HindeSight

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August 10

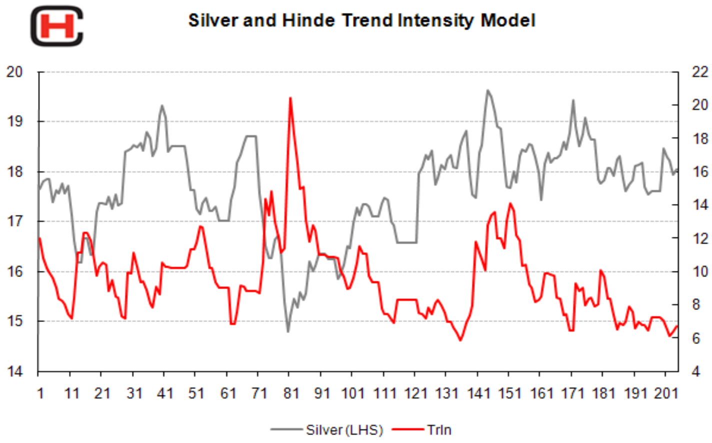
Silver Velocity- The Coming Bullet

Money can lose its value through excessive abundance, if so much silver is coined as to heighten people's demand for silver bullion. For in this way the coinage's estimation vanishes when it cannot buy as much silver as the money itself contains…The solution is to mint no more coinage until it recovers its par value

Copernicus

Silver Velocity to rise

Our Hinde Silver Trend model has reached a significant low that usually precedes a dynamic move. This move can be lower or higher but our other technical indicators signal a move higher is the most likely scenario.

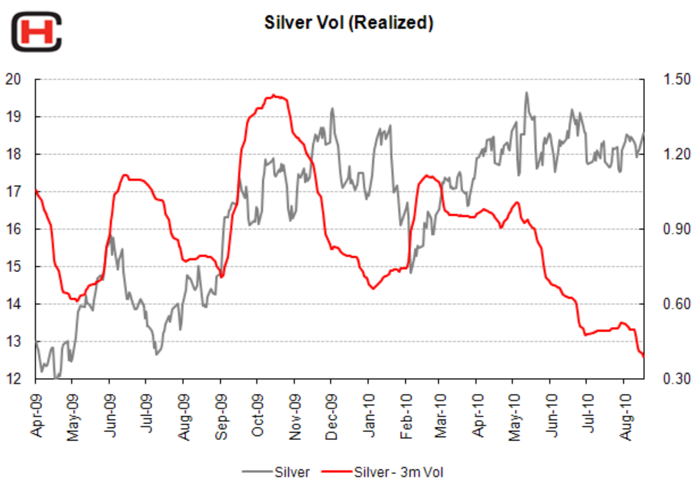


Silver Seasonality

Our silver seasonality analysis suggests that the trend will be directionally higher in price.

Silver Volatility

Other than just purchasing silver bullion (in allocated form), speculators could purchase volatility. As one can see from the chart below historical price volatility is at the lowest standard deviation on a rolling 3 month basis that it has been for sometime. Straddle break evens look attractive or likewise out-the-money call premiums look cheap, for those who agree with our directional bias for a move higher.



Silver's timeless fascination

Mankind's timeless fascination with silver stretches back millennia. As early as 700 B.C., the Mesopotamian merchants used silver as a form of exchange. Later, many other civilizations also came to recognize the inherent value of silver as a trading metal.

The ancient Greeks minted the drachma, which contained 1/8th ounce of silver; and in Rome, the basic coin was the denarius, weighing 1/7th ounce. And let's not forget the English shilling "sterling," originally denoting a specific weight of silver, which has come to mean excellence. In fact the words for "silver" and "money" are the same in at least 14 languages.

Silver or money is derived from the Ancient Greek: **ργήντος** - argēntos, gen. of **ργήεις** - argēeis, "white, shining"). The Incas of Peru called it the "tears of the moon" because they were awed by silver's strange gleam and the Chinese believed that a silver locket hung around a child's neck would ward off evil spirits.

In recent years silver has grown to be regarded as the poor man's gold. However we suspect silver will shake off this unfortunate shackle and give gold a "run for its money" as the old idiom goes.

There are key fundamental differences between gold and his poor cousin silver. Demand for gold is almost entirely from those holding for financial safety and protection of purchasing power and likewise from fabrication that preserves it. Gold is rarely if at all consumed. A base metal is the opposite, it is consumed. Like iron for example.

Here silver is unique, