

## Silver/Gold Ratio Reversion 2

Silver has endured a rather tough June so far. After peaking just under \$16 on the 2nd, this white precious metal plunged 12% to just over \$14 by the 15th. This is certainly a significant decline for less than 2 weeks, so silver traders are anxiously wondering what it portends. Will silver languish in the summer doldrums again this year?

Perhaps, only time will tell. But I suspect this year silver will buck its typical [lackluster summer trend](#) and prove exceptionally bullish. Due to the wildly volatile market behavior of the past year, silver happens to be in a very unique position today. It remains *seriously* undervalued relative to gold. The ongoing rectification of this anomaly alone should lead to silver buying on balance in the coming months.

Provocatively, the gold-price trends are the single most important driver of the silver price. The reason is simple. Silver investors and speculators all watch the gold price as well, it is the primary ingredient coloring their sentiment. So when gold is looking strong, they flood into silver and bid it up rapidly. And when gold weakens, many are quick to exit silver. The technical results of this behavior are striking.

A couple years ago I did a comprehensive study of the interrelationship between silver and gold since 1971. As the 7 comparative charts in [that essay](#) revealed, silver has almost always followed gold's lead throughout our entire modern era. Where gold goes, silver follows. History is crystal clear on this. I like to joke about this nearly-ironclad relationship by calling silver "gold's lapdog". It irritates some folks.

This quip is certainly not intended to denigrate silver, but to illustrate a very profitable technical truth for traders. I am a long-time silver investor and speculator. I started recommending physical silver coins as investments back in late 2001 when this metal languished just above \$4. Some of our best-performing long-term investments today are elite silver stocks we recommended way back in 2002. I've been long silver, very profitably, since before the great majority of today's investors ever considered owning it.

And over this secular silver bull's span, I've learned that gold is often the key to gaming silver's short-term trends. To trade the white metal successfully, you have to understand the dominating role gold plays in shaping silver-trader psychology. While silver may temporarily decouple from gold in rare extreme situations, over time it will always revert back to following its far-larger and more-important cousin.

This is exactly why silver has more potential to rise this summer than in any other I've witnessed in this bull. During last autumn's stock panic, silver traders

panicked with the rest of the world and aggressively dumped the metal. Since silver is such a tiny and hyper-volatile market, this intense selling drove it down much faster and farther than gold was falling. The resulting unprecedented anomaly persists to this day.

This peculiar episode is easiest to understand when illustrated visually with a chart. The blue line is silver, superimposed over gold in red. Both metals are rendered on zeroed axes so there is no visual distortion. I ran the data back several years or so before the panic, so the baseline behavior of silver relative to gold can be established before the wild and crazy events of late 2008.



Before the Great Stock Panic of 2008, silver tracked gold beautifully. When gold was rallying, traders would flood into silver forcing it to surge higher and faster than gold. When gold was correcting, silver selling would drive outsized declines relative to gold. Silver was doing just what it always had, amplifying and leveraging underlying moves in gold. And this relationship is mathematical, not just visual.

Between January 2005 and August 2008, a long-term pre-panic span, silver had a correlation r-square with gold of 94.7%! This is stellar, unbelievably high as any statistician will tell you. It means that nearly 95% of the daily price action in silver was statistically explainable by gold's own daily price action. We traded this relationship to much success, studying gold to figure out when a new upleg was probable and then buying silver and silver stocks to leverage gold's run higher. It was great fun.

But during last autumn's brutal stock panic, the first [in 101 years](#), silver's very tight correlation with gold suddenly vanished. Silver actually *decoupled from gold*, something I never thought I'd witness. While startling, the reasons behind this extraordinarily peculiar event offer excellent insight into the perceived nature of gold and silver among traders today.

The stock panic terrified speculators. When the S&P 500 plummeted 27% in less than 4 weeks in October, traders rushed to liquidate all risky assets. They sold absolutely everything, fundamentals be damned, in a desperate rush to raise cash and end the intense financial pain. Silver has always been a risky speculation and it was treated accordingly. It plunged 25% to the very days of that October stock selloff. Provocatively it even bottomed on the same days as the stock markets in October and November!

Gold too was hit in this maelstrom of fear, but to a much lesser extent. Gold is a classic safe-haven play, a place to protect capital in financial crises. While the enormous deluge of capital surging into the US dollar (cash) [weighed on gold](#), it still weathered the panic better than almost everything else but the dollar. Traders weren't as quick to liquidate their gold as their silver, as it was still perceived as a refuge in the storm.

The results of silver being treated as a speculation during the fear bubble, while gold generally wasn't, are clear above. When the dust settled, gold had only been driven down to a 14-month low. But silver, which even long-time contrarians weren't excited about holding in the hyper-fearful panic environment, plummeted to a 34-month low. The intense fear had driven silver to decouple from gold, an incredible anomaly.

Silver's mathematical correlation with gold was even broken during the panic, it tended to move with the general stock markets instead. Universally all speculators were watching the plunging stock markets for trading cues, so all risky assets including silver mirrored the S&P 500. Between September and December last year, the months that encompassed the stock panic, silver's r-square with gold plummeted to 52.5%. Gold's influence had faded dramatically, gold no longer dominated silver traders' sentiment.

Since those crazy events, silver has been recovering. Its post-panic r-square with gold is rising again, up to 81.8%, as gold's psychological influence is once again starting to override the stock markets'. But although gold was soon bid back up to pre-panic levels, silver has lagged far behind. So many silver traders were hurt so badly during the stock panic that they are in no hurry to redeploy their remaining capital. Their reluctance to return has created big opportunities for us today.

As this chart illustrates, based on pre-panic history silver should be trading between \$18 and \$19 or so given today's prevailing gold levels. This is about a

third higher from where it was trading earlier this week. As time continues to dull the psychological wounds from the panic, as the fear continues to fade, I have no doubt that silver will reestablish its decades-old historical relationship with gold. Traders today can ride this reversion higher in silver itself and the companies that mine it.

A more precise way of measuring the relationship between silver and gold is the Silver/Gold Ratio. The SGR simply divides the daily silver close by the daily gold close. But since the result is a hard-to-digest tiny decimal (0.0152 this week), I prefer to use the inverse of this SGR. Also known as the Gold/Silver Ratio, it yields numbers that are easier to follow mentally (65.7 this week). In other words, an ounce of silver is worth 1/66th an ounce of gold.

But charting the GSR natively is misleading when analyzing silver, because when silver rises this ratio falls. So I prefer to invert the GSR axis and call it an SGR (which it effectively is at that point), thus a rising ratio logically indicates relative strength in silver compared to gold and a falling one relative weakness. When this blue SGR-proxy line below is rising, silver is outperforming gold. When it is falling, gold is outperforming silver.



For at least several years prior to the stock panic, the SGR averaged 54.9. An ounce of silver was worth 1/55th of an ounce of gold. And this average was derived from a pretty tight relationship as the SGR line above shows. The 55 SGR average wasn't skewed by a few radical extremes, but driven by a longstanding trading range with relatively mild deviations from the mean. It was this bull's pre-panic norm.

But when speculators panicked last autumn, the SGR plummeted. It shattered a rising secular support line that had held for years. By the time the stock panic bottomed in late November, and hence silver bottomed that very same day because that's when fear was the most intense, silver had hit its worst levels relative to gold of its entire secular bull. Silver was trading under \$9 while gold was around \$745, a huge disconnect.

That day at silver's nadir, the SGR fell to 83.5. An ounce of silver was merely worth 1/84th of an ounce of gold! And during the final 4 months of 2008 which encompassed the stock panic, the SGR averaged 75.8. These were just stupid-low levels that made no sense at all, like most prices late in the panic. Extreme fear had driven such intense selling that prices totally decoupled from their underlying fundamental realities.

But extreme emotions never last for long, their very intensity soon burns itself out. And to hardcore students of the markets, even in the very heart of the panic it was crystal clear that such cheap silver levels relative to gold couldn't be sustainable. So we did the only thing good contrarians can do in a panic, we *bought* aggressively and recommended our subscribers do the same. They've been richly rewarded.

As of the latest Zeal Intelligence, a new long-term investment in an elite silver stock made in the bowels of the panic had already nearly *tripled*. In Zeal Speculator we bought [the silver ETF](#) when silver was still under \$10. We've since added more successful silver trades in both our monthly and weekly newsletters. Trading this mean reversion in the SGR has already been very profitable, and it is not over yet.

Back in early February when I wrote [the original essay](#) in this series, the SGR was running near 72 which wasn't much above the panic average. Today, about 4.5 months later, it is near 65. Since silver was radically more oversold than gold during the stock panic, it is rallying much faster than gold emerging out of the panic. So before this year is out the SGR should again converge with its 55 historical average.

This means even if gold does nothing, which is highly unlikely given the [coming inflation scare](#), silver has plenty of room to run higher this summer. Despite recovering considerably already, it still remains way too cheap relative to gold. At \$925, \$950, \$975, and \$1000 gold, the long-term 54.9 average SGR yields near-term silver target prices of \$16.85, \$17.30, \$17.76, and \$18.21. All of these are nice gains over today.

But for a variety of reasons I doubt the SGR will conveniently stop at its average. First, note the SGR's rising secular support line above that was broken by the panic. It showed a long-term tendency for silver to rise a bit faster than gold.

And this makes sense since silver is such a small market. If investor interest and capital deployed in gold and silver each grow by a similar amount, silver will rise faster. If you extend that SGR support line, it hits 50 now and about 48 by the end of 2009. Let's call it 49.

At 49 SGR secular support, at \$925, \$950, \$975, and \$1000 gold, silver would trade at \$18.88, \$19.39, \$19.90, and \$20.41. These prices are obviously even more attractive and much higher than today's. But even this is nowhere close to the best-case scenario. Even with flat gold, the SGR could very well shoot a lot higher than 49, at least temporarily.

Once a long-standing equilibrium (a 55 SGR) is disrupted in the markets, there is usually a countermove *in opposing proportion* to the original disruption. Visualize a playground swing. Hanging straight down is equilibrium. If you pull the swing 1 foot in your direction and let it go, it will initially swing about 1 foot in the opposite direction before normalizing. But if you pull it 10 feet in your direction, a bigger disruption, the counterswing will be proportionally larger. The SGR was dragged far off equilibrium by the panic.

So it would not surprise me one bit to temporarily see the SGR swing proportionally in the opposite direction. Silver was so beaten down in the panic that the return of silver speculators will probably drive it far higher than gold would suggest is prudent. I don't know how high the SGR could go in such a silver greed spike, but examine the chart above and make a guess. We could be in for a major silver spike before SGR equilibrium is restored, which would be wildly profitable for those long silver.

But perhaps the most bullish thing of all about this SGR reversion is that all my analysis so far assumes gold merely stays flat. But this is very unlikely. Not only are the [yellow metal's fundamentals](#) very bullish today, but the Fed's recent [doubling of the US monetary base](#) will soon stoke the biggest inflation fears since the 1970s. When mainstream investors start reallocating capital into gold, all bets are off the table on how high silver could go. Gold is the big silver wildcard right now, and it is an exceedingly bullish one.

While I own lots of physical silver, and am still trading the silver ETF, I believe the biggest opportunities by far in this SGR reversion are in the elite silver stocks. While silver was sold off far more aggressively than gold warranted during the panic, silver stocks were in turn dumped even more aggressively than the dismal silver prices warranted. Silver stocks, still recovering, remain too cheap relative to silver today.

Thus we could easily see a doubling to quadrupling of most great silver stocks' prices, *from here*, by the time this SGR reversion fully runs its course. Add in the first inflation scare of the modern era, and the gains could be even bigger. Silver stocks are a minuscule specialized sector with a trivial total market capitalization

relative to not only the broader stock markets but even gold stocks (which themselves are a tiny sector).

At Zeal we've been trading this SGR anomaly since the heart of the panic. But the panic was so damaging to silver companies' abilities to raise capital to finance their endeavors that we needed to figure out which silver stocks could survive and thrive in this tough environment. So back in March we launched a comprehensive 3-month fundamental-research project to find our favorite 12 post-panic silver stocks.

Our initial screens turned up nearly 100 primary silver stocks trading in the US and Canada. Provocatively, back in late March they had a *collective* market cap of just \$6.8b. This is astoundingly small! At the end of March the gold stocks of the flagship HUI index had a collective market cap of \$144.1b. And the S&P 500's ran \$7217.8b. So if *anyone* gets interested in silver, these stocks are going to skyrocket. They are just too small to absorb any meaningful capital inflows.

My business partner Scott Wright, one of the best commodities-stock analysts in the world, painstakingly whittled down this universe of primary silver stocks until we had our favorite dozen. He then wrote an outstanding new 33-page [report](#) analyzing each of these fantastic silver companies' fundamentals in depth. It is a fascinating, educational, and entertaining read, a vast array of research and analysis condensed into a highly-valuable summary. It is these elite silver stocks we will trade going forward.

Just days ago, we published this brand-new silver-stock report. At just \$95 (\$75 for Zeal subscribers), it is an amazing value. Even if you are an accomplished silver-stock analyst, it would take you hundreds of hours to attempt to replicate this research. And if you haven't already spent many years wading through SEC reports, company releases, and many other arcane sources of information, you'd never be able to undertake such a complex project. So if you are interested in elite silver stocks, [buy our new report today!](#)

As always we'll continue to analyze and trade silver and the silver stocks going forward in our acclaimed [monthly](#) and [weekly](#) subscription newsletters. While these popular free web essays outline some of our basic research, it is only in our newsletters where we tie everything together and launch high-potential stock trades for the good folks who finance our hard work. [Subscribe today](#) and see what you are missing!

The bottom line is silver remains way too cheap relative to prevailing gold prices. And history strongly suggests this anomaly, driven by the stock panic, will not persist. Silver needs to rise considerably to normalize with gold even if the latter stays flat, which is unlikely. The gigantic money-supply growth and coming

inflation scare should drive incredible mainstream interest in deploying capital in gold and silver.

While silver itself will see nice gains in this inevitable SGR reversion, the gains in the best silver stocks will dwarf silver's. Not only is this sector tiny, but investors and speculators largely abandoned it during the panic. As they return, and traders new to silver stocks join them, we will see elite silver stocks multiply in value. The still-unwinding panic aftermath should lead to a far-from-typical summer for silver.

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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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