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After commodities' strong rally since the beginning of the year, is it still worth jumping in?

Keep on rockin' until the music stops


Keith Richards

The first half of this year brought in renewed strength to a few of the beaten-down commodities (and related stocks). Energy (both West Texas Intermediate oil and natural gas) has had a strong run of it since the February lows.

So too has gold and silver – both of which have run hard after their January lows from a four-year bear market.

Some readers may be wondering if any of these commodities are worth investing in at this point, having seen such an aggressive run of late. Here, then, are my notes on how I expect to play these commodities over the coming months within the ValueTrend equity platform that I manage.

Let's start off with energy. I tend to avoid directly playing natural gas, unless it's part of an integrated energy company like **ExxonMobil** (XOM-NYSE,$90.91) or **Chevron** (CVX-NYSE, $102.26). Oil itself is reaching an attractive entry price point again.

At ValueTrend, we've been looking for a pullback on oil into the $44 to $45 zone to increase our exposure to energy. We had a certain level of confidence that it would do so as oil came into its second seasonal buy period – the first being from February to May.

Following the first seasonal period of strength, energy and related stocks can be a bit soft through late June to the end of July. They can then stage a second-leg rally from late July into October (see *Thackray's Investor's Guide*).

WTI was indeed getting a little overbought as it played with $50 per barrel in June, and probably needed to pull back. Right on schedule, it is reaching $45 support as we enter the second half of July.

The market looks for an excuse to drive pricing in a direction that charts suggest possible beforehand. This time, it was greater than expected gasoline production by U.S. refiners. We've heard this song before – as I said, the market needed a reason to pull oil back from an overbought condition. I've previously noted $44 to $45 as a support level in my writings and blogs.

My mid-term target for WTI crude oil is around $60 in the coming six to 12 months. From there, the fundamentals and technical picture will have to be evaluated before prognosticating towards further upside.

The **iShares S&P/TSX Capped Energy ETF** (XEG-TSX, $11.73) suggests less weakness in the producers than we are currently seeing in the price of oil itself. However, there should be a certain level of negative followup by the producers if oil pricing remains soft for the remainder of this month.

We've recently added one energy stock to our portfolio. We are about eight per cent directly exposed to energy stocks via XEG and our BNN top pick **Vermilion Energy Inc.** (VET-TSX, $43.17) right now. We are considering a direct play in the commodity via the **U.S. Oil ETF** (USO-NYSE/Arca, US$9.90), which we have traded before quite successfully. USO is amongst the largest and most liquid ETFs in the world.

We expect that energy stocks will shrug off a little momentum in the coming weeks, and would use that as an entry point to increase our exposure.

The gold chart also shows us that its big picture looks positive – given the positive break in trend earlier this year. So too does the silver chart. In the short term, however, gold, and silver may be due for a temporary pullback.

Not only are they more than 10 per cent over their 200-day moving averages (a condition that I have noted to be indicative of an overbought market), but the seasonal period for a bit of weakness in these metals is approaching.

Like energy, it's best to buy gold in late July or early August according to *Thackray's Investor's Guide*. Silver is often best bought in September for an upside play into late winter.

Adding to the overbought momentum on the precious metals, and the seasonality tendencies, is the discrepancy between "smart money" (commercial hedgers and large position traders) and "dumb money" (small speculators and retail). Statistical genius Jason Goepfert offers crowd behaviour research via his website, www.sentimentrader.com.

Mr. Goepfert's research shows a level of enthusiasm among retail investors towards the precious metals that has not been seen for 23 years. Data going back to 1993, including the 2011 highs on gold, shows no comparative for the rampant speculation by small investors in gold lately.

That's a bit disconcerting. Silver too has had a strong movement lately on the back of retail ("dumb money").

Ordinary investors are all over ETFs and stocks that play off of these two metals. Meanwhile, commercial hedgers (or the "smart money") are selling out of these metals – at least at this moment.

Don't get me wrong—the charts for both gold and silver look fantastic. But the momentum oscillators are getting overbought, and retail investors are getting excited about these metals.

When "smart money" is selling, and "dumb money" is buying, it can often lead to an ugly ending.

Similar trends in the flow of money by these two groups (smart versus dumb fund flow) occurred before the oil bubble in 2007 and tech stock bubble in 2000. For those of us who were trading during either of those times, you may recall that it went REALLY well for quite a while on both of those sectors, and there was plenty of money to be made! But then…the music stopped.

Keith on BNN

Thus, my long-term approach on gold and silver is playing the trend while there's money to be made, and then leaving the game before that music stops.

The correction that the smart money is predicting may take a while to happen, so we might as well enjoy the ride while the music continues to play.

I'll be on BNN's *MarketCall* on Wednesday, Aug. 24 at 1 p.m. Phone in with your questions on technical analysis on your favourite stocks during the show. Call toll-free at 1-855-326-6266. Or email your questions ahead of time (specify they are for Keith) to marketcall@bnn.ca.

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