Silver Will Sleep Again

"It's like trying to find gold in a silver mine…" – Elton John & Bernie Taupin

I have not written on silver since March 2005, even though both the commodity and silver-mining stocks have risen and fallen substantially since then. Let's redress that right now and see what has been going on with the white metal.

First and foremost, silver has taken a beating in recent months as have nearly all physical commodities. It has lost 50.4% of its value on a rolling-contract basis since its high on the date of the Bear Stearns bailout on March 17, 2008 through December 12, 2008. Gold, in contrast, has fared better with a loss of only 19.1%. The only physical commodity in the Reuters/Jefferies CRB index to gain over that period has been live hogs, which after years of admonition have been the bulls on Wall Street and may one day exact revenge upon the bears.

To hear precious metals' many fans tell it, this was not supposed to be; the metals were to be a refuge in parlous times such as this. But, as I noted back in August, gold failed in this task. Moreover, we have six decades of data indicating the PPI-deflated price of silver climbs at about 0.01% per month, nothing more. We are now at real prices reached first in December 1967. How and why that should be a refuge from anything is not clear.

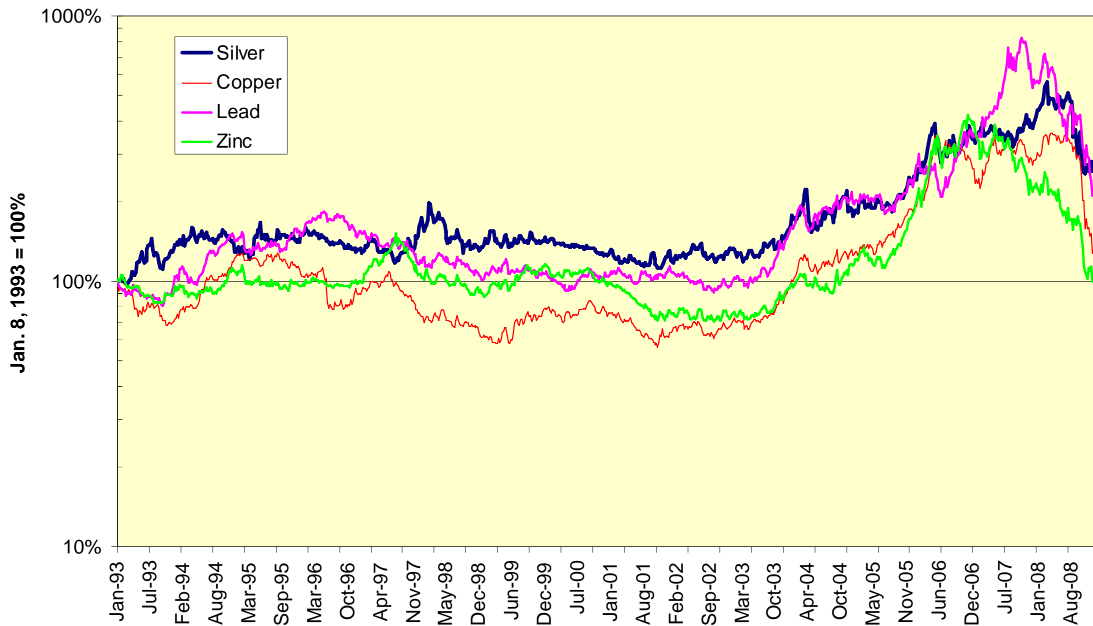
One Brief Shining Moment

Joint Product Relationships

While it is easy to understand why silver often is associated with gold in investors' minds, the simple reality is the two metals are produced in different mining operations and have vastly different final uses. Gold's principal use is to be reburied in above-ground vaults as a store of value; silver has a significant number of industrial uses.

Moreover, 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. And indeed silver has held up better than these other metals.

Silver Has Stood Up Better Than Its Joint Products

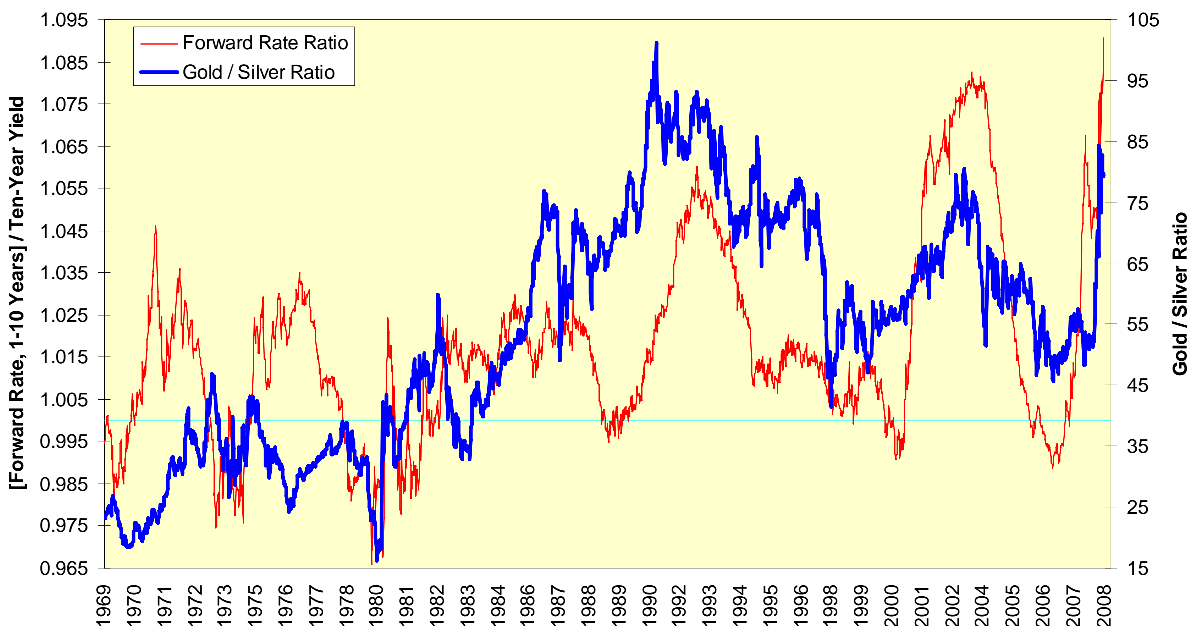


The Gold/Silver Ratio

While gold and silver should not be compared to each other any more than should gold and crude oil, a topic I addressed in September 2005, the simple fact of the matter is traders do. As gold, which has traded more as a physical commodity and less as a financial asset in recent years than it used to, tends to be driven more by monetary factors than silver, a rising gold/silver ratio should mean rising inflation expectations and vice-versa.

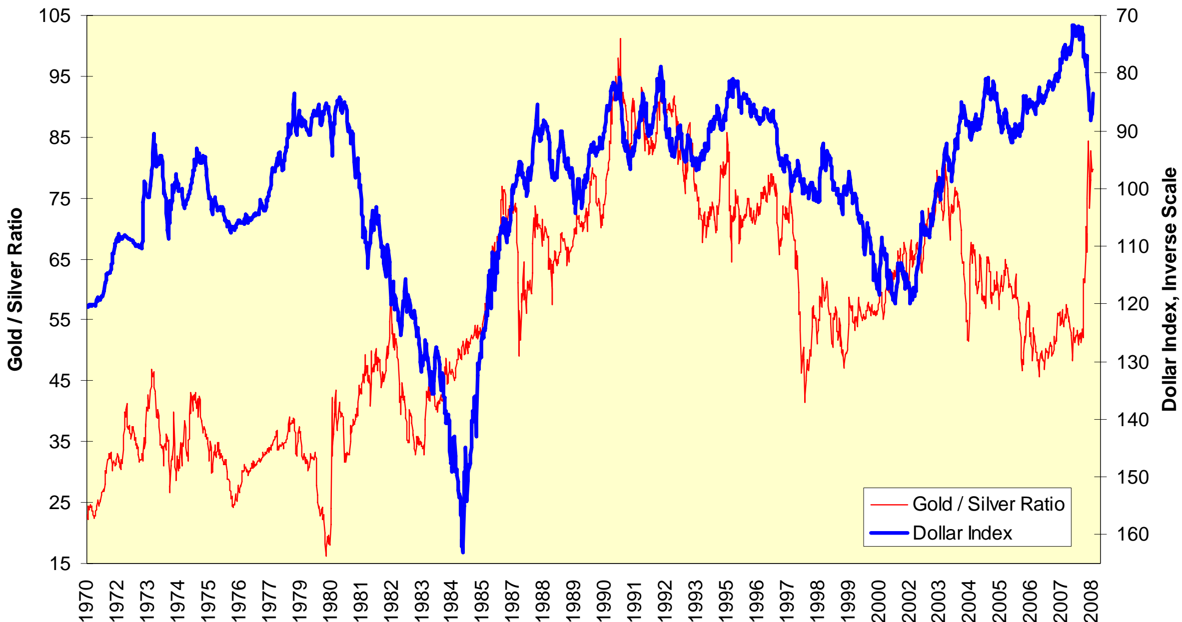
This certainly was the case in the 1980s and 1990s. The gold/silver ration then tended to lead the shape of the yield curve as measured by the forward rate ratio between one- and ten-year Treasuries; this is the rate at which we can lock in borrowing for nine years starting one year from now, divided by the ten-year rate itself. This relationship reversed in recent years as the forward rate ratio led the gold/silver ratio. As relationships such as this are not supposed to reverse lead-lag relationships, we should conclude this one was never fundamentally sound.

Gold/Silver Ratio And Monetary Policy



We can reach an identical conclusion for the relationship between the gold/silver ratio and the dollar index. If gold is in fact a hedge against dollar weakness, a dubious proposition in recent years, 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 recent rally. Once again, a reversing relationship such as this is prima facie evidence of a flawed market hypothesis.

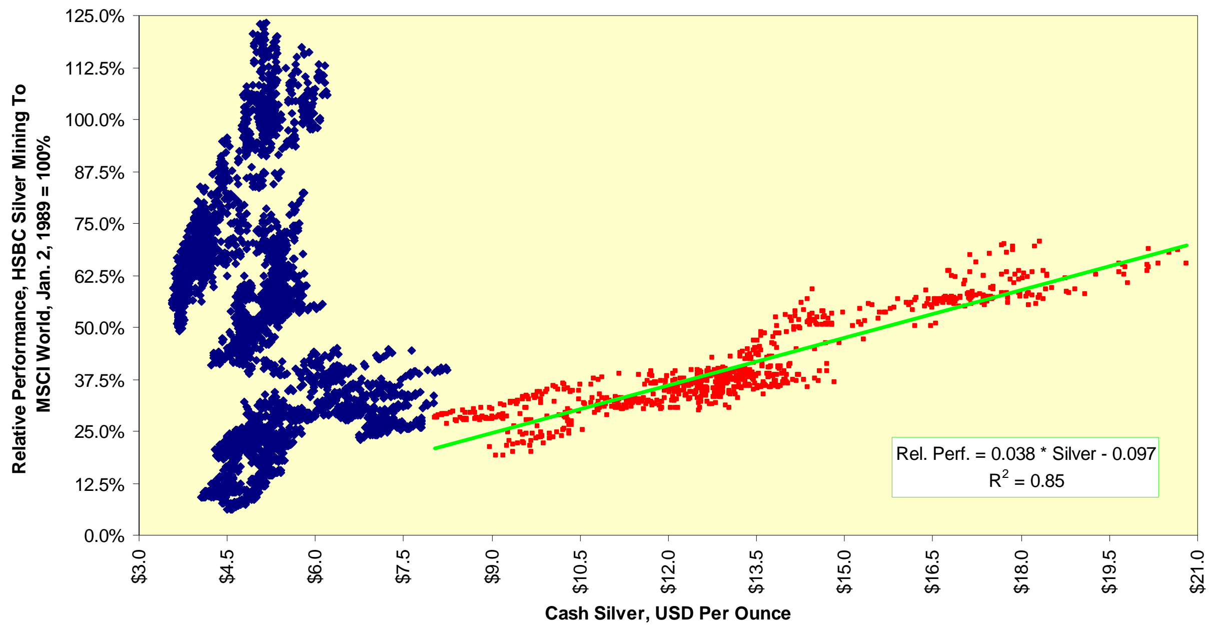
The Dollar And The Gold/Silver Ratio



Silver Miners

What is not flawed, though, is the hypothesis proffered here in January 2006 that the huge flow of funds into indexed commodity investments were distorting the relationship between commodity-linked equities and their underlying commodities.

This is demonstrable in the case of silver by mapping the relative performance of the HSBC global silver mining index to the MSCI World index as a function of silver prices. If we split the data stream in November 2005, a time when silver prices started to break out to the upside, we see the pre-November 2005 relationship was essentially random while the post-November 2005 relationship is strongly linear. Restated, the relative performance of silver miners became interchangeable with the price of silver regardless of all the other things affecting stocks, such as index betas, risk preferences, interest rate discount factors and, most critically here, the costs of operating silver mines. As noted in October, mining stocks can disconnect to the downside from commodity prices for all of these reasons.



The same caution offered in October is offered today: Just because something has collapsed in price does not make it a good value. It may make it a broken stock, and in this case a broken stock linked to a commodity in a downtrend. About the best we can offer here today is the time to have shorted these issues is in the past; the next bull market in precious metals will be years in the future. Silver slept for two decades after the Hunt Brothers' 1980 debacle; it can sleep again and frustrate anyone who gets near it. Why bother?