November 14, 2012 – Relative Valuations

Relative Valuations

A little over 20 years ago at the peak of the Japanese real estate bubble, it was reported that property values there had grown so extreme that the value of the Imperial Palace in downtown Tokyo was said to equal the total value of all the real estate in the state of California. I know that seems absurd now, given that the Imperial Palace was situated on a plot of land 1.3 square miles in size, but speculative bubbles can grow to unprecedented heights. No doubt Japanese real estate and stock market values grew way too high and have corrected ever since.

As an analyst, it is the relative comparison of the Palace grounds to the total value of California real estate that was most instructive. After all, on any practical measurement, it is not possible to rationally justify this relative valuation. For instance, what would the income stream be from renting out all California real estate relative to the rental income from the Imperial Palace? Which would you rather own (if it were possible) Â? all the real estate in California or the Imperial Palace? Back in the late 1980's, the prevailing market price of each suggested it was evenly matched.

The real lesson here is that when relative values become extremely mismatched, it is usually a much safer bet to anticipate a re-adjustment between comparable assets than it is to guess if one or the other might be too high or low on their own. In other words, it was easier to predict that the relative value between the Imperial Palace and total California real estate in 1989 would dramatically adjust, than in predicting if overall prices would rise or fall at that time. Of course, this was a bet that would be difficult for most people to take advantage of, except in intellectual terms. But what if it were possible to identify a current relative imbalance between two similar assets that would allow everyone the opportunity of practical participation?

I believe that such an opportunity exists in the current relative valuations between gold and silver. Let me be careful in describing why I think all the facts point to gold being as overvalued relative to silver as much as the Imperial Palace was overvalued to total California real estate in 1989. While I believe gold is wildly overvalued relative to silver, in no way do I think gold is a bubble about to burst (as was Japanese real estate in 1989). I can see gold advancing hundreds of dollars given current circumstances. But that does not detract from my contention that gold is way overvalued compared to silver. Perhaps a better way of putting it is that silver is grossly undervalued relative to gold.

The first fact I would draw upon is the relative valuations of markets in general. This is an easy computation. Gold is often referred to as a small market, but that is not the case in terms of relative valuation. The current dollar value of the world's 5+ billion gold ounces is near $9 trillion. World gold mining and recycling production add $150 billion worth of gold to existing above ground supply every year. Considering that the total value of all the world's publicly traded stocks is less than $50 trillion, as is all the world's total public debt, $9 trillion is not a small valuation for a single asset. And if gold price projections of $3500 or $12,000 are achieved, gold would be worth more than the entire world's current stock or government debt total value. I know that many gold proponents believe that the sky is the limit for the price of gold, but trees don't generally grow to the sky.

I suppose it is not impossible for gold to reach outlandish price targets, but if that value came to exceed the value of all the world's publicly traded companies, with their many millions of employees and billions of customers, that would indicate a seemingly absurd relative valuation. In fact, this is the biggest headwind for gold, namely, that it has achieved stunning returns over the past 10 to 12 years, far outpacing the growth in other broad valuations. But the flip side, a sharp increase in the price of any asset (silver included) does detract from true investment value. A decade ago, the total value of the world's gold was around $1.3 trillion (4.4 billion oz X $300) versus a world stock market value of $25 trillion, or 5%. http://rwer.wordpress.com/2010/11/30/world-stock-market-capitalization-4-graphs/ Today gold represents nearly 20% of world stock market value. Gold is more expensive relative to almost every other investment market due to its outperformance over the past decade. I'm not implying that gold doesn't have good reason to climb further, just that its gains to date have made it more expensive relative to just about everything else.

If gold's price outperformance has made it more expensive relative to other markets, I must acknowledge that silver's price performance has been even better than gold's over the past 5 and 10 years. But the difference is that while silver is up eight-fold from the decade's price lows, there is so little silver above ground relative to gold that the total value of the world's silver is still miniscule compared to other asset classes. Above ground world silver bullion inventory is slightly higher than a billion ounces, meaning a total value of less than $35 billion. Not $50 trillion like in world stock values or the $9 trillion that all the gold is worth. In other words, even though silver has climbed more than just about anything else over the past 5 or 10 years, the total value of bullion silver (1000 oz good-delivery bars) is three-tenths of one percent (0.3%) of all the gold and less than one-tenth of one percent (0.1%) of all the world's stocks. It would be hard to come up with smaller fractions than that.

In this case, the smaller the total value, the better. If silver tripled in price and gold didn't move at all, the value of silver bullion inventory relative to gold would still be only one percent. It is the remarkably small relative size of the silver market that creates the potential for outsized gains. Even if silver were to triple in price that would only translate to the world's silver bullion inventory being worth $100 billion; that's about the same dollar effect of a $20 move in gold today. Silver's total value is measured in the tens of billions; gold is measured in the trillions.

Relative size may be important, but it is not everything. There is a fundamental difference between gold and silver in how the total demand for each is structured. Gold is primarily an investment and jewelry market; silver is primarily consumed industrially and in other fabrications (jewelry, photography, coinage and alternative energy (solar) and biomedical, etc). Only about 15% of silver's total mine and recycling production is available for investment or about 100 million oz per year. Compare that annual dollar amount of silver (less than $3.5 billion) to the $150 billion of new gold produced each year.

More important than size is the nature of the relative demand structure in gold and silver. Gold is basically non-utilitarian, mostly because it is too expensive for it to be consumed industrially on a large scale. That's not a knock on gold, just a dispassionate observation. Silver is perhaps the most utilitarian of all metals, being consumed in more different applications than any other metal. If gold were to suddenly disappear from the face of the earth, aside from the financial loss to the former owners, little would be lost to most of the world's citizens. If silver were to suddenly disappear, so many industrial and electronic applications would be deprived of a critical material, it would have an impact on the world's standard of living. Modern life would change if there were no silver.

It is the starkly different demand profile between silver and gold that holds the most promise for silver vastly outperforming gold in the long run. Because silver is widely consumed on an industrial basis, this creates the potential for a physical silver shortage not likely to occur in gold. After all, since is gold is not widely consumed on an industrial basis the chance of many gold industrial consumers panicking is remote. That's not to say that the price of gold can't move higher, just that it won't be because industrial consumers are rushing to build gold inventories. With silver, it's more a case of when will the physical shortage hit, not if it will occur. That's not to say that large investors and central banks won't buy gold, even though many have already done so, but that's not the same type of fevered buying seen in a shortage. Above everything else, Experience is said be the best teacher and for that reason it is hard to imagine the effects of something that has never occurred. The world has never experienced a full-blown physical silver shortage in which industrial corporations try to protect their continuing operations by stockpiling a critical ingredient not readily available. Many would scoff at a pending silver shortage simply because it has yet to occur. But any item that is consumed has the potential to experience a shortage; whether by natural disaster or some other sudden production interruption or even by a gradual depletion of working inventories below critical levels. If the available inventories of any consumable commodity get low enough, as I believe to be the case in silver, it doesn't take much to set off an industrial user buying panic. But in the case of silver, there is a unique factor that almost guarantees a buying panic will be set off.

Almost unique among all commodities, silver is both a vital industrial commodity, widely consumed due to its special physical properties, and as an elemental investment asset.
This combination means that either demand is capable of tripping off the other. To my mind, it is only a matter of time and of which goes first. Because investment demand can ignite overnight, especially given the flood of new silver investment vehicles made available over the past five or six years, I suppose it's natural to see that demand as setting off the user demand. But it is the user inventory demand that has always made my mind almost shut down when contemplating the potential price impact. I don't expect this user inventory demand to be necessarily long-lasting in terms of time, but intense beyond belief. Please remember that I am talking about something that has never occurred in silver, so you must decide for yourself the likelihood of such a panic. But my life's experience has taught me that if a genuine silver shortage does develop, there will be no historical parameters by which to estimate price. Prices in a shortage are extreme and unique to the item in the actual shortage. I can see that shortage coming in silver and not in gold, which is the essence of my argument that silver will outperform gold in spectacular manner. We all invest to achieve the best possible returns and the facts support silver being the best investment possible, as it was over the past decade. That is not to say that gold won't or can't go higher in price and I hope it does because that will make silver a better relative value.

Maybe the best thing of all is that there is a ready explanation for how silver got to be such a relative bargain compared to gold and other assets. Something had to create what I'm calling an investment mismatch on the scale of the Imperial Palace versus all the real estate in California. In the Japan of the late 1980's the cause was clearly an unprecedented speculative mania fueled by leveraged buying the world had rarely seen. In the case of silver, it has become incredibly cheap due to the long term silver manipulation. I'll spare you the discussion of the manipulation in detail today, but it is important to understand silver is incredibly undervalued due to a specific causation. I can't imagine what else could possibly explain silver becoming as cheap as it is today relative to gold.

Finally, there was a video interview yesterday featuring Commissioner Bart Chilton talking about the silver manipulation. I was taken aback by how specific Commissioner Chilton was on the matter. It was an interview that has garnered wide attention and comment.

http://rt.com/programs/capital-account/bart-chilton-regulations-global/

My reaction is two-fold. First, I am elated that the subject of the silver manipulation has come to be so widely understood. As I need not remind you, this has been my main professional focus for more than 25 years. The main reason it obsesses me is that it is such a serious matter, as no market crime is more important than price manipulation. Since discovering that JPMorgan was the big silver short 4 years ago due to CFTC correspondence to lawmakers, I have tried my level best to convince others of JPM's involvement. Considering how widespread has become the awareness that it is JPMorgan at the heart of the silver manipulation, I can also state that I am elated about that as well. While I am most grateful for the financial support from subscribers and from Investment Rarities that has enabled me to delve into and make known the manipulation, my chief motivation was always to end a market crime that I found most offensive. How could I not be ecstatic that so much has been accomplished?

My second reaction is different. I'm appalled that the CFTC and the CME have not dealt with this matter in a forthright and aboveboard manner. Concentration is an incredibly specific issue and JPMorgan holds a manipulative share of the COMEX silver market, currently over 32% on the short side. The Hunt Brothers were judged guilty of manipulating the silver market for holding a 20% share in 1980. Had there ever been a single participant that held 32% of the long side of COMEX silver since 1980, it is a certainty that the CFTC and the CME would not have rested until that position was eliminated. Yet for more than 4 years, the CFTC has only pretended to investigate while JPMorgan manipulated the silver market continuously.

One of the real dirty aspects to this is that by deliberately stalling and pretending to investigate, the CFTC has allowed important statute of limitations to approach kick in time-wise, thereby threatening to deprive those harmed in the great silver price smashes of 2011 from legal remedy. This is a case of the CFTC not only failing to fulfill its most important mission, but of, effectively, protecting JPMorgan at the expense of legitimate market participants, which is flat-out disgusting. My distain for the CFTC is clearly shared by many, judging by the comments published on the interview above and in every other similar discussion I have seen on the Internet. In a democratic society, it is dangerous when a government agency disregards the clear will of the people, particularly when the people's will is on high moral and legal grounds.

I applaud Commissioner Chilton for his comments on the silver manipulation; but the time for talk has long expired. The crooks at JPMorgan and the CME have manipulated the price of silver for far too long while the CFTC has sat by and allowed it. The good news is that the coming physical silver shortage will end the manipulation in due course, despite no help from those who should have acted long ago. At least none of them can ever say that they didn't know.

On a housekeeping note, I plan on migrating back to Florida over the next few days. As a result, the weekly review will probably be delayed by a few hours or even into Sunday. Sorry for any inconvenience.

Ted Butler

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Silver – $32.60

Gold – $1725

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