No Silver Lining In Silver Rally

Watch a pendulum swing. It does not go from one side to dead vertical, stop, and return. No, it moves all the way to the other side of an arc, adjusted for the effects of friction. Many traders feel as if they should duplicate one of these behaviors. The compulsion to alternate positions, to always follow a long position with a short position is extreme, as is the tendency always to stay on one side of the market as a perma-bull or a perma-bear.

Silver has brought out both of these tendencies in me, and at different times, but as we shall see below, temptation can be resisted. The metal's meteoric rise during the Hunt Brothers' ill-fated attempt to corner the market in 1979-1980 and its subsequent fall into more than twenty years of torpor gave produced a bad association for many traders. Like pork bellies, which recently were at an all-time high in nominal dollars, silver was something for which commodity analysts always found themselves on the defensive: You deal with *that*? In the pre-Internet days, it symbolized price totally unrelated to economic value and it was associated with the worst peacetime inflation in American history.

One Brief Shining Moment

No Gold Medal For Silver Yet

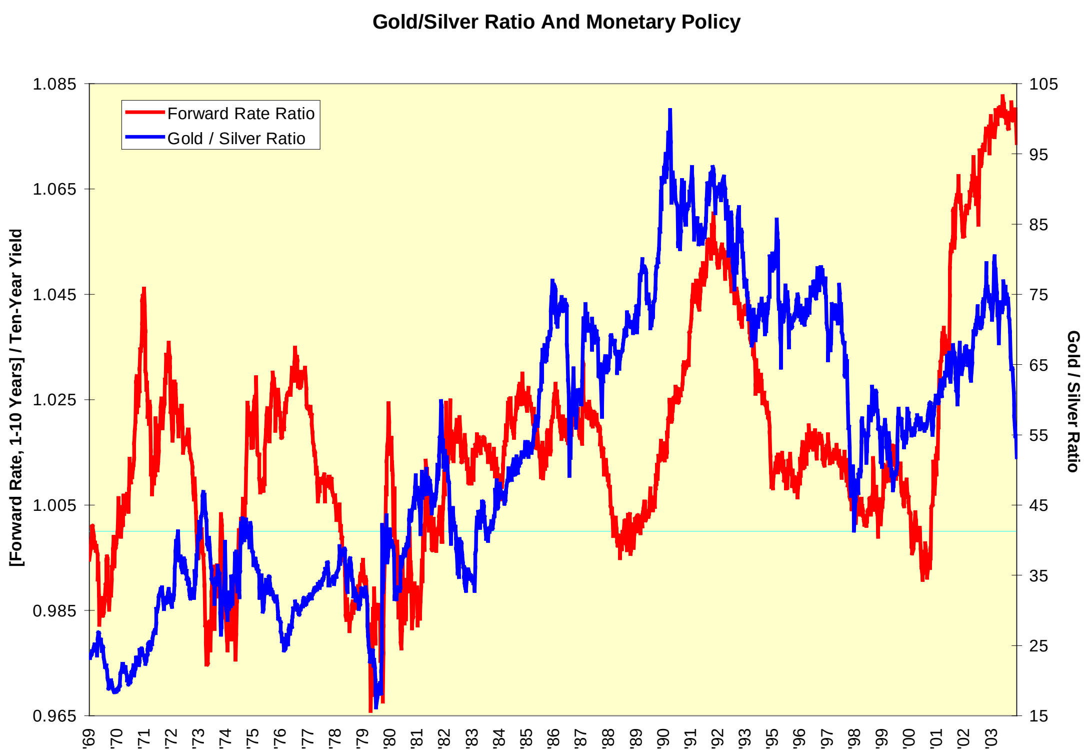
Silver, unlike the gold with which it is forever and perhaps improperly associated, is an industrial metal as well as a store of value. Its principal use, photographic film, is in what appears to be an irreversible decline relative to digital image capture, so much so that the editors of Dow Jones found no reason to keep Eastman Kodak in their Industrial Average.

I turned bullish on gold in March 2001 for monetary reasons with the federal funds rate then at 5%. I figured that further rate cuts would both weaken the dollar and raise expected inflation relative to the financial costs of holding gold. However, I withheld a bullish call on silver on the basis that industrial fabrication, chiefly for electronics, would not rise until the economy improved.

That bullish call came in January 2002 and was apologized for in September 2002. The bullish call was not followed by a bearish call, but I did not want to stay on the long side of the equation without any sort of evidence that it was the correct place to be. By August 2003, I was talking up the gold/silver ratio, here defined as the bullion price of gold divided by the bullion price of silver, both expressed in dollars per ounce, on the grounds that inflation would be rising - who knows? Maybe it has been - and that silver production would be rising as copper and lead-zinc production increased.

Monetary Metals And Monetary Policy

The gold/silver ratio, which had peaked over 80 in June 2003, stayed in the mid-70's until October, and then began a break that has carried it down below 52 even as commodity prices in general rallied, the dollar weakened and the spread between TIPS and normal Treasury bonds grew. Something was amiss: If gold is a better barometer of inflation than silver is, and if inflation chatter is back on the airwaves, then shouldn't gold be firming relative to silver instead of engaging in one of the sharpest weakenings over the past three decades?

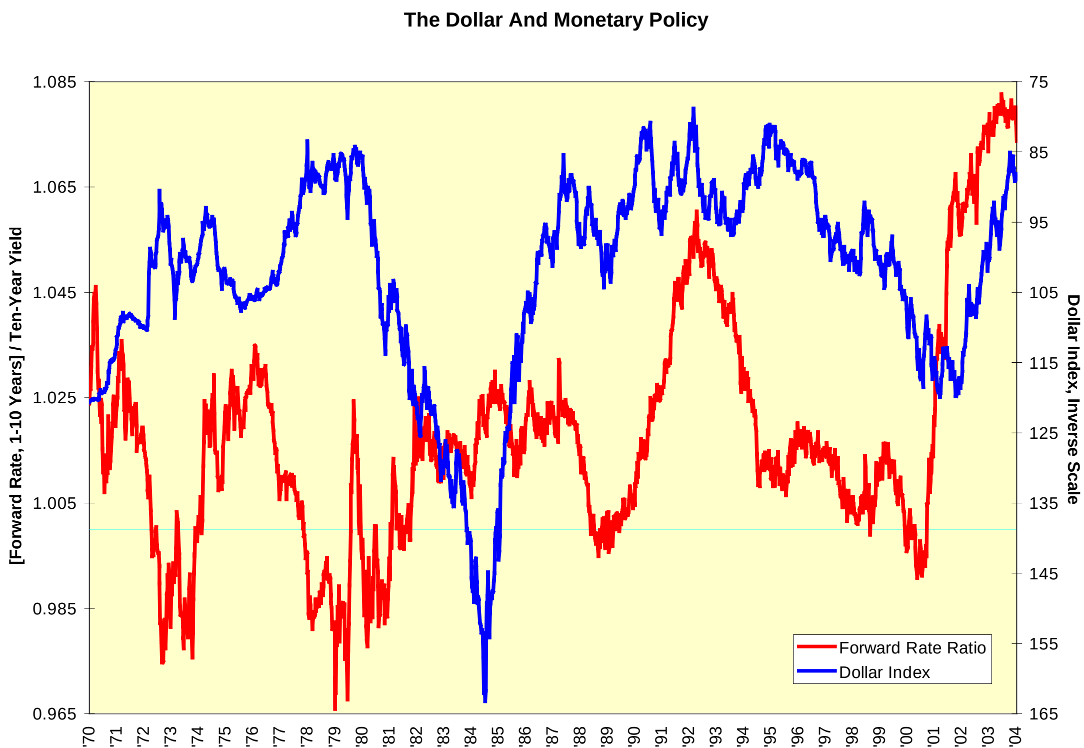


Markets should anticipate changes in policy as well as react to past data, a statement that occasionally seems ludicrous following a major government report, or before a major government report, depending on when you get the information. Here the gold/silver ratio may be anticipating, with a clarity and a consistency that has evaded many economists over the past year, the long-awaited flattening of the yield curve.

The shape of the yield curve can be summarized by taking the ratio of the forward rate between one and ten years, the rate at which borrowing costs can be locked in for nine years starting one year from now, to the ten-year note rate itself. The more this ratio exceeds 1.00, the steeper the yield curve and by extension the greater the inflationary expectations.

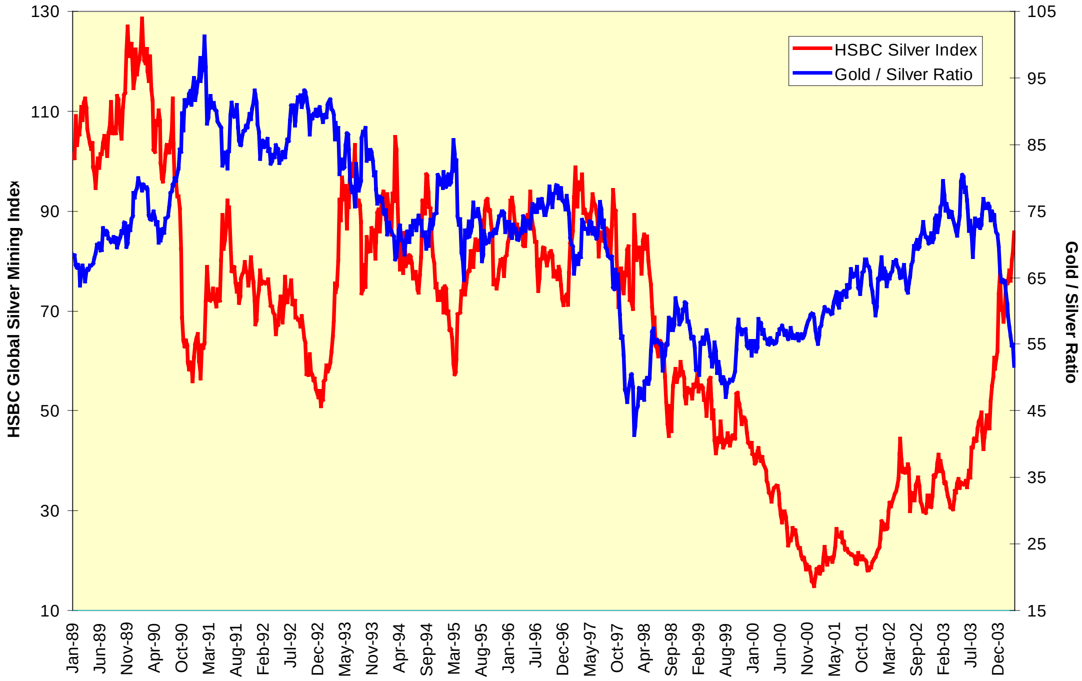
The gold/silver ratio rose consistently throughout the 1980s, a period of declining inflation, and peaked in February 1991, a full year and one-half before the yield curve started to flatten in September 1992. It hit its low just over 41 in February 1998, another full year and one-half before the yield curve began its strong steepening in September 2000. If this pattern continues - and I squirm a little at suggesting such a strongly deterministic relationship - the yield curve will be flattening in a major way by the end of the year. The yield curve may remain steep until that point by virtue of the long end pricing in a series of increases in the federal funds rate well before the Federal Reserve itself swings into action.

Many of the effects of monetary policy on the gold/silver ratio derive from the strong influence of the dollar on gold prices, and in turn from the strong influence of monetary policy on the dollar. When monetary policy tightens, or is anticipated to tighten, we should expect to see the dollar firm, and unless expected inflation rises faster than both the dollar and short-term interest rates, we should see gold prices languish, as noted here in [February](#).



Trying To Find Gold In A Silver Mine?
If the monetary environment turns less favorable for the metals, is it too late to jump into the silver mining stocks? The HSBC Global Silver Mining Index has at last recovered to its levels of the mid-1990s, hardly historically high levels for the long-suffering silver sector. However, silver is pushing rich valuations relative to gold as measured by the gold/silver ratio, and if gold itself is facing monetary resistance, the upside for silver may be limited as well unless we see a reincarnation of the Hunt Brothers.

Gold/Silver Ratio And Monetary Policy



The last time the gold/silver ratio moved sharply lower in a short period of time, early 1998, the HSBC index dropped soon thereafter and continued falling for another two years. Some things are for selling, and some things are for buying. Right now, the silver miners look ripe for selling, but if the pendulum stops in the middle, you can always buy them back.