

BEWARE: THE EYE OF THE STORM

Today I want to briefly discuss the typical corrective patterns which occur during major market sell offs. By my reckoning we have had three, including this present one, over the last 10 years. These events can be likened to a Hurricane or, as we call them here in Australia, Cyclones. As the storm approaches you get the initial blast which lasts until the eye passes over. The eye sees a temporary reprieve. Unsuspecting people may mistakenly see this as an end to the storm. Once the eye passes, the storm continues its ferocity before moving on.

Corrective phases in markets similarly look to occur in three distinct waves. You get the initial wave of selling before a temporary reprieve, followed by a continuation which ends with a deeply oversold market. The following weekly chart looks at the Dow Jones Index (bottom section), a 14 week RSI (middle section) and finally the XAU (top section). I have circled the three major corrective market events.

DOW JONES INDEX VS XAU



The first thing to note is the initial break down or the commencement of the first wave lower. The first wave usually ends with the RSI at least breaching 30. At this point we get a sharp wave two rally (green circles). These bounces are usually pronounced enough to attract some nervous money back from the sidelines. It is my opinion we are currently at this point. As people get a sense that the European Debt Crises (EDC) is slowly being averted, unsuspecting money is being lured back into the markets (like the eye of the storm). This however will more than likely be a temporary reprieve as people come to realize the EDC has much longer to play out. At any moment we could see an abrupt end to the present rally and the commencement of the third wave lower.

As precious metals investors we tend to be more concerned about the XAU. The top section of the chart shows precious metals shares are rarely immune to severe market shocks. If this third wave lower plays out, I would expect precious metals shares to also correct sharply. In past events, a good entry level for gold stocks has typically been when the 25 RSI level is breached for the Dow Jones Index (confirming the third wave). Gold shares (XAU) usually bottom before the mainstream markets (the Dow Jones). I suspect the main reason for this is the gold price tends to bounce back quickly after the initial bout of “flight to liquidity” selling. The gold shares correct harder than most due to the perceived risk associated with the sector. This presents wonderful buying opportunities which are quickly snapped up, marking the commencement of the next sustainable rally (green vertical lines).

Technical Analysis is far from a perfect science, which is why I always lean towards keeping core positions in what I consider to be quality precious metals companies irrespective of market conditions. I trade in and out of non-core holdings and have recently started closing some of these positions, battening down the hatches so to speak, as the dangerous eye wall approaches!

If you are interested in investing in the gold mining sector and want to equip yourself with the best and most affordable fundamental information, I encourage you to visit www.goldnerds.com. Alternatively, if you want access to my free precious metals newsletter you can sign up at www.globalspeculator.com.au

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