Annual Review/Preview<?xml:namespace prefix = o ns = "urn:schemas-microsoft-com:office:office" />

The end of the year is an admittedly arbitrary cut-off in evaluating what is a continuous process, but we do need some reference point to check our bearings as to where we've been and where we may be going. Sometimes, the year end involves soul-searching and gut-checking, as was the case for silver at the end of 2008, when the bottom fell out and the price collapsed by 25% (worse at the lows). Fortunately, there is no gut-checking this year, as silver soared by 83% (and gold by almost 30%). Instead of reflecting on the validity of silver as an investment because of poor performance as we did back then, we are now faced with the task of deciding whether we've overdone it on the upside. In both cases, we must rely on the facts as we know them to be.

In reviewing the returns of various commodities and other investment assets over the past year, I am struck by a number of observations. While commodities were generally strong, there were wide variances between them. Not all precious or base metals were up by close to uniform percentage amounts. If I had to characterize commodity performance in general terms, it appeared that the individual supply/demand situation in each commodity exerted more influence than general conditions. The dollar index was virtually unchanged for the year. Stocks were generally higher. Bonds were mixed and real estate bounced along the bottom.

I encourage subscribers to reread last year's annual review (Dec 30, 2009), as my themes have barely changed a year later. Those themes included what a great investment silver had been for that year and for the decade, the growing silver investment boom, the issue of position limits and the role of the CFTC regarding those limits, and the role of JPMorgan as the big silver manipulator. I anticipated that 2010 would be a remarkable year for silver. I don't want to waste your time (or feed my ego) with a point by point review, as I intend to impart a different (but familiar) message today instead.

I will say, however, that I am amazed about how things evolved for the year, particularly about my observation that my identification of JPMorgan in 2008 and 2009 as the big silver short was an important development. In retrospect, important was an understatement, considering the number of lawsuits filed and the explosion of commentary and videos (both funny and insulting) featuring JPM. From an initial informed speculation on my part back in late 2008, that JPMorgan is the big COMEX silver short has become common and universal knowledge. Most amazing of all is the lack of public response by JPMorgan to some very specific allegations of wrong-doing.

Regarding investment returns, both for the year and the decade, silver has almost been in a class of its own when compared to the practical investment alternatives commonly available. Let's face it I have a very narrow focus. I have not been interested in analyzing and writing about a wide range of investments. I have chosen to write about silver because of my interest in ending the long-term silver manipulation. Most likely, when that manipulation is ended, hopefully soon, I will stop writing about it. (No, I don't know what I will do then or when I grow up). In the interim, the manipulation has created one of the greatest investment opportunities ever. We are in the process of realizing that opportunity, as the manipulation is ending. Ending, but not yet terminated. I missed my bet that the manipulation would end in 2010, but I think I came close. Please allow me to roll my prediction over to 2011.

Silver closed the year more than 7.7 times greater than the $4 price low earlier in the decade. (Gold is up more than 5.6 times its dead low of $252). My great personal relief is that no one could have lost money as a result of following my advice to buy and hold silver over the past ten years. Having said that, you shouldn't be following my advice (or anyone else's), but instead be relying on your own thinking and common sense after analyzing the facts presented. At almost $31 an ounce, what do the facts suggest for the future course of the silver price? Is silver a buy, sell or hold?

As a value oriented investor, my natural inclination is not to chase price higher. Higher prices on an asset reduce its investment value, all things being equal. The investment case for silver has always been primarily that its true value was misrepresented by its price. Therefore, the dramatic price increase over the past year and decade does not increase silver's investment appeal in terms of under-valuation. Value investors look to buy low and sell high. Other investors, perhaps most investors, get more attracted to an asset as the price climbs, but not value investors.

So does that mean, as a value investor, that I feel silver is over-valued? No, not at all. In fact, I think the contrary; that silver is undervalued and has a long way to run. Then why the heck am I even discussing that the big price increase may reduce silver's investment value appeal? For several reasons. One is to be alert to avoid getting emotionally caught up in the price rise so that it destroys analytical objectivity. Silver appears to be playing out exactly as it should play out, based upon all the facts. But there will come a day when it will likely overshoot to the upside and we want to be on guard for that day and not be so emotionally involved that we fail to recognize it. Ironically, it's sometimes easier to analyze the facts objectively when things are going against your premise than when the price is telling you are correct. That's because you are more aware of risk in the dark times, than when all is wine and roses. $31 is certainly not silver's dark time, but is it too good? The facts suggest the price still has a long way to go higher.

The first fact is the structure of the COMEX silver market, still the dominant pricing factor in silver, although that dominance is fading, due to the transition of the physical market to the forefront. Almost all of this year's dramatic 83% price rise occurred in the last three or four months of the year. For the first time in history, this silver price rise was not fueled by speculative buying and commercial selling. After the biggest price increase in modern silver history, speculators held much lower long positions and commercials held much lower short positions, with the largest commercials (the big 4, aka JPMorgan) accounting for almost 75% of the total commercial short reduction (from the peak commercial short position on Sep 28). The fact, simply stated, is that price rose as speculators sold futures contracts and commercials, especially the biggest, bought back shorts, for the first time in history.

What does this simple fact mean? It means COMEX speculators didn't cause the silver price to rise; COMEX commercials caused the price to rise. It means that it is silly to suggest the market is over-bought due to long speculative buying, as the fact is that there is less of a COMEX speculative long position than there was before the rally commenced. It means the big commercials are responsible for pushing the price up, just as they were responsible for keeping silver down when they first sold short. JPMorgan holds a big short position and the price of silver is contained; JPMorgan buys back some of its short position and the price explodes. (Maybe someone can construct a paint-by-the-numbers coloring book for the regulators). Further manipulative proof aside, the market structure on the COMEX is highly supportive of much higher silver prices, as there is less potential speculative selling after the price rally and plenty of commercial short covering to come.

The second fact is that silver did rise 83% this year, on top of the prior year's near 50% gain. The two-year gain in silver (from its $11.33 close on Dec 31, 2008) is over 172%. There are not many widely-known and available assets that performed as well (gold is up a bit over 61% since 2008). The incredible out-performance of silver compared to gold is bound to increase the curiosity of investors in general and, in particular, of gold-only investors to investigate the reasons behind silver's performance. This brings me to a familiar theme and my message of the day and year, namely, to urge gold-heavy or gold-exclusive investors to please make a switch to silver.

Why do I persist in my switch from gold to silver message? The main reason is because so few gold-heavy investors have yet to do so. I think I have had much more success exposing the silver manipulation and in urging folks to buy silver outright than I have had in convincing gold-only investors to make a serious switch to silver. I base that on the still lopsided dollar amount currently residing in gold bullion versus the dollar amount invested in silver bullion. If even the smallest fraction of the $4 trillion+ currently residing in the world's gold bullion inventory were to try to convert to silver, the price would be over $100 in an instant. Think I'm kidding? Do the math. A quarter of one percent of the $4 trillion value of world gold bullion inventory comes to $10 billion, an amount about equal to the world's largest stockpile of silver bullion in the big ETF, SLV.

You tell me what the price of silver would be if someone tried to quickly buy an amount of silver equal to what it took almost 5 years for the SLV to accumulate. If I had been more successful in convincing gold-only investors to make the switch to silver, it would already be reflected in a much higher silver price.

While many analysts and commentators predict that the gold/silver ratio will decline in the future and that silver will out-perform gold (still others predict the opposite), I maintain that the average gold investor is unclear what such a ratio change means to him or her. That's because very few commentators actually spell it out, as there seems to be a fear in stating the obvious. Forget about the ratio tightening; say what it actually means you should do if you think it will tighten, namely, sell gold and use the proceeds to buy silver. And there is only one reason gold should be sold and the proceeds used to buy silver in order to make a lot more money. I don't want to drift into a philosophic debate about what is real money or the eternal essence of gold and silver; my point is simple, you should make a lot more if you switch, as has been the case for the past year, two years and ten years.

The third fact is that investment demand for silver has been booming, both on an absolute basis and relative to gold. Long-time readers know that the silver investment boom has been a theme of mine since before it commenced several years ago. This silver investment boom (along with the ending of the COMEX silver manipulation) is directly responsible for the large price gains to date.

Silver investment demand has come to be recognized as a price-driving force in the main stream media, including a recent Wall Street Journal article. But there can be a difference between a fact and the interpretation of what that fact means. In the case of the WSJ article and other reports, the interpretation is that the silver investment demand, should it fade, would be detrimental to the price. I agree with that premise, but I would submit it is only one possibility, with another possibility more likely to occur. More probable is that silver investment demand will not only continue, but is likely to intensify, particularly compared to gold demand.

Over the past year, roughly 150 million ounces have been accumulated by the worlds publicly traded ETFs and other silver investment vehicles, virtually all the amount of silver "left-over" after industrial and other fabrication. This represented more than 20% of annual mine production and came to a dollar amount of roughly $3.5 billion dollars. Gold witnessed an inflow of around 11.5 million ounces into the world's ETF-type vehicles, for a dollar amount close to $15 billion. The gold ETF metal accumulation took place mostly in the first half of the year, while silver deposits occurred mostly in the second half of the year. This suggests that the recent relative metal movements more accurately reflect the current trend of increased relative silver demand compared to gold. In addition, there have been continuing reports and evidence of tightness and delays in silver shipments, while no delays have been obvious in gold.

I am sensitive to not wanting to sound negative on gold, but I must risk that in order to promote the switch from gold to silver. Aside from basic facts like that there is less silver bullion in the world than there is gold bullion and the dollar amount of the gold inventory is more than 100 times greater than the dollar amount of silver inventory, the key premise of my argument is that the world's investors were familiar with the attributes of gold, while they were in the dark about silver. (I don't want to say flat-out that the gold trade is crowded, but compared to silver it is like a Tokyo subway at rush hour). All that had to happen was for enough of those investors to discover the real silver story. The recent price outperformance of silver compared to gold may serve as a giant alarm clock to awaken investors to the merits of silver, particularly the really big investors who already own gold.

The mega investors I speak of go by names like Soros, Paulson, Einhorn and Tudor Jones. All have publicly extolled the virtues of gold and bought significant amounts. Not one has openly extolled the merits of silver or has shown up as a significant silver investor in public reporting documents. But these investors are always on the hunt for the best returns and the fact that silver has outperformed gold by almost three times over the past two years is sure to come to their attention. And the way these things usually turn out, the first mega investor who does invest in silver is likely to set off a chain reaction by other mega investors, as birds of a feather usually do flock together. This is what occurred in gold over the last two years and there is no reason to not expect it to happen in silver.

These big hedge fund investors first moved into gold after the financial panic in 2008 because gold held up better than almost anything else. They were attracted by gold's relative outperformance to other assets at the time. They should be similarly attracted by silver's recent spectacular outperformance to gold. The only difference will be what happens if and when they do move on silver. There is a lot less silver available for their investment buying than there was gold when they moved into gold. John Paulson bought around $3 billion worth of gold in 2009. At $30 an ounce, a similar dollar amount would come to close to 100 million silver ounces. Think of the mess of putting ten pounds of flour into a two pound bag and you'll get an idea of the mess such a size purchase would make on the upside in silver. Another thing to remember is that it took quite a leap to first invest in gold by these big hedge funds as they had never done so before. Once you've already made that leap to buy a precious metal, it isn't a big leap at all to buy a different metal that promises much better returns. All these guys live for is finding better returns. They will surely find those returns in silver if they look and study the facts; just the same as you found them by looking and studying the facts.

Two of my critical factors, namely, investment demand and short covering seem to be kicking in, but with a very long way to go before being finished. The third, user inventory buying panic hasn't yet commenced. Here we are, at the start of a New Year, with silver having put in a spectacular performance and it feels more like a beginning than an end. As I say too often, I couldn't make this up if I tried.

Health and Wealth in years ahead.

Ted Butler

January 1, 2011

Silver – $30.90

Gold – $1422