

Reflections[®]



About this Newsletter

Reflections is a monthly publication written by John Gilbert, CIO, GR-NEAM. Each issue focuses on current capital markets and investment topics. Our clients find it somewhat unique from many investment publications typically received.

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First Bubble, R.I.P. Next, Step Forward

It was not a question of whether the Federal Reserve's program of quantitative easing would produce asset inflation. It was only a question of when, and in what asset. We have the answers—the second generation of quantitative easing, and silver, respectively. Silver's recent performance was spectacular and very brief, and had all the signs of vertigo. Unless the contractionary undertow in the U.S. economy dissipates, there will be another Fed program and other asset inflations. These are pejoratively referred to as bubbles.

The frequency of bubbles spawned by easy money, which has occurred for centuries but in modern form can be dated to Japan in the late 1980s, has people and especially the media seeing bubbles everywhere. The majority are not true bubbles. A bubble is a self-propelled price frenzy, a defining feature of which is that prices accelerate as valuations have ceased to make any sense. A bubble is particularly apparent when those prices actually rise vertically. Such a move aborts time and does not even permit the calculation of a slope.

Silver satisfied any and all bubble criteria. In Chart 1 we show the price against time.

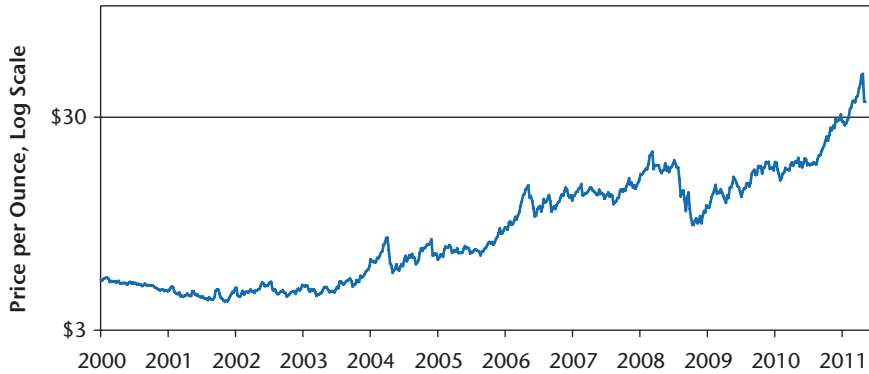
Chart 1. Silver



Sources: Bloomberg L.P. and GR-NEAM Analytics

In the next chart we show the same data in semi-log form to try to dignify silver's performance. A logarithmic vertical axis removes the graphical distortion caused by long passages of time or, in this case, the compounding of very high rates of return. The effort is a failure. The price even went essentially vertical on a semi-log scale as shown in Chart 2, and was unsustainable.

Chart 2. Silver

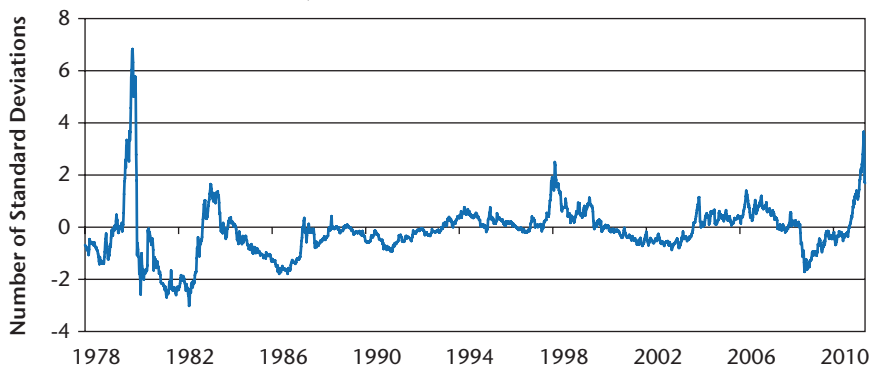


Sources: Bloomberg L.P. and GR-NEAM Analytics

Silver does have a number of uses in fabrication because of its attractive physical and chemical characteristics, but it is classified as a precious metal because it is relatively scarce and because it historically had a putative role in monetary systems. When the dollar was on a gold standard in the 19th century the contractionary effect of gold's scarcity produced the bimetallism movement, which fought for the pegging of the dollar to silver as well as to gold. The debate was a significant factor in the Presidential election of 1896, and while silver's fans lost, it retains its place as a precious metal.

We can consider silver's value relative to gold as an aid to navigation. In Chart 3 we show the ratio of the price of an ounce of silver to gold, expressed in standard deviations. By early May 2011, silver reached a level surpassed only briefly in 1980 when the Hunt brothers attempted to corner the silver market.

Chart 3. Silver to Gold Price, in Standard Deviations



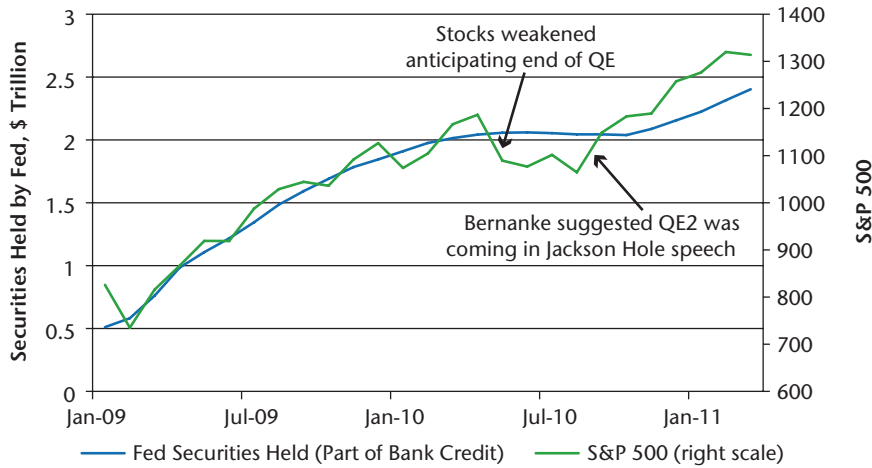
Sources: Bloomberg L.P. and GR-NEAM Analytics

Then, as now, the futures exchange drove the most extreme speculation from the silver market by raising margin requirements on silver futures. The Comex did so this time when silver suddenly approached \$50. In 1980, when the futures exchange raised the margin requirement, the market began falling and the Hunts could not meet their margin requirement and had to sell. Their losses were reportedly \$1 billion at a time when \$1 billion went a lot further than it does today.

Silver has provided a public service by reminding us what a true bubble looks like. This is not to say that before monetary reflation in the U.S. is finished silver cannot again approach \$50 or even trade through it. But it is unlikely to do so on its own. It is likely to need help from other assets, primarily gold, in an environment that is giving up on paper money and attaching to real assets. It is early to handicap the probability of such an outcome.

We know that the central rule of government behavior is that it produces unintended consequences. In trying to satisfy its dual mandate of full employment and price stability, the Fed hoped to reflate housing and jobs. They have largely failed in doing so, but were better at reflating the stock market. They were really good at inflating silver. We have discussed before the contractionary undertow that persists in the U.S. from shrinking household and financial sector balance sheets. That appears to be intact. In Chart 4 the relationship of Fed buying of government bonds and the performance of the markets makes clear that without the reflationary efforts of the Fed the U.S. remains subject to slowing or contraction.

Chart 4. Quantitative Easing and Stock Market



Sources: Bloomberg L.P. and GR-NEAM Analytics

The obvious question, then, is whether the end of quantitative easing that ends in June 2011 will again invite economic slowing and give the Fed the opening to go at it again. If they do, the only question is which bubbles form. And whether, like housing and unlike silver, they affect assets that have the size to affect economic stability. If that were to be the case, we begin to collect clues about the shape of the end of this financial cycle.



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