MarketWatch

Opinion: Gold stages another false mini-rally

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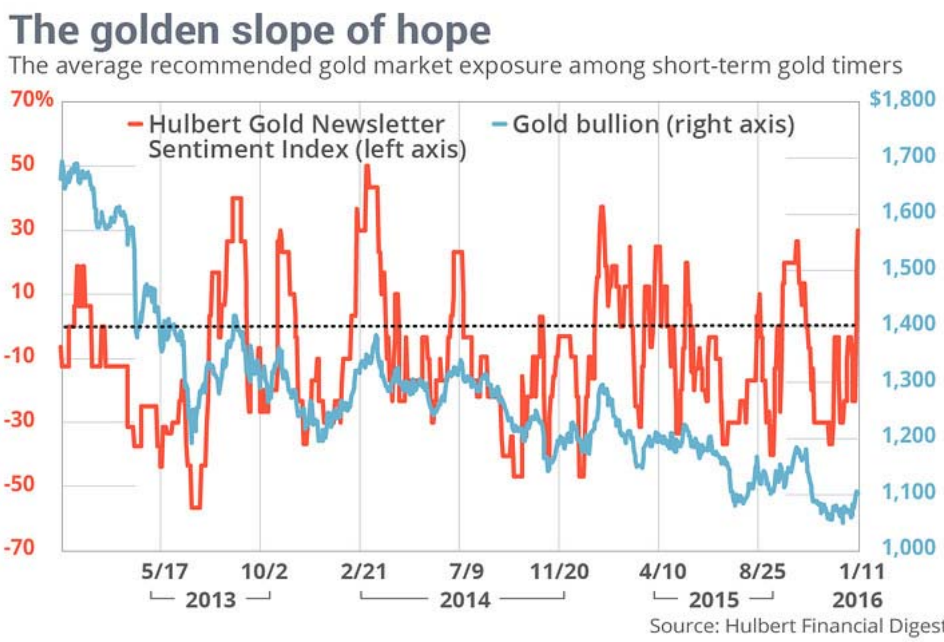
The price of the precious metal has jumped, but deep-rooted pessimism needs to set in before a true rebound begins



CHAPEL HILL, N.C. (MarketWatch) — Gold continues to suffer from too much optimism among short-term market timers.

That's the conclusion contrarian analysts are reaching upon analyzing gold-market sentiment. They argue that a bottom in prices won't be in place until there is a lot more pessimism and despair among gold-market participants.

Gold, in other words, is still looking for a strong and enduring "wall of worry."

Consider the average recommended gold-market exposure level among short-term gold timers (as measured by the Hulbert Gold Newsletter Sentiment Index, or HGNSI). As you can see from the chart at the top of this column, this average has risen more than 53 percentage points over the past four trading sessions, a remarkably large jump in such a short time.

The occasion for this big jump was a rally of over $40 in the price of gold bullion, which was enough to persuade long-suffering gold investors that happy days were here again. Unfortunately, their reaction is just the opposite of what typically happens at more significant bottoms. According to contrarian analysis, those more important bottoms are instead accompanied by skepticism and disbelief.

Not surprisingly, therefore, gold this week has pulled back — including another $10 per ounce on Tuesday.

As I wrote a month ago when I last devoted a column to gold-market sentiment, a more enduring gold-market bottom isn't likely to occur until the gold market timers "throw in the towel in a big way, and then remain stubbornly bearish in the face of the initial rally off a low." Notwithstanding the past month's volatility, of course, gold today is virtually unchanged from where it was when I wrote that month-ago column.

An objection to this downbeat contrarian conclusion comes from some gold traders who argue that sentiment plays less of a role during major economic or geopolitical upheavals. And they think there currently are more than the usual number of potential candidates for such upheavals — everything from a resurgence of inflation to a major terrorist attack, a currency crisis in China or a major bear market on Wall Street.

But I'm not at all sure that gold would go up during any one of those crises.

My skepticism about gold's hedge against a crisis derives from a study from the National Bureau of Economic Research titled "The Golden Dilemma," by Claude Erb, a former commodities portfolio manager for Trust Company of the West, and Campbell Harvey, a finance professor at Duke University. They analyzed gold's historical behavior during periods of inflation, hyperinflation, currency devaluations, geopolitical chaos and so forth, and found that during those periods gold just as often fell as it rose.

Gold traders' arguments to the contrary are therefore just more evidence of their eagerness to turn bullish. Contrarians will be inclined to buy only when those traders no longer exhibit such eagerness.

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