Observations On The Gold/Silver Ratio

Old Westerns often had some misanthrope utter the line, "Smile when you say that to me." This is good advice for those of us in the financial commentariat whenever we observe you should be happy to pay hefty capital gains taxes for that meant you did well. It also applies whenever you tell precious metals aficionados they should be happy to see both their favorite bullion rise and the stock market rise as well. They prefer a different combination.

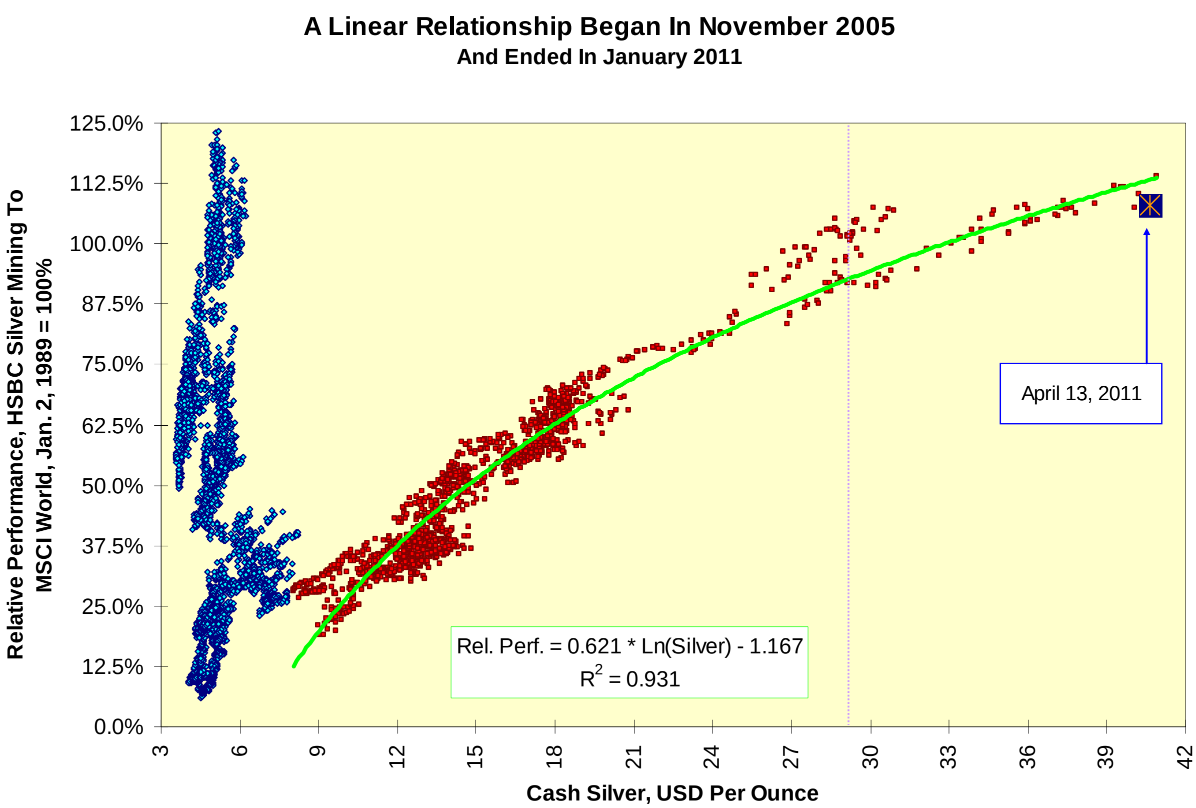
The Gold/Silver Ratio

True precious metals buffs always find time to mention the gold/silver ratio (GSR); this often is accompanied by Biblical references to silver talents, and if those Biblical stories of King Solomon having 700 wives and 300 concubines are true, there was plenty of talent available. Regardless, a rising GSR often is a sign of inflationary pressures rising faster than industrial demand and vice-versa as silver has far more industrial uses than the does the more-monetary gold.

However, the GSR has been collapsing to levels not seen since 1983, a period when both metals were in the early phases of what were to be twenty-year bear markets and when inflation was falling in the aftermath of Paul Volcker's tight monetary policies. The dollar was in its strongest bull market since fixed exchange rates ended in the early 1970s. The decline of the GSR today in an environment where inflationary expectations are rising and the dollar is weakening serves as yet one more indication each and every intermarket relationship can and does change. One size does not fit all.

Relative Performance

Let's revisit a relationship discussed last December between the relative performance of the HSBC Silver Mining index to the MSCI-Barra World index as a function of silver prices (Yes, for the record I was bullish on silver at the time for those of you keeping score at home). That relationship had been linear between November 2005 and January 2011; data points in the chart below for the January 1989-November 2005 period are marked in blue.

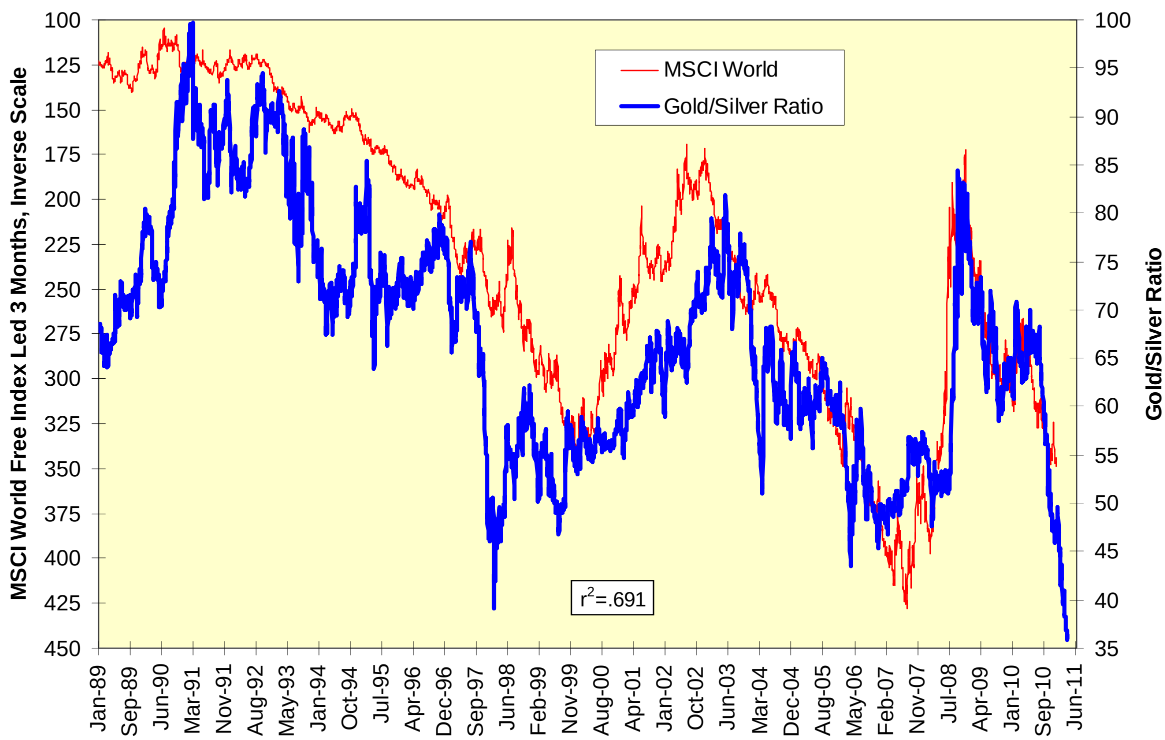


Please note how the relationship turned into a logarithmic one after silver crossed over $29 in January. The relative performance of global silver miners is capturing a declining percentage of silver's gains. This is evidence of what is called an embedded short call option on silver and reflects rising uncertainty over the metal's ability to sustain its gains.

An Implied Forecast?

A second twist arises if we map the GSR against the MSCI-Barr World Free index; the GSR leads the World index by three months on average. The implication here is the global equity bull market can continue over the next three months at least; we may be headed for rising inflation but that will be rising inflation without a financial crisis and without a significant downturn in industrial or hoarding demand for silver.

Does Falling Gold/Silver Ratio Imply Rising Equities?



This should make the gold and silver bugs happy, right? Yes, especially if they have to pay higher capital gains and collectibles taxes on their holdings.