Silver Disappoints Again

Buying low and selling high is the only trading system proven to work over time. Others apparently have caught on to this trick judging from the promotional literature flooding my various in-boxes replete with well-timed entries and exits. I guess these self-promoters are all wildly rich from their efforts and are just doing this because they want to share, right?

Silver used to be one of the favorites of the boiler room crowd. All tangible assets were during the inflationary late 1970s and early 1980s, and the more exotic a metal was, the better. I recall being at a conference luncheon where someone at an adjacent table called over to me in what had to be an impromptu burst of due diligence, "Howard, what's indium?"

This past January, I suggested buying silver-related equities on prospects for a weaker dollar and (oops!) the economic recovery increasing industrial silver demands. Another reason, illustrated below, is that real silver prices are no higher today than they were in the Kennedy administration. Real silver prices haven't been below $3.00 an ounce since Camelot, so going long at the then-prevailing $3.29 in 1983 dollars seemed like a good idea, and in a pure sense was: The price is now $3.42 in 1983 dollars. Too bad we have to trade in 2002 dollars.

A Tarnished Picture

In addition, silver had a strong gold market going for it; the Philadelphia Gold & Silver index (XAU) is up 26% on the year. This is well below the high of up 62% at the end of May, but up nevertheless. Gold prices have risen close to 15% in 2002 in response to low short-term interest rates and to the weakening dollar. Global silver stocks have performed well, too: The Hong Kong & Shanghai Bank Global Silver Mining index (JCGMSIL) is up a tidy 38.8% since January.

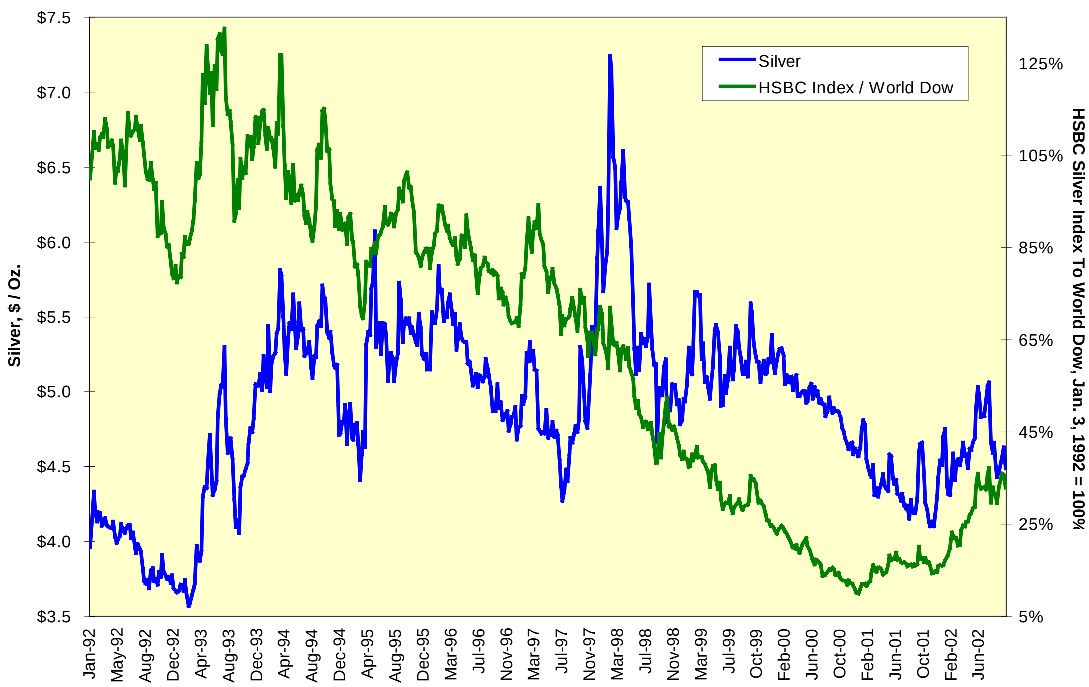
Even more significant for silver than gold is copper. This sensitive coincident indicator of global economic activity just hit a nine-month low. Most silver is produced in association with either copper or lead and zinc. As copper production falls, silver production falls, and that should support silver prices. However, the weak economic conditions depressing copper prices also are depressing silver prices.

Does Everything Stink?

Stealing a phrase from duly anointed Bond King Bill Gross, who proclaimed recently "stocks stink," allow me to chip in that silver stinks. Can we complete the syllogism: Stocks stink and silver stinks, so silver stocks must stink? No, but they need to shower more frequently than most.

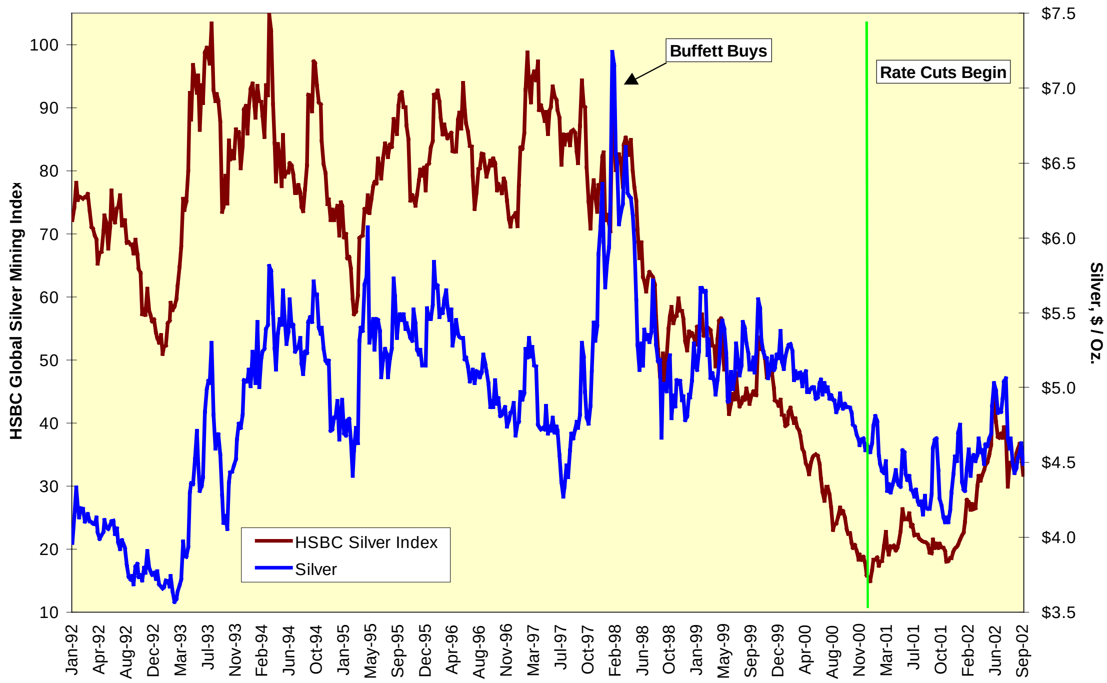
Silver stocks don't have the distinct relationship to silver we should expect from commodity-linked equities. If we compare the JCGMSIL to the Dow Jones World index over the past decade, we cannot find any incremental relationship between the silver miners' performance and the price of silver itself. This would akin to saying that copper is irrelevant to Phelps Dodge, or nickel is irrelevant to Inco, or platinum is irrelevant to Stillwater Mining.

Separated At Birth



The relative performance of silver miners to the broad market traces out a mirror image of the broad market's trends. We should not expect a silver miner to keep up with a tech stock in a bull market, nor should we expect it to collapse apace in a bear market. So, let's make a more direct comparison, the JCGMSIL against silver prices, even though this ignores general equity market trends.

A Broken Relationship



The relationship prior to the Asian crisis and its effect on world copper prices was poor, and the silver market received a further shock when Warren Buffett completed his purchase of 129.7 million ounces of the white metal in late 1997. Once the Fed began cutting interest rates in early 2001, which led to expectations of an economic recovery and a weaker dollar, the JCGMSIL finally ended its slide, and both it and silver prices have risen since.

It does not appear as if this recovery is going to continue much further. Inflationary expectations have, for the time being, either disappeared or have been replaced with fears of deflation. The dollar has ceased falling against other major currencies, and the flattening of the yield curve by virtue of the long end falling is signaling further economic weakness and a lack of inflation.

Until the Fed drives short-term interest rates below the expected rate of inflation, monetary policy cannot be classified as accommodative. Fed Governors McTeer and Gramlich got it right in their FOMC dissents this past week. Until there's more money, there's no reason to expect any physical asset with a holding cost, gold included, to move higher.