HUI and Stock Selloffs

Adam Hamilton February 16, 2007 4000 Words

Whenever two contrarians meet to discuss the financial markets, odds are three opinions are going to emerge about what is coming next. Yet within this cacophony of ideas there are a couple strategic trends that command nearly unanimous support among the contrarian community today, the gold bull and the stock bear.

Gold is powering higher in a secular bull market because its fundamentals are outstanding. Global gold investment demand is growing relentlessly, particularly out of the rapidly industrializing Asian nations. But gold mined supply, with new-mine lead times running up to a decade, just cannot keep pace. Rising prices are the only economic option when demand is growing while supplies are constrained.

And the general US stock markets almost certainly remain mired in a secular bear despite the cyclical bull we've seen over the last four years. Such secular bears tend to last seventeen years or so in history, but ours only started in 2000 so it is almost certainly not over yet. And it is totally normal and expected for powerful cyclical bulls to erupt in the midst of these long secular bears to keep hope alive and seduce the bulls into complacency ahead of the next brutal downleg.

With these gold-bull and stock-bear theses incredibly well fleshed out and virtually unassailable, holding both of these views together creates plenty of psychological angst for contrarians. The great majority of physical gold investors eventually end up migrating a sizable portion of their investment and speculation portfolios into gold stocks as well. And here lies the problem. When the next major stock selloff hits, will gold stocks get sucked down in the bearish maelstrom?

Interestingly this is not a new concern by any means. I remember contrarians agonizing over this very issue endlessly in 2001 and 2002 during the wicked bear market following the 2000 stock-market tops. But today since the stock markets have now been strong for so long, and because sentiment indicators like the VIX are nearing all-time lows betraying extreme complacency, this issue is becoming particularly poignant again.

I analyzed the hard statistical relationship between the HUI unhedged gold-stock index and the flagship S&P 500 general-stock index a couple years ago. In those studies I found that there is no long-term correlation between gold stocks and general stocks, definitely a good thing for contrarians owning gold stocks but fearing a general-stock selloff.

Yet despite no meaningful mathematical relationship, we have all seen days where gold stocks seem to rise with a strong stock market or fall with a weak stock market. In the charts section of our website exclusively for our subscribers, we have a General Markets Overview webpage. It has real-time intraday charts of the major stock indexes, major commodities-stock indexes, the precious metals, and sentiment proxies all on one page for easy comparison. I keep this webpage open all day every day to deepen my understanding of any interrelationships.

Although I know intellectually from my research that gold stocks will eventually follow gold, their only real long-term driver, I can't count the number of days the stock markets have apparently influenced the HUI. For example, gold can be up and the HUI is rising with it, but then in the middle of the day some event like a Fed comment will hit the wires and the general stock markets will tank. Even when gold remains strong, the HUI can sell off with the S&P 500.

Events like this, while short term in nature, really spark fears among contrarians that gold stocks are going to get the stuffing beaten out of them when the next real general-stock downleg emerges. I certainly share in these fears when I see the HUI temporarily decouple from gold and follow after the stock markets like a lost puppy. And I know from my e-mail inbox that our subscribers are concerned about this as well.

Unfortunately I don't have a definitive answer on whether or not the HUI will follow the stock markets down. *Anything* can happen in the markets at *any time*, they are ultimately just a probabilities game. As mere mortals, neither you nor I can see the future. So if you want ironclad assurance that the HUI is not going to plunge when

stocks start their next death spiral, you are never going to get it. We contrarians will always face this risk and we will never be able to fully break free from its psychological shackles.

But we *can* study the past and gain an idea of the probabilities in play. Based on past HUI performance in this bull during stock selloffs, is it likely to get crushed when the next stock selloff inevitably hits? If the HUI has been strong during past major selloffs in the stock markets since 2000, then we should have a good chance it will continue its defiant behavior during the next selloff.

This first chart shows the entire history of this secular gold-stock bull and secular general-stock bear. In cyclical terms, or the shorter multi-year cycles found within bigger nearly-multi-decade trends, the S&P 500 has been in both a wicked cyclical bear and a powerful cyclical bull. So we couldn't ask for a better environment in which to analyze the HUI since we've seen the best (or worst) of both stock worlds since 2000.

In strict technical terms, the S&P 500 cyclical bear that lopped a massive 49% off of this flagship index's value in less than three years ended in early October 2002. But technicals only *measure* bears' progress, it is *sentiment* that drives the bears in the first place. From October 2002 to March 2003 general-stock sentiment remained very poor in an environment plagued by concerns over Washington's coming invasion of Iraq.

Stocks nearly eclipsed their October lows in early March 2003 in the week leading up to the war. But once the bombs started flying and armor started rolling and the markets realized their worst fears would not be realized, sentiment turned on a dime. The day the war started the stock markets soared and their cyclical bull we've seen for the past four years launched. So in pure sentiment terms, I believe the March lows are where the cyclical bear ended and the cyclical bull began.

In grand-picture terms, the S&P 500 bled 49% during its cyclical bear and gained 82% in its subsequent cyclical bull. On a sidenote, the S&P 500 has *still* not recovered to its pre-bear high yet despite this asymmetrical loss and gain. After a big decline it takes far larger gains just to claw back to even, which is probably why the great Warren Buffett says the most important rule for investing is "never lose money".

In light of the S&P 500's gargantuan $13t market capitalization which gives it the inertia of an oil supertanker, it is hard to imagine a wilder ride for the US stock markets than what we've seen since 2000. It would be really hard, and a vanishingly low probability event, for whatever the next downleg looks like to somehow put what we saw in 2001 and 2002 to shame. Thus I could not imagine a more volatile general-stock environment over which to analyze gold stocks.

And you know what, overall the HUI's behavior in the midst of this tremendous general-stock turbulence has been

downright awesome. From its November 2000 secular low to its latest May 2006 interim top, the HUI is up a staggering 996%! Meanwhile the S&P 500, from its March 2000 secular top to its latest interim high this week, is actually *down* nearly 5%. Which would you rather have for risking your hard-earned capital for seven years? A 996% gain or a 5% loss?

And over these seven years, the HUI has had three massive uplegs that are numbered above. The first and largest, an incredible 145% gain in about six months, actually happened *during* the most brutal downleg in the general stock markets! The second 125% one over eight months happened early on in the stock cyclical bull while the third 137% specimen over twelve months ended last May.

So strategically are the general-stock-market fortunes affecting the gold stocks? Not so you'd notice! The HUI's overall bull-to-date performance has been outstanding as the gold stocks soared higher with gold on balance. This happened during *both* the cyclical-bear and cyclical-bull phases in general stocks. Thus the general stock markets' performance is obviously not the strategic driver of the gold-stock bull.

If this behavior established over seven wild stock-market years continues, then we contrarians have nothing to fear from the general stock markets. Let them halve or let them double, it makes no difference. All that matters for gold stocks over the long run is the price of gold. And fundamentally gold's bull ought to continue powering higher for another decade or so, which has to be the perfect omen for gold stocks.

Despite this strategic comfort, we've all seen those days when the HUI forsakes its first love of gold and starts chasing after the stock markets like an adulterous lover. When the next major bear downleg in the stock markets erupts, will the HUI have the strength to remain faithful to gold? Will HUI investors hold tough or panic and join the surge for the exits? Our best chance of understanding the odds here lies back in studying the last cyclical bear from 2000 to 2002.

Although the romance of the concept of crashes dominates contrarians' psyches, the truth is outright crashes are exceedingly rare. True crashes, say a 20% decline in the stock markets in no more than a week, virtually always happen only *right after* major secular tops. Years into a secular bear, as we are today, the threat is not crashes but long prolonged downlegs, selling lasting months on end that gradually decimates the markets. This "slow" approach gradually boils the bulls in water like frogs before they know what ate them for lunch.

The brutal bear market from 2000 to 2002 that lopped-off half the value of the best and biggest American companies took this gradual approach. It was largely steady selling, driving down prices on balance. But several times during this period, steep downlegs emerged where prices started plummeting much faster than usual. These devastated psychology, but they were followed by sharp V-bounces and bear rallies that restored hope to

the bulls and kept them in the warming boiling pot.

Note above that during the relentless yet gradual selling between major downlegs the HUI did just fine. It rose on balance in Q4'00 and Q1'01, was flat in mid-2001, and rose in early 2002. Thus during the last cyclical bear the HUI had no problem at all rising when general stocks were selling off day after day. Without panic-type conditions that only fast and aggressive downlegs can spawn, falling stocks aren't a threat to the HUI.

And surprisingly the actual steep downlegs were not as dangerous to gold-stock investor psychology as most people want to believe today. The three most dangerous plunges of the last bear happened in Q1'01, Q3'01, and Q2'02. If you are wondering how the HUI is likely going to weather a steep downleg in the US stock markets today, carefully examine these three quarters. The HUI was typically incredibly resilient until the very end of these plunges.

During the first steep downleg in Q1'01, the HUI actually completed an impressive 113% upleg! From late January to early April, the S&P 500 plunged by 20% in its first truly horrifying downleg of its bear. Over an identical period of time to the day, the HUI actually *rose* by over 8%! But over the first two-thirds of this plunge, the HUI actually rallied 22%. It wasn't until the latter third when some general selling bled into gold stocks. So the HUI was immune to this particular downleg until its terminal stage. This is certainly *not* the stuff of nightmares.

After that the HUI did rally along with the V-bounce in general stocks following their April 2001 low. But while stocks soon topped again and started grinding relentlessly lower, the HUI held strong in a high sideways consolidation in the summer of 2001. The next brutal downleg in the S&P 500 started and ended in Q3'01. This one caused much wailing and gnashing of teeth among the stock-market bulls, it really temporarily ripped their bullish sentiment to shreds.

From mid-July to late September, the S&P 500 plummeted 21%. As you can see in this chart, it was an incredibly fast and vicious decline. If ever there was a time when gold-stock investors should have been panicking as wildfires raged in general stocks all around them, this was it. Yet over this identical period of time to the very day, the HUI actually *rallied* 14%!

This is an interesting example as it illustrates a dynamic that has largely been forgotten today. When general stocks are freefalling, investors seek refuge. Of course gold, the only stable investment throughout all six millennia of human history, comes to mind first. Physical gold is bought but so are gold stocks. So sharp panics don't always scare gold-stock investors into selling like sheep, sometimes they scare general-stock investors into *buying* gold stocks. Even the sharpest downlegs can have a positive impact on the HUI.

The final exhibit here is the long Q2'02 stock downleg. It was slower, starting in March and ending in July, but devastating in depth with a 32% decline. How did the HUI do overall? From identical start and end points it was up 24% during this 32% stock-market plunge! Yet even this doesn't tell the whole story. During the initial two-thirds or so of this stock downleg, the HUI soared 73% while the S&P 500 fell 11%. Then after topping in early June 2002 at the end of its first massive 145% upleg, the HUI entered correction mode.

No bull market climbs in a straight line. Prices rise then soar to very overbought levels and greed abounds, so a correction down or consolidation sideways is necessary to rebalance sentiment. Initially the HUI largely consolidated, it was only down 5% over the first six weeks after its early June interim high. Over this same period of time, the S&P 500 fell 12%. But the next twelve trading days, from July 10th to July 26th, are probably the most misunderstood of this entire bear for the HUI/SPX relationship.

The HUI essentially crashed in the latter half of July 2002, plunging 32% in just twelve trading days! On the chart above it looks like this HUI crash was sympathetic to the general stock markets, and it was to some extent. But over those same twelve days where the HUI surrendered a third of its value, the S&P 500 only lost another 7%. Yes there was a sharp and terminal move lower in general stocks, but the HUI correction that had been ignored for too long came roaring back with a vengeance far exceeding any stock-market leading.

So the case can be made that the terminal stage of the sharp July 2002 plunge in the stock markets hit the HUI, but I think this link is tenuous at best. And if this argument is advanced, the worst form it can take is that the HUI could succumb to a general panic near the final third of a steep downleg, the terminal stage right before the V-bounce. Ever the speculator, I see this not as a threat but as *an opportunity*. It means that when general

stocks are due to V-bounce and the VIX is super high, it is probably a great time to add gold-stock positions too.

But other than this erratic and not-always-seen terminal-stage influence, steep stock downlegs really don't seem to bother the HUI at all. Over the three massive downlegs discussed here, the S&P 500 lost an average of 24%. Yet over these exact same times to the very day, meaning I am not considering the HUI's own rhythms to its own advantage here, the HUI averaged 15% *gains!* So it really doesn't seem like steep bear downlegs ought to frighten us, and they are the biggest psychological threat within any bear.

Moreover, during the seventeen-year secular bears that follow seventeen-year secular bulls in stocks, the first cyclical bear of the secular bear is usually the most volatile and violent. While we could certainly see another 50% decline in the S&P 500 by the end of its next cyclical bear just as happened in the midst of the last great bear in 1973 and 1974, odds are it will be a *relentless gradual decline* over two years or so and not a series of sharp downlegs. History tends to show that downleg volatility abates considerably as a great bear matures, which makes sense because valuation extremes moderate throughout the long bear.

If downlegs get less steep and volatile as cyclical-bear declines become more balanced over time, then we probably won't see anything as bad as 2001 and 2002 again in this secular bear. And the HUI really thrived, generally totally ignoring the stock markets when they were just gradually selling off on balance like they ought to in the future. Once again while I don't know the future, I think the odds definitely favor the HUI doing just fine during the next cyclical stock bear.

And while we are looking at HUI performance relative to general stocks, I figured we may as well take a look at the cyclical bull since 2003 as well. In this chart and the previous one, I drew in little arrowheads to show relevant areas of HUI and SPX movement. The key here is that the HUI can move up, down, or sideways while the S&P 500 *independently* moves up, down, or sideways. Both gold stocks and general stocks march to the beats of their own drummers and sometimes these beats are synchronized but often not.

The biggest surge in the S&P 500's cyclical bull happened in early 2003 after the Iraq invasion failed to spawn the worst military, economic, political, and environmental disasters feared. The HUI rallied right alongside the general stocks. It is crucial to realize though that gold was rallying to new bull highs over this same period in 2003, so odds are the HUI was just following its primary driver and not the general stocks.

In Q2'04 the HUI corrected sharply while the S&P 500 just meandered sideways in a consolidation. Here we had a relatively sharp selloff in the HUI, again because of a gold correction, that had nothing at all to do with the stock markets. Just as the HUI can rally just fine on its own regardless of stock action, it can also fall just fine on its own too and doesn't need the stock markets' help to push it off a cliff.

We saw another example of this between Q4'04 and Q2'05. The HUI entered a long and difficult correction psychologically and ground lower on balance. Yet during this time the stock markets continued marching higher on balance in their increasingly well-defined cyclical-bull uptrend. The HUI's actual interim low in May 2005 happened about a month *after* the nearest S&P 500 interim low, there is no correlation at all.

Then from Q2'05 to Q2'06 the HUI commenced an utterly massive upleg, the third of its bull, and soared 137% higher. Over this same period of time, the S&P 500 rallied too but quite modestly. It only managed a 13% gain. Since its May 2006 interim high the HUI corrected sharply and general stocks corrected modestly, the HUI then consolidated sideways while stocks rallied, then the HUI fell while stocks continued rallying, and then the HUI started rising again while stocks still rallied. Stocks aren't driving the HUI!

The moral of the story here from my perspective is yes, the HUI and S&P 500 had more of a correlation since 2003 in a strategic sense but *they should have* since they were both in bull markets. When two markets are moving up on balance, even when driven by different drivers, they are going to have far more in common than when one is moving up and the other down. But tactically the HUI and S&P 500 relationship was all over the place with no clear predominating condition.

Since 2003 the S&P 500 has rallied 82%, certainly a very impressive move by anyone's standards. Yet this is *typical* in a cyclical bull in the midst of a secular bear. Meanwhile the HUI rallied 245% since 2003 in its own parallel bull. Once again gold stocks as a sector utterly annihilated the large-caps' performance even when the latter were in their most powerful and persistent bull market in years.

In light of all this, as a gold-stock investor and speculator I am going to spend my time worrying about gold, not general stocks. Yes general stocks are overdue for another cyclical bear, and yes the HUI can sometimes get sucked into terminal-stage downleg panics to some extent. But overall the HUI's performance even through these brief sentiment storms has been stellar. The HUI rallied through *all* of the steepest downlegs during the last bear market in general stocks.

And there are two other important factors for contrarians to keep in mind when this concern arises. First, as happened in 2001 during the steepest and sharpest downleg of that bear, a general-stock panic not only scares contrarians but it scares mainstreamers into *buying* gold stocks as a position of refuge. So there is always a pretty good chance that any future sharp downleg in general stocks would actually fuel *additional* gold-stock demand and lead to a rising HUI on the safe-haven play.

Second, gold stocks are vastly better positioned to rally today than they were in 2001 and 2002. Back then virtually no one knew about gold stocks, gold's own bull was young and unproven, and gold-stock valuations were obscenely high. Today contrarians are telling mainstream friends about our massive gains in gold stocks and spreading the word. Today even the most jaded Wall Streeter is forced to acknowledge gold is in a bull market, and CNBC even talks about gold now which it barely ever did in 2001 and 2002. And today gold-stock valuations are far lower and getting more reasonable all the time.

With more awareness and more investors likely to buy gold itself during trying stock-market times, I suspect our odds are rising that a steep stock-market selloff will end up being *bullish* for gold stocks. Of course gold is their ultimate driver, but a panic shocking mainstreamers into deploying into gold stocks sure can't hurt temporarily. It will just add to the large gains we contrarians continue to earn in this tiny and neglected sector.

At Zeal we've been aggressively buying elite high-potential gold stocks since gold's latest October lows and we've done quite well. I still believe we are early on in a major upleg and expect a big move in gold stocks soon, which have been lagging gold considerably in 2007. If you want to ride this next upleg to big potential gains in elite hand-picked stocks, please subscribe today to our acclaimed monthly newsletter.

The bottom line is the HUI has thrived on balance since the 2000 stock-market tops *regardless* of general-stock activity. While the HUI and S&P 500 are not correlated overall, there are times when they do move in parallel. Interestingly the biggest risk to the HUI does not occur until the latter third or so of steep downlegs, and the sometimes resulting minor plunge in the HUI creates great buying opportunities.

Contrarians need to remember that it is *gold* that drives gold stocks. It is not the stock markets, not interest rates, not real estate, not geopolitics, not the Fed, and not CNBC. As long as gold's secular bull remains intact

fundamentally, gold-stock investors have nothing to fear. We have already weathered some utterly brutal stock selloffs and I have no doubt we'll fare just fine on balance through the next one.

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