Structural Logic

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Why the Big Drop in Gold? Understanding What Happens to Financial Markets When New Economic Data Does Not Support Fed Policies

Gold prices plunged $80 or 6.5% in less than two trading sessions on the strong and unexpected indication that the US job market was stabilizing. What was that about? So that prompted an inquiry from a client who asked me on Friday, why the big drop in gold prices? Why indeed. Here I am reminded of two snail jokes.

A snail is at the police station. He's telling the officer on duty about how he was just mugged and robbed. "It was these two turtles!", the snail sobs. "They beat me up and took my money!
"The officer asks, "Did you get a good look at them?"
The snail says, "No! It all happened so fast!"

Same snail, different joke. A farmer hears a knock at his door late one winter's night. He opens his door, looks around and looks down and there, at his doorstep, is a snail. The snail says, "Can I come in, I'm really cooooold?" The Farmer says, "No, get outta here you stupid snail," and kicks him across the garden. Three years later, the farmer hears a knock on his door. He opens the door, looks around and looks down and there on his doorstep is that snail, who says, "What was that about?"

Fact is, as traders and investors we can't afford to be snails for two reasons. First, if things are happening too fast and you do not understand why, as risk managers we owe it to ourselves to get out of harms way so that the markets do not rob us of our capital in the process. Markets tend to be decisive and move fast once they have made up their mind on a particular matter. Risk managers should only put capital at risk when you have identified a high probability trade setup and when you can control your risk exposure. If these two preconditions can not be met, no trade should be taken. Secondly, as risk managers, we don't have three years to figure out why a market reacts, overreacts, or underreacts as it does to an economic announcement. But rest-assured, that when a market underreacts or overreacts to an economic announcement, it is trying to tell you something.

A case in point was is the 6.5% in gold prices on Friday's December 4 2009 jobs report for November. 6% is a considerable swing for any market in just one day. The overreaction caught me by surprise, as it was happening. My surprise was a tell that I did not fully appreciate what market participants were pricing in. It was only as the day wore on, that I began to get it.

Markets run plays like a football playbook and I had seen this play before. During the jobs recovery of 2004, Gold was spooked much like the manner in which it had been spooked on Friday's job stabilization report. On April 2 2004, the BLS reported 353,000 jobs had been created. This was huge news because economists were only expecting 100,000 jobs. Gold prices plunged that day. In two days, gold prices plunged $18 to $414, losing 4.2% of its value in two days.

Gold market participants remained spooked until the May 7 2004 jobs report which also was a huge upside surprise to economists. Another 324,000 jobs had been created, far more than the 185,000 economists were expecting. Gold prices plunged another $16 from the close of Thursday May 6 to the Monday May 10 2004 selling climax low at $371.

All told, the total damage wreaked upon gold prices from the job recovery in the spring of 2004 was a 14% decline from the April 2004 jobs report high to the May 2004 jobs report low. Why such a strong reaction? Simply because market participants feared the jobs recovery would signal the Fed would have to hike

interest rates, and remove the punchbowl from the party. The fear was legitimate enough, even if unfounded under the Greenspan Fed. They didn't call him Easy Al for nothing and he took his sweet old time removing the punchbowl. Greenspan's series of gradual 25 bps rate hikes took two full years to complete his tightening of monetary policy. By the time Greenspan was done raising rates in June 2006, gold prices recovered from their ill-founded fears to $732 by May 12 2006. Essentially, gold prices doubled between its May 10 2004 low at $371 to its $732 May 12 2006 high, when the Greenspan rate hike cycle was completing.

Financial markets are discounting mechanisms. The key point to takeaway from the 14% decline in gold prices in the spring of 2004 is this: market participants were discounting a shift in economic/monetary policies at the Federal reserve towards tightening as a result of the job recovery. They were correct that the jobs recovery would prompt the Fed to tighten, but they had no idea that Greenspan would be slower than a

snail in doing so, even though Easy Al had made clear that rates would remain accommodative "until the slack in labor resources" had been absorbed. Easy Al stuck to his accommodative guns throughout 2004-2005. This gave credibility and added weight to the Fed statement about leaving rates accommodative until the "slack in labor resources" had been absorbed. As the Fed's accommodative stance became more credible, gold prices recovered substantially.

Ben Bernanke is practicing that same accommodative policy as Easy Al for the big banks, but only more so. On Friday December 4 2009, I sent out a short memo to clients addressing the carry trade unwind taking place in the currency and gold markets on November 2009 jobs report indicating that the jobs market had stabilized. The viciousness of the carry trade unwind in these markets on Friday's jobs report signaled that market participants were clearly nervous about this prompting a shift in Fed policies. It was a déjà vu moment for me. Market participants were running the same "market jitters" play as they did in the spring of 2004. A client emailed me back to say "I thought the Fed already has stated that it plans to keep interest rates low throughout 2010."

Yes, I replied, that is the Fed's basic monetary policy for the next 12 months. And most market participants believe that is a credible statement. So, why should market participants in gold and currency carry trades have been nervous at all? Simply because the economic data pointing to the jobs market stabilizing may not entirely support all of the Fed's economic policies. It's not just Fed's monetary policy that is accommodative. It's also that trillion dollars of excess liquidity that they have injected into the insolvent big banks. On that score, the Fed has been much more stringent. They promise us that they have the tools to remove the excess liquidity through "reverse repos" and possibly by issuing their own debt, if push come to shove. Moreover, they are telling market participants that they will remove that excess liquidity when the day comes to remove that liquidity becomes self-evident. The idea is a strong recovery will require a shift in Fed policy to remove that excess liquidity sooner than later. And just last week, the Fed was "testing" its ability to do reverse repos with primary dealers. This is an indication that they might be inclined to suck some of that liquidity out of the big banks.

So, the huge selloff might have been sparked by big banks worrying that their might be a little less liquidity to play with in the not too distant future. Now here is where we must judge and question the Fed's credibility and resolve to remove the excess liquidity on the balance sheets of the big banks. Because the Fed has also reassured us that they would provide as much liquidity to the zombie banks as required to keep them zombified. The stabilization of the jobs report drives a wedge between the two Fed promises to provide as much liquidity to the big banks as required, but also to remove that liquidity quickly and efficiently when conditions warrant.

In short, a stabilization in the jobs market does nothing to improve the balance sheets of zombie banks. An improvement in the big bank balance sheets is the prerequisite which would allow the Fed to mop up the excess liquidity, not am improvement in the jobs market. So, in short, the Gold market has probably overreacted a bit, and may continue to trade lower into the next jobs report. When market participants are reassured that the Fed is in a box and that the excess liquidity must stay in the system for the foreseeable future, gold prices will resume its trend higher and currency carry trades will be put back on.

The Current Gold chart below.

GCA - Gold - Combined, Daily Continuation
O= 11576 Bar
H= 11592
L= 11450
L= 11535
Δ= -153
nfp -1
Dec 3 2009
1226.4
1145
-6.5%
-81
2008 Year High 1034
1054 cg
1030
Oct 29
Spring 2004 correction was
27 days ~ if the spring 04
correlation sticks we should
see gold down into Jan
A 15% gold correction from 1226
targets 1042
13000
12500
12000
11479
11000
10500
10274
10115
10000
9500
9000
8500
Feb Mar Apr May Jun Jul Aug Sep Oct Nov Dec 2010 Feb