Silver Hopes Spring Eternal

What is it about the passing of the vernal equinox that turns my thoughts to silver? Was it last week's trapdoor opening under various physical commodities, an untoward development in this alleged era of "hot commodities?" Was it the impending anniversary of a long-ago evisceration of a silver position by the Lords High Executioners of the COMEX, now part of the NYMEX, wherein the white metal made it from limit-up to limit-down without an intervening uptick?

Or was it a reminder that next week Prince Charles will be marrying a woman whose previous husband, Andrew Parker Bowles, once held the title of Silver Stick in Waiting to the Queen, a now-defunct honorific bestowed upon the commanding officer of the Household Cavalry (and yes, there is also a Gold Stick in Waiting)?

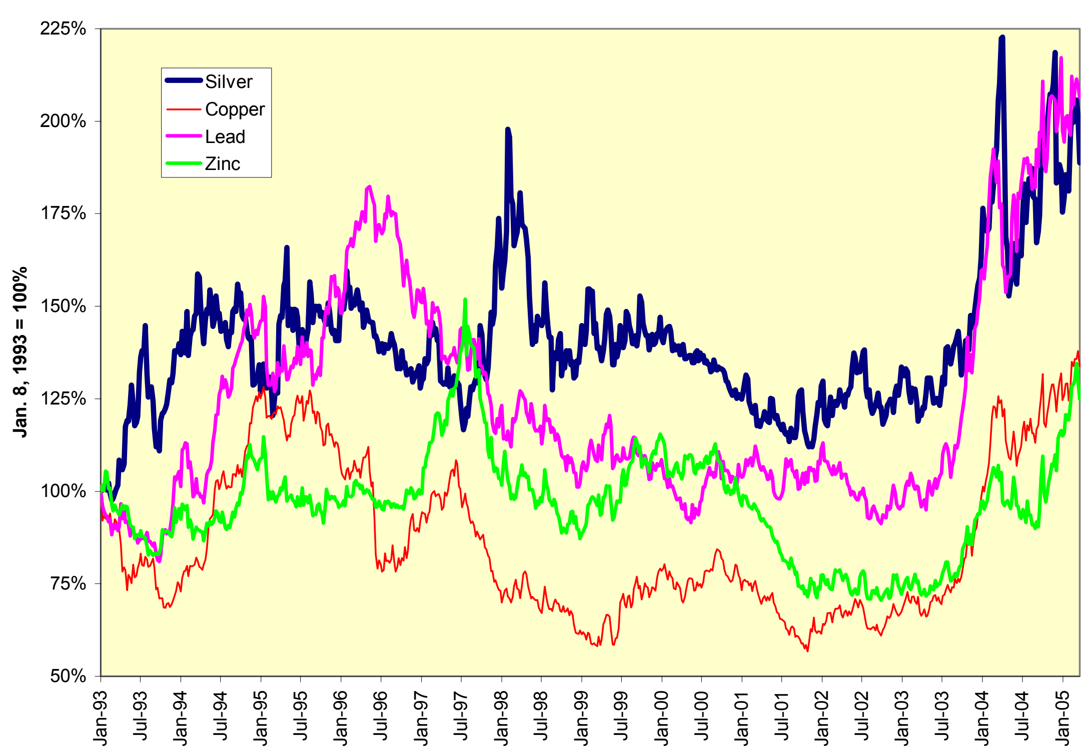
No, the trigger was the following reader e-mail:

> If silver is the industrial metal everyone claims it is then why is it that the silver miners and producers never seem to make a profit and cover their cost of production? In any other industry the suppliers would increase the prices of the final product so they could generate a profit.

Let address this question and then update a column from a year ago on silver, the metal for which hope springs eternal. Much of the silver produced in the world is not the result of dedicated silver mining, but rather as a credit to either copper mining or lead and zinc mining. As the prices of these metals rise and production of them increases, more silver is produced as a by-product and sold for the prevailing price. The economics of the copper mine ride on the price of copper, not on the price of silver and other metals produced in association.

The surge in silver prices since January 2003 has been an impressive 41.3%. Over the same period zinc has increase 73.0%, copper 98.4% and lead, a metal that surely defines slow and steady, 114.9%. The last sustained increase in the prices of these metals occurred in 1993-1994. The Federal Reserve increased short-term interest rates seven times in 1994 and early 1995, and the price of silver entered a long decline punctuated only by Warren Buffett's huge purchase of 129.7 million ounces of silver in late 1997.

Miners Get The Lead Out



No Gold In Silver Mining

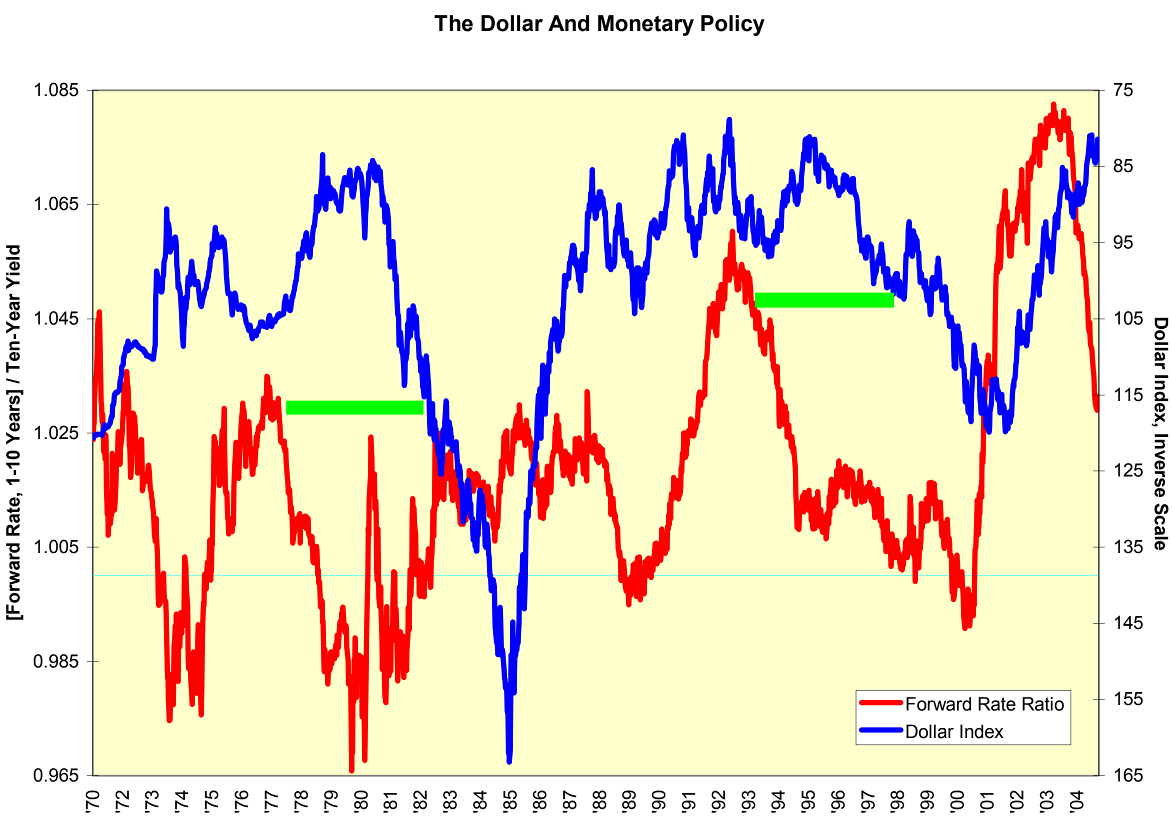
The profitability of silver miners is surprisingly low. Apex Silver Mines lost $0.37 per share over the past twelve months, while Sunshine Mining & Refining lost $0.116 per share. Pan American Silver and Silver Standard Resources, two Canadian firms, lost C$ 0.20 and C$ 0.077 per share, respectively.

The question why they simply do not raise prices to cover their costs is answered simply. The miners are competing not only with recycled silver and silver produced as a credit but with customers who can stare down price increases. In addition, the central tenet of Austrian economics is prices determine costs, not vice-versa. As the price of silver rises, the costs of suppliers such as landholders, equipment manufacturers and labor rise to capture the rent of the higher prices. If this sounds a little like a lose-lose proposition, it is.

The Macro View

Much of the commodity rally of 2003-2005 has been a logical response to low interest rates. These low rates not only lowered the costs of holding commodity inventories and raised inflationary expectations, they lowered the exchange value of the dollar as well. With more dollars chasing commodities already being bid higher by Chinese and other growth in demand, and with each dollar being worth less, how surprised can we be when commodities rally on a dollar basis?

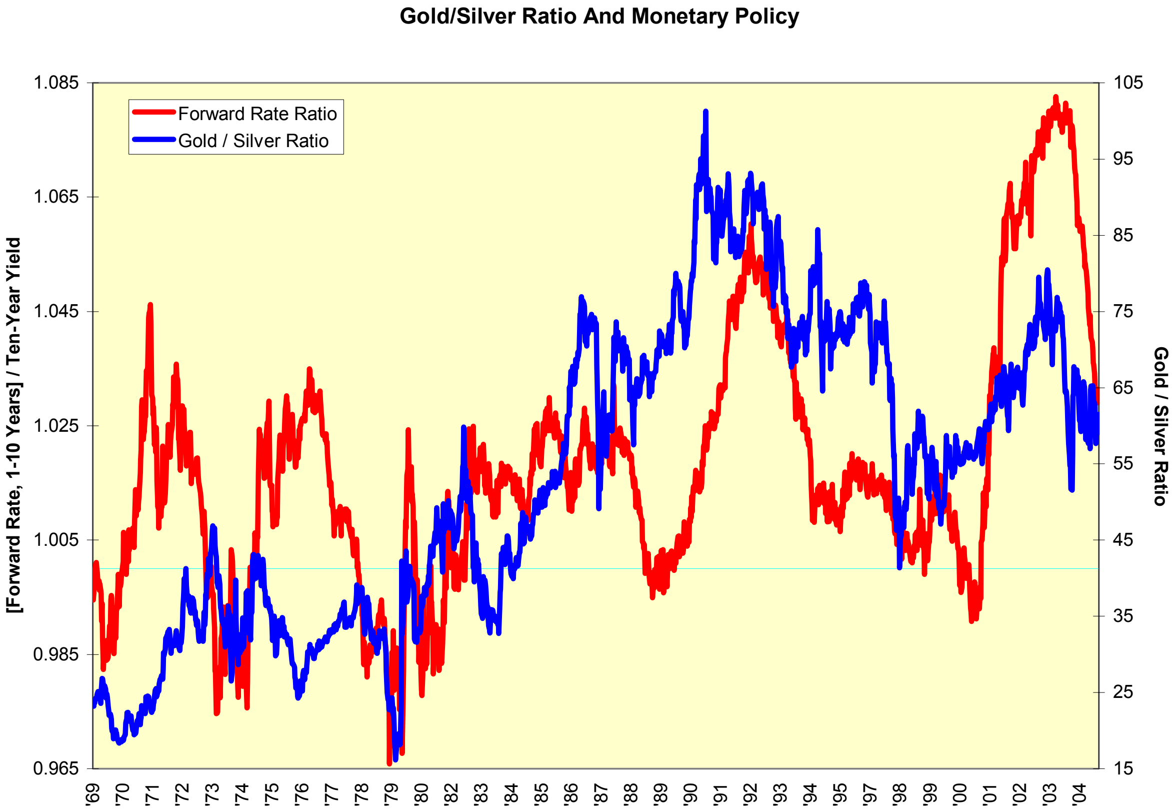
While the FOMC maintained the "measured" language in its statements following the March 22nd meeting, they made it clear they were concerned about rising inflationary expectations. Let's measure the shape of the yield curve by the ratio of the forward rate between one and ten years, the rate at which we can lock in borrowing for nine years starting one year from now, to the ten-year rate itself. In two previous episodes of rate hikes accompanied by a flattening yield curve, the late 1970s-early 1980s and again in 1994, highlighted with green rectangles, the dollar began to firm and remained on a firming course for several years thereafter. Neither higher interest rates nor a stronger dollar are supportive of silver prices.



The Golden Constant

If the dollar firms on the back of a flattening yield curve, a trading opportunity arises in the gold/silver ratio. Gold is far more of a monetary metal than is silver, which still has a large industrial demand in photography and electronics.

Higher interest rates, lower inflationary expectations and a firmer dollar, all of which go together, reduce the price of gold relative to silver. This suggests a simple trade in the futures markets of selling gold and buying silver.



What about simply buying silver today as an inflation hedge? The answer is silver, like most commodities, fails to live up to its billing as an inflation hedge. If we deflate silver by the Producer Price Index we see a weak upward slope over time by virtue of the Hunt Brothers' ill-fated attempt to corner the market in 1979-1980. Otherwise, the real price of silver is no higher than levels first reached in 1979, and that price does not include the considerable opportunity costs of holding the metal for 26 years. It may gall the silver bulls to hear it, but you certainly would have done better in financial assets.

Will any of this deter the breathless pitches you will hear for buying silver and other metals? Not a chance.