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Market Update - Why Price Pullbacks Needn't Cause Panic
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Market Update: Why Price Pullbacks Needn't Mean Panic

Gold prices eased overnight and are currently trading around USD $1,720 an ounce as Hurricane Sandy batters the east coast of North America, closing down Wall Street and threatening to cause major disruption to the US economy over the next few days.

The easing in the gold price caps a subdued month, with prices falling from USD $1776.00 on Friday the 28th September. This has been matched in the price of silver, which has fallen around 8% over the last month and is currently trading at around USD $32.32 per ounce

Whilst this pullback has frustrated many gold bulls who predicted that the Federal Reserve's announcement of QE3 would send gold much higher immediately - it is a healthy and, in many ways, expected correction in an ongoing bull market.

It is worth keeping in mind that gold was trading at only $1600 an ounce back in August, when talk of a QE3 program first started gaining credence in the market place. By September 13, when the Fed announced the programme (committing to buying $40bn worth of mortgage-backed securities potentially in perpetuity) gold had already spiked to USD $1733 per ounce and kept on going, hitting $1791 an ounce on October 4th.

Considering the near $200 per ounce increase in the gold price over the two months from August to early October, a pullback was neither unexpected nor unhealthy. In fact, since the beginning of the precious metals bull market back in 2001, there have been four major corrections where the gold price has fallen by somewhere

between 15 and 30% (silver has been even more volatile). All of these have tested the patience and resolve of longer-term investors, and would have been particularly painful in the short-term for those who bought in at those interim peaks. However, as **the graph in this excellent article** highlights, these corrections have merely been blips on the long-run charts for precious metals.

Investors in precious metals would do well to remember this when they see the markets fluctuate, as they do on a daily basis. All of the reasons to buy gold (volatile markets, political uncertainty, low interest rates globally and central bank money printing) are still valid, giving credence to those who expect the bull market (which has seen gold prices go up by on average, 17.50% per annum for 11 years now) to continue.

With that in mind, it was interesting to hear talk this past week from Goldman Sachs' Chief Economist, Jan Hatzius who expects the Federal Reserve Bank's QE3 programme will be expanded from $40bn per month to potentially $85bn per month, and that this expansion could begin as early as December. This would be done to offset the end of 'Operation Twist', which is where the Federal Reserve has been selling one set of bonds to purchase others (i.e. Operation Twist did not involve printing money, per se).

As Hatzius states "***We believe that the committee will be reluctant to do anything that markets would interpret as a slowdown in the pace of monetary easing, such as an indication that the pace of asset purchases will slow in the foreseeable future. Our baseline expectation is a continuation of the current pace of asset purchases of $85bn per month on an open-ended basis, which would imply that the current $45bn per month in twist-financed Treasury purchases is replaced by $45bn per month in QE-financed Treasury purchases.***"

(Source: **Forbes**)

If history is any guide, an expansion in the Federal Reserve's Balance Sheet should be supportive of higher gold (and silver) prices over the long term. This is because the correlation between the size of the Federal Reserve Balance Sheet and the price of gold is very strong. Many market analysts were predicting a gold price of around $2,400 by the end of 2014 based on the QE3 programme printing only $40bn per month. If The Fed does increase the scale of QE3 as Goldman Sachs think they will, the same logic would imply an even higher gold price in the future. In fact, some analysts, using this formula to extrapolate forward, are now **calling for gold prices north of $3000** in the next two years, which would represent a near doubling from its current price.

If the gold price were to increase in such a fashion, there would be good reason to expect that silver would also perform well and increase in price. Whilst silver is still, in some ways, suffering an identity crisis (as it is both an industrial and a monetary metal), it's worth keeping in mind that silver has also had an incredible 10 year run, rising from around $4 an ounce to over $31 today. In periods where the gold price appreciates strongly, silver has often outperformed gold, leading to a narrowing in the gold:silver ratio. This ratio, which is calculated by dividing the price of 1 ounce of gold by 1 ounce of silver, currently sits at 54 ($1707 divided by $31.73). As more investors look to put a portion of their wealth into precious metals, this ratio could well fall. It is worth remembering that in the last precious metals bull market, the gold:silver ratio fell to around 10 (albeit briefly).

For those who are prepared to take on higher levels of volatility within their precious metal investments, the potential narrowing of this ratio in the future makes silver an asset worth looking at.

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