

# Gold Stock Surge

Earlier this week, the US stock markets (S&P 500) fell 4.6% to their lowest close since November 20th's panic low. It was a very unpleasant day as latent fears of bungled government meddling flared up again. But one sector, the gold stocks, was able to buck this very weak tape. That very day the HUI gold-stock index rallied 2.6%.

This action was actually a microcosm of what we've seen since the stock panic's lows. At its very best in early January, the S&P 500 (SPX) was up 24.2% from its panic lows. That certainly wasn't bad, but since then those gains have been pared to 4.8%. The stock markets aren't plunging anymore, but they certainly aren't recovering very enthusiastically either.

Meanwhile, gold stocks as measured by the HUI were up 76.0% in early January over the very same 30-trading-day span where the SPX saw its greatest post-panic gains to date! And provocatively, back in early January gold was only trading in the \$860s so the growing gold excitement we've seen this week was *not* a factor behind gold stocks' initial outsized post-panic gains.

At best from its own panic lows (as of this week), the HUI has soared 113.8% since late October! For investors and speculators looking for sectors that are thriving in this challenging time, gold stocks are it. The financial media's oft-expressed lament that nothing is doing well in these markets is simply untrue. Gold stocks have already rallied strongly and odds are the majority of their surge *is still yet to come*.

It may seem odd to be very bullish on a sector that has already more than doubled in less than 4 months, but gold stocks are not your typical sector. Gold stocks have one major driver, the price of gold. In long-term fundamental terms, the gold price determines their profits and hence their ultimate stock prices. In near-term sentimental terms, the daily gold action drives traders' desire to add capital to this tiny sector.

And as you know if you've seen any CNBC lately, the strong gold surge over the last week or so is a big deal. Even mainstreamers are getting interested as the psychological milestone of \$1000 again looms large. With gold soaring \$89, or 9.9%, in just 6 trading days, traders are naturally getting a lot more interested in the gold stocks that leverage this metal.

Long ignored by all but a few contrarians despite their epic 1331% bull run between November 2000 and March 2008, the gold stocks are still a tiny sector. At the end of January the total market capitalization of all the stocks of the HUI was a trivial \$123b. Meanwhile the S&P 500's was running at \$7785b, 63x larger even at today's depressed stock-market levels. So if even a small fraction of mainstreamers decide they want some gold-stock exposure, this sector will *fly*.

But interestingly, the bullish case for gold stocks goes far beyond the new interest \$1k gold is generating. Like most sectors, gold stocks were sold off far too aggressively in the midst of the stock panic. They have yet to even reflect the low-\$700s gold seen in the panic, let alone today's much higher gold prices. If they simply mean-revert to their years-old historical relationship with gold, they will rally mightily.

Two charts will make this case crystal-clear. The first simply shows the price of gold (red) and the HUI gold-stock index level (blue) over the past year. Both vertical axes are zeroed so raw percentage changes are easier to compare visually. While gold really held up pretty well during the stock panic, gold-stock *traders* did not. They let their intense fears cloud their logic and judgment leading them to sell like mad.



Last summer the HUI was drifting lower in a typical modest downtrend often seen during the [summer doldrums](#). But in late July, the HUI plunged below support. This was when the GSEs, Fannie Mae and Freddie Mac, were imploding which greatly exacerbated the credit crunch. Owners of the ubiquitous GSE debt, which is backed by American residential mortgages, started dumping their bonds and parking capital in vastly safer US Treasuries.

Of course foreigners first had to buy US dollars before they could buy Treasuries, so the US dollar surged in one of its [strongest rallies](#) ever witnessed. This led to a sharp \$127 (13.9%) gold plunge in the first half of August. Not surprisingly the gold stocks, which are driven by gold, plummeted in sympathy. The chain of

events from this bond panic ignited by the GSE implosion kicked off the HUI's brutal 67.7% plunge.

With gold weak, gold-stock traders' psychology was already shaken before the stock panic. And gold actually recovered by mid-September, blasting \$160 (21.5%) higher in just 7 trading days. The HUI rallied sharply on gold's strength, hitting 354 in late September. It probably would have continued rallying from there, but then the psychological maelstrom of the [Great Stock Panic of 2008](#) slammed into the markets. Gold stocks did not escape.

A panic is a [bubble in fear](#), investors and speculators rush to sell *anything and everything* in order to raise cash fast. In just 5 weeks, gold-stock traders sold so aggressively that they drove the HUI 57.2% lower! The HUI has never seen anything like this before and probably won't again in our lifetimes, since true stock panics are once-in-a-century types of events. This was catastrophic for gold-stock sentiment.

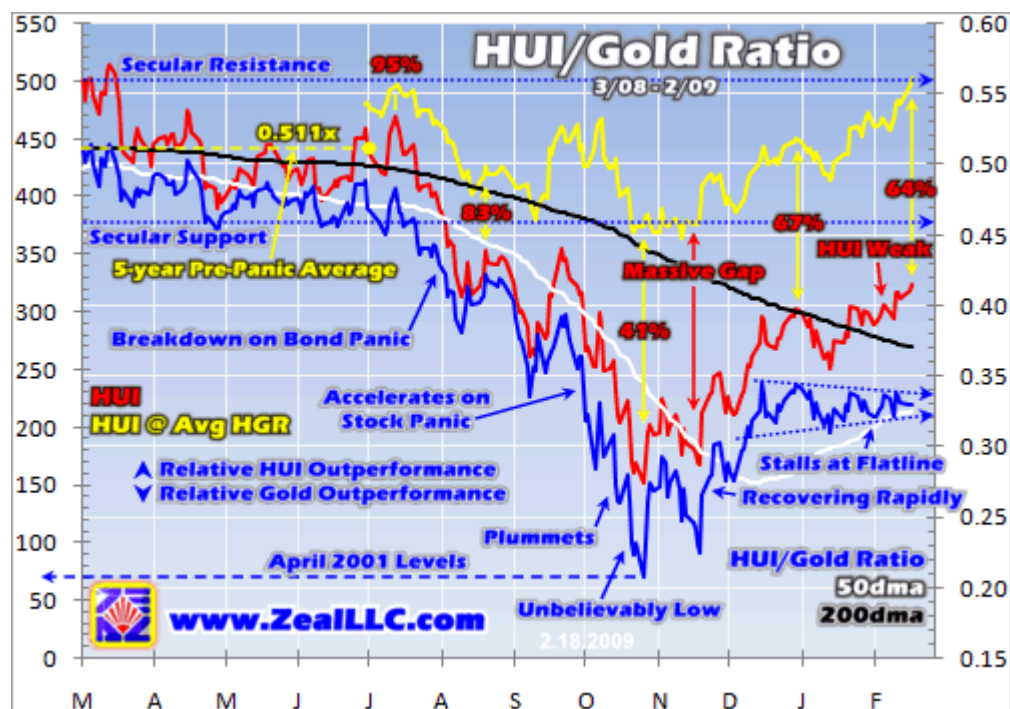
But the great irony of all this is gold only fell 18.9% over that 5-week stock-panic span. Throughout history, even [during stock bears](#), the gold stocks tend to follow gold on balance, not the stock markets. Sure, extreme fear in general stocks can *temporarily* spill into gold stocks from time to time. But strategically they always ultimately march to the beat of the gold drummer. Since gold governs their future profits and current psychology, it rules them with an iron fist. So this huge disconnect was very strange.

Even if gold had done nothing since, even if it had lingered in the low \$700s, it was crystal clear during the panic that gold stocks were radically oversold. We were buying aggressively in late October and early November, as the best time to go long is when everyone else is terrified so the bargains are the greatest. A pair of new gold-stock and silver-stock investments I recommended to our newsletter subscribers near those panic depths were already up 69.2% and 105.8% as of this week.

I was buying when everyone else was selling because the longstanding relationship between gold stocks and the price of gold was all out of whack. In the 5 years before the stock panic, the HUI/Gold Ratio (HGR) had usually traded in a tight range between 0.46x and 0.56x. It averaged 0.511x over this secular time frame. In other words, the HUI index generally traded around *half* the price of gold. You can see a long-term chart of this [HGR relationship](#) in an essay I wrote just after the stock panic.

