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Market Insights

IS THIS A TOP FOR GOLD AND SILVER…AND HOW DO WE KNOW?

October 27, 2025

Gold last Tuesday had its worst one-day decline for 13 years, and it has slid further since then in sometimes choppy trading. Since Tuesday morning, gold is down 9%. The stocks exhibited leverage on the downside, plunging virtually 10% on Tuesday and are further down today after a failed rally attempt at the end of last week. Some investors are concerned the bull run is over; "we've been here before," they are saying.

> ***To jump to my conclusion: this is not the top, not by a long chalk. However, there is a risk that the pullback has further to go.***

To start, let's put the decline in perspective. Although one can say that gold's one-day drop is unusual, it is not unique. We had a far worse drop in October 2008, while May 2006 was its equal—who still remembers that? And note, that in both cases, gold recovered very shortly after those sell offs. The pullback so far is less than a modest 25% retracement of the recent rally. Such retracements are usually between 40% and 60% of the prior move. And however painful the past week's action has been, we are back only two weeks (for gold) and a month (for gold stocks). Blank out the last week and most investors would be very happy with a $4,100 gold price, or gold stocks that have more than doubled this year. So far, then, this is a very modest pullback. It would be unusual if this was all there was.

To reach my conclusion—and address the second question in the title of this article—there are three broad methodologies. First, we look at the drivers of the metals and assess whether they have changed, or may do so. Second, we can look at momentum indicators, such as flows, RSI or volume and moving averages. And third, and arguably most important for gold and gold stocks, is sentiment, and much of that is anecdotal.

Gold is difficult to value

Valuations can be tricky with both gold itself and with the gold stocks, most obviously with the metal. Unlike the stock of a manufacturing company, for example, where we can look at the stock price versus various metrics—revenue, cash flow, NAV, dividend and so on—and assess a value relative to other companies in its sector, relative to its history, and indeed intrinsically. Gold famously, as its detractors never tire of telling us, has no revenue and does not pay a dividend.

And even though gold stocks can be valued on traditional metrics, the reality is that a major move in the price of gold will affect the stocks, be they otherwise over- or undervalued. This is unlike the experience of most companies in other sectors. Moreover, in cyclical sectors, such as resources, valuation metrics can be misleading, particularly at tops and bottoms. If stock prices move up faster than resource prices and margins, for example, which they can do at a top when investors pile in to a small sector, valuation metrics will appear low. And vice versa at a bottom, when earnings collapse even faster than the stock prices, and price-to-earnings multiples and other valuation metrics go up.

How then does one value gold and determine whether we might be at a top? One can certainly look at the gold price and importantly the price adjusted for inflation; looking at that, gold would be expensive, exceeding the 1980 peak adjusted by the CPI by about 13% or the money supply. For this to have any validity assumes the CPI is an accurate gauge of inflation. Moreover, at best, it only tells us about the price, not the value.

One way to judge gold's value is to compare it with other metrics: gold to money supply, gold to debt, gold to financial assets. On the first of these, for example, the gold price today has kept up with the growth of the U.S. money supply since gold was set free in 1971, but is well below both its 1980 and 2011 peaks. The gold-Dow ratio has been popularized (by, among others, Pierre Lassonde), which shows, even after gold's dramatic recent rise, it remains on an historical basis closer to its lows (2000, 1971) than its highs. One can also compare gold to other commodities, whether a single one like silver (in the popular gold-silver ratio) or to the entire complex. Remember, that these show relative value not absolute. I would not bet the bank on any one such ratio, though taken together may be a good starting point for valuation.

Then we can look at how this move in gold has compared with other recent bull markets. Looking at a log chart of the gold price, it becomes immediately clear that the gold move from 2015 has not been as great as the bull move from 2001, nor the move in the 1970s. If gold had the same percentage move as it did during its last bull market (from 2001 to 2011), then gold would need to move to over $7,000. Again, this is not conclusive; there have been several good bull moves where gold topped after a smaller move. But it is another indicator putting the gold move in perspective with others. Perhaps this and other ratios better answer the question "Might gold go higher or is it more likely at an extreme?"

Gold stocks are trading below average valuations

Gold stocks are somewhat easier to value. First, of course, we look at traditional stock valuation metrics, being aware of perverse results at tops and bottoms. We can compare relative to other sectors as well as to the sector (and individual stock's) historical averages.

On many metrics, most stocks carry lower valuations today than their long-term averages. Since we expect multiple expansion as the gold price moves up, this in itself is noteworthy. It might seem perverse to state that stocks are better value today after they have more than doubled, but of course the denominators have been

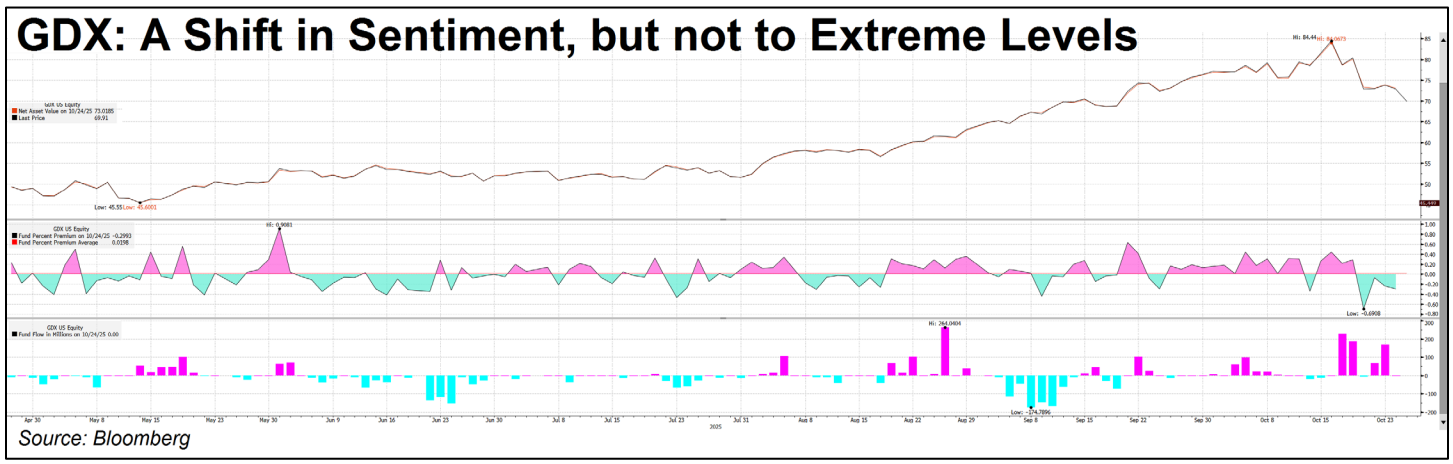
changing (as well as the price). As the price of gold moves up, so too does the value of the mines and a company's reserves. Indeed, they increase on a leveraged basis to the price of gold since a higher gold price not only increases the value of existing reserves to the same degree, but a higher price can bring more resources into the reserve category. Similarly, a higher gold price with reasonably static costs will increase cash flow and net cash flow on a leveraged basis.

So, to take one example, if we look at the price-to free cash flow (my favorite metric) for Agnico Eagle, we see it is not on the surface the bargain that would attract Ben Graham, and the multiple is indeed higher today that at year end. However, other than 2024, it carries a lower price-to-free cash flow than it did for each of the prior five years, and, in fact, has rarely been much cheaper in its 40-year history.

One can look at the various technical indicators one might use for any stock or the broad market. These include relative strength, volume on price moves, market breadth, insider buying (or selling) and technical analyses of various types. These indicators, broadly speaking, show gold stocks a little stretched, but by no means at historic extremes. The GDX ETF for example has been bouncing along just under and occasionally over the RSI overbought level all year, and then moved just above it for most of the last month. (It is now well under, close to its annual low, and closer to the oversold level.)

Sentiment towards the sector is negative

For me, with gold and gold stocks, assets for which demand can be emotional, sentiment is a very important indicator. There are hard sentiment indicators and soft ones. Most important of the former are flows. For all of this year, flows into the GDX ETF and into mutual funds were negative. The GDX saw ongoing net outflows all



year—over $3 billion for the year to date, a lot for a fund that started the year worth less than $10 billion. There was a shift in the last month towards net inflows, but still hardly a flood of money pouring in. Most public mutual funds indicated that outflows were continuing even into October, though they noticed a perceptible shift in the balance in the last few weeks. Again, these would suggest a short-term top but not the top.

The chart shows the price of the GDX at top. In the middle is the premium or discount at which it traded, with more premiums in recent weeks, though neither consistent nor large. And the bottom panel shows flows. While there has been a distinct shift in flows in recent months, again it is neither consistent nor overwhelming inflows.

If we go back to the 2011 top—something that can be classified as a top—we do indeed see buildup of inflows throughout 2011, building to a unprecedented crescendo in August and September…just as gold and the gold stocks were peaking. In addition, the fund was trading at a premium for most of the June to September period, peaking in September.

Interestingly, last week saw the largest inflows, nearly half a billion dollars. This suggests to me that there are investors who have been on the sidelines waiting for a correction. Note the GDX appeals mostly to retail and non-specialist investors; the gold specialist as well as the type of highly sophisticated investor who has been buying gold over the past year will look for individual stocks, not an ETF, still less a mutual fund. So these flows are a good indicator of retail and generalist interest.

Overbought but under-owned

Various surveys of different groups—financial advisors, family offices, individual investors—show that gold is significantly under-owned relative to the past. Recent surveys by different groups show that family offices have less than 1% exposure to gold; that 78% of investment advisors have "less than 1%" exposure in client accounts; and more than half individuals have zero exposure. Historically, before 2011, gold would represent 2.5% of U.S. investment portfolios on average, so there is much further to go.

I know of no example in any market where there was a major top without public participation. By that indicator alone, we cannot be at a top.

Typical market developments we usually see at tops include silver outperforming gold; juniors outperforming seniors; new equity issues coming fast and furious; and a spate of M&A activity.

A shift towards a more aggressive market

Silver has indeed outperformed gold over the past six months, though the gold-silver ratio remains at very high levels, while the silver price only barely (and briefly) exceed its 1980 peak. On an inflation-adjusted basis, it remains very cheap.

Juniors have started to outperform in the last several months, but only just and continue to lag on longer-term periods. There has been a flood of secondary issues—I receive several each day--but so far they are not totally worthless companies raising excessive amounts of money, nor have we yet seen the marijuana or crypto or lithium junior switch to a gold company, another thing that happens at tops. And lastly, though we have indeed seen a pick up in M&A across the space in the last year, for the most part these have been transactions that made sense without massive premiums; we have not yet seen much in the way of stupid M&A, overpaying for marginal or worse assets, such as we very much saw in 2011.

And last is soft sentiment, the extent to which gold and gold stocks are a topic du jour, which I consider very relevant for an emotive asset like gold. The shoe shine boy (today, the barista or Uber driver) has not been offering me his latest gold stock tip. The financial media has started to mention gold, but nowhere near as much as one would see at a manic top. There have been no long lines outside gold dealers. And at dinner parties, gold is not the hot topic; if I mention gold, people turn away! This is very different from 2000, at the height—and top—of the dot.com mania or 2007 at the height of the housing bubble.

Add all this together, and the conclusion is the same: gold and gold stocks were beginning to get a little overbought, warning of a pullback, but nowhere near as much to call the top.

What is near-term outlook?

When accessing gold as with any asset, the outlook for the fundamental price drivers are important in assessing whether or not one is at a top. For gold, the drivers of the last three years—the people and institutions buying and the reasons they have been buying—remain intact. Nothing has changed the reasons people have been buying, whether it's the world's central banks wanted to diversify away from concentration in a single asset,

one issued by a fiscally profligate nation, one that has taken to weaponizing its dominance; or wealthy families concerned about high debt levels around the world; and so on. So the buying will continue, in my view, even if it is after a pause. Most of this buying if not price agnostic is certainly price inelastic.

What kind of pullback might we see? A retracement of 50% of the recent up-move (a standard retracement that would take gold back to $3650) would not be gut-wrenching for gold but would see significant declines in gold stocks. While that is possible, the state of the market, gold's fundamentals, equity valuations, and sentiment suggest, on balance, the probability of a short and shallow pullback, perhaps a pause for a few months, such as we saw from April through August this year, where the stock actually firmed. Gold's lack of meaningful follow through after Tuesday is certainly a positive, and looking ahead, the gold market may focus on the next Federal Reserve meeting this week. A dovish tone to the meeting could see gold move back up, taking the stocks back up with it.

What should an investor do?

How are we planning to manage this? Much depends on your risk tolerance and how you are positioned now. For global investors, particularly the more conservative ones, we already have a high allocation to gold, even if we have sold some in recent weeks. We do not see the need to rush in and buy more. For the dedicated gold investor or the more aggressive global investor, with cash, we might be buy one or two particular situations now, but leave some cash in case there are further declines. For the new account, we definitely want to take advantage of this decline to take positions, even if we do not fully invest necessarily. The coming week might provide some indications of the direction of markets, and thus how aggressive or otherwise we might want to be. Lastly, for the investor who is underweight gold in his overall portfolio, this would definitely be a good opportunity to add funds so we can take advantage of some top-quality companies whose stock prices have moved into attractive buy ranges

President & CEO

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