SILVER NEWS AND ANALYSIS

POSITIVE PROSPECTS

Silver: still dependent on gold for upside, but fundamentals stronger

GFMS asserts that "a great deal will be required from investment demand this year" as the key element in the silver price over the past year has been a pronounced shift in investor behaviour.

Author: Rhona O'Connell
Posted: Wednesday , 07 May 2008

LONDON -

The latest Silver Survey from the Silver Institute, compiled by independent research house GFMS Ltd., points to the positive prospects for investment demand, for this year at least, citing the primary influences as follows; expected gains in gold prices, continued US dollar weakness [these two of course are not unconnected], growing inflation fears and a further substantial inflow of money into the commodities sector. On this basis, the group says that it would be surprised if this did not translate into another major year-on-year gain in silver prices in 2008. It is perhaps significant though that the case for silver investment is in some ways a "second order" argument, as it depends on the rest of the sector, not purely on silver's stand-alone fundamentals.

In terms of underlying supply and demand, the market remains in a surplus, prior to investment activity, which obviously includes Exchange Traded funds and these are an important focus of the market this year as they have been more than equal to the task of absorbing the excess and indeed extracting metal from existing holders. The opening paragraph of the study points out that the "key development changing silver's fortune has been the pronounced shift in investor behaviour".

The Survey points out that until the beginning of this decade, the market needed to absorb large amounts of metal that had been dishoarded from private stocks, a throwback to the investment boom and bust of the 1970s and 1980s. Over the first part of this decade, this source of metal has dried up and latterly investment has become a market fixture, with this process accelerated by the launch of the silver Exchange Traded Funds since 2006, part of the wider interest in commodities as an asset class as a whole and a reflection of silver's psychological link with gold.

Last year's fundamentals saw higher mine output, but this was partially offset by substantial dehedging, so that mine *supply* came in at 645.6 million ounces (20,080 tonnes) compared with 640.6 million ounces (19,924 tonnes) in 2006. Higher and more volatile prices reduced demand for jewellery, silverware and coins and medals, but not by much, with the combined total falling from 267 million ounces (8,314 tonnes) to 260 million ounces (8,087 tonnes), a contraction of just 2.7%. Gold jewellery demand, by contrast, increased in 2007, but had fallen sharply in 2006 in response to the changing price environment. Between 2005 and 2007, gold jewellery demand contracted by 11% over the two years, while silver jewellery demand fell by just6%. This is in part because a higher proportion of silver jewellery has additional mark-up charges that dilute the continued value of the metal than is the case in the gold market.

Photographic uses remain in decline, dropping by 11% last year to 128.3 million ounces (3,991 tonnes). In the peak year for silver use in photography, 1999, demand was 227.9 million ounces or 7,088 tonnes, comprising 26% of total demand (excluding ETFs). Demand in this sector has therefore dropped at an annual average rate of 7% per annum in the face of relentless competition from the digital sector. The fall since the peak therefore amounts to 3,097 tonnes.

The area of particular interest is "industrial applications", which have grown from 339 million ounces (10,544 tonnes) or 39% of total in 1999 to 455 million ounces (14,161 tonnes) or 54% of total. Industrial usage has thus increased by 3,617 tonnes since 1999, more than offsetting the fall in photographic offtake.

The annual rate of growth over the period equates to 3.8% per annum and grew by 7% last year. With the electrical and electronics sector again the mainstay, although brazing alloys and solders also registered "respectable" growth. In the US, the slowdown is expected to cause many existing areas of silver demand to decline this year, although it is interesting to note that environmental considerations should underpin continued growth in photo voltaic cell demand, aided further by high oil prices that are strengthening the competitiveness of this technology. Looking back, environmental concerns have also helped the silver market, as it was the banning of lead in solders that rejuvenated silver use in this sector.

Total industrial demand in 2007 thus amounted to 844 million ounces or 26,239 tonnes, an increase of just less than 1%. This meant that the underlying balance between supply and demand, prior to investment or inventory changes, was a small surplus of almost 26 million ounces or 806 tonnes. Exchange Traded Funds, however, absorbed roughly 1,590 tonnes over the year.

For the market as a whole, investment thus remains the most interesting element, with investor activity the main driver of silver's high and volatile price in 2007, and expectations for gold prices were an important consideration for silver investors. This is expected to remain the case during the rest of 2008 and despite the fact that investment is a relatively small component of the supply-demand balance, the activity of investors is disproportionately high when it comes to price discovery. This is a factor that is very much helped by the limitations to short-term price sensitivity of the other supply-demand variables (again contrast this with the gold market). The ebb and flow of investor activity has been the main influence of the direction and level of silver prices during 2007 and into the early months of 2008.

While silver has an investment constituency that looks solely to the metal's fundamentals and their expectations for its prospects independent of other commodities, the Survey reinforces the view that the majority of institutional and private investors pay close attention to gold and base metal prices when considering the strategies with respect to silver. This is borne out by rigorous mathematical analysis that looks at silver's correlation with other commodities. Analysis of investor and speculative activity suggests that the net impact of investor activity on the underlying physical market was very similar in the case of both silver and gold during the course of 2007, notably modest investment between January and April, heavy selling through to late August and then heavy interest in the last four months of the year with the sub-prime crisis fuelling interest in gold and, by contagion, affecting silver.

During 2007, despite soaring mine production growth (which is up by almost 2,200 tonnes over the past four years), de-hedging increased, there was a sizeable drop in government sales and industrial demand was solid, leading to a relatively small surplus of supply over industrial demand and the "contribution of silver investment was sufficient to take prices to fresh highs".

The Survey questions whether this dynamic can be retreated in the future. Silver mine supply is expected to register further gains, and, assuming that there will be relatively little attrition in supply from scrap and government sales, the market will have to absorb additional metal. With prices in excess of $15 affecting demand levels, and in view of the outlook for global GDP and industrial growth, this look unlikely and the onus therefore lies on investors, and possibly de-hedgers if a price fall is to be avoided. The prospects for further substantial dehedging look limited (the book now stands at just 1,824 tonnes) and there is a distinct possibility that by-product producers will look to lock in high by-product credits.

This therefore points to the investor as the key driver in the silver market this year. So far, they appear to be delivering, with combined ETF holdings rising by almost 1,000 tonnes in the first quarter of 2008. The Survey suggests that the prospects for further investment demand remain positive for the reasons outlined at the opening of this piece, notably gold, the dollar, inflation and inflows into the commodity sector.

Print story Email story

Back