This narrower span over the past year offers higher resolution on the HGR developments during the stock panic. When the HGR is rising, it means the HUI is outperforming gold. Conversely when the HGR is falling, it means gold is outperforming the HUI. Often in this latter case, as the blue HGR line below

shows, gold's outperformance means gold is simply *not falling* as fast as the HUI in a correction.



During the panic, the HGR plummeted to its lowest levels since April 2001 when gold traded in the \$250s! Initially the huge US dollar spike ignited by the bond panic, and then the tsunami of fear unleashed by the stock panic, conspired to batter gold stocks to ridiculously unreasonable levels relative to the price of gold. On October 27th, the HGR bottomed at the unthinkable level of 0.207x. The next day in our popular [Zeal Speculator](#) alert service, I bought and recommended the GDX gold-stock ETF.

Here's what I wrote to ZS subscribers on October 28th, the day after the HUI closed at its panic low of 152. "And how about gold? We are witnessing the biggest inflationary event in US history, and that is saying a lot. All of this bailout capital will eventually flood into the real economy and drive incredible inflation. I've been long gold since the \$250s (early 2001) continuously and I've never felt more bullish than I do today after this nasty financial panic and its resulting bailout mess. Gold's fundamentals are stellar."

"Yet the HUI closed near 152 yesterday, which is end-of-the-world levels as far as I am concerned. This index hasn't been this low since mid-2003! Where was gold trading back then? In the \$350s! Is this madness or what? We have a gold price over twice as high yet stock prices are apparently discounting mid-2003 gold levels. This is clearly not rational and reflects the sentimental nature of this stock selloff."

Today this seems like an easy call in hindsight, but it was *very* contrarian at the time. Even long-time gold-stock fans were capitulating, with widespread predictions for gold falling to the \$600s even in the traditional gold-bull community. Dig up your favorite commentators' newsletters or essays *published the last week in October 2008* and see what they were writing about gold's and gold stocks' potential back then. Most were extremely bearish, with very very few bulls out there at the panic depths.

But being brave when everyone else is afraid is the essence of contrarianism, and I have never seen blood flowing in the gold-stock streets like I did in late October and early November. It was HGR analysis, that gold stocks were way too cheap even relative to then-prevailing gold levels, that provided the fundamental reasoning for fighting popular sentiment. And this same HGR analysis is still why the gold stocks are so bullish *today*.

The blue line above is the HGR while the red one is the raw HUI. But I added a yellow one too, a hypothetical HUI based on the 5-year secular average HGR of 0.511x. The yellow line is where the HUI *should have* traded since July if it had tightly followed its historical average relative to gold. While just a thought exercise, it really helps place the HUI's great potential then *and now* in proper perspective.

On October 27th when the HUI bottomed, it closed just under 152. But at 0.511x the gold price where it usually oscillates around, it should have closed at 374! That day the HUI was trading at about 41% of where the gold price implied it should be! Talk about the mother of all gold-stock anomalies. I really think we'll never see another one anywhere near this magnitude in our lifetimes, stock panics are so rare.

Back in July before this whole mess started, the actual HUI was trading at 95% of the hypothetical HUI based on the previous 5 years' average HGR. By mid-August, this gap had grown to 83%. And from there it just kept expanding until it mushroomed to the massive 41% levels seen at the depths of the panic. Maybe 80% is somewhat understandable in a scary time, but 40% of where the HUI ought to be trading? No way. It was ridiculously silly.

Since those panic lows, the gap between the real HUI and HGR-implied HUI has narrowed. By late December after the HUI had *doubled* out of its panic lows it was still trading at just 67% of where the hypo HUI ran. And as of this week, the HUI had actually lost some ground relative to gold at 64%. Note above that the blue HGR line has been stalled in a tight, flatlined wedge since mid-December.

Such low HGR levels have never persisted for this entire 8+ year gold-stock bull. And I doubt they will be able to persist today, especially with gold's powerful performance starting to put the neglected gold-stock sector on more mainstream investors' radars. Sooner or later it is highly likely the HUI will return to its

longstanding historical relationship with the price of gold. Interestingly, as I wrote a couple weeks ago [silver](#) is very bullish today for the same gold-normalization reasons.

At \$1000 gold, a 0.511x HGR implies a HUI level of 511. This is 58% higher than *today's* HUI levels! And this bullish case for gold stocks right now is understated in a couple key ways. First, [gold's fundamentals](#) are spectacularly bullish today partially due to the [enormous monetary inflation](#) Washington has baked into the pipelines. If gold continues powering higher as it ought to, the HUI's case gets even more bullish.

Second, after major extremes in one direction the financial markets often tend to overshoot in the opposite direction. If gold drives mainstream interest in the tiny gold-stock sector, gold stocks could rocket up so far and fast that they exceed the HGR's 0.511x average. At the tops of previous gold-stock uplegs when traders got excited, the HGR exceeded 0.60x [on multiple occasions](#). Take 0.60x and apply it to \$1000 or higher gold and gold stocks look like the best buys on the planet today.

But what if gold retreats? This panic drove home the point that anything is possible in the markets, they don't have to act rational over the short term. Amazingly the HUI was so oversold during the panic that this shouldn't really matter. At \$950, \$900, and \$850 gold, the HUI at its 5-year-average HGR ratio would still run 485, 460, and 435. These numbers are still 35% to 50% higher than today's HUI levels. It is mind-blowing just how cheap gold stocks got relative to gold during the madness of the panic.

I've been a speculator all my life, I bought my first stock (IBM) with my own money (earned from mowing lawns and fishing golf balls out of water traps) when I was 12. After decades actively in this game, I know exactly how hard the psychological component is. Dealing with the greed and fear smothering our own hearts is incredibly challenging. It is hard to deploy capital when everything looks terrible and you are scared.

Yet this is when the big money is made. You could wait and buy gold stocks after the SPX and US economy start recovering and the markets start looking normal again. But by that time the lion's share of the gains will have already been won. It didn't feel comfortable buying in the depths of the panic. Even though I *knew* prices were irrational, I couldn't tell if the panic was over yet in late October and early November. But I bought and recommended gold stocks then anyway, ignoring my own emotions.

And it doesn't feel comfortable buying now when gold stocks have lagged gold's surge. Look around the Web and you can find countless reasons, and logical rationalizations, why gold and gold stocks should plunge. Fear and bearishness and pessimism is rampant, not a great deal better today than at the panic lows.

Most traders are waiting for lower prices later, until they're "comfortable", but they'll probably miss the boat playing that game.

Gold stocks may indeed go lower, anything can happen. But there is no doubt they are far too cheap relative to gold *today*. At Zeal we spent the panic months deeply researching *the fundamentals* of virtually all of the world's publicly-traded gold producers. We knew the buying opportunities were tremendous, but we needed to narrow down the field fundamentally to find the best stocks. In mid-December we finished our research and published a 36-page [comprehensive report](#) on our 12 favorite gold producers.

Since this report was published, the general stock markets have fallen 12.8%. Meanwhile the HUI was up 11.0%. But as of this week the average absolute gain of the 12 stocks we profiled is 16.1%, exceeding the HUI's performance by nearly 1.5x. With the HGR still trying to recover from the panic anomaly, the buying opportunities still remain fantastic today. But like any bargains these gold-stock prices won't last forever. Buy our awesome [new gold-stock report](#) today, get off the sidelines, and start making some money.

We have also been adding positions in elite gold and silver stocks in our acclaimed monthly [Zeal Intelligence](#) newsletter. If you want to really understand what is going on in the markets, to steel yourself from succumbing to the thundering herd's mood swings, to see what (and when and why) we are trading ourselves, [subscribe today](#). After a panic is the greatest time to get active, get learning, and get trading. Carpe diem!

The bottom line is gold stocks have surged mightily since their panic lows. But they were so radically oversold then that their surge remains young. Almost no matter what gold does, the gold stocks need to rally greatly to reclaim their long historical relationship with the price of gold. Today's gold-stock bargains aren't as epic as they were in the depths of the panic, but they are still among the best of this entire bull.

And boy, if you add the growing excitement around \$1000 gold and the tiny size of the gold-stock sector into this whole HGR-anomaly mix, the bullish gold-stock case gets wildly more compelling. Investors everywhere are tired of hiding in cash yielding nothing, they are looking for a strong bull market to deploy their idle capital in. Once they discover gold stocks are it, the sky is the limit for this gold-stock surge.

Adam Hamilton, CPA

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