**May 24, 2014**

**Ideas On Low Gold Volatility -- and A Story That Goes With It**
**By Bob Ward**

This week we discussed the very quiet gold market and its possible implications. Was it meaningful? Was it a prelude to a huge move? Could the next leg of the bull market be in the offing?

Pondering these ideas I turned to the historic data to try to come up with an answer. The GLD ETF has almost ten years of price data now (inception November 2004) and is the most convenient trading vehicle for many of us.

Seemingly simple questions often have complicated answers and I became immersed deeply in the analysis. Finally, I found an answer that is both sensible and compelling, but because it is complex a bit of background may be helpful to better understand it. That means a story goes with it.

*          *          *

Long, long ago when I was a fledging gold trader I was invited to dinner by the two guys who ran Republic National Bank's Gold Department. RNB was one of only a handful of big gold traders in NYC at the time. The year was 1979 and Bunker Hunt was in the midst of squeezing the silver market.

We discussed money making opportunities in the markets, as always happens when traders get together. The questions are usually blunt: Where you making money these days?  (You never know where your next idea will come from.) Then they asked me: What do you think of silver? As I recall, silver was trading about $25-$28 at its all time highs -- four times higher than its last bull market high in 1974. And I was highly biased to the downside for two reasons. First, I thought the price level was far more than insanely overbought. Second, we had very large spread positions that were theoretically correct, but taking on more water every day. The whole market was in chaos at the time.

But they weren't as interested in my gut feel as they were in my charting skills. They asked: How does it look on the charts. I replied, "It's making a triangle now and whichever way it breaks out it's going to go big. Since we are already trading $25 I can't imagine that's going to be up!"  Famous last words.

A few weeks later it broke out of the triangle on the upside and soon went to $50 (January 1980). Then, only two months later (March 1980), it collapsed to $10 and everybody was terrified the entire industry would be bankrupted. Dark days in the precious metals business.

The point is, there was a huge trade within that simple triangle idea, but you had to neutralize your head/gut biases to benefit from it.

*          *          *

Triangles are classic chart patterns frequently seen on every price chart ever made. They can be short term or long term, big or small, regular or irregular, and the list of descriptions goes on. But one thing they all convey the same is congestion. That is, the market is backing and filling, not making any progress particularly, chopping up anybody betting on a trend. In short: “You ain’t a-goin’ nowhere.” Until the breakout comes.

What triangles also do is lower volatility. Since the market keeps reversing the players who bet against trends are having a good time fading every move, both up and down. The trend followers have to start betting smaller as they lose and the reversal players start parlaying their profits betting bigger. The market activity lessens and the price ranges lessen. All tend to lower volatility.

This also means price equilibrium is being reached. The market is finding a price level where those who need to own the commodity are in balance with those who need to sell it. If perfect equilibrium occurs the market stops dead at one price and stays at that same price for days and days and days, everybody happy to transact at that perfect single price.

But while Voltaire’s Dr. Pangloss would think it the best of all possible worlds, nature abhors equilibrium as much as it abhors a vacuum. And markets are merely an extension of nature.

Equilibrium connotes a calm, balanced, unchanging scenario. In reality, change is all that matters. Without change there is no adaptation, no growth, no need to develop defense responses, no energy, no excitement, no chaos, no opportunity. There is no need to trade any longer because everybody knows what the price will be tomorrow, and the next day. The market dries up and dies.

In trading terms, when the market reaches an equilibrium people have calmed down and largely stopped trading on their theories and have unwound all the positions that were forcing them to worry and caused them to “talk their book.” As they lose their positions they also lose their opinions, and stop making or losing money. They gain a whole new cooler perspective of the market’s fundamentals and are less convinced they know where the market is going or what the future holds. Suddenly they are allowing the market to show them the way instead of fighting it. And since they have lessened their positions they can more easily get on board with the new breakout move. Thus the potential is created for new and lasting moves.

*          *          *

That brings us back to present day where the gold market has created both a large and small triangle of late, but both were duds. It turns out that triangles are best predictors of a "breakout to come" when they break out before the triangle is two-thirds completed. That is to say, when the market can't wait. When you are able to draw a nice looking geometric triangle and the market winds down slowly and fills out the very tip at the end, you have a fizzle, a dud. That's what has happened of late. The market has lulled itself to sleep.

Furthermore, from only the end of December we had a $200 spot gold upmove ($1,190-ish to $1,390-ish). A classic 50% retracement down of $100 to $1,280-ish, a further 50% bounce of $50 to $1,330-ish, and a panic down day or two with slow dead quietness until we now rest around $1,290 -- the dead center of the $200 upmove. We have reached equilibrium.

So, we now have the potential for a new and lasting move a bit down the road -- but what's it gonna be? All we can do is look to the past performances and see if a pattern exists.

* * *

We have a two-part theory to test historically:

1. The market has been very quiet lately
2. Very quiet markets can lead to breakouts

So, has the market been very quiet lately? How do we measure "very quiet" and how long a period is "lately"?

We looked at one-, two-, three-, six-, nine-, and twelve-month periods over the GLD price data since origin (last 10 years roughly). We looked at how big a high/low range the market had during each of those look-back periods.

By spreadsheet analysis and graphs we counted how many times the market was "quietest" for each look-back period ("quietest" being defined as spikes down to low volatility):

Latest one month: approx 50+ cases
Latest two months: approx 25+ cases
Latest three months: approx 16+ cases
Latest six months: approx 12+ cases
Latest nine months: approx 8+ cases
Latest twelve months (range% below 20%): 4 cases including now

To be "very quiet" implies a not-so-normal occurrence. So, although the past one month has seemed very quiet, that same level of quietness was seen at least five times a year for the past ten years. Not at all out of the ordinary. We opt, rather, to look for the rare situations and we have one. Only four times in the past ten years has the gold range for 12 months fallen below 20% of the price level. Last week was the beginning of the fourth time.

This, in our mind, certainly qualifies as "very quiet lately". Now the question remains, what happened the last three times? Did it lead to breakouts? Was there a consistent pattern and rule to help us make money?

The simple answer is, yes, and the rule is "trade in the direction of the breakout," just like with triangles.

A quiet, range-bound market implies congestion, similar to triangles, and follows the same rules. Look for the next breakout and go with it…as long as it continues to work.

The three past periods where the 12-month range % was below 20% were:

1. November 2005: During the six months after the breakout prices rose more than 40%
2. June 2007: During the six months after the breakout prices rose almost 50%
3. Oct. 2012-March 2013: During the three months after the breakout prices FELL almost 25% (in addition to the 15% they had already fallen while waiting for the breakout)

Using only three samples is not good science, but it is enough to make a warning note to oneself that very quiet periods in gold have, over the past 10 years, been precursors to the start of some big trend moves. Ignore them at your own risk.

We are at $124 GLD now, almost dead center middle of the last twelve-month price range ($136-$114).

Sometimes these quiet periods last a lot longer than we'd like, but until a breakout is near no action is called for. The market will tell us when the equilibrium is over. Meanwhile hope for the best, but always protect yourself against the worst.