

Gold: A game changer?

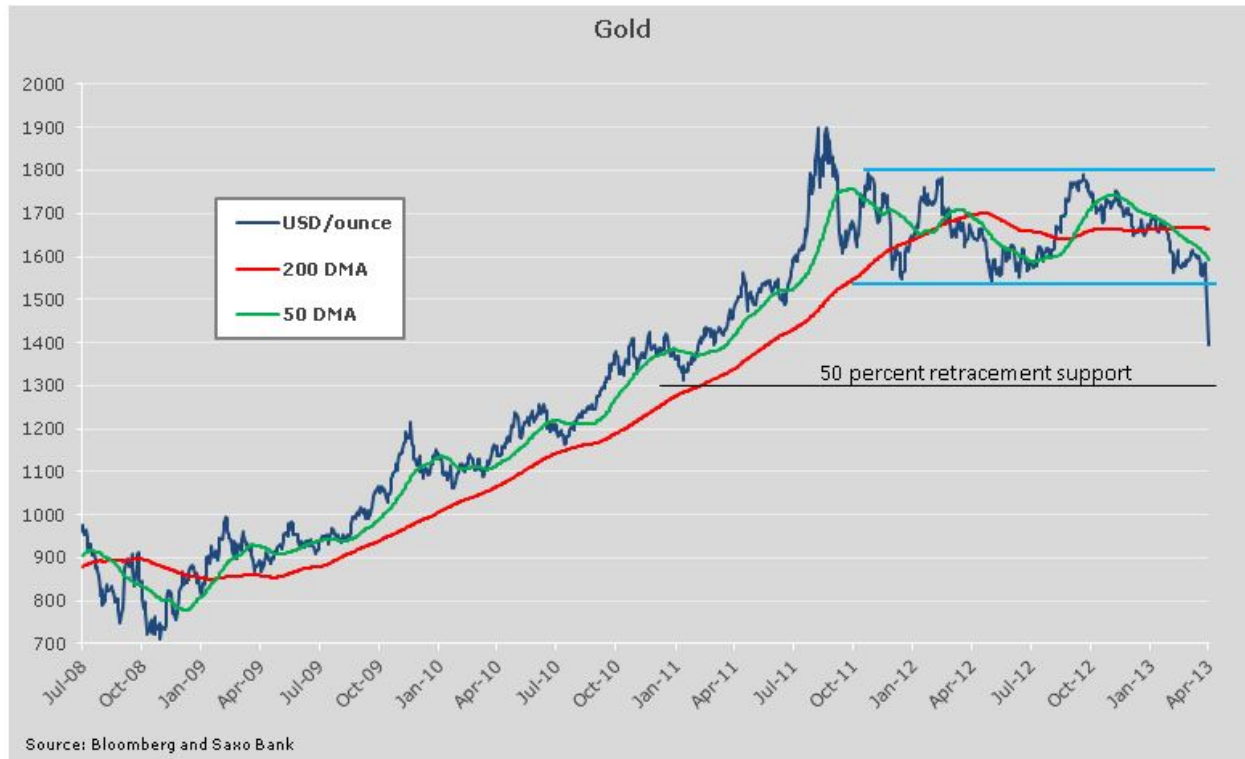
The near free fall in gold over the past few trading days has pushed other financial news off the front pages. Gold, which has been the darling of many investors over the past decade and has offered rich rewards during that time, is suddenly looking vulnerable. Will this latest move spell the end of the rally that began back in 2001 or will history show this as being a great opportunity to invest?

Up until last Friday, gold had spent the past 18 months consolidating in a wide range between 1,525 USD/oz and 1,800 USD/oz. But particularly since last September, we have witnessed a slow drift lower following a third rejection of the 1,800 USD/oz level. Speculative traders such as hedge funds, which tend to be quick on the trigger when changes are looming, began losing faith back in September: from a peak net-long futures and options position of almost 20 million ounces, they started a gradual reduction that, by last Tuesday, had seen their position dwindle to just 5.6 million ounces.



Investors who used Exchange Traded Products (ETPs) or Exchange Traded Funds (ETFs) to gain long exposure to gold continued to accumulate or maintain their position well into February, by which time the ongoing price weakness began to have an impact. This investor segment is generally viewed as longer-term. Apart from many small retail investors, it also includes some big hedge funds such as Paulson & Co, which by the end of 2012 held 21.8 million shares in the biggest fund, the SPDR Gold Trust. The trigger in February that led to a pick-up in ETP holdings

being reduced was the technical break below 1,625 USD/oz, which a few days later was followed by the technical sell signal called the death cross on February 20. Such a signal, which is triggered when the 50-day moving average crosses the 200-day, has on two out of three occurrences during the past five years triggered 15 percent and 8 percent sell-offs.



With so much invested in exchange-traded products, the ball began rolling. During the past month, we have witnessed continued long liquidation despite fundamental support coming from the European debt crisis represented by Cyprus, softer economic data from the US and China, and a massive asset-purchase programme from the Bank of Japan.

What really rattled investors' nerves last week was the potential for Cyprus to sell its gold reserves to cover losses. Such a sale could easily be absorbed by the market. But the worry spread that this, if implemented, could become precedent for other peripheral Euro area members' central banks. Such action would have a much greater impact on gold markets considering the current holdings of countries like Spain and Italy. Adding to this continued price downgrade from another of the major bullion houses, the course was set and once the 1,525 USD/oz support level was reached and breached, as if it did not exist, waves of selling orders from both the spot and futures market sent the price into a tailspin. During the initial hour of carnage last Friday, almost 9 million ounces of gold futures had swapped owners.

Technical perspective

The USD 59 loss on Friday was followed by an even greater move today and the big question everybody is now asking is when will the selling stop? As mentioned earlier, fundamental support has risen but has been ignored in recent weeks. Until a floor can be established, additional economic weakness that could point towards a continuation of support from asset purchases in the US will have limited if no impact.

The Technical picture obviously looks very bleak, with strong resistance now established between 1,500 USD/oz and 1,525 USD/oz, an area that undoubtedly will be met by new selling should that be revisited soon.

The downside looks pretty open down towards 1,300 USD/oz, which represents a 50 percent retracement of the rally following the Lehman Bros collapse in the autumn of 2008. Also it is worth noting that the current price just above 1,400 USD/oz is within the consolidation area between 1,300 USD/oz and 1,425 USD/oz, where gold spent six months from late 2010 to early 2011.

Once the dust settles

The multi-year rally is over, but it is probably too early to make a call for a complete trend reversal. The coming days and weeks will be very important as this has now become a war of nerves. Will ETP investors, especially the larger ones, be forced to continue selling? Along with hedge funds going net-short, this scenario could create further weakness. Or will the current slowing economic climate eventually trigger some support? As mentioned in previous outlooks, we maintained a constructive view on gold, but were also aware that a break below 1,500 USD/oz would be a potential game changer. We look for support towards 1,300 USD/oz followed by a long period of consolidation, with the USD 1,550 per ounce area offering resistance.

The process of rebuilding investors trust will be a long one and one that has not yet begun.

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