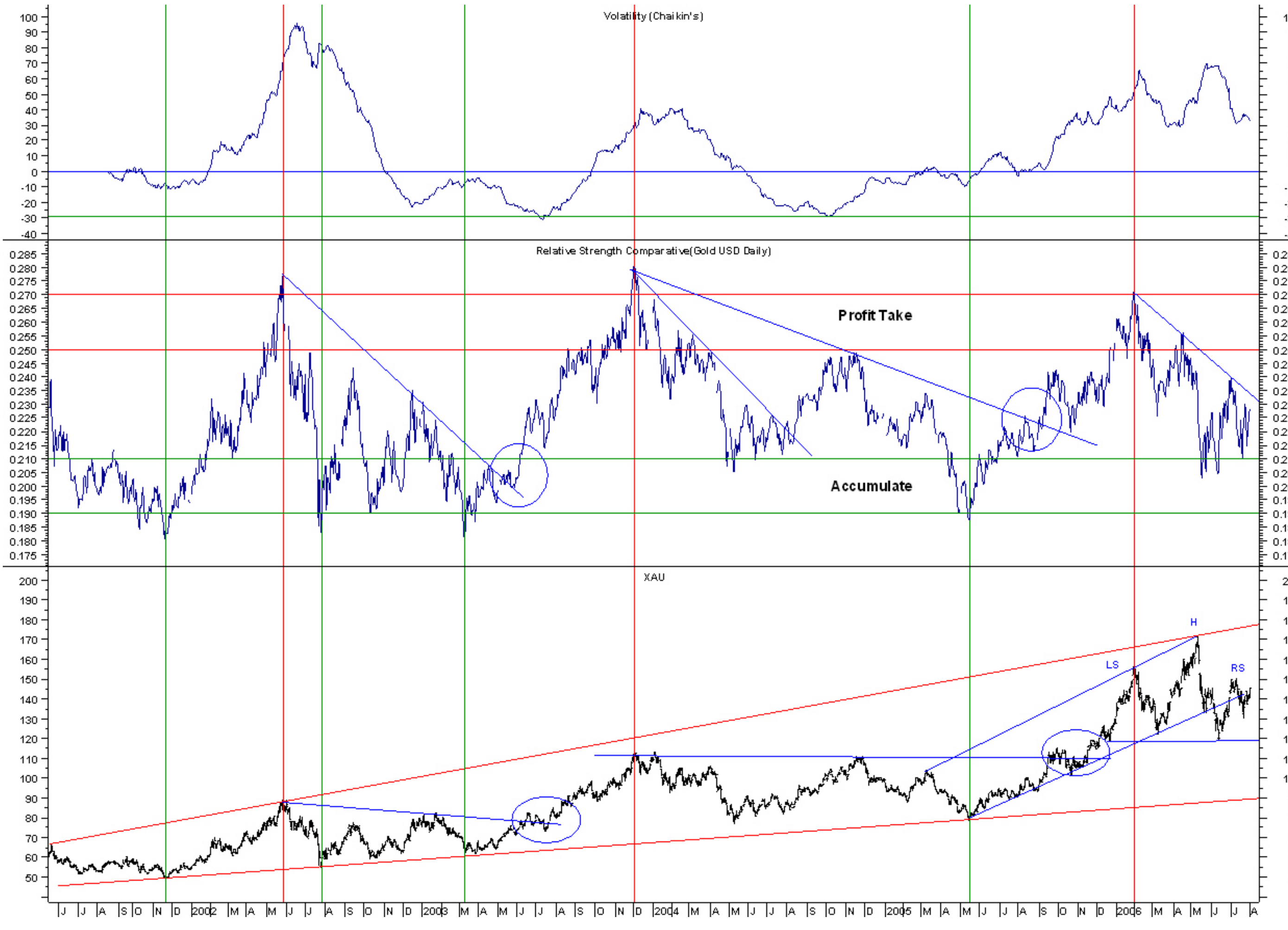
THE VOLATILITY WAR

This month I want to talk to you about volatility and what I believe it means in the context of markets. Volatility, by definition, implies significant swings in the price of what ever it is you are analyzing, suggesting there are two camps directly opposed to one another. One group is determined the price is going higher, buying profusely and telling others to do the same. The other group is not convinced and uses this buying interest to unload some or all of what they hold, or alternatively short the market. Regardless of who is right and who is wrong, these market conditions make it very difficult for any sustainable rally to occur. I am of the opinion that volatility needs to be low for any sustainable rally in a market to ensue. Sustainable rallies in the precious metals markets have historically commenced when volatility is low and excellent value has prevailed. These situations have generally occurred when people have become frustrated and have lost interest. Let me demonstrate what I mean. Below is an historical chart of the XAU.

XAU INDEX



The middle section is the XAU/Gold ratio which we use to determine value. The top section is a volatility index which is based on the difference between the daily highs and the lows averaged out over 100 days. The Green and Red vertical lines indicate the key turning points determined by the XAU/Gold ratio (Value). You can see that there is a strong correlation between volatility and these respective turning points. When Gold shares have become historically expensive (Red vertical lines), this has been at a time when market volatility has been at its highest. This is not surprising given that when anything becomes increasingly expensive it is only natural that you are going to get increased profit taking and consequently more volatility. Alternatively, when we look at the commencement of two of the largest rallies in the XAU in April/May 2003 and April/May 2005, we can see the respective volatility levels were below 0 having spent 3-6 months in negative territory. This, to my way of thinking, makes sense in that the low volatility implies less uncertainty and less opposition, which is what you would expect given the XAU/Gold ratio points to phenomenal value. One exception to this rule was July/August 2002 when the XAU/Gold ratio fell heavily over a brief two month period to levels indicating excellent value, whilst the volatility levels remained high. This suggested an excellent buying opportunity resulting from the panic selling but a low probability of a sustainable rally, given the volatility levels and the remaining uncertainty. Over the following 6-8 months the XAU did indeed consolidate and we found an entry point with a higher probability for a rally with longevity in 2003.

Markets need time to resolve these volatility conflicts which take place after major movements one way or the other. This brings us to where we are today. A look at the volatility index shows us that the level of uncertainty remains very high despite what seemed like a sharp sell off in May and June. This correction hasn't been met with the same pessimism as past corrections probably due to the fact that there is more conviction in this Precious metals bull market at the present stage. Whilst this sell off took the XAU/Gold ratio briefly towards the lower quarter of the chart (value wise), it very quickly rebounded and we have been in limbo ever since. At some point this battle will end. I am not convinced we are embarking on a sustainable rally at this time as Gold shares remain moderately priced and there is simply too much volatility. Whilst a seasonal rally remains highly probable (perhaps up to previous highs), I would not be surprised to see more of the same until this conflict has been resolved and better value prevails. I think 2002/03 may give us a pretty good indication of what we could potentially expect going forward.

There are a handful of analysts at the present time dismissing the relevance of the rather innocuous looking Head and Shoulder pattern that has formed in the chart of the XAU over the last 6-8 months. Whilst it is true that this pattern is not bearish unless the neckline is breached (Presently at about 120), a look at the long term trend line (Presently at 90) indicates that the index could fall some way before jeopardizing the validity of this bull market. With financial markets in a precarious position right now, rising inflation fears and much speculation over interest rate hikes, I think one should at the very least consider some of these bearish implications. The precious metals markets and the general equities markets have more or less been joined at the hip now for an extended period of time. If there was to be a severe market contraction, I think it would be foolhardy to believe that precious metals shares would be immune, at least in the initial stages anyway. Only time, of course, will be the ultimate judge of how this intriguing battle plays out.

Troy Schwensen

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