

# Silver/Gold Ratio Reversion

While wreaking its unbelievable destruction, last quarter's financial-market panic certainly showed no favoritism. Launching from ground zero in the financial stocks, shockwaves of selling blasted out through the entire market landscape. Everything speculators once loved was left in ruins, including silver.

Back in July 2008 when the financial markets remained oblivious to the tsunami of fear approaching, silver averaged \$18.07 on close. But by November when popular stock-market fear reached a fever pitch, silver only averaged \$9.81. A 45.7% loss on the monthly averages, not merely the extremes, in just 4 months was enough to test the faith of even the most dedicated long-term silver bull.

But even at the very bottom when things looked the bleakest, it was clear silver's extreme lows were anomalous and not sustainable. The day after silver's \$8.92 closing nadir on November 20th (not coincidentally the very day the general stock markets bottomed too), I published an essay called "[Silver in Crisis](#)". The conclusion was silver's selling was way overdone. So we were buying ridiculously-oversold silver stocks at the time.

One new long-term elite silver-stock investment we made in [Zeal Intelligence](#) in November in the heart of the panic was already up 81.9% as of this week. It pays big to be a contrarian and be brave when everyone else is afraid. Indeed, since those depths silver has strengthened considerably. Over the past week it has averaged \$12.46, 34.1% higher than its average \$9.29 close in the week leading to its panic low.

This impressive run in silver has led some traders to wonder whether it is getting overbought and the *short-term* risk-reward equation is shifting out of its favor. With a good fraction of my own capital deployed in physical silver and various silver stocks, silver's near-term outlook intrigues me too. Of course I am very bullish on silver in a secular sense, but after my research this week I'm bullish on the coming months too.

Despite all silver's own fundamental merits, its primary technical driver is nearly always the price of gold. In a favorable gold-price environment, speculators' interest in all the precious metals grows. So they deploy increasing amounts of capital in silver. In this tiny market, it doesn't take much buying (relative to larger markets) to drive big and fast price spikes. And when gold is weak, silver speculators lose interest fast.

This gold-driving-silver dynamic remains controversial among some silver investors, but it certainly shouldn't be. In 2007 I did a study encompassing decades' worth of big silver uplegs/bulls and [the resulting charts](#) are crystal clear. Silver generally lags gold initially, but as gold gathers steam speculators flock to

silver and ignite the sharp moves higher this restless metal is so famous for. Gold leads the way.

In recent years this centuries-old positive correlation of silver with gold continued. This first chart compares the raw silver and gold prices over the last 4 years or so. Note that these vertical axes are both zeroed, so there is no scale-induced visual distortion of this critical relationship. Prior to the financial panic in late 2008, silver indeed maintained a very tight correlation with the gold price.



The bullish ascents of the blue silver line and red gold line in recent years are very similar. In fact you could probably pass one off for the other if there were no price labels on the vertical axes. And this close relationship is not just visual, but statistical. Between January 2005 and August 2008 (a secular pre-panic span), the daily correlation r-square between the silver price and gold price ran 94.7%. In other words, nearly 95% of the daily price action in silver was mathematically explainable by gold's own.

But during the stock panic, silver suddenly radically decoupled from gold. Gold was fairly resilient through this fear bubble, but silver just plummeted. While the yellow metal merely hit a 14-month low at worst, silver spiraled down to a horrific 34-month low. It was trading way back at early-2006 levels before the dust settled and its price started stabilizing. This fascinating decoupling is actually the basis for silver's near-term bullish thesis today.

During the stock-panic months (September to December), silver's correlation r-square to gold plunged to 52.5%. Only about half of silver's daily price action

was statistically explainable by gold's. This is still based off a positive correlation, but a much weaker one than we typically observe in silver. It wasn't necessarily this weaker correlation that caused silver's problem, but its newfound mid-panic asymmetry. The correlation grew lopsided to the downside.

On most days during the panic months when gold was up, silver would rise too. But usually it would just pace gold's gains at best, and sometimes not even match them. But on days when gold was down, silver would often plunge dramatically and multiply gold's losses. Playing out over months, this outsized downside pressure on silver whenever gold was weak led to the serious decoupling evident in this chart.

Why was silver so much weaker than gold during the financial panic? Silver's price is much more dependent on sentiment at any given time than gold's. And sentiment during the panic was exceedingly rotten. Speculators sold everything universally, sparing nothing. The riskier any particular asset, the more aggressively it was liquidated to raise precious cash and to protect from the threat of further losses.

Silver is a speculators' playground in the best of times, a very exciting and hyper-volatile precious metal. But in the worst of times, the stock panic, silver's very attributes that usually work for it suddenly conspired against it. As a tiny market easily blown about by relatively small shifts in capital flows, unlike gold it wasn't big enough to decently weather the intense fear-driven selling. And of course the farther it plunged, the more selling it sparked. As its price crumbled, anxiety soared even among its biggest fans.

By the time the panic-driven sentiment storm started to abate, silver was far lower than the gold price suggested it should be. It was extreme fear that drove this silver anomaly, and this extreme fear was driven by a global stock panic. Not only is that panic over today, but general fear and anxiety in the markets have been abating continually since late November. And with no more extreme fear to hold it down, shouldn't silver recover to historical norms relative to the gold price?

I not only think it will, but I am betting on it. A relationship that has been demonstrably very strong [for decades](#), and has actually existed for centuries, probably can't be totally wiped away by a fleeting fear bubble lasting a few short months. Silver is highly likely to mean revert to its long-time relationship with gold. We can nicely quantify all this with the Silver/Gold Ratio, which the next chart explores.

Technically the SGR is the silver price divided by the gold price. Unfortunately this leads to tiny numbers that I have a hard time wrapping my little brain around. At \$12 silver and \$900 gold, the true SGR is 0.0133. I charted this and unfortunately it really isn't very intuitive. This is the same reason currencies with

low values (like the yen) are quoted differently in forex markets than currencies with high values.

So I decided to use an easier-to-digest proxy for the SGR, the inverse of the silver/gold ratio. At \$900 gold and \$12 silver, this is 75. An ounce of silver is worth 1/75th an ounce of gold. To make this SGR proxy properly reflect silver strength and weakness, I had to invert its axis. A falling SGR means silver is getting weaker relative to gold and vice versa. This resulting chart is very interesting.



During the 44 months leading up to the Great Stock Panic of 2008, silver averaged 1/55th the price of gold (I'll just use this number rather than the fraction from here on out). This pre-panic 54.9 average was fairly tight too. It wasn't defined by a few rare extremes, but many years of gentle meandering near the middle of a range between 65 and 45. Despite the countless market-moving gold and silver developments since 2005, this 55 average held nicely.

Incidentally, if you do any deep silver-stock or gold-stock research, the miners will often report equivalent numbers. A primary silver miner will take its byproduct gold production and convert it into silver ounces using the cash equivalent. A primary gold miner will do the opposite, converting its byproduct silver into the cash equivalent of gold ounces. In countless SEC reports I've waded through of gold and silver miners, this 55 ratio is usually the number they all use for equivalent calculations. It is well-established.

And over recent years, the variance in the SGR has actually decreased considerably as you can see above in the tightening wedge. All this leads me to believe that an SGR near 55 is far more normal for this bull market than the levels seen during the stock panic. As speculators fled everything including silver, its price plunged far more than gold's. This drove the SGR to its lowest levels of these entire precious-metals bulls.

It was the [plunging stock markets](#) that drove this *extreme* universal fear. So silver fell to its lowest level relative to gold on November 20th, the very day the S&P 500 swooned to its lowest close of the panic by far. That day, silver at \$8.92 was only worth 1/84th of the price of gold at \$745! I had never imagined such a low SGR was even possible prior to that panic, and I am certainly not the only silver investor who was surprised by it. The panic blew apart all kinds of previously unassailable historical relationships.

And incredibly such an extreme wasn't just a single-day anomaly. During the entire panic (September to December), the SGR averaged 75.8. This is just ridiculously low relative to silver's history with gold. Gold was actually being bid up mid-panic as investors recognized that its performance was really quite good compared to nearly every other asset during the panic. But speculators, quaking in fear, refused to return to silver as readily as the gold investors returned to gold.

For a variety of reasons, I fully expect silver's historic relationship with gold to normalize. It has existed for so long that a fear bubble in the stock markets lasting a few months shouldn't be able to sever it forever. Nothing fundamentally changed on the silver or gold mining fronts during the stock panic, so the secular-bull pictures for both metals look similar today as they did back in July. And silver speculators will always be interested in the much larger gold market and watch it for clues on how to bet on silver.

At \$900 gold and a normal historical 55 SGR, silver should be trading near \$16.36 today. This is 30.8% higher than it was trading in the middle of this week! So even if gold does nothing, a simple mean reversion in the SGR to pre-panic levels implies a silver price much higher than today's still-depressed levels. Until silver returns closer to its normal range relative to gold, the short-term case for this white metal remains very bullish.

And interestingly there are a few factors that make silver's near-term potential look far more bullish than this simple mean reversion to reflect today's prevailing gold prices implies. The first is gold's own bullish fundamental outlook. The second is the strong tendency in financial markets for extremes in one direction to rebound with such momentum that they overshoot into the *opposite* extreme before normal relationships are reestablished. And the third is the way most silver is mined today, as a byproduct.

For many reasons I outlined in an essay in late December, [gold's fundamentals](#) are awesomely bullish. Its price is likely to rise substantially to dramatically in 2009. I can't imagine not seeing at least a 20% gain in this calendar year. So a mean reversion of the SGR to *today's* gold prices is conservative. If we indeed see gold power higher this year, then the usual 55 ratio implies an even higher silver price to reflect it. As an added bonus, a rising gold price will entice speculators back into silver much more rapidly than a flat one.

And while I am more cautious on this secondary factor, I think it is fair to mention it. Extremes in the financial markets are driven by sentiment, a great pendulum of popular consensus swinging from greed to fear and back again. This pendulum almost never gets pulled to extremes in one direction, starts swinging back to recover, and then simply stops dead mid-swing at normal levels. Its momentum usually carries it well through normal to the opposite direction. Applied to the SGR, this means we could very easily see a temporary spike well *under 55*.

At \$900 gold and a 40 SGR, silver would easily exceed its March 2008 bull high to trade above \$22 in a greed spike. And if you run the math for a higher gold price or better SGR, it gets even more bullish. But realize this reversion thesis certainly doesn't need either a higher gold price nor an outsized oscillation of the SGR to the other extreme. It is plenty bullish for silver even if gold stays flat and the ratio merely returns to normal.

A true fundamental factor spawned by the panic could play a role too, and it is very bullish for silver. Something like 3/4ths of all the silver mined worldwide is merely a byproduct, primarily of base-metals mining. And the [base metals' prices](#) were obliterated in the fear that surrounded the stock panic, plunging by more in a few months than they fell in the *entire* Great Depression in some cases. If base-metals miners respond to this crisis by mothballing mines or reducing production, the mined silver supply could fall as well. Less silver for speculators to chase means higher prices sooner.

In light of all this, a really compelling bullish case can be made for silver over the near term. We've been trading accordingly in our subscription newsletters, recommending various silver trades that should thrive as the silver price returns closer to its historical relationship with the gold price. Unless gold plunges, which is very unlikely in today's [inflationary world](#), the silver price needs to go higher regardless of any other factors.

In the new February issue of our acclaimed [Zeal Intelligence](#) monthly newsletter, I recommended a silver stock that big capital will flood into as the silver price normalizes with gold's. And as always, it is full of deep, insightful, and actionable contrarian financial-market analysis that you can't find anywhere else. Fortunes will be made emerging from these panic anomalies, so [subscribe today](#) so you don't miss out on the coming gains.

The bottom line is silver's primary driver is the price of gold. But general fear grew so intense in the sentiment firestorm of the stock panic that silver radically decoupled from gold. It was driven to incredible lows that are unlikely to persist as fear abates and the financial markets return to normal. As speculators slowly emerge out of their fear-induced stupor, they will return to silver and other speculative assets.

So almost regardless of what happens anywhere else, the silver price should gravitate towards more normal levels relative to gold. Even if gold stays flat and silver merely returns to its average ratio with gold, this white metal still has excellent near-term appreciation potential. And of course the best silver producers' stocks should nicely leverage any silver gains driven by its mean reversion to normalcy with gold.

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So how can you profit from this information? We publish an acclaimed monthly newsletter, [Zeal Intelligence](#), that details exactly what we are doing in terms of actual stock and options trading based on all the lessons we have learned in our market research. Please consider joining us each month for tactical trading details and more in our premium Zeal Intelligence service at ... [www.zeallc.com/subscribe.htm](http://www.zeallc.com/subscribe.htm)

Questions for Adam? I would be more than happy to address them through my private consulting business. Please visit [www.zeallc.com/adam.htm](http://www.zeallc.com/adam.htm) for more information.

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