May 15, 2010

Precious Metal Response to Market Panics of 1987 & 2008

Introduction

There's an old Wall Street saying "*sell in May and walk away*". The primary reason for this is May begins a period of time when trading volumes become thin and bullish returns on investment have been allusive. Thus far for 2010, wise investors have sold early in May and walked away.

Recently trading volumes have surged and volatility has increased dramatically. The cause of the surge in both volume and volatility is the dramatic loss of confidence in the Eurozone as a result of their failure to adequately address sovereign debt issues. The chart below is the volatility index for the last 30 months.

One of the best international indicators to gauge investor confidence is the underlying currency performance of a country or region. Rapid declines in the value of a currency can quickly have an adverse effect on the trade of bonds and equities priced in the currency. One reason is that foreign investors quickly see their profits evaporate as forex losses build. To prevent the loss of capital they begin to sell and repatriate the proceeds, this puts even more sell side pressure on the currency. If a full fledged currency crisis erupts, it can place the entire economy at risk. Investors don't have to look very far to see how currency crises ruined the economies of Argentina eight years ago or more recently Iceland.

It is no secret that the Euro has been under selling pressure in 2010. The year has been earmarked by a steady decline in the Euro due to Greece default fears. There have been periods of strength in the common currency due to temporary euphoria

induced by rhetoric from EU leaders. However, markets finally have called the EU's bluff after seeing through the jawboning exercise by their lack of action. It wasn't until CDS spreads and bond yields for the P.I.I.G.S. of Europe began to explode that the EU finally came up with a $1 Trillion sovereign debt rescue package.

It has been one week since the "shock and awe" fiscal bailout was announced. The intent of it was to restore confidence in Europe and the Euro. At first the Euro experienced a major rally going from $1.27 to just under $1.31; it appeared the market was confirming what EU leaders had intended. But as the business week got underway, the Euro began to slide until by the close of Friday it reached 18 month lows under $1.24. Europe had just played its full hand, yet the Euro, i.e. confidence in Europe, has continued to erode. It now appears that the markets are giving the rescue package a vote of NO confidence. If $1 Trillion cannot instill faith in the Euro block, we can safely assume $2, $3 or even $5 Trillion should fail to do the same.

The Author believes that the world may be on the cusp of a significant currency crisis of not just the Euro but also its cousin the British Pound. Markets are beginning to get a hint of the malaise that may come as equities have come under increasing pressure. The sharp intraday move in the US market indexes May 6th may have been an appetizer for what is to come this summer. The purpose of this article is to take a historical look at how the precious metal market behaved during the market panics of 1987 and 2008. This may enable investors to prepare for the market's response if the brewing European crisis becomes a global asset route.

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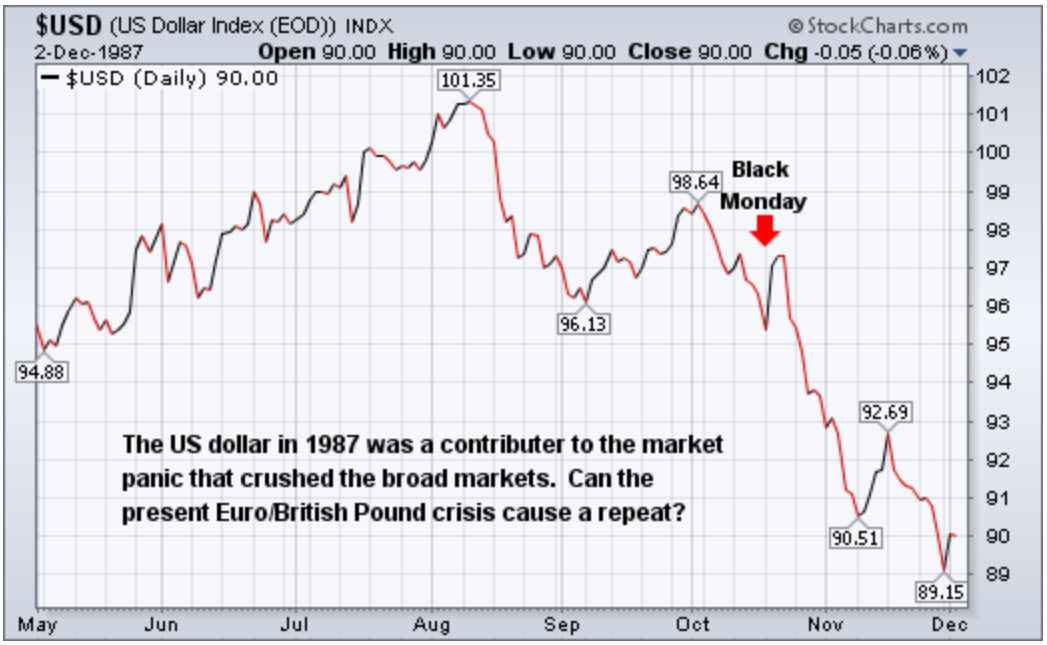
1987 Precious Metal Market Response

There are two well recognized market panics over the last 25 years that sent shock waves through the world; 1987 and 2008. We'll begin our analysis by focusing on 1987.

The Dow during the Spring and Summer of 1987 pushed higher setting new all-time highs for several consecutive months until reaching a peak in August 1987. Volume was relatively thin for setting a string of new highs, which is usually a yellow caution flag for traders. In early October, bulls tried to retest the August high but failed. There was a confluence of several factors that led to Black Monday, October 19th. Some have said a falling US dollar along with an over-valued market and program trading contributed to the violent one day decline. The reasons for the plunge are not as important in this article as how the precious metal sector reacted to it.



Now we move onto how the precious metal (PM) sector reacted to the events of 1987. It appears that the mining stocks themselves detected trouble ahead better than those of the metals gold and silver. PM stocks rallied all summer long moving roughly 50% higher in three short months. The PM stocks reached a peak roughly one month later than the Dow. One would have thought with fear gripping the market in October 1987 that precious metal investments would have thrived. However, the exact opposite occurred as precious metal equities fell almost twice as much as the broad markets. It took approximately 6 weeks from the time the initial slide began to when the low of the move was made.

The next two charts show the response of gold and silver in 1987. Both had brief runs higher prior to and on Black Monday. Gold quickly recovered but silver fell steeply and stayed in negative territory for the remainder of the year relative to its price before the broad market selloff.

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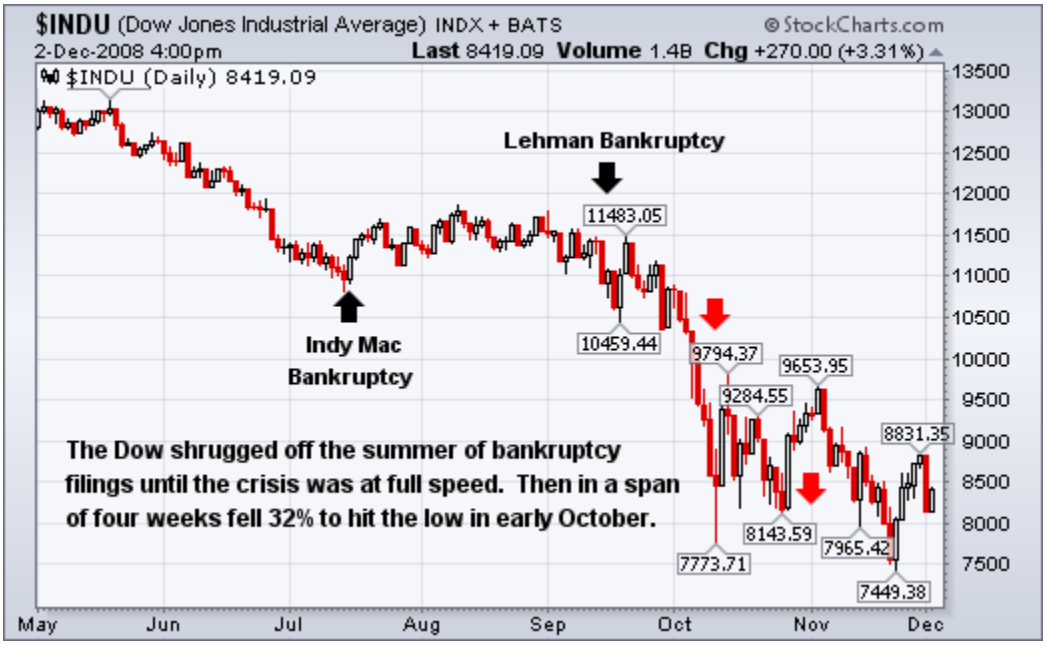
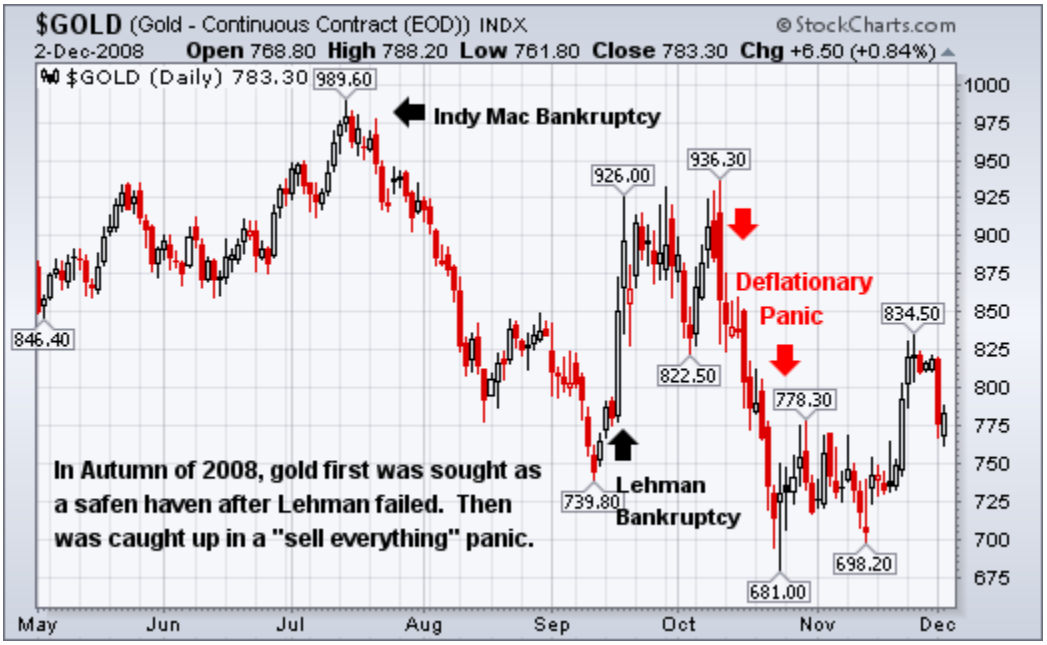
2008 Precious Metal Market Response

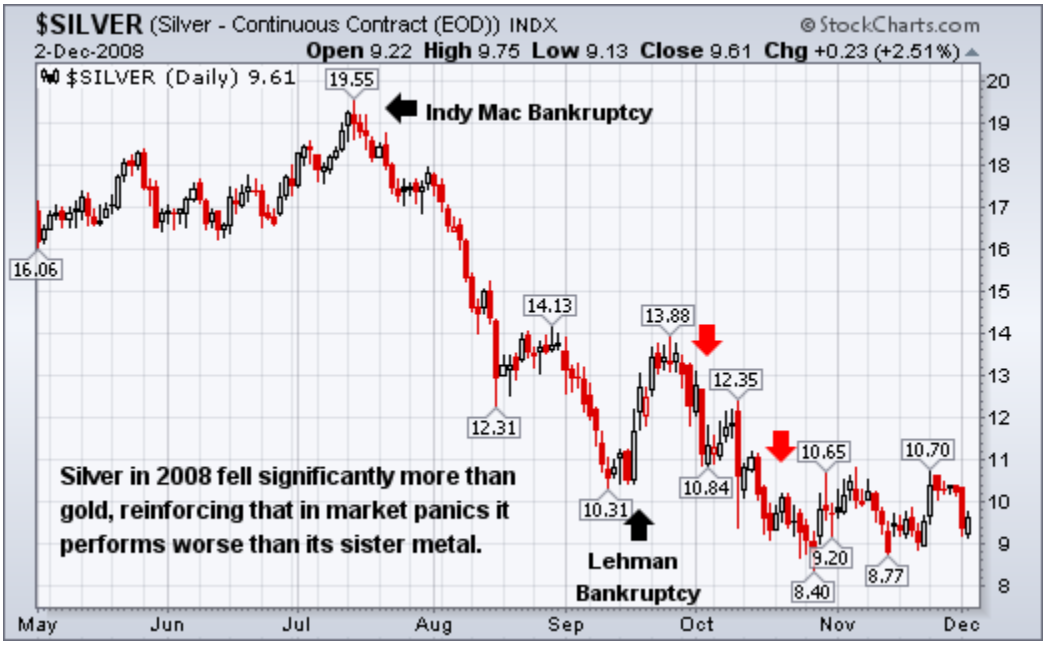
The Dow in 2008 ground lower during the first nine months of the year. The index absorbed several major negative events such as Bear Stearns, Indy Mac and the Lehman Brother's bankruptcy without a major single day 1987 style plunge. The accumulation of negative news and a severe liquidity crunch ultimately did cause the market to selloff. Unlike in 1987, the US dollar soared when the 2008 crisis intensified being viewed as a safe haven at the time.



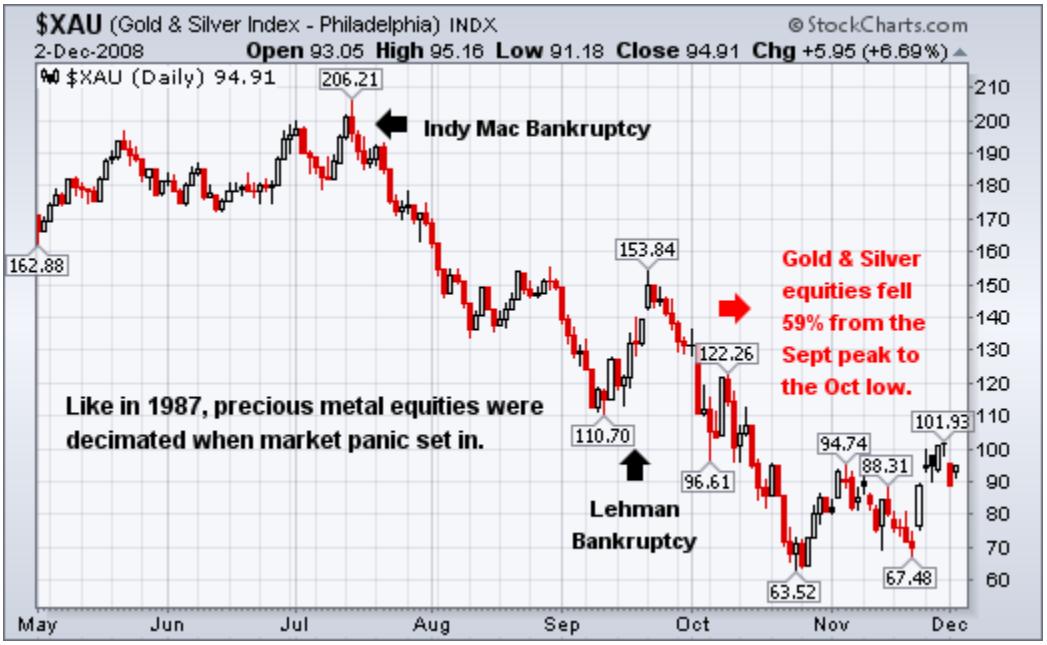
Gold and silver experienced large volatile swings in 2008 as the crisis intensified. Gold initially reacted positively to the Indy Mac bankruptcy in July but then fell 25% reaching a low in September. The metal then soared when Lehman filed for bankruptcy. Gold consolidated for three weeks until the US dollar sprinted higher as world-wide liquidity dried up and panic set in. Gold reacted by collapsing $250 in under three weeks.



Silver reacted much the same way it did in 1987. Its move was an amplified version of gold. Gold from its near term peak in July to its low of October lost 31%. Silver on the other hand lost 57%.



The losses in gold and silver paled in comparison with the mining equities which shed over 2/3rds of their value from their July peak to October lows.



Conclusions

Today investors find themselves in a familiar position to that of 2008. Confidence in the European Union and its common currency has been severely damaged. The sovereign debt crisis was to have abated last week with the announcement of a major $1 Trillion bailout. Now that Europe has seemingly initiated their last solution the possibility of a full blown currency crisis has now become a grave possibility. A question in investors' minds is: How will PM investments perform at times of crisis?

Two periods of extreme market panic were reviewed. The reaction of gold, silver and mining shares were shown. What we can conclude is when extreme panic sets into the markets, precious metals get caught up in selling. Gold had the least decline and recovered faster than both silver and PM equities. Silver has shown during crisis that it will follow gold's lead in a magnified manner. The least stable precious metal investment during a crisis is mining equities, which lost 46% and 69% in 1987 and 2008, respectively. Just because precious metals reacted negatively in the past does not mean they will repeat either 1987 or 2008 performance; but in a new crisis they may rhyme.

About the Author:

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