SPX Driving Gold

Among gold investors, the major drivers of the gold price are well-known. From mine production and central-bank sales to jewelry and investment demand, gold's fundamentals have been and will continue to be extensively studied. But over the past year, a curious and sometimes dominating new gold driver has emerged.

Believe it or not, it is the US stock markets. And they certainly have not been driving gold in the traditional loose opposing manner. Historically, secular gold bulls happened during secular stock bears. Over these long time frames (17 years or so), persistent stock-market weakness gradually ramped up gold investment demand. But over the past year, we've seen something quite different from this precedent.

Rather than moving in opposition to the stock markets strategically, gold has often moved *with them tactically*. On a day-to-day basis, there has actually been a high *positive* correlation between the stock markets and gold! This peculiar tendency was driven by the sheer craziness of the stock panic. And even though it is gradually abating today, gold traders can only ignore it at their own peril.

The stock markets' newfound influence on gold is two-pronged. The primary way they drove gold into an odd positive correlation with stocks was through their impact on the US dollar. Thankfully this link will continue to fade as the post-panic normalization continues. The secondary way is through stock-market capital chasing gold via the GLD gold ETF. As GLD grows, so will stock-market capital's impact on gold prices.

In order to illuminate these important forces, I'm going to use the flagship S&P 500 (SPX) to represent the US stock markets as a whole. The SPX's main impact on gold over this past year was not direct, it acted through a secondary agent that happens to often drive gold on a daily basis. This agent is the US dollar, and we'll use the US Dollar Index (USDX) to represent it. This first chart examines the SPX's powerful influence on the USDX over the past year or so.

Of course the defining event of this past year was the first stock panic [in 101 years](). In a technical sense it ran from early October to mid-December, the [unimaginably wild]() 55-trading-day span through which the VXO implied-volatility index stayed over 50 continuously. In the heart of the panic in October, the SPX plummeted 27% in just 19 trading days! It was an epic bloodbath of staggering proportions.

And while this panic is indeed the core of the SPX's newfound influence on gold, we have to go back a bit farther to get critical context. Last April, the USDX hit an *all-time* closing low. Its long [secular bear](), which started way back in July 2001, had gradually slashed the dollar's international value by 41%. So the dollar certainly wasn't healthy going into last autumn's stock panic. In fact, as you can see above, it merely consolidated near its all-time lows from March to July.

By July 15th, the USDX was only 0.5% above its bear lows from 3 months earlier. That very same day gold closed near $976 while the SPX hit 1215. This mid-July-2008 timeframe is critical because that is when the global financial markets started transitioning from a [normal stock bear]() to panic mode. But it wasn't in stocks that the seeds of the stock panic were sown, but in the little-followed world of bonds.

Last July, the US mortgage giants Fannie Mae and Freddie Mac teetered on the verge of bankruptcy. In one month, their stocks plummeted 72% and 78% respectively! All over the world, large foreign investors who owned trillions worth of mortgage-backed bonds watched nervously. Would they get paid back if

these GSEs went under? Would the US Treasury honor its implied (but never guaranteed) backing of GSE debt? The MBS market was an exceedingly scary place to deploy capital last summer.

Some of the big foreign investors wisely decided to pare their massive GSE bond holdings, as well as mortgage-backed securities from other countries. They wanted to shift as much of their GSE exposure as possible into US Treasuries. Since Washington prints its own currency, no matter what happens Treasuries *will* get repaid. And monetary inflation really doesn't matter for the shortest-term Treasuries. So a mad rush to buy short-term Treasuries ensued worldwide.

Many foreign investors had to first buy US dollars before they could buy US Treasuries. So the USDX started rocketing higher in this bond panic. Check out the sharp August USDX spike above. By early September, the panic buying moderated so the USDX fell sharply. The US Treasury had *nationalized* Fannie and Freddie with taxpayer money, short-circuiting the bond panic. But then within a couple weeks the failure of Lehman Brothers sparked the actual stock panic.

The fear surrounding these events, fanned to great heights by disastrous government interventionism, led to a mass exodus from stocks worldwide. Investors wanted out at any price, anything to end the pain. So once again cash and US Treasuries became the destination of choice to weather the epic storm. Foreign investors were dumping their local currencies to buy US dollars, which drove a blisteringly fast USDX rally.

By the time all the dust settled, the USDX had skyrocketed 22.6% in just 4 months. It was easily the biggest and fastest move this index has ever made over such a short span! And with the USDX's history stretching all the way back to 1971, this record rally was no mean feat. This once-in-a-lifetime dollar surge's impact on gold was catastrophic, as you'll see in the next chart.

But for now, realize that the dominating driver of the US dollar once the stock panic started was *the fortunes of the SPX*. Like clockwork on days when the SPX was down big, dollar buying accelerated dramatically. Conversely on days when the SPX rallied big, serious dollar selling would erupt. In fact, over the entire 18-month span of time in this chart, the SPX and USDX had an r-square of 86% based on a negative correlation. 86% of the USDX's daily behavior was statistically explainable by the SPX's!

This opposing influence is readily apparent visually as well. Note above that the USDX was only strong when the SPX was weak. And when the SPX strengthened, the dollar dutifully weakened. Weak stocks drove more flight capital into the dollar for temporary refuge while strong stocks enticed it back out again. If you were watching the SPX and USDX on a minute-by-minute basis during those panic months, this inverse relationship was overwhelmingly obvious.

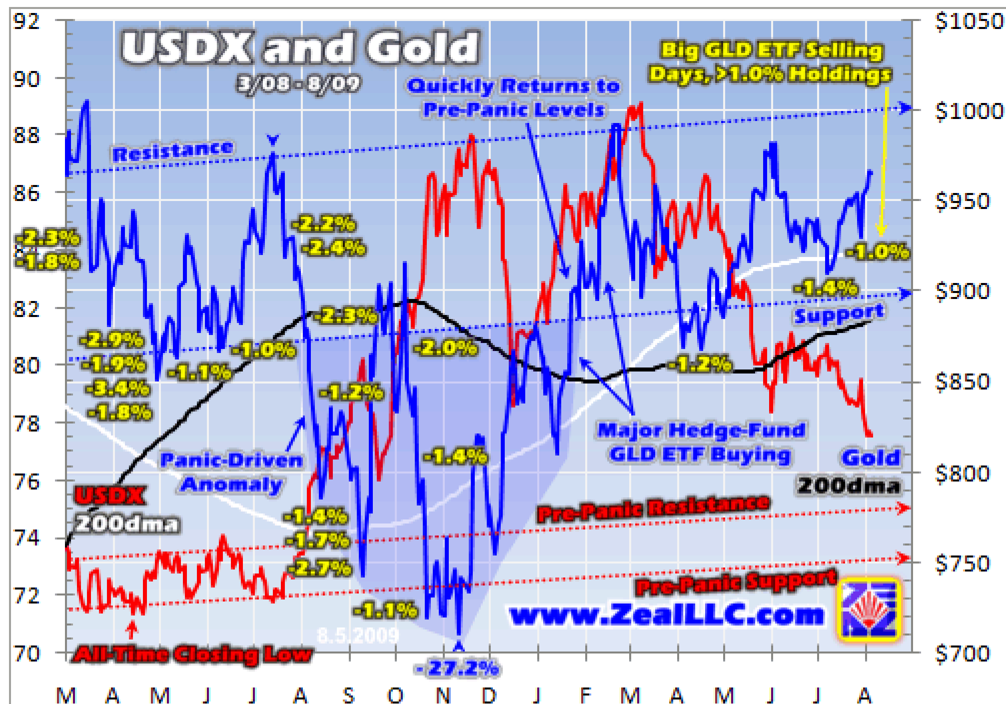
On days when the SPX fell to new panic lows, the USDX surged to new panic highs. In October this happened 5 separate days, a new panic low in the SPX clearly drove corresponding new panic highs in the USDX. And almost all the dollar's other highs occurred on days the SPX was weak but didn't hit new lows. This behavior continued in November, when the USDX hit new highs on the only 2 days the SPX fell to new panic lows. Approaching the secondary March despair low, we saw this phenomenon again on 5 separate days.

The key point here critical for gold traders to understand is that *the only reason* the US dollar rallied so dramatically was because extreme stock-market fears were leading to panic dollar (and Treasury) buying. While the chart above proves this conclusively, if you were actively watching the SPX and USDX in real-time during the panic months you would have reached the same conclusion. The dollar's sharp rally was purely technical, driven by extreme sentiment, and had nothing at all to do with fundamentals.

And even though the stock panic formally ended in mid-December (VXO back under 50), this powerful inverse SPX/USDX relationship continued. After stocks recovered from the despair Washington's crushing socialism created in February, they started rallying sharply in March. The USDX fell in lockstep with the SPX's rise. The only interruption of this trend was the USDX's March 18th 2.9% plunge (third largest down day ever, biggest in 24 years) on the Fed's announcement it was starting to *monetize* long-term US Treasuries. The oversold bounce out of this selloff temporarily let the USDX rise with the SPX.

While this particular strong inverse SPX/USDX relationship should gradually fade as the markets continue to normalize out of the panic, it is still driving the USDX. Note the sharp recent decline in the USDX in July that "just happened" to start right when the SPX started rallying sharply off 880. Everything we've seen since early March strongly suggests that the continuing recovery in stock prices will continue to weigh on the US dollar.

Now that it is crystal clear what drove the USDX during the stock panic, consider the USDX's impact on gold. Gold is the ultimate money, the mortal nemesis of all the fiat-paper currencies worldwide. So when the US dollar rallies, futures traders are often quick to sell gold. The bond panic, then stock panic, drove the mighty USDX rally. And that USDX rally drove heavy gold selling. Ergo, the transitive driver of gold's weakness last year was indeed the stock panic. The SPX is driving gold!



The same USDX span from the first chart is shifted to red in this chart, with gold superimposed in blue. Note that gold was doing quite well on balance last spring and summer before the panic-driven USDX rally ignited. It was consolidating high after a strong rally rapidly carried it from about $650 to $1000 by mid-March. After such a strong move off relatively low levels, consolidating between $850 and $950 was quite impressive.

The day the USDX bottomed in July 2008, just before the bond panic started driving flight capital into US dollars, gold closed at $976. So the range between $925 and $975 was a righteous pre-panic level for gold. Without the bond and stock panics, I suspect gold would have had no problem at all staying in the $900s or at least above its high-consolidation support line rendered here.

Everything below this support line was just a panic-driven anomaly. This blue-shaded area would never have existed without the panics to drive it. Gold did indeed plunge 27% between mid-July and mid-November, which wrought catastrophic damage to sentiment among gold traders. But this move was driven by the biggest dollar rally ever witnessed in a time when futures traders were also terrified and wanted to hold cash instead of commodities futures. Gold's panic selloff matches the dollar rally *perfectly*.

Carefully examine gold's behavior relative to the USDX's between mid-July to mid-November. Without exception, every single sharp selloff in gold was driven by a corresponding sharp rally in the USDX. The only time during this span the dollar retreated, between the bond panic and stock panic in mid-September, gold actually rocketed over 21% higher in just 7 trading days!

Gold's only problem during the panic was the USDX, which was directly driven by the SPX. Incidentally, this should give much comfort to those still concerned that gold didn't soar during the stock panic as most gold investors (including me) expected it should have during an episode of extreme market fear. That fear drove so much capital into US dollars and US Treasuries globally that gold didn't stand a chance of overcoming such an unprecedented headwind.

Since gold's panic weakness was merely technical, driven by the unnatural USDX strength, the moment the USDX topped (*the very day* the SPX bottomed in late November) gold started soaring. On the first day out of the stock-panic low, November 21st, gold's monstrous 7.4% rally actually exceeded the SPX's mighty 6.3% one. By the time this sharp gold recovery finally took a breather in late February, this metal had soared nearly 40% in just over 3 months.

Such a quick return to pre-panic levels underscores the fact that gold's panic weakness was a total anomaly, a cruel yet ultimately irrelevant twist of fate driven by panicky market forces far larger than the gold market. And since that recovery, gold has largely traded back within its pre-panic trend over the last 7 months or so. $925 to $975 was normal before the panic, and now that the panic is gone these same levels are normal again. That's far superior to the SPX's levels this summer compared to last.

The USDX's major influence on gold over the past year has important near-term implications for gold traders. Prior to the bond panic, the USDX was languishing around 72 to 73. Since stocks bottomed in early March, the USDX has been rapidly falling back down towards those pre-panic levels. Because of this trend, I really doubt the USDX will stop near 78 today as Wall Street hopes. *At best*, it will probably continue back down into its pre-panic trend rendered above. Call this 73 or so, a lot lower from here.

But the cold, hard reality is the dollar's fundamentals today are radically worse than they were last summer. The Fed has doubled M0 in a matter of months, the most inflationary event in its entire history. Washington is hellbent on running the biggest deficits the world has ever seen. These panic-driven developments are flooding the world with new dollars at a time when interest rates are far too low to make it an attractive currency.

Large foreign investors see this monumental surge in dollar supply and they worry about the dollar's purchasing power. They want to pare back their still-massively-overweight holdings in US dollars and US Treasuries. So dollar investment demand is falling at the same time dollar supply is exploding. With less demand bidding on far more supply, it's inevitable the US dollar bear is going a lot lower. So odds are the USDX won't stop for long in its pre-panic trend, but grind even lower.

And if gold's behavior relative to the USDX since last summer is any indication, further dollar weakness will be *very* bullish for gold. Despite the bearish sentiment plaguing this metal, it will probably break decisively above the psychologically-important [$1000 level soon]. Gold traders may have got the short end of the stick in the panic, but our gains coming out of it should ultimately make the inconvenience of last autumn look trivial.

In addition to this SPX-driven USDX influence on gold, a secondary mechanism exists for stock markets to influence gold prices today. It is the GLD gold ETF. While it's beyond the scope of this essay to fully develop stock capital's influence on gold via this GLD conduit, I would be remiss in not mentioning it in an essay about the SPX driving gold. GLD is a big and growing player in the gold world, far more important than central-bank gold sales these days.

GLD's mechanics are very important to understand. I've explained them in depth in past essays on [this leading ETF]. This vehicle allows stock capital to easily and quickly slosh into and back out of physical gold. If stock investors buy GLD shares at a faster rate than gold is being bought, this ETF's custodians have to issue more shares to keep GLD from decoupling from the gold price to the upside. They then use these proceeds to buy more physical gold, effectively shunting stock capital into gold bullion.

The power of this force is readily apparent above. Between mid-January and late February, gold rocketed 22% higher in just 5 weeks. It was a crazy-fast move. What drove it? *Heavy* [GLD buying] by an elite hedge fund. As discussed in depth in the 3/09 Zeal Intelligence for our subscribers, this "GLD Rush" forced this ETF to increase its bullion holdings by 238 metric tons (30% growth) in just 5 weeks! It was awesome to see stock-market capital that wouldn't traditionally buy gold coins still bid up gold prices.

But the conduit for stock capital that GLD creates is a double-edged sword. Just as differential GLD buying pressure leads to underlying bullion buying, differential GLD selling pressure leads to bullion selling. If stock investors sell GLD shares at a faster rate than gold itself, GLD's price will threaten to decouple to the downside. This is unacceptable since GLD's mission is to *track* gold. So GLD buys back shares to sop up the excess supply. It funds these purchases by shrinking its holdings, actually selling physical gold.

On the chart above, I overlaid every day over the last 18 months when GLD selling was large. I defined these big GLD selling days as single days when this ETF's custodians were forced to liquidate 1% or more of its entire holdings. The actual percentage liquidated on each day is noted in the chart. The area I want to focus on today is the panic anomaly's impact on the gold price, from mid-July to mid-November.

Over this span, there were 10 separate trading days where stock investors were selling GLD shares so fast that its custodians had to sell 1%+ of their bullion into the marketplace. These individual sales could be very large at times, exceeding 15 tonnes dumped within hours. Stock investors, mainly scared by the bond panic's USDX-driven impact on gold, often sold GLD far faster than gold was falling. Naturally this differential selling pressure, equalized into gold bullion by GLD's custodians, exacerbated gold's selloff.

In the context of this essay on the SPX driving gold, the takeaway is to realize that stock-market capital amplified gold's panic selloff considerably. Significant new capital flowing into any asset usually translates into higher volatility, and GLD opened up gold to vast pools of stock-market capital that never before had easy access. These new stock investors, during the panic selloff, were more scared than traditional gold investors. And they aggressively sold accordingly.

But much more capital returned after the panic than left during it, driving the sharp gold rally between mid-January and late February. As GLD continues to grow in the future, stock investors' impact on gold price fluctuations will grow as well. Personally, I think this is exciting. The more investors and speculators ultimately gaming gold, the higher its secular bull will climb. At a cost of more volatility along the way, of course.

At Zeal, we've been painstakingly studying this gold bull since its humble beginnings in April 2001. We dig deeply because superior understanding leads to more profitable trades for us and our subscribers. Back in late October in the heart of the panic we were advising them on the anomalous nature of the gold selloff. We recommended buying aggressively then. Many of our gold-stock and silver-stock trades made since then are already up 50% to 100%+. Join us, share in the very profitable fruits of our hard work. Subscribe today to our acclaimed monthly newsletter!

The bottom line is the US stock markets have become a major driver of gold over the past year. And this is not the traditional inverse secular relationship, but a positively-correlated tactical one. Intense fear in stocks led to flight capital flooding into the US dollar. The resulting sharp dollar rally hammered gold, causing it to plunge with stocks. And as recovering stocks led to dollar selling, gold rallied with the SPX.

While this peculiar relationship will fade as the stock markets recover from the panic, it still exists today. And with the US dollar likely to at least fall back to its pre-panic levels, this is very bullish for gold over the coming months. Further dollar weakness should help drive gold decisively over $1000 soon for the first time ever. This is exceedingly bullish for the still tiny and overlooked precious-metals-stock sector.

Adam Hamilton, CPA

August 7, 2009

So how can you profit from this information? We publish an acclaimed monthly newsletter, Zeal Intelligence, that details exactly what we are doing in terms of actual stock and options trading based on all the lessons we have learned in our market research. Please consider joining us each month for tactical trading details and more in our premium Zeal Intelligence service at …
www.zealllc.com/subscribe.htm

Questions for Adam? I would be more than happy to address them through my private consulting business. Please visit www.zealllc.com/adam.htm for more information.

Thoughts, comments, or flames? Fire away at zelotes@zealllc.com. Due to my staggering and perpetually increasing e-mail load, I regret that I am not able to respond to comments personally. I will read all messages though and really appreciate your feedback!

Copyright 2000 - 2009 Zeal Research (www.ZealLLC.com)