

GOLD WARS: WHAT IS THE DIFFERENCE BETWEEN A CORRECTION AND A REVERSAL?

There are few things more emotional in the markets than a good gold fight.

My colleague Tony Cherniawski (www.thepracticalinvestor.com) have had so many discussions and read so much conflicting literature about gold that our heads are literally spinning. We suspect that the same is true of many readers of this CNBC blog.

Many analysts look at the decline in gold as a minor or temporary pullback. Tony and I do not entirely agree on this topic, so this makes for interesting discussion at the very least. This is Tony's side of the story: Janice-- I have a pattern that has a high degree of reliability to prove it. It is called the Head and Shoulders pattern.



The Head and Shoulders Top is not a “pullback.” It is a bearish reversal pattern. Of all the reversal patterns, the Head and Shoulders is the most popular and well known. What is often overlooked is that studies of the Head and Shoulders pattern find that it has a very high (93%) degree of reliability. (Source: Encyclopedia of Chart Patterns, by Thomas Bulkowski).

The popularity of the Head and Shoulders pattern with traders stems from its recognizability. The characteristic three humps with the middle being higher or larger makes this formation easy to spot. That is why I wonder why analysts still maintain their positive outlook for gold. The pattern above is very well developed, with a final pullback to the neckline, which indicates that it is ready to begin an impulsive decline toward the minimum target. What is more, if gold cannot recover from its minimum target, there is a lesser (63%) probability of a further extension toward the average target of 847.

For the past year, gold has been trading inverse to the dollar. In fact, this inverted relationship has been popular in the dollar carry trade. So, let’s take a look at the dollar, as well.



Interestingly, there is an inverted Head and Shoulders Pattern in the Dollar. Head and Shoulders Bottoms have an even higher degree of reliability than the Head and Shoulder Top. Only 5% of these patterns fail. A huge 83% of these patterns reach their predicted price range. Although the minimum targets are quite modest, the average rise may be as high as 38%, making the Head and Shoulders Bottom one of the potentially most powerful patterns known to traders. (Source: Encyclopedia of Chart Patterns, by Thomas N. Bulkowski)

How can a “conservative” asset like the U.S. Dollar rise 38%? The answer lies in the unwinding of the dollar carry trade. Traders who went short the dollar and long “any other asset” now have to start unwinding their trade by selling their “any other asset” and buying the dollar. We will soon find out just how massive this trade is. Don’t be on the wrong side of this trade.

Here is my side of the story: Tony, I am a short-term gold futures trader. I rarely carry positions for more than 48 hours. As a trader, I have no bias about where price will go or when it will get there. I have a plan based on technical and macro analysis, as gold cannot be traded “in a vacuum.” The most two most important elements in my trading are price and order flow. I will go where they are telling me to go, and the direction does not matter. Last night, I started shorting gold heavily and am still short as we speak today. But, I am much less short than I was in the early hours of this morning. I still think that the gold bears are targeting the 1026 area. But I am not attached to this number do I care if it gets there—with or without me. Your analysis is among the best I have seen, Tony. But I do not trade from analysis, rather than from signals and setups. I suggest we wrap this up now, Tony, and have a nice soothing cup of chamomile tea.