Silver – Leave Your Tin Foil Hat at the Door

It used to be said that one could judge someone by the company they kept. The problem for those moderately or opportunistically attracted to silver a look around most of the information sources for the metal will find the airwaves jammed with a flock of tin-foil hatted enthusiasts that are obsessed that the Powers That Be are manipulating down its price to get back at them. This is enough to put anyone serious off any metal. Between the gold bugs and the tin-foil hatters, the two metals that should be explicable in the most simple of monetary or store-of-value terms, are periodically turned into sideshow acts with resident freaks.

The length of the current malaise in the two metals has put the conspiracy theorists into a form of shock which has lessened their presence as opinion-formers. Paradoxically one hears more of them on the way up than when silver, for instance, is down in the dumps. On the way up they claim that the Fed/Big Banks/Bilderberg are holding back the rise. When the prices are down they are far more tranquil (usually because they are licking their wounds and wallowing in "I told you so" retrospective justification.

Post Meltdown

We have not been silver bulls for so long it's difficult to remember when it last happened. Definitely we were of that persuasion when it was under $10 per oz. And we were decidedly of the "throw baby out with bathwater" when it soared to $50 in what we thought was a bout of collective insanity. Thus when I started turning bullish last year and predicted an $18 high for this year I thought I was being rather daring. However it was less than two weeks into the year that our target was fleetingly reached. This rapid move was not on any impetus we had foreseen but rather on the back of the surprise surge prompted by the Swiss franc revaluation. Not unsurprisingly the price has slid back in sympathy with gold.

I do however feel silver has the potential to outperform gold. The main rationale behind this is that I don’t expect gold to do much better than a high of $1,300 for 2015.. or at least not a sustained period over that level. Meanwhile silver with its industrial applications has the potential to ride economic recovery in the West (yes, I am still a bull on Western economies).

Another thought that has struck me is that while the dip in gold to nearly $1,100 highlighted just how many gold producers were skating on thin ice with really high cash costs that were near the gold price or even higher. The vast bulk of silver producers had cash costs of $9 or lower when silver was a a “lowly” $14 per oz. This in an indisputably good position to be in and even better when one considers the kicker of Zinc, Lead, Copper or Gold that many silver miners have in their mix.

Demand – Three Words

The chief fact we would focus on here is industrial, industrial, industrial. This is almost all you need to know. The whiplash from the declining demand for silver for photographic purposes is now history. The vast bulk of industrial applications for silver carry on and stronger Western economies should underpin and enhance this. The chart below shows the lay of the land. The metal is only reliant for 20% of its demand from investors.

Some Supply Considerations – Investment Drought to Bite

The Silver Institute is the main industry body (read lobby group) and despite what one might expect to be an innate bias, I have always found their silver surveys (which are prepared by the respected consultants GFMS) to be a fairly accurate reflection of what the supply/demand situation is and what it might become. In one of their recent surveys their arguments for a tighter supply situation were primarily:

- Mine supply expected to peak in next 2-3 years
- Current price levels maintaining production but constraining investment in new capacity
- Supply from secondary sources will remain under pressure. Falling from 25% of total supply in 2012 to 16% forecast for 2014
- Hedge book remains at low levels and hedging is not forecast to return to the market in strength
- Government sales are not expected to be a feature of the market in the years ahead

Of these I might note on the first point that a significant chunk of production comes not from primary mines but from secondary production at Lead/Zinc mines which has proven to be rather price insensitive. With a swathe of these mines in decline due to underinvestment in these two metals during their dark phase, silver output should be the collateral damage of their imminent closure. Meanwhile it is hard to think of too many new silver mines that have come out of the gate in recent times. Mexico and Peru have some large known deposits but they remain in limbo more due to the sick state of mining finance markets rather than 415-16 per oz being unattractive levels at which to produce. It’s worth noting here that Chesapeake’s Metates deposit in Mexico has M&I resources of 518mn ozs of silver amongst its other goodies.

As for government sales, the long serve leakage of silver into the market has come from the Russians. While they have been in financial strees in recent times, they have also been reported as strong gold buyers. With oil not being the “black gold” it was, we would see the Russians selling less silver and instead keeping it for a rainy day. It is not as if the Russian Central Bank feels such a warm inner glow towards holding dollars or Euros these days.

The "Eternal" Ratio

Back in the dim dark past when I was President of the supply-side thinktank, Polyconomics, the resident guru Jude Wanniski commented to me that historically, over the centuries, an ounce of gold had an approximation to the value of a good man's suit (not the suit of a good man). Silver fans would also point out that a historical ratio to gold of 15 to one reigned for many centuries and that even accepting a "new normal" of 50 to one then the silver price is out of whack.

At the moment the Holy Grail for silver "bugs" is to see silver back at the ratio that was "established" when gold crossed $1000 in early 2008 and silver briefly hit $22. It was like all their Christmases had come at once. When gold retreated to $650 in October 2008 silver was back under $10 which was like being blasted back to the Dark Ages for a silver "bug". In the crash of 2008 the ratio blew out to 83:1.

When the rally in gold began in late 2008 the silver crowd have been rubbing their lucky rabbits' foot, lighting candles to Macumba deities and dancing naked by the full moon to try and get their ratio down to its true destiny (i.e. 50 to one). Their hopes were more than fulfilled when the spike to $50 in early 2011 took the ratio down to 31:1. Since then disappointment has been their daily meal.

Therefore the ratio at its peak was a tad above 30 to one while at the darkest hour it was back at over 80 to one.

Historically though the ratio was closer to 15 to one over the years when bimetallic currencies ruled (essentially until the end of the 19th century). The hot button issue of US elections in the 1880s and 1890s was the gradual eclipse of silver. Curiously one might even speculate that silver's relative decline coincidentally (or maybe not) dates back to when it became an industrial metal in the photographic applications. Silver bugs rather ironically are constantly touting new applications for silver (the latest being biocides) while gold's advocates feel no need to underpin demand with industrial applications, beyond jewelry.

Conclusion

So this is like a golden moment (pardon the pun) when one does not have to be a tin-foil hatter to like (or, indeed, prefer) silver. The supply dynamics are good.. the demand dynamics are also favorable and the price of the metal is not at some crazy unsustainable level. As long as financing remains mired in misery there is NO chance of a flood of new production for 2-3 years AFTER financing avenues reopen. Therefore the secret here is to filter through projects that have special things going for them.

Advanced towards production is a good indicator. Having meaningful Zinc components in the deposit will also open more financing avenues. Good jurisdiction is always a perennial positive. And finally we might mention management committed to producing rather than just promoting. Such unicorns do exist and in coming weeks we shall be hunting them…..