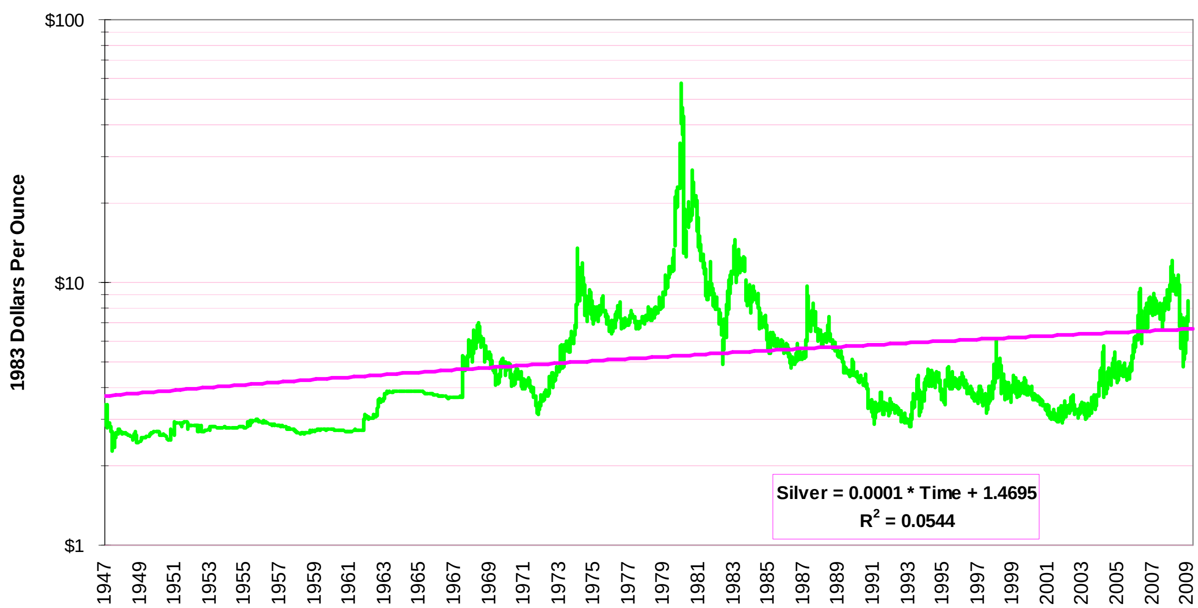
Will Silver Streak Again?

One of the better ways of identifying the veterans in this business is with their attitude towards silver. Anyone who remembers the glory days of physical commodities in the late 1970s and early 1980s regards silver as a beast, a volatile first-derivative of gold and symbionts to soybeans capable of breaking your heart at least once a day. And, yes, they used to trade silver off of soybeans and vice-versa when both commodities were regarded as inflation indicators.

Then came Paul Volcker, now part of the Obama administration, scorching short-term interest rates and, most critically a plethora of new and more exciting financial trading instruments to ruin the party. The Hunt Brothers attempt to corner the market was stymied, prices broke, and silver entered a quarter-century of going nowhere. If we deflate silver prices by the producer price index, we see the real trend in silver prices over the past six decades has been a 0.01% per month increase. The Hunt Brothers' escapades and the "hot commodities" rally of 2005-2007 stand out as one brief and one briefer shining moment; a sort of Dr. Evil and Mini-Me duet.

One Brief And One Briefer Shining Moment



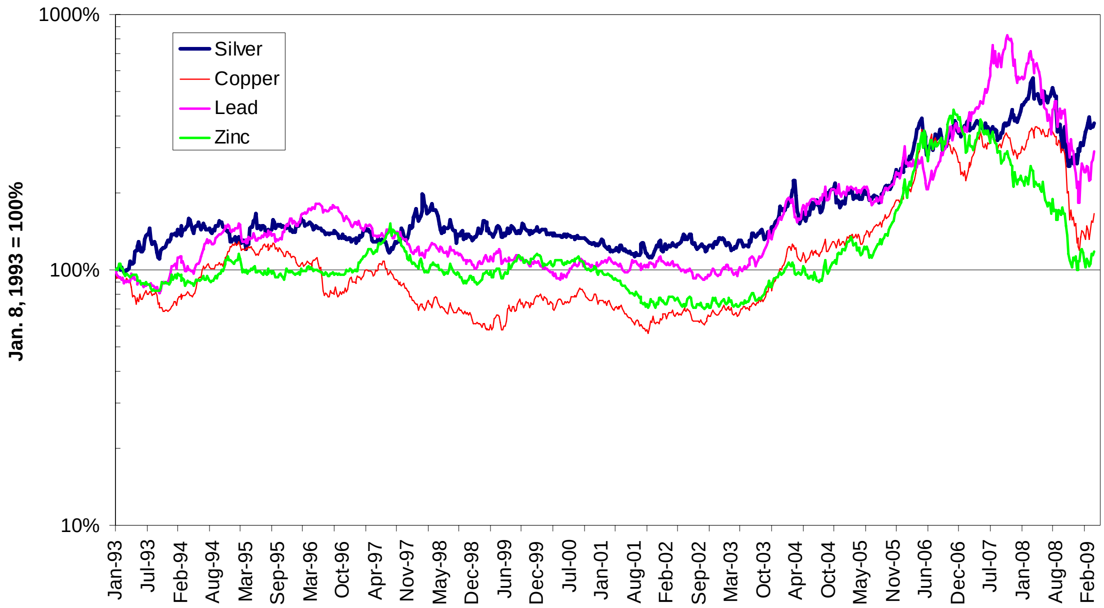
Anyone who cut their trading teeth in the 1990s can be forgiven for thinking silver is a dullard's game; anyone who cut their trading teeth after 2003 probably just regards it as one more commodity underlying an exchange-traded fund.

The reality is a mix; silver is hardly a refuge from financial stress as the first generation of gold bugs averred, and it hardly is a defense against inflation, as the long-term chart above shows. It is, however, a very useful industrial metal in photography, electronics, and water purification systems and, of course, in artwork and jewelry. Photography was, for years, the principal use of silver; that is disappearing as photography is increasingly digital – and we are not about to run out of digits.

To hear its advocates, you would think the world's demand for silver would have outstripped its supply a long time ago. But the dominant aspect of silver going forward might be going back to the future, and that is a market that simply is not that interesting except for an occasional and always spectacular outburst.

With prominent exceptions such as the Spanish colonial-era mines in Mexico, Peru and Bolivia, themselves legacies of pre-Columbian civilizations, much of the world's silver today is produced as a credit from the mining of copper and lead-zinc ores. Declines in the production of these metals often lead to reduced production of associated silver and a concomitant bid in silver's price. As zinc and lead prices peaked in December 2006 and November 2007, respectively, and copper peaked in July 2008, we should be seeing a relative bid in silver's price as this mine-credit production dwindles. And indeed silver has held up better than these other metals.

Silver Has Stood Up Better Than Its Joint Products



Electrum

Silver is to gold what Gehrig was to Ruth, Pippen to Jordan or the Sundance Kid to Butch Cassidy, an indelible sidekick. The link to gold, except in the naturally occurring alloy of electrum, is almost wholly artificial. The real link, if we may be so crass, is both metals are shiny and therefore valuable as jewelry. While gold is almost wholly inert, silver simply collects surface tarnish from airborne sulfur compounds and can be polished easily; contrast this with the way copper turns green and iron rusts. But beyond this, the two metals are not substitutes in industrial applications and as noted above, generally are produced from different ore bodies.

While silver's greater supply and industrial uses make it more of an actual physical commodity and less of a financial one, it is often traded as a spread to gold using the gold-silver ratio. This trade's proponents love to go back to ancient history to recite the 10:1 – 13.5:1 ratio of gold prices to silver prices on a common weight basis. However, the gold/silver ratio has been anything constant over the years; it was just over 20:1 in the first quarter of 1980, and then traded over 91 in the early 1990s. The current ratio is near 70.

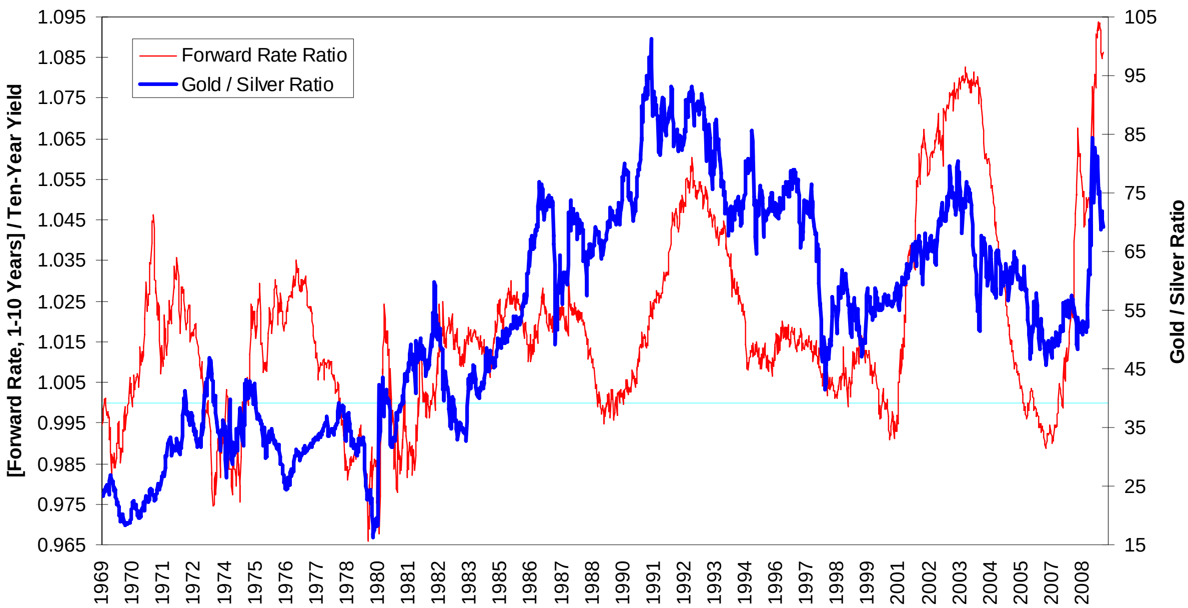
The relationship of silver to gold led to one of the most famous speeches in American political history, William Jennings Bryan's 1896 "cross of gold" speech wherein he importuned on behalf of bimetallism, or the use of silver as well as gold, as the backing for the dollar. The period from the 1870s through the early part of the 20th century was characterized by deflation as the economy was growing far faster than the gold-based money supply. Today the dollar is backed by a smile.

The Gold/Silver Ratio

It is that last statement that leads adherents of precious metals to look at the gold/silver ratio (GSR). Even though rising income-related demand in India and in the Persian Gulf has changed the nature of gold from more of a financial commodity to more of a physical commodity over the past decade, it is still more of a financial commodity than silver. This means dollar debasement should push the GSR higher.

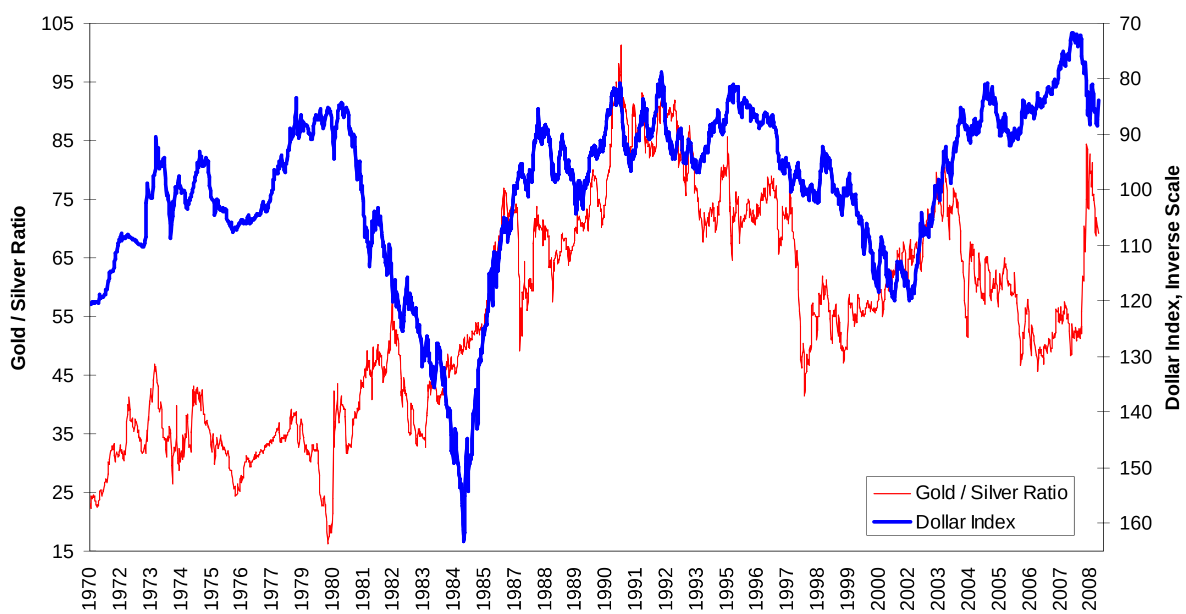
But even this verity has come into question of late. If we map the GSR against the U.S. yield curve as measured by the forward rate ratio between one and ten years ($FRR_{1,10}$), the rate at which we can lock in borrowing for nine years starting one year from now, divided by the ten-year rate itself, we see how the GSR used to lead the $FRR_{1,10}$. That relationship reversed after 2000; in the last two monetary cycles, the $FRR_{1,10}$ has led the GSR. As relationships such as this were averred to be permanent, we properly should regard the original logic behind the GSR as a monetary indicator to be wanting.

Gold/Silver Ratio And Monetary Policy



What about that other evil, dollar debasement? If we map the GSR against the dollar index, plotted inversely, we can reach a similarly dismissive conclusion. If gold is in fact a hedge against dollar weakness, the ratio should have risen as the dollar weakened between 2002 and early 2008. It fell instead; worse, it has now jumped during the dollar's late-2008 rally during the credit crunch. Once again, a reversing relationship indicates the original theory was a weak one. At best, we should conclude the GSR may be a trading instrument and a well-behaved one at that, but we should not consider it to be a market indicator.

The Dollar And The Gold/Silver Ratio

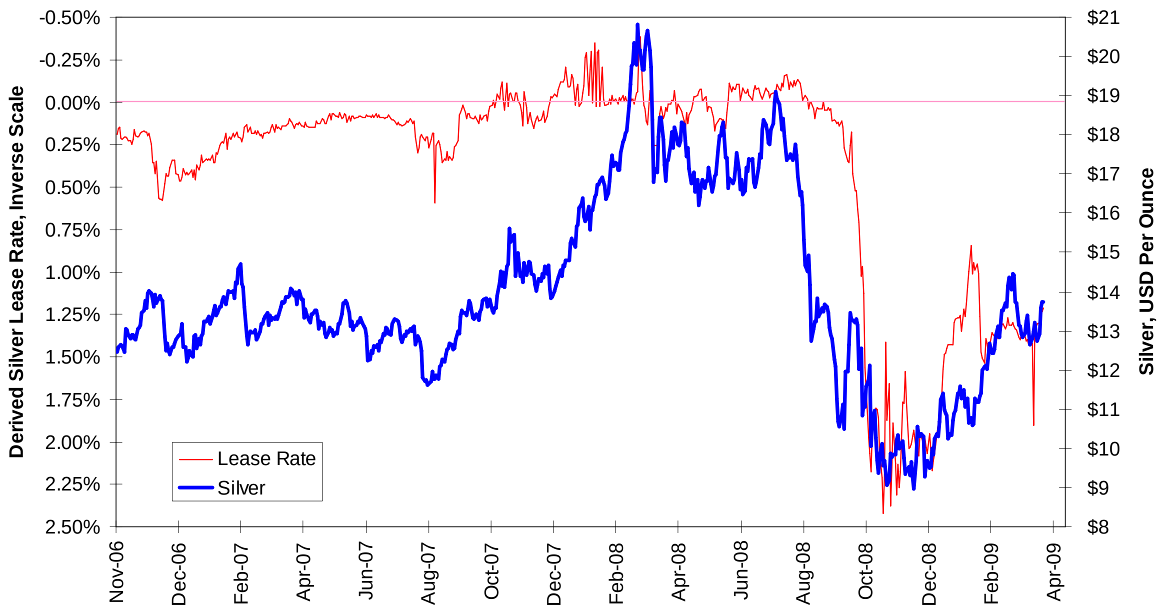


Lease Rates

Precious metals buffs see a global government conspiracy aimed at them; we have to wonder why these sophisticated traders are so fearful of bumbling governments, but that is a story for another day. Other prices manage to rise and fall without vast official conspiracy theories involved, and it is interesting how these theories operate in one direction only, to drive silver and especially gold lower.

When LIBOR shot higher during the 2008 credit crunch, the derived lease rate, or difference between three-month LIBOR and silver lease rates, plotted inversely, rose just as silver prices were falling. The simple explanation was silver holders were liquidating their positions to get cash, and the rate borrowers were willing to pay for silver fell relative to the rate they were willing to pay for bank deposits, and that is that. Silver's aficionados lived for the day of that financial crisis, and when it came, they found their precious metal was just so much chattel to be pawned in the global auction market.

Lease Rates Rose As Prices Broke

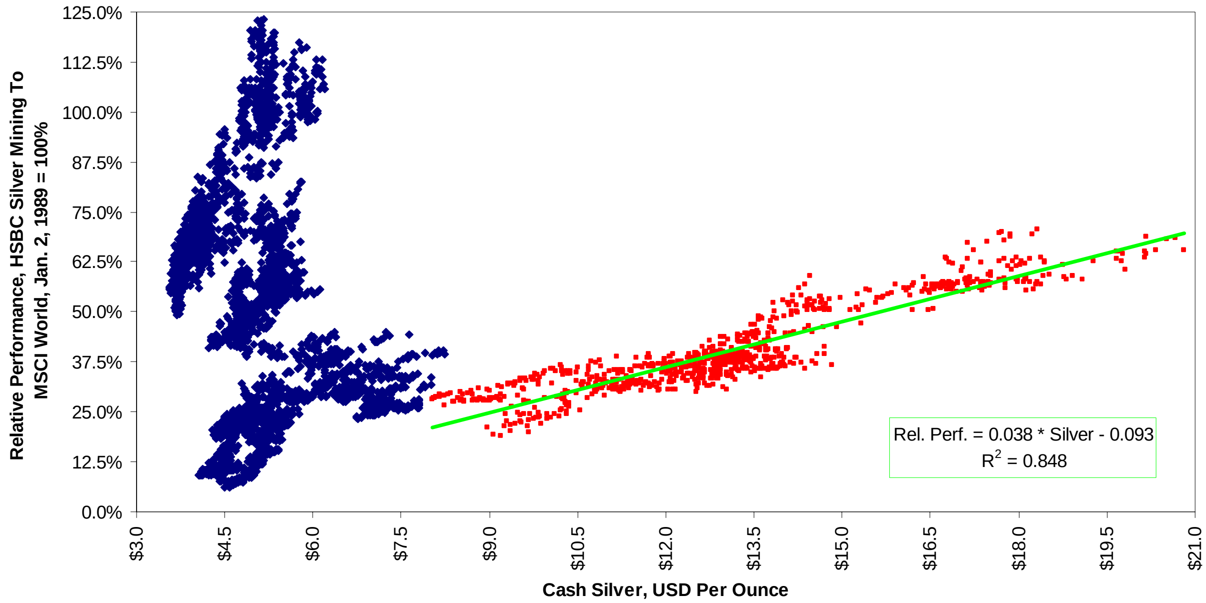


Miner Distress

Worse yet, silver was just another commodity being buffeted by the long-only commodity funds and by hedge funds who somehow failed to see the difference between how commodity-linked equities and the underlying commodities should trade.

The "hot commodity" boom of 2005-2008 changed and confused investor behavior. We can illustrate this by mapping the relative performance of the HSBC Global Silver Mining index to the MSCI World index against silver prices themselves. Prior to November 2005, the relationship was random, as should be expected. After November 2005, the relationship turned strongly linear. This indicates the price of silver was being set by dedicated fund flows, and that the traders controlling these flows were willing to confuse the profitability of silver miners with the price of silver. This was an expensive mistake as silver mining stocks fell almost 84% between silver's March 2008 high and the end of October 2008, while a continuously rolled silver futures contract lost "only" 55.3%.

A Linear Relationship Began In November 2005



Where will silver go from here? Financial history tells us bubbles do not re-inflate in consecutive market cycles; once one bursts, it takes years for chumps, er, investors to return. It took a quarter-century for traders to get comfortable again with the precious metals. It is time to turn your attention elsewhere.