Sand Spring Advisors LLC

Cyclical Commodity Turns

By,

Barclay T. Leib

May 16, 2000

We were looking at the chart below of monthly gold, and simultaneously studying the recent price behavior in July Wheat, when we noticed some interesting cyclical price behavior in both. Frustrated a bit by Wall Street's silly continued non-admission of a bear market in equities, we thought we'd take this opportunity to shift our focus a bit and discuss developments we see brewing in certain commodity markets. In so far as all markets are intertwined and related, some of our observations here on the commodity front may indeed have some bearing on how and when equity investing continues to fall from grace.

First of all, gold has a most definite cycle approximating 8 years plus a few months that is due to bottom in the year 2001. This cycle undeniably stretches back as far as 1960 when a speculative attack on the U.S. dollar led the London price of gold to rise from its then official price of $35 to $40 an ounce. The central banks of the U.S., Britain, Belgium, Holland, West Germany, Italy, France, and Switzerland all subsequently were forced to form the "gold pool" to re-peg gold at $35.

Flash forward from then approximately 8 years….
Mar 1968: Because of significant demand pressure, the gold pool was replaced with a two-tier system -- an official price that remained fixed at $35 an ounce, but a market price that soon soared above $100.

8 years 5 months later….
August 1976: gold low at $102.20 led to a 3 ½ year rally into January 1980 of some 832%;

8 years 5 months later….
February 1985: gold low at $284.25 led to a Dec 1987 high some 76% higher;

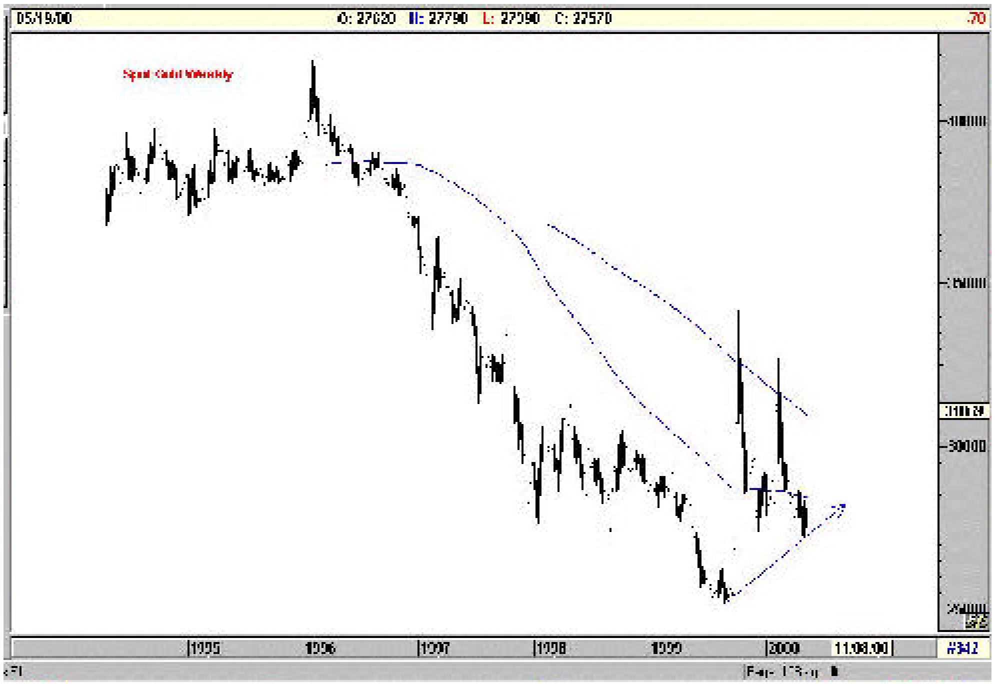
8 years 1 month later….
March 1993: gold low at $334.70 led to a Feb 1996 high 25% higher.

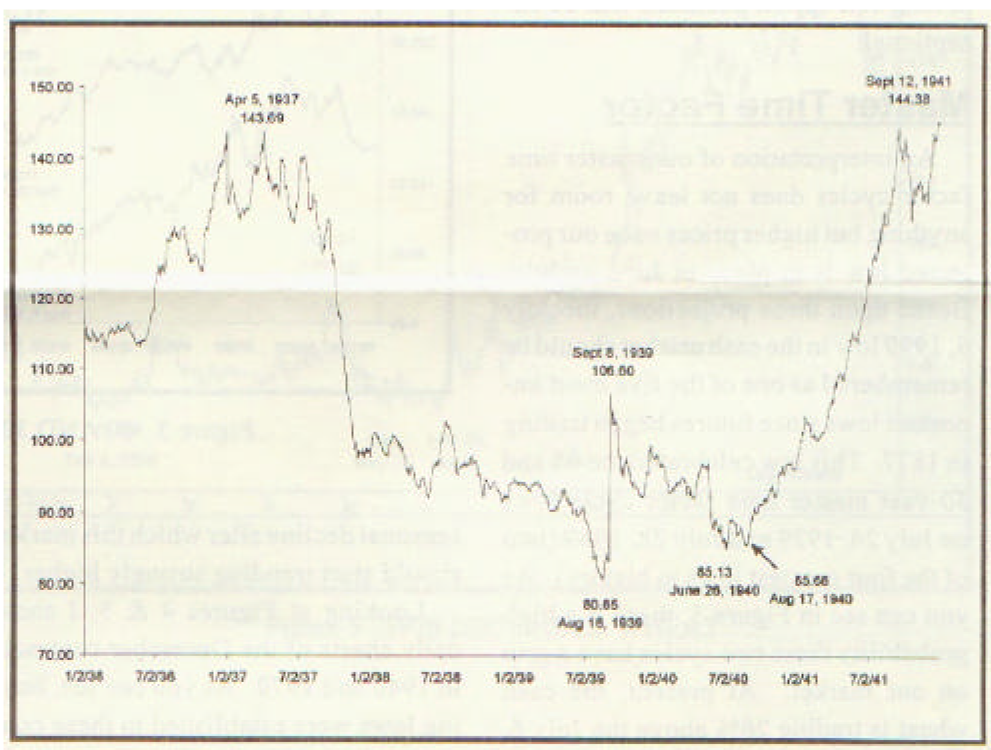
Looking from 1976 onwards, each of these prior cycle lows is marked by an arrow on the chart below. We now are due for another low of some significance that ideally should occur on or about August 2001.

Unfortunately using this technique alone, one might expect that gold bulls will have yet another year of purgatory as this market slowly sets itself up for the final resumption of its longer-term uptrend . With time we have no doubt that gold will eventually vault to a 5th wave high toward $1,083 basis its overall longer-term Fibonacci rhythm and wave count depicted below. This should leave the entire last twenty years as an extensive wave 4 correction. But the question remains what will we do between now and August 2001? Might we have to visit $197 first? We certainly hope not, but if the above mentioned cycle plays itself out, this final bear phase could certainly last just long enough and move just low enough in price to bankrupt a few more mining houses – thereby sewing the seeds for the final reversal and recovery.

Do I sound suddenly and uncharacteristically bearish? Well I am worried, but I am not quite a bear here – at least not yet.

Before gold bulls completely lose heart about the short-term prospects for gold, please note the pattern match we have pictured below between the current daily gold chart and that of the 1940 PPF Commodity Index (borrowed from the National Institute of Investment Research).



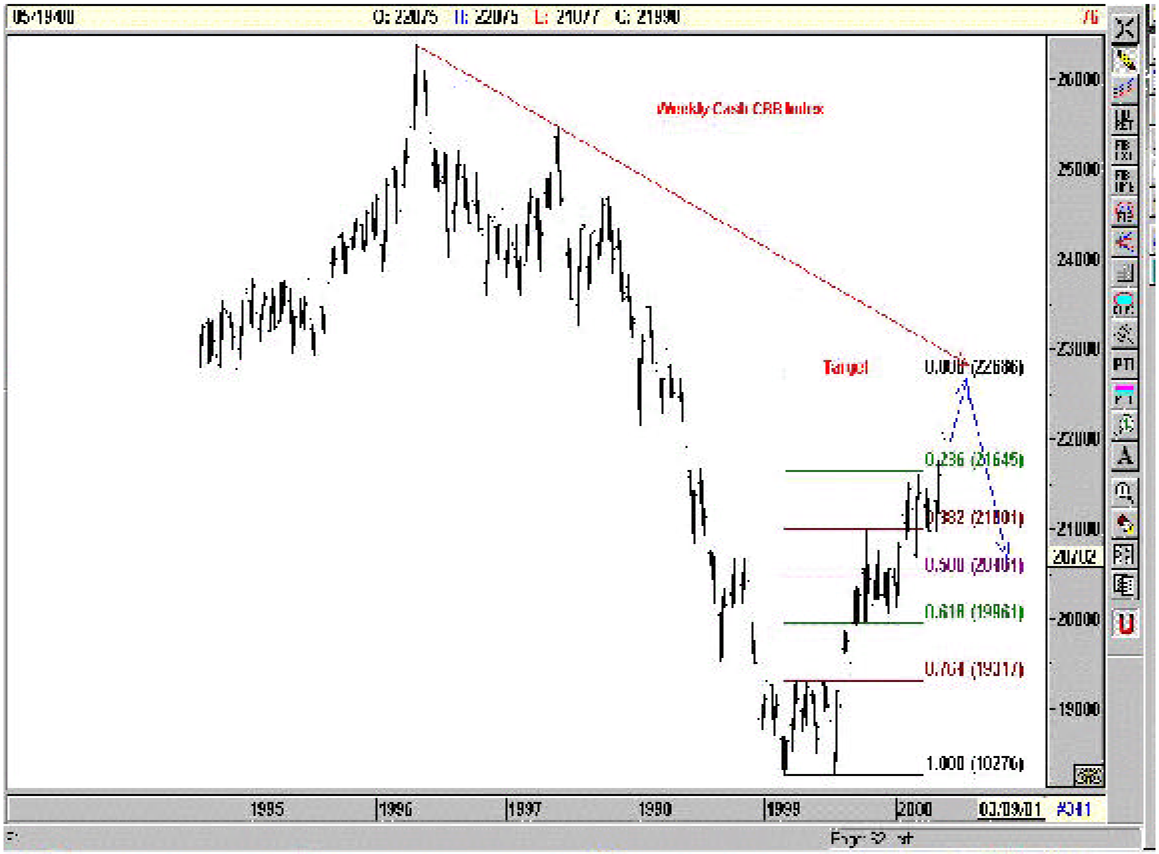


Source: National Institute for Investment Research

When we eyeball these two charts, do we see a certain similarity of pattern? You bet we do. The initial near vertical ascent in that old commodity index chart is followed by almost a full year of backing and filling, followed by a sudden blastoff in price once again. Since its September 1999 low, gold has been following an ever-so similar path, its initial jump now being slowly digested well into the year 2000 with much backing and filling. On a stand-alone basis, this latter "pattern match" would suggest that gold won't sag all the way into 2001, but is ready to turn much higher much sooner. We are intuitively constructive the metal when we look at its current formation. We also like the relatively firm performance of silver of late. When June gold futures recently made new lows on May 1st, July silver failed to do so. We have seen this type of 'footfall' by the silver market on several occasions in past years just in front of major reversals higher. For whatever reason, silver starts to act as a leading indicator of renewed metals strength before the gold market finally turns.

This leaves us of course with two potentially divergent paths. Are we to trade down into August 2001, or straight up from here? Our answer should soon be more or less obvious as the uptrend line depicted on the weekly gold chart on the prior page either holds or does not (a weekly close below $269 spot would be technically very bad). For the moment the market is teasing us to death – using up mental energy and patience -- but alas that's what bottoming formations are supposed to do. Otherwise too many simple trend followers would catch the move.

It is also possible of course that <u>both</u> our short term bullish perspective and intermediate bearish cycle prognostication could end up being satisfied! Suppose for argument sake, gold starts a steady move higher now that rallies up into the $340-370 price region, but then fails. This would still conceivably leave enough time for the gold price to come back down into a more permanent secondary low (either marginally above or below our current low) next year, satisfying both sets of analysis. It would also fit with our long-standing call to see today's CRB get up to approximately 227, but then hit substantive overhead resistance.



Wheat

There are also other commodity markets making cyclical turns higher at present, or scheduled to do so shortly. One of these is wheat, a market that has fallen mercilessly since its 1996 high. We recently put out a Chart du Jour suggesting that the weekly chart pattern of wheat was looking quite constructive. Prices have stepped a bit higher since that missive. The pattern analysis discussed below is generally consistent with our longer-term bullish chart perspective. We simply risk at present being a bit early in our bullishness, a fault of impetuousness we have been known to commit in the past. Nonetheless, we offer up this analysis as an introduction to some fine long-term analysis of agricultural commodities done by James Flanagan of newsletter "Past, Present Futures," and as a confiming indicator to our own belief that something big is brewing here.

According to Mr. Flanagan, the current 70% decline in the price of wheat since 1996 represents the 22nd "historic low" in wheat since futures began trading in 1877. He defines a "historic low" as one that comes after at least a 50% decline in price basis the nearest futures. Flanagan argues that wheat has previously sketched out three distinct bottoming formations in the prior 21 "historic low" occasions:

A) In 9 of 21 instances immediate advances of a large magnitude took place off of the final low (imagine a V bottom);

B) In 2 of 21 instances, extensive basing took place over multiple months (imagine a saucer bottom);

C) In 10 of 21 instances, intermediate advances occurred followed by secondary corrections into higher bottoms (often lower lows basis the nearest futures, but not basis cash prices – imagine an Elliott 1-2 advance).

Now for any one who follows such things, wheat left an important low together with many other commodities back in July 1999, but did not experience an immediate self-sustaining advance. Instead it has meandered back lower, the cash price still well above the July 1999 low but the nearby futures contract having broken to lower lows as of late December 1999. According to Flanagan, this clearly puts the current wheat market in his class (C) type of secondary low – something he refers to as the "buying low."

Now here is the interesting part. Of the 10 prior instances of this category (C) type of bottom, nine out of ten of them ended between June and August. In the prior 10 instances, once a low is finally in place, wheat has experienced an average advance of 89% in just under eight months time. Moreover, many of these lows happened to have occurred in "0" years – namely July 1, 1880; May 12, 1900, August 16, 1940, and July 20, 1960. Is there some sort of 20-year cycle at work here? Probably not, but as we sit in May 2000, it's certainly something to think about. Some would argue that there is a 60-year commodity cycle, 1880, 1940 both marking significant commodity troughs, with 2000 now potentially due as another.

If we measure our Fibonacci bands between the highest monthly close of wheat and the lowest monthly low, we get a Fibonacci rhythm that appears relatively complete and is pictured below. Now the question simply becomes, can the 100 and 200-day moving average resistance be overcome up in the 342-352 region? If and when the nearby wheat futures price does vault above this region, we will get a good confirming indication that a major low is already in place – a low that would generally be in line with past cyclical tendencies to rally out of significant lows during the June-August seasonal period.

Surely, the interplay between all of these charts is not absolutely clear. If anything they all appear positive in the short term, but the longer-term picture remains less orderly. But within the commodity sector, and especially the agricultural grains, something clearly seems afoot.

In the chart below of daily July Corn, our Fibonacci extrapolation of the market's current rhythm points to an eventual high of 273 ½. Yes, there is a large gap near 224 that risks getting filled, but we like the way that this market is currently holding above the depicted 200-day moving average. Until that sculpted moving average support is broken, we would expect nothing but good things out of this market. The March high likely marked the end of a five-step Wave 1 rally, followed by an A-B-C wave II decline into early May. More recently we would see the May jump and retracement as a potential 1-2 leading to an eventual 3 of III rally now directly in front of us.

So here is the bottom line as we see it for the moment:

Stay long the wheat and the corn until the CRB reaches 227 – then start to be more cautious. These market could be just beginning huge on-going moves, but they should make at least a temporary high when this CRB objective is met.

Buy gold against its trendline support, but psychologically be ready to kick it out if that trendline breaks or after a sharp rally. Cyclically the summer of 2001 will represent a more logical cyclical time for a major bottom to occur here. If we start creeping higher from here, so be it. We still would see a significant cyclical bottom in gold toward August 2001 that could offer perhaps a safer secondary buying opportunity – even if it were to come at a marginally higher or lower price level.

The overall fundamental rhythm could well be: a continued whiff of inflation for now that takes the commodity sector ever higher in the short term, wheat and corn acting a bit like last year's move in oil. Eventually the higher inflation and interest rates cause equities to collapse, ushering in a final dose of deflationary pressures. This precipitates the final gold retracement or low in 2001 – followed most likely by massive central bank reflation in lieu of outright bond defaults that will be increasingly threatened by that time.

Gold will indeed get to $1,083 someday in the next 10-years, but there's still much more sloppiness to get through first.   Trade from the long side in gold for now, but if you start seeing spot prices back below $268, stand aside. August 2001 and the next level of significant support down at $197 are both too far away to offer much comfort.

Send us your comments at info@Sandspring.com.