Silver Investment Supply/Demand<?xml:namespace prefix = o ns = "urn:schemas-microsoft-com:office:office" />

Silver is a unique asset that holds a dual-role as both a vital industrial material as well as being an important investment vehicle and store of value. Either role can drive the price of silver by itself. Therefore, it is important to appreciate the supply and demand factors for silver from both roles. Today I would like to introduce a new perspective in how to look at the investment component in the silver supply and demand equation. But first let me quickly summarize the current state of market fundamentals for silver as an industrial material before getting into the subject of this essay.

The world produces around 740 million ounces of silver per year from mining (primary and by-product) and recycles another approximate 160 million ounces from scrap recovery. That makes total current supply 900 million ounces. The world consumes about 750 to 800 million ounces in fabrication demand including industrial, jewelry and coinage. This means roughly 100 to 150 million ounces are "left over" each year. World production and consumption will change over time, but are generally not subject to drastic changes quickly.

Up until a few years ago, the world consumed about 100 to 150 million ounces more silver than it produced annually, so we depleted world silver inventories by that amount each year. The world did that, basically, for some 60 consecutive years, from World War II to around 2006. This took world silver inventories down some 90% over that time span, from 10 billion ounces to around 1 billion or less. Since 2006, the inventory depletion process has reversed and now we add a similar amount to world silver inventories that were formerly removed. Generally, what caused the reversal in the inventory pattern was the rise in silver prices from the single digits to much higher levels.

When many first learn that we are no longer in a commodity deficit situation in silver, they assume that will be bearish for the price. I understand that knee-jerk reaction. After all, I had written for years that the prior 60 year deficit consumption pattern in silver was the most bullish circumstance possible for any commodity. And it was. But it was also a pattern that couldn't possible last indefinitely, as you can only draw down from inventories if there are enough inventories to draw down from. Once inventories reach the practical bottom of the barrel, that's it. In silver, we hit that wall and prices started to reflect that, starting around 2006. While many have trouble accepting that silver is no longer in an industrial consumption deficit, the facts bear that out. As an analyst, my job is to interpret the facts, not try to deny or alter the facts. I don't mean to give short shrift to the supply/demand factors in silver from a production and industrial consumption perspective, but I want to transition to silver's investment supply and demand picture.

Incredible as the timing may seem, no sooner had we reversed the inventory depletion process in silver that a new phenomenon appeared on the silver scene. That new silver phenomenon was net investment demand, which had been absent for more than a half century. The ending of the silver consumption deficit and the beginning of the silver investment process came in almost simultaneously, but there were clear indications that investment demand would strengthen. Over three years ago, I wrote about the "Coming Investment Boom in Silver" http://news.silverseek.com/TedButler/1201020133.php

Here's the bottom line, the way I look at it. I'm trying to keep this a simple as possible, but please know this may not be a simple concept to grasp immediately. After we deduct total fabrication demand from total current production, we have 100 to 150 million ounces of silver left over each year for world investors to buy. If that amount is too much for the world's investors to absorb, then we will go down in price until the low price entices enough investment buying. If that amount (100 to 150 million ounces annually) is not enough to satisfy all the world's investors, then we will go up in price.

The trick is in gauging the potential buying power of the world's investors versus the supply of investment silver available for purchase. There are two prime components to silver investment supply. The first is the amount available from current production net of industrial and all other fabrication. We did that already above, and arrived at 100 to 150 million ounces annually. The second component is potential selling from investors of silver bullion already owned. There are about a billion ounces of silver bullion owned in the world, with the majority residing in ETFs and other visible categories, like exchange inventories. A third potential source of new supply would be the melting down of household silver objects, as occurred in 1979-80. This source of potential supply could not come to the market clandestinely, as it would be noticed openly. Since there has been no notable melt of household silver to date, let's leave it in the potential category until it becomes obvious this silver is coming to market.

Now, let's further convert the 100 to 150 million ounces of silver available for investment annually from current production (mine plus recycling) into a monthly total of 10 to 12 million ounces. The world has 10 to 12 million ounces of silver available for investment each month from current production. One last step; let's convert it from ounces to dollars, by multiplying by the current price, $37 as this is written. Rounded up, the world's investors have less than $450 million worth of silver available for purchase each month from current total production. That's the supply of silver available to the world's investors monthly.

The only reasonable way to quantify if $450 million worth of silver is too much or too little for the world investment community to absorb monthly, is to compare it to something else. The closest and natural comparison for silver is always gold; which has been the case for hundreds, if not thousands of years.

So let's quickly do the same investment supply calculations for gold that I just did for silver. Of total current production (mine plus recycling) of 100 to 110 million ounces a year, there are about 50 million ounces of gold available for investment annually. That breaks down to more than 4 million ounces a month of gold that must absorbed by investors in order for the price of gold to be maintained at current levels. In dollar terms, at current prices, that works out to more than $5.6 billion of gold per month. All things being equal, if investors don't buy $5.6 billion worth of gold each month, the price would tend to soften. More than $5.6 billion coming in from investors monthly and the gold price should rise.

The first thing you should notice is that more than 12 times more new investment dollars are required to flow into gold to maintain the price than is required in silver to maintain the price. Stated differently, it takes more than $5.6 billion coming into gold each month to move the price higher, where it takes only more than $450 million flowing into silver to goose the price. Silver only needs 8% of gold's required investment flow of $5.6 billion monthly to absorb all the silver available from current production monthly. Less buck, more bang in silver. That's good for the prospects of silver continuing to outperform gold.

While many fret that silver has moved too high in price, both on an absolute basis and relative to gold, the disproportionate amounts of investment flows in each are generally overlooked. The relative investment flows required in gold and silver fully explain silver's outperformance to date. What have the relative investment flows been recently and what potential exists for the future? Remember, gold requires 12 times more in monthly investment dollar flows than does silver at current prices.

In pure apples versus apples comparisons, gold is not getting 12 times as much money flows as silver, but much less. Or stated differently, silver is getting much more of a relative investment flow. For instance, the US Mint, which is required by law to produce gold and silver bullion coins to meet investment demand, provides a great metric by which to measure the relative dollars flowing into each. For the full year 2010, investors bought approximately twice as much gold, in dollar terms, as they bought silver, in the flagship US Eagle program. That means silver purchases were six times stronger than the 12 to 1 ratio outlined above. So far in 2011, demand for Silver Eagles is running even with gold on a dollar basis, meaning silver is attracting 12 times as much dollar demand as the investment flow ratio would suggest. I believe the investment flows into silver would have been even stronger in silver's favor, had the Mint been able to keep up with the demand for Silver Eagles.
http://www.usmint.gov/mint_programs/american_eagles/index.cfm?action=sales&year=2011

Let's look at another apples to apples comparison, the relative investment flows into the biggest metal ETFs (exchange traded funds) in silver, SLV, and gold, GLD. During 2010, almost 5 million ounces of gold was deposited into the big gold ETF, GLD, worth about $6 billion. In the big silver ETF, SLV, about 40 million ounces were deposited in 2010, worth about $1 billion. This six to one dollar ratio means that silver dollar flows were twice as strong as the 12 to 1 investment flow ratio established above. From the beginning of this year, however, the investment flows into silver relative to gold have gone off the charts. The big gold ETF, GLD, has experienced an outflow of around $3 billion, while the silver ETF, SLV, has shown a continued inflow of around $250 million. This shows that the dollar investment flows into silver have been much stronger relative to gold's investment flows. If you were looking for a reason why silver has been outperforming gold, look no further.

It is not just that silver offers a compelling case on a relative investment flow based upon current production availability compared to gold. Investment supply, as I've indicated earlier, can also come from sales by holders of existing inventory. In silver that amounts to roughly one billion ounces, or $37 billion at current prices. Let's do the same exercise for gold. Gold bullion inventory is around 3 billion ounces (out of 5 billion total gold ounces in existence). At $1400 an ounce, gold bullion inventory is valued at $4.2 trillion (with a "t"). That means the gold bullion inventory is worth more than 100 times what the silver bullion inventory is worth. Ask yourself this — which would serve more as a potential drag on price, the potential sale of $4.2 trillion worth of something or the potential sale of $37 billion worth of something else? Is it any wonder that silver has and can outperform gold considering that silver investment flows have been so much stronger on a relative basis? As always, it is not my intent to bash gold; I am simply pointing out some stark differences between silver and gold.

I believe that these numbers accurately reflect the current and future likely relative investment flows into silver and gold. As such, there should be little question as to why silver has outperformed gold in price. Investment outperformance by silver has been no fluke. Silver needs less of an investment flow to impact price than does gold, and has been getting a much bigger flow than is required. The only question is whether silver will continue to receive a stronger relative investment flow than gold in the future. I believe it will and would like to offer my reasoning.

One of my longstanding reasons behind silver getting a stronger investment flow than gold is because people are just learning the real silver story, while the gold story has been much more widely publicized and understood. This can be seen in the fact that so many big hedge funds have taken substantial positions in gold, yet I have detected no big hedge funds owning silver. What is the real silver story? To me, the real silver story is one that recognizes that silver has been manipulated in price by concentrated short selling on the COMEX. Any analysis of silver that does not recognize this feature is defective, in my opinion. Amazingly, most silver commentary has yet to focus on the silver manipulation.

Let me try to summarize this investment flow concept in silver. Investment flows are the likely key to price performance. Investment flows can turn on and off in a heartbeat. Investment demand is comprised of paper and electronic money. The supply of physical metal available for investment is constricted by the physical realities of taking metal from the earth. It is much easier to write a check or send a bank wire than it is to actually produce physical metal. It is, therefore, much easier for investment demand to swamp physical production in the short term. That's why it took the Sprott Organization 2 months to secure 15 million ounces of silver; there are only 10 to 12 million new silver ounces available for world investment each month. It's hard to put ten pounds of flour into a two-pound bag without making a mess. Likewise, it's hard to put a billion dollars into a market where only $450 million worth of material is available without making a mess in the price to the upside.

This is also why the giant concentrated short position is such a big darn deal. With only 10 to 12 million ounces of silver available for world investment monthly, how could the sudden short sale of an additional 30 million ounces on the COMEX not overly influence the price? That's why we need legitimate position limits.

Lately, I've had a mini-silver Eureka moment. Not a profound Eureka moment, like I experienced more than 25 years ago, when I suddenly realized that silver was manipulated in price by excessive COMEX short selling. Let's face it, how many Eureka moments can one experience in life? I accept that I've already had my quota of true revelations. But the mini-Eureka moment I refer to is somewhat related to the big one. It has to do with all the recent stories and opinions about silver being over-priced and about to fall. Yes, I concede that silver could fall in price on a short-term basis. Anything can happen on a short-term basis, especially in a market that is as manipulated as silver. But my point is different.

What has occurred to me is that there is a strong common denominator behind all the recent opinions and stories that silver should sell-off in the near term. The common denominator is that all those that hold that opinion never mention that silver has been manipulated. Their collective opinion is based upon silver being over-priced, period. Well, guess what? If silver hadn't been manipulated and had been in a free market condition for the past 25 years, I too, would agree that it was overdone in price to the upside, especially compared to gold. But that is not what the facts reflect.

What the facts reflect is that silver has had the most persistent and concentrated short position of any commodity in history. The facts reflect that there is a current formal investigation by the Enforcement Division of the CFTC based upon the concentrated silver short position. The facts reflect that many thousands of investors have written to the Commission, officially on the record, both in the past and presently, demanding and requesting that the silver manipulation be ended and legitimate position limits of 1500 contracts be enacted. And not one person or entity has yet to speak up to show why 1500 contracts (7.5 million ounces) is the wrong limit for silver.

These facts are not present in any other commodity. If they were present in corn, or soybeans or cattle or copper or gold or crude oil or any other commodity, you would think these facts would be widely discussed or acknowledged by anyone giving advice on whether to buy or sell those commodities. Yet, even though these unusual facts are unique to silver, I never see them mentioned in the opinions or articles advising the sale of silver. Are these people blind to the obvious?

I think what it comes down to is this — either you see the silver manipulation or you don't. Perhaps it might also be a case of someone seeing the silver manipulation and the facts surrounding it, but simply refusing to believe it for some misguided reason. Regardless, it sets up a beautiful circumstance. Seeing or not seeing the silver manipulation creates a clear line of demarcation. A line of black or white with no grey shading. You either get it or you don't.

If you don't get that silver has been and is manipulated, for sure the price looks excessive and cruising for a bruising. If you do grasp the manipulation, you admit that the crooks might smack it down, but you also know that the real price will only be seen when the manipulation is terminated. I can't help but feel that the strongest holders in silver are those who grasp the manipulation and that those who have benefitted the most to date by the increase in silver prices are those who get that silver has been manipulated.

This also has everything to do with how silver has and will behave in relation to gold. The shocking outperformance of silver compared to gold is either over if you believe silver hasn't been manipulated; or is just starting if you believe the end of the silver manipulation lies ahead. You look at how silver has outperformed gold and conclude it is overdone (if you don't believe in the manipulation argument), or you know it has a long way to go. I know how I feel in every fiber of my existence and this has been behind everything that I have ever written. It's up to all silver investors to decide for themselves how they feel about the manipulation and the real silver story.

Ted Butler

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