A NEW ANALYSIS DEFINES LIKELY FUTURE MARKET TRENDS

By Adrian Douglas

Many Café members will have read my regular updates on market directional tendencies using my proprietary Market Force Analysis. I have just discovered a very powerful alternative way of using market force analysis.

Figure 1 shows the gold price cross-plotted against the market force indicator (MFA) from 2000 to 2007. This plot eliminates time because the POG on any day is plotted against the MFA value on that day. What is apparent is that there are two major trends shown by the red lines, which correspond to Phase 1 of the bull market and phase 2. Phase 1 correlation is not quite a straight line so a slightly curving line has been drawn. What can be concluded is that most of the time the POG and the MFA have a well defined linear relationship. There are times when the price moves above the red line. This means that the price is moving much higher than the market force would imply is sustainable. This inevitably leads to a correction. The major corrections in the bull market to-date are easily identifiable and are circled at $350, $425, $450 and $720. The data has two options. It can plot along the red line or it can plot above it. This means that the difference between a minor short term pull-back can be distinguished from a major multi-month correction.

CROSS PLOT OF GOLD PRICE vs MARKET FORCE

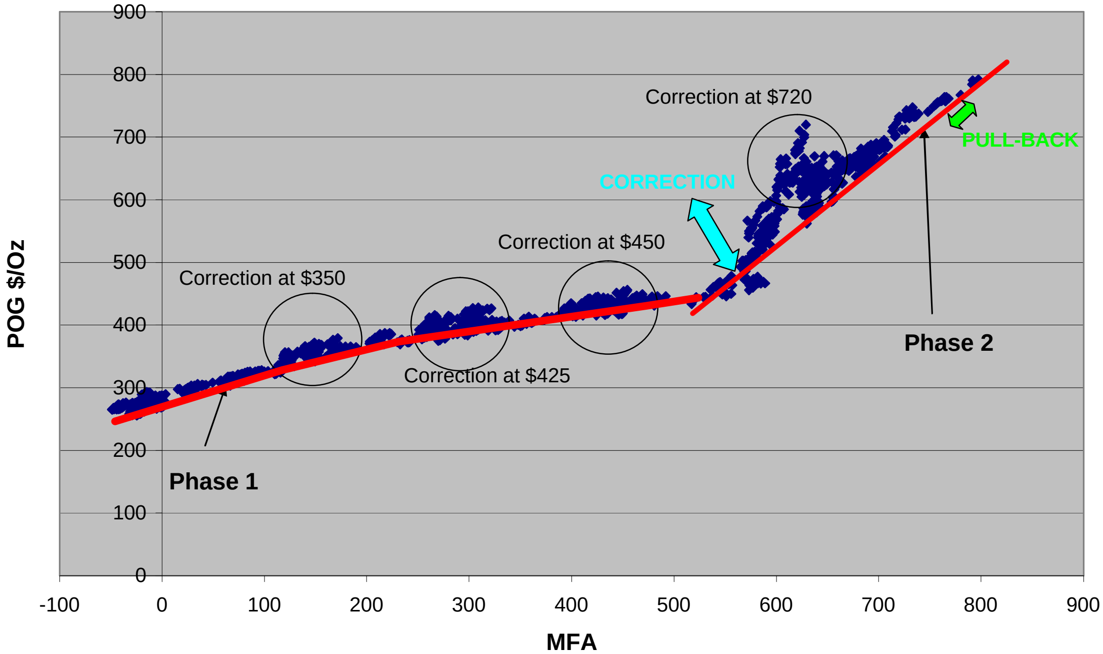

FIGURE 1

If there is a pullback the data will move down the red line and when gold resumes its rally again the data moves up the red line. This is indicated by the bright green arrow being parallel to the red correlation line. Due to the fact that the POG and the MFA are in equilibrium on the correlation line, these pullbacks will be minor. These are the sort of moves that lead to a few down days in an otherwise upward rally. This is like a beach ball floating on the sea; it may bob up and down but its movement is not dramatic because it is supported by the water. If, however, the price moves above the red correlation line, moving orthogonal to the red line (as indicated by the bright blue arrow), then the price can not be sustained and must eventually fall back down to the red correlation. This can take months to be accomplished and is what we know as a major correction and consolidation. To continue the beach ball analogy, this is like a gust of wind picking up the ball high in the air; it must eventually drop down to the sea again.

Notice that the data at the POG $800 level, where we are today, falls exactly on the red correlation line. This means that there is no major correction due; only a few minor pullbacks can occur. Only if the data starts to plot significantly above the red correlation line (as it did at POG $720) can a major correction occur. This is quite a stunning revelation considering how far gold has rallied. The fact that almost no data has plotted below the red line correlation in 7 years means there is almost no chance of it occurring now. A major correction, therefore, can only occur from a point significantly above the red line correlation. Gold needs to rally much higher and faster from here to rise above the correlation line.

In Figure 2 a cross-plot of the price of silver against its MFA is shown for 2003 to 2007. Again two phases are clear with two different slopes. There are two clear corrections evident where the price of silver rose too rapidly with respect to the MFA. The silver price at these junctures was unsustainable. It can be seen that currently the POS is lying almost exactly on the phase 2 correlation line indicating that the price of silver is in no danger of any major correction. Minor pull-backs and down days are possible but a major correction is not.

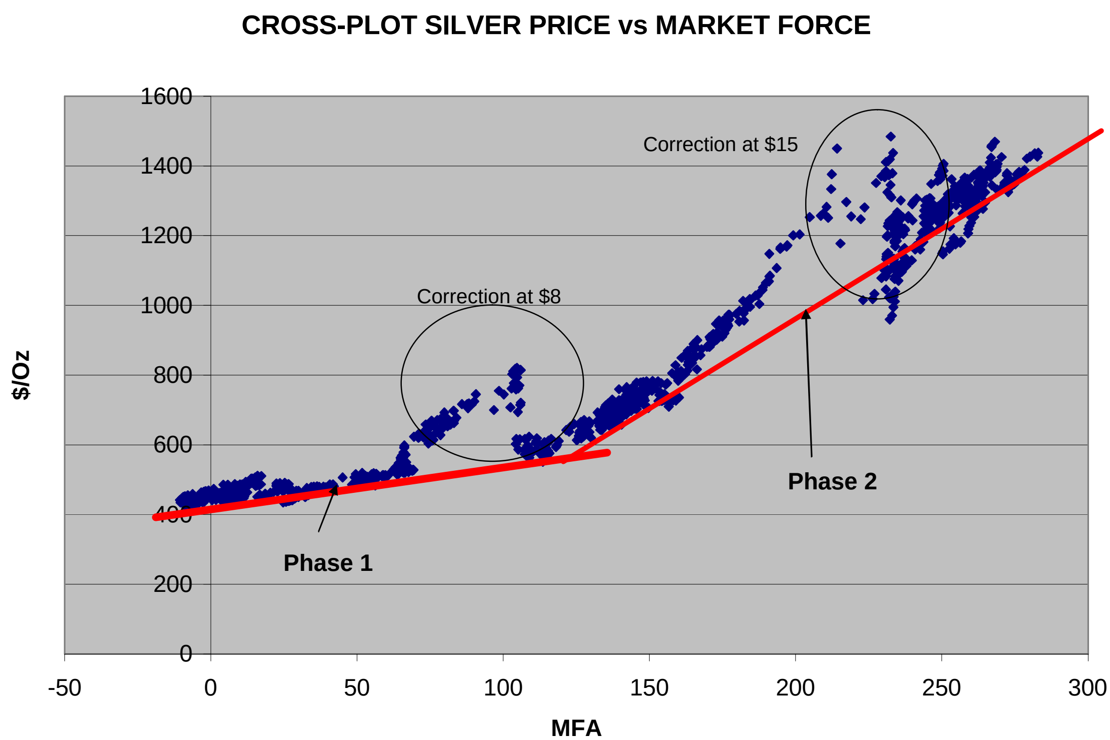

FIGURE 2

This novel view of the precious metals market shows that there is no likelihood of a major correction despite the current nervousness among investors who think that $800 is a high price for gold! The prices of the metals are in equilibrium with their market dynamics and are not in that sense “over-bought”. In fact on this analysis the gold and silver rallies look very young and healthy.

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