Gold Stocks Bull Market Rebirth

Gold stocks are actually enjoying a great month, a stark contrast to this year's brutal death spiral lower. But after catapulting up by more than a quarter in less than a month, investors are wondering what to do next. Is it time to cut losses before the catastrophic plunge resumes, or double down on the birth of a major new upleg? With this sector still wildly oversold and absurdly undervalued, I'm betting on the latter.

Traders viscerally despise precious-metals miners and explorers these days, for good reason. Year-to-date as of late June, the flagship HUI gold-stock index had plunged an astounding 53.4%! This was against a backdrop of stellar general-stock performance, where the benchmark S&P 500 surged 12.4%. Even gold's rotten year to that point, -26.7%, was great compared to the excruciating gold-stock carnage.

With a horrendous track record like that, many investors wonder why anyone would even risk a penny in this sector. The answer is simple, past performance. Over a 10.8-year span ending in September 2011, the HUI skyrocketed an astonishing 1664.4% higher! Vast fortunes were won in the last decade's greatest bull run, during a secular bear in general stocks no less. Over that span the S&P 500 actually fell 14.2%.

There's understandably not many gold-stock bulls left after this year's cataclysmic purge, but a stubborn remnant of battle-hardened contrarians remain. We are bullish on gold stocks because we are bullish on gold. Gold stocks were abandoned this year because traders believed gold's secular bull had died. But if it hasn't, and gold resumes powering higher, gold stocks must be bid up radically to reflect this reality.

I've studied and written about gold's wildly unprecedented 2013 selloff a great deal. It was largely driven by two factors, forced liquidations among highly-leveraged futures traders and a capital rotation out of the huge GLD gold ETF into general stocks. But these two sources of outsized gold supply flooding the market are inherently unsustainable. They have burned themselves out and are already starting to reverse.

The dominating gold-futures market is extremely out of balance, with speculators' long contracts nearing stock-panic lows and their short contracts around wildly-outlying record highs. This is going to ignite a monster gold short squeeze as traders buy gold futures to unwind these anomalies. And once gold's new upleg convinces money managers it is righteous, they will flood back into GLD to ride gold's recovery.

And if gold is heading higher again, the gold stocks are due for the biggest upleg of their entire secular bull. Just a month ago, sentiment was so apocalyptic for gold stocks that traders hammered them to HUI levels first seen nearly a decade earlier in September

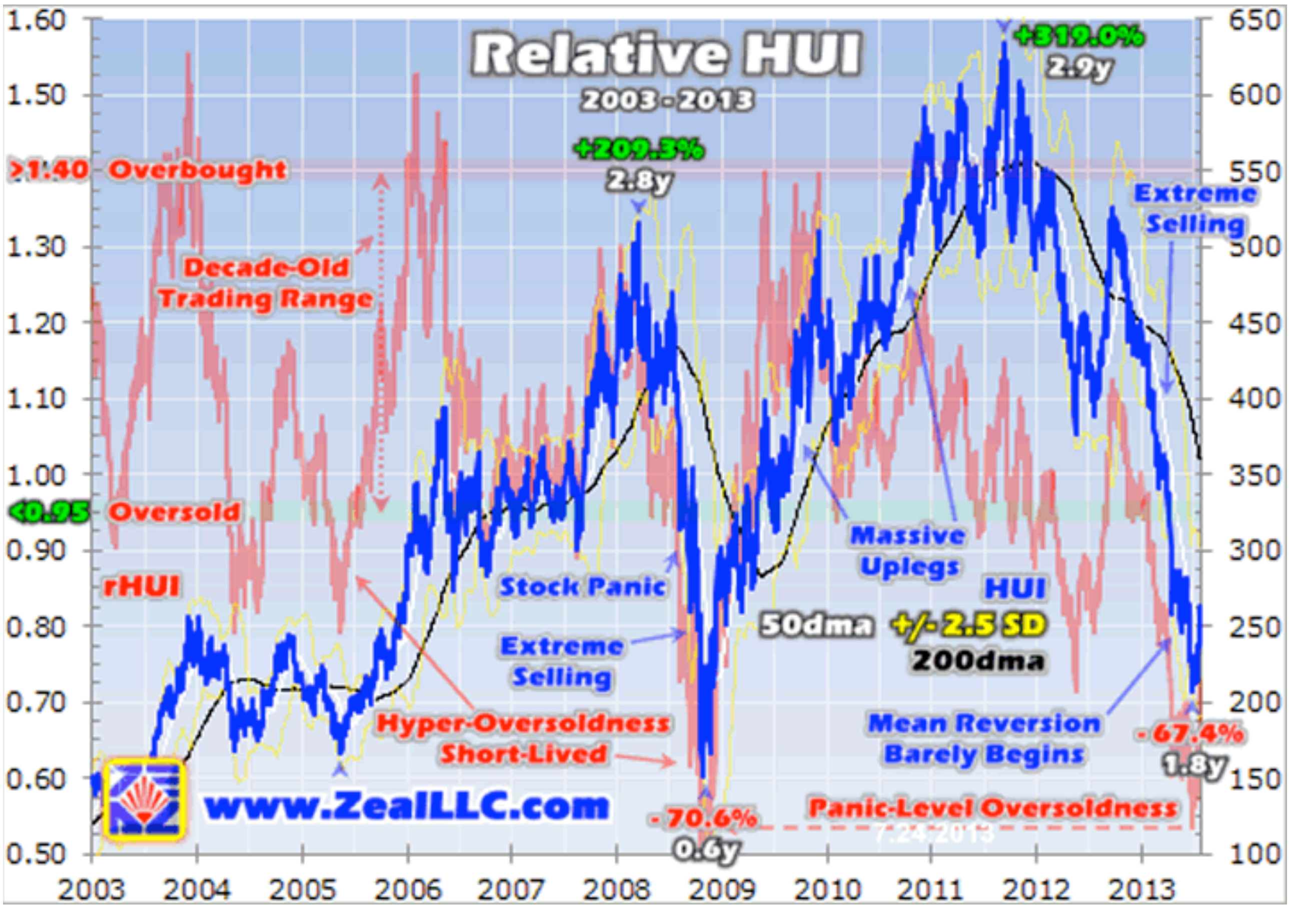
2003. But back then gold and silver were merely around \$390 and \$5.25. So seeing these same gold-stock levels with gold over 3x higher was absurd!

Traders were betting gold would keep on plunging indefinitely, and gold stocks were priced accordingly. But as gold recovers from 2013's unsustainable selling anomaly, this whole sector will have to be dramatically repriced. That's why we're in store for a breathtaking renaissance in gold stocks, a rebirth to a new golden age. And the 26.9% HUI gains over the past month or so are merely the tip of the iceberg.

Mean reversions are one of the most powerful forces in all the markets, and I've never seen a sector more overdue for a bigger one than gold stocks. When historical relationships that defined an entire secular bull are temporarily knocked seriously out of whack, they inevitably bounce back and overshoot as long as the underlying secular bull remains in force. So as gold recovers, the gold stocks are going to soar.

There are two powerful mean-reversion dynamics that are going to force gold stocks dramatically higher in the coming years, technical oversoldness and fundamental undervaluation. The former is detailed in this first chart, which shows the leading gold-stock index over the past decade or so. It is superimposed on top of a simple yet powerfully-effective technical indicator I created many years ago called RELATIVITY

Relativity measures oversoldness (the time to buy low) and overboughtness (the time to sell high). These conditions arise when a price has moved too far too fast to be sustainable based on its own historic precedent. The indicator simply divides a price by its trailing 200-day moving average, resulting in a multiple that forms a horizontal trading range over time. The HUI's oversoldness remains near records.



Blasting up over a quarter in less than a month sounds like a big rally, and it is. But this nascent bounce has still barely even made a dent in the HUI's staggering year-to-date losses. You wouldn't even notice it on the far right of this chart if I hadn't pointed it out, it is utterly trivial in context. So on a pure technical basis, the gold stocks still have vast room to surge higher to mean revert back up to their historical norms.

In late June the HUI was battered to just 0.535x its 200dma. Normal oversold levels for this index over the past decade are way up at 0.95x its 200dma, so this was a stupendous anomaly. The only other time such extreme oversoldness was witnessed was during 2008's once-in-a-century stock panic. That was the last time traders truly believed gold's secular bull was ending, so they raced to flee from sinking gold stocks.

With the greatest general fear we'll see in our lifetimes gripping the stock markets back then, the HUI was hammered to far-more-oversold levels than this past month's. At worst in October 2008, this index was crushed to 0.382x its 200dma! But out of extreme oversoldness, extreme uplegs are born. When selling waxes that intense, everyone susceptible to being scared into selling is sucked in which leaves only buyers.

Indeed over the subsequent several years, the HUI more than quadrupled to dazzling new all-time record highs. And the smaller elite gold and silver miners and explorers we trade multiplied the gains in the major gold stocks that dominate the HUI. The brave contrarians who bought during and shortly after 2008's crazy stock-panic selling anomaly, including us and our subscribers, subsequently won fortunes.

Even more interesting in light of today's extreme gold-stock anomaly was the blinding speed of that initial upleg. Mean reversions out of one extreme nearly always overshoot to the opposite one. The farther you pull a pendulum to one side before releasing it, the farther it swings to the other side of its arc before stabilizing. Just 7 months after the HUI's hyper-oversold October 2008 low, it had rocketed back up to overboughtness.

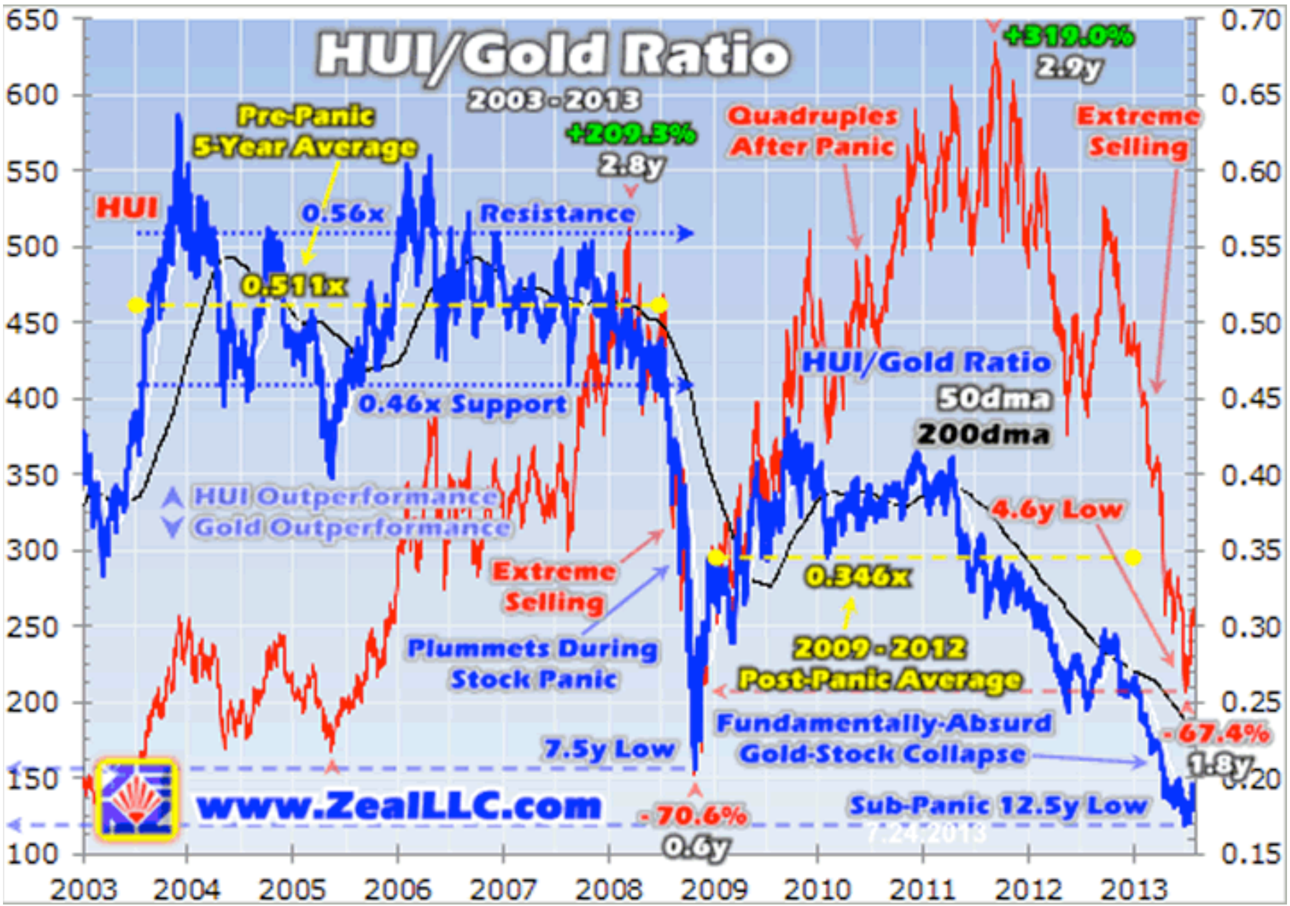
That metric has been 1.40x the HUI's 200dma historically, as you can see in this chart. Any time the HUI exceeded that level, it had advanced too far too fast. Thus it was due for a healthy correction to rebalance away the excessively-greedy sentiment that always prevails at major toppings. This precedent suggests the HUI could again rebound to overbought levels around rHUI 1.40x easily within the next year or so.

This is really stunning and highlights the sheer magnitude of gold stocks' anomalous 2013 selloff. Today the HUI's 200dma is near 360, or 44% higher from this week's levels. Add 40% on top of that, and we are talking about a 504 HUI in relatively short order. That is a doubling from here merely from a normal technical mean reversion out of exceedingly-oversold levels. The gold stocks' rebirth is going to be big.

Some traders argue that with the HUI down 67.4% since its September 2011 high, the secular gold-stock bull has to be dead. No bull can weather such a catastrophic loss. But gold stocks have always been an exceptionally-volatile sector unlike any other. Back in 2008 thanks to that stock panic, the HUI plummeted a similar 70.6%. Yet it still more than quadrupled to new bull highs over the subsequent years.

Secular commodities bulls don't end when technical milestones are breached, they end when global supply-and-demand fundamentals no longer support them. And gold drives gold-mining profits, and profits ultimately drive stock prices universally in the markets. So as long as global gold demand growth exceeds supply growth on balance, gold is heading higher and the gold stocks will follow. It's that simple.

The second mean-reversion dynamic that is going to catapult gold stocks higher after technical oversoldness is fundamental undervaluation. This is best expressed through the HUI/Gold Ratio, the daily close of the HUI divided by the daily close of gold. Charted over time, this shows when the gold stocks are relatively expensive or relatively cheap compared to the dominant driver of their profits and hence stock prices.



In late June when gold stocks hit their nadir, the HGR fell to 0.169x. The HUI close was just over a sixth of the gold close. Of course any ratio means nothing without context, and the past decade of gold-stock price action provides plenty of it. HGR levels have historically been somewhere between much to far higher for gold's entire secular bull. So a massive mean reversion is overdue in the HGR as well.

Before 2008's epic stock panic shattered all kinds of longstanding market relationships, the HGR averaged 0.511x over a 5-year secular span. Assuming that gold never rallies again, at this week's gold levels a 0.511x HGR implies the HUI at 675. That's a staggering 170% higher from where the HUI traded mid-week. And as gold continues rallying, first on futures-speculator short covering and later on general investment demand flooding back, this target rises accordingly.

But you sure don't have to agree on pre-panic HGR levels returning. The HUI plummeted far faster than gold during the stock panic, and the resulting psychological shock broke countless pre-panic gold-stock investors. They gave up and will never return, too scarred from that once-in-a-century event. Incidentally it crushed the HGR to 0.207x at worst, a 7.5-year low. June 2013's extreme was far worse.

After the stock panic's higher extreme-low HGR, this ratio rebounded dramatically and overshot as the HUI recovered far faster than gold. This is how mean reversions usually work, which is why they are so darned fun and profitable to trade. In less than 11 months after the stock-panic lows, the HGR soared to 0.437x as the HUI leveraged gold's gains. Assuming flat gold, a similar run today would mean a 131% rally.

But again keying off a mean-reversion overshoot may seem too aggressive. So let's consider a far-more conservative one, the entire post-panic average HGR before 2013's radically unprecedented gold-selling anomaly. Between 2009 and 2012, the HGR averaged 0.346x. There is absolutely no doubt in my mind that the HUI will return to this modest level, it is one of the surest bets I've ever seen in my entire life.

Just hitting 0.346x at current gold levels, with no overshoot, would put the HUI at 457. That's still 83% higher than today! And lest you worry 450 is unattainably high, which it sure feels like, that was actually where the HUI began 2013 before this year's extreme selling anomaly. Traders have come to accept June's gold-stock levels as normal and righteous, but they are anything but. They were an unsustainable extreme.

But these assumptions are way too conservative for a mean reversion, which will definitely overshoot to the upside after the HGR just plummeted to 12.5-year lows. The HUI has never been lower relative to the metal that drives gold-stock profits in this entire secular gold bull! And the idea that gold will remain flat is silly given futures speculators' record short positions that helped drag it down. These have to be covered.

The only way to do that is by buying back the vast quantities of gold effectively borrowed and sold in the futures market. This buying will drive a monster gold rally. The unwinding of these shorts will certainly at least push gold back up to the levels it entered 2013 at, near $1675. Plug in the 0.346x post-panic-average HGR to that gold price, and you get a 580 HUI target. That's 132% higher than current levels!

Add in the inevitable mean-reversion overshoots in both gold and the HUI, and pick smaller high-potential fundamentally-awesome gold and silver stocks that amplify the HUI's gains, and you can see why this battered sector looks so exceedingly bullish today. The unwinding of price extremes, especially when they are downside ones driven by unsustainable fear and despair, is truly a wonder to behold.

That's why gold stocks are about to be reborn, arising like phoenixes out of the ashes. Both technically and fundamentally, gold stocks were hammered down to levels far too extreme to be sustained. Investors and speculators were selling them on the premise that gold's secular bull had given up its ghost so the metal was doomed to spiral far lower still. But as July is already proving, that thesis simply wasn't correct.

Hyper-oversold sectors subsequently rally dramatically as prices mean revert. The same is true with wildly undervalued sectors fundamentally. And with both mean-reversion dynamics converging in the hated gold stocks, their price-appreciation potential in the coming months and years is epic. As long as gold's secular bull is alive and well, gold stocks are just beginning their biggest upleg of this entire bull.

Six months from now, you won't have to be a contrarian to ride it. Traders will have finally seen with their own eyes how far and fast gold stocks climbed, how thoroughly their renaissance obliterated late June's despairing psychology. But the price of waiting will be forgoing huge gains, probably on the order of a double from here. Real contrarians are far better off buying now, before the rest of the traders figure this out.

The bottom line is gold stocks are being reborn out of the ashes of this year's wildly anomalous selloff. With gold itself recovering and due to head much higher in its own mean reversion, it is literally impossible for gold stocks to remain excessively low. They are overdue for a massive mean reversion higher of their own out of hyper-oversold and radically-undervalued extremes. It's going to be huge.

In late June gold stocks traded at levels first seen a decade ago when gold was only a third as high. They hadn't been that oversold since 2008's once-in-a-century stock panic, after which they more than quadrupled. And relative to gold, they'd never been lower and more undervalued. These extreme anomalies couldn't last and are already unwinding. The mean reversion out should be this bull's biggest gold-stock upleg.