

July 21, 2011 – A Nervous New World

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For more than 25 years, I have closely studied the silver market from a supply/demand and market structure perspective. For almost 15 years before that, I traded silver, along with other commodities, as a commodity and stock broker. In all those 40 years, I have tried to avoid analyzing silver in the context of it being an asset of last resort in a world financial crisis. Not because silver is not an asset of last resort but because that attribute has always been widely accepted and written about. I have always strived to uncover new and unique aspects to silver; there was no real value added in me writing about what was already known.

Today, however, I would like to share some thoughts that have come to concern me recently about general world financial conditions and silver. Before I do that I wish to assure you that I still hold an optimistic outlook that many of today's financial problems in the US and the world will be resolved in a fairly reasonable manner. But I don't think resolution will come easily or without some type of a real scare. Nor do I think a worst case outcome is impossible. Importantly, I don't want to paint a picture that silver should be held only because the world is headed to hell in a hand basket. Based upon all the facts, silver should do fine almost no matter what world financial circumstances are eventually witnessed.

One of the things that concerns me the most is the proliferation of debt in almost all quarters, particularly on a government level. Any time the quantity of anything is greatly increased, value is decreased. That collective world debt has grown disproportionately to the world's ability to service that debt is a serious problem. Sluggish economic growth in the western world makes the choices for reducing debt burdens more difficult. Even with shared sacrifice, the reliance on debt will not go away quickly or easily. Because almost all government debt is basically a paper obligation (backed by creditworthiness, as opposed to a lien on specific property), all paper obligations may become suspect in a financial crisis. Assets completely disconnected from the ability of a creditor to meet obligations generally become more valuable in such crises. Hard assets, like silver, become more in demand if paper assets are shunned. In a moment, I'll try to explain why silver may be the best hard asset refuge in a crisis.

The proliferation of world debt has also resulted in an enormous explosion in derivatives products, such as credit default swaps, that has created the potential for exacerbating any financial crisis. It was just such derivatives products, especially those issued by AIG, which brought the world to its financial knees in 2008. Back then, silver sharply declined in price, due to an increasingly obvious (in retrospect) manipulation by large New York banks that were heavily short silver. It will be hard for that manipulation to occur again. Any new financial crisis is likely to be met with soaring silver prices.

My other chief concern is that the animosity between the two political parties in the US has grown to alarming levels never witnessed in my lifetime. I have always monitored the political mood of the country, although I try to be politically neutral. What I see today is most alarming. In almost every instance, there seems to be automatic disagreement and disengagement on every issue along party lines. Considering the economic circumstances in which we find ourselves, such political head banging can hardly be considered constructive. Combined with the levels of debt and related derivatives concoctions and the weak economy and high levels of unemployment, this political backbiting raises the odds of a miscalculation and financial accident.

My sense is that the European debt crisis and the clash over the US debt ceiling and deficit have had the unintended consequence of instilling doubt in the minds of many where that doubt never existed. Confidence is a tricky thing; hard to earn, easy to lose. Perhaps people should have been more concerned about debt and financial matters earlier, but more are currently as a result of recent headlines. This undermines the confidence needed to continue to buy and hold paper debt obligations. Maybe this confidence is not lost overnight, but it does erode gradually and enhances the chance a panic will come at some point. In a genuine financial panic, it is hard for me to conceive how people won't flock to hard assets, particularly precious metals.

I understand that I have just outlined the most popular argument for owning gold and silver, namely as an insurance policy against inflation and financial calamity. This is the argument I have tried to avoid for decades, not because it had no merit, but because it was widely advanced. I had always considered the insurance argument as a bonus and not the central reason for owning silver. I still feel that way, but recent events have made me more sensitive to outside financial factors. It seems to me that as more people are exposed to daily reports of world debt struggles and political infighting in the US, more will become convinced of the wisdom of diversifying away from paper obligations and towards assets not depending on the promise of others. Certainly, price increases in precious metals will only solidify that process.

Gold and silver are, of course, assets that are no one else's liability. As such, they are the perfect antidote to a world increasingly worried about everyone else's liabilities. The great thing about precious metals is that they are so different from conventional paper financial assets as to be completely distinct and unique in substance. Years ago, I remember writing that silver was in a different realm than other financial assets. Most financial advisors suggest diversification as a method of increasing the safety of a portfolio; to spread out holdings among different stocks and bonds and other securities. But what could be more of a diversification than including assets of a completely different realm, namely, hard metal among paper financial assets? Ask any gold or silver investor what fears flash before their eyes when financial crises threaten. I assure you the last thing they are worried about is the hard metal they own. That peace of mind alone would merit inclusion of metal in an all-paper portfolio.

To my mind, the inclusion of metal in an all-paper portfolio in today's world is a no-brainer. After all, gold and silver have outperformed just about every other paper investment over the past five or ten years. The harder choice is which one should be emphasized — gold or silver? The difficulty in deciding diminishes as the level of objective investigation increases. The more time one spends in studying the merits of gold or silver makes the choice for silver much easier. Let me highlight a few.

There is less silver bullion inventory in the world than there is gold bullion inventory; around one billion ounces of silver versus three billion ounces of gold. Common sense would suggest that an item more rare than another similar item would reflect that relative rarity in price. While silver has vastly outperformed gold over any reasonable time period over the past ten years, the rarity of silver is vastly underappreciated. I would guess that maybe one out of every million of the world's inhabitants knows of this fact. Even among those exposed to the rarity of silver compared to gold, few accept it. Inevitably, as more come to learn and appreciate this startling fact, more will choose to invest in silver.

While much more silver is mined and produced each year than gold, when one considers the fact that silver is an important industrial commodity compared to gold, a different picture emerges. After subtracting the industrial and other fabrication usage of silver and gold, the amount of each — left over — and available for investment the attraction of silver becomes clear. Who cares if more silver is produced if most of it is spoken for by industrial and other fabrication consumption. Very few people consider silver in this perspective. As time progresses, more will.

The most important factor to consider in deciding between silver and gold is the price of each. Because gold is so much more expensive than silver, the dollar valuations of each are distorted. At current prices and the amount of gold and silver bullion inventories in the world, there is more than 120 times more gold in the world than silver in dollar terms. What this means, among other things, is that it takes a lot more money to move the gold market than it does to move the price of silver. That's probably the biggest reason for why silver has been outperforming gold. There is nothing on the horizon to suggest that will change anytime soon.

As more people are subjected to the daily reports of a financial world in distress and of political animosity, their thoughts will naturally gravitate to assets with no liability to that stress and animosity. As more people come to learn of the rarity and value of silver compared to gold, their choice will be to buy and hold silver. The trick, as always, is to beat the crowd.

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