The Gold to Silver Ratio & How Investors Use It

The formulaic definition of the gold-to-silver (g/s) ratio is exactly what it sounds like. It is the amount of silver ounces that it would take to purchase a single ounce of gold at prevailing market prices. For precious metal investors, the g/s ratio is an important indicator used to determine the most opportunistic times to buy or sell the two precious metals.

Based on this morning's gold and silver prices of approximately $1,298 and $18.60 an ounce, the ratio is at just under 70 as I write this. This means that it would cost about 70 silver ounces to purchase just one ounce of gold. This figure is far above the historical average of the ratio. This tells investors that at their current prices gold is relatively more expensive than silver and silver is likely to outperform in the future.

In February of this year the ratio touched 83, marking its highest level since the credit crisis. Silver outperformed gold during spring and summer months driving the ratio as low as 66 in July. This was the lowest level since September of 2014. This is still well above the 35 level where the ratio bottomed out five years ago. This bottoming of the g/s ratio in 2011 coincided with the highs for the two metals, and signaled the commencement of the recent 5-year bear market for precious metals. This is actually a recurring trend as extreme highs in the ratio often indicate the beginning of a rally for both of the metals, while extreme lows (such as 35 in 2011) often mark the start of a new bear market for the precious metals. It makes sense for silver to outperform during bull markets, and vice versa, as it is viewed as the more "risk-on" trade of the two metals.

And if you look at the performance of gold and silver recently, it certainly appears the indicator is working its magic again this year. The g/s ratio topped out during the first few months of 2016 and many would argue that we have been in a precious metals bull market since as the YTD returns for gold and silver are 22% and 33%, respectively.

What is the Historical Average of the Gold-to-Silver Ratio?

Well that all depends on who you ask. The true historical average is about 15 or 16, but this is because a number of currencies used to be backed by both of the precious metals. This monetary standard of bimetallism was made famous by Alexander Hamilton. Over time this policy waned, and silver became less and less important from any monetary perspective. Today most currencies including the US dollar are considered fiat money and are no longer backed by either of the hard metals.

Since the 20th century the average g/s ratio is 47 and over just the last 100 years it is closer to 40. Over the last 20 years and 5 years the ratio's average has been 61 and 63, respectively.

Silver has long been believed to track the price of gold due to store of value demands. Yet recently the demand for silver has been driven largely by its increasingly important role in industrial production. Many silver bulls believe that its new role as a key input is likely to be

more advantageous than its role as a precious metal in the future. Silver's industrial use also means that its future performance will be more closely tied to global growth, and consequently more highly correlated with stocks than gold is.

A MarketWatch article from earlier this year quoted Mark O'Byrne, the research director at Goldcore, who stated that "silver remains a compelling buy at these levels and will likely be the surprise outperformer in 2016." His thesis was based largely on the g/s ratio trading at extreme highs, with a median value of about 75 so far in 2016, well above any historical average.

O'Byrne also said the following about his expectations for the ratio to contract as both metals move higher in the future:

> *"Silver's industrial uses should mean that the gold-to-silver ratio will likely gradually regress to the average," also noting that if the "tiny silver market was to see high net worth or institutional funds enter it, then the ratio could return closer to the historical average of 15 to 1."*

The last time the gold-to-silver ratio was as low as 15 was 1980. See below for a 20-year chart of the ratio. The ratio has hit a ceiling around 80 four times in the last 20 years and every time it has done so, it has subsequently fell to at least 48 before recovering. At the beginning of 2016 the ratio hit 83 and has trended lower since. The major moving averages have turned over in the coming months and confirmed a new downtrend (circled in green). Another important thing to note is that the last two times the ratio touched such inflated levels, it signaled the beginning of a long-term bull market for silver. You can see this in the bottom pane of the chart.

Disclosure: I own long positions in a number of Gold and Silver companies: AG, GPL, PAAS, SLW, FFMGF, BRIZF, MUX, SAND, RGLD, NAK, GSV, GG, RGLD

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