pessimism that it will take far more than a 10% rally to lure gold investors back into the market. We're not there yet.

Best vs. Worst Market Timers

Another sentiment indicator is based on the contrasting forecasts of the gold-market timers with the best track records and those with the worst. Currently, according to the Hulbert Financial Digest, the worst timers, on balance, are more bullish than the best ones.

So to bet that gold's bear market is over, you have to bet that the worst gold timers are, uncharacteristically, now going to be right.

The Hulbert Financial Digest defines its group of best gold timers to include the 25% of monitored timers with the best risk-adjusted gold-timing performances. The worst timers, in contrast, are those in the worst performing quartile. Regardless of whether the performance period used to determine these quartiles is the last one, five, 10 or 15 years, the consensus gold-market exposure recommendation of the worst quartile is markedly higher than among the timers in the best quartile.

Miners vs. Bullion

Another popular gold-market sentiment indicator focuses on the relative performance of gold-mining stocks and bullion. The presumption behind this indicator is that both bullion and mining stocks should, over time, turn in more or less similar performances. So whenever one falls significantly behind the other, it's time to bet that the spread between them will narrow and return them to equilibrium.

If so, then you might think that gold-mining stocks represent a low-risk buying opportunity right now, since those stocks have lost twice as much as bullion since the fall of 2011. But note that, even if you accept the presumption behind this sentiment indicator, it doesn't necessarily follow that gold-mining stocks are poised for huge gains. Instead, the correct implication is simply that those stocks will outperform bullion — and that could also come to pass by their not falling as much as bullion in an ongoing gold-bear market.

In fact, according to a recent analysis by Claude Erb, a former commodities portfolio manager for Trust Company of the West, the underperformance of gold-mining stocks in recent years could just as easily be used to argue that gold bullion will drop another 50% or that gold-mining stocks will increase by 100%. The only way to be assured that you will make money from a narrowing of the mining stocks/bullion spread is to simultaneously buy the stocks and sell short an equal dollar amount of gold bullion.

If you don't want to do that, then betting on this sentiment indicator can be risky indeed. Erb, in an interview, pointed out that a year ago many gold traders were already concluding from the lagging mining stocks that they were poised for a big rally. One January 2013 column in Oil & Energy Daily said that "this indicator hasn't been wrong in 27 years — and right now it's screaming 'buy!'" From when that column appeared to gold's low at the end of last year, the NYSE Arca Gold Miners Index fell 55%.

Long-Term Valuations

Erb, along with Duke University finance professor Campbell Harvey, was the co-author of a **January 2013 study** published by the National Bureau of Economic Research — which I featured in a February 2013 column for *Barron's* on the price of gold. The study suggested that gold remained significantly overvalued, even though its bear market at that point was already 16 months old. By the end of the year gold had shed nearly $500 an ounce.

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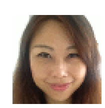

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Unfortunately for the gold bulls, Erb's and Harvey's study suggests gold is still overvalued. One valuation indicator they point to is equivalent to a stock's price/earnings ratio: It is the ratio of gold's price to the Consumer Price Index. According to their calculations, and given the historical average level for this gold/CPI ratio and where the CPI index currently stands, gold's "fair value" today is around $820 an ounce — about $500 lower than where it now trades.

To be sure, this is a long-term indicator, and — even if it is on target — it doesn't preclude significant shorter-term rallies along the way. But with both the sentiment and valuation winds blowing against higher prices right now, it's hard to make a case for a major new gold-bull market.

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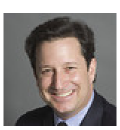

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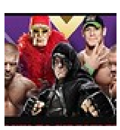

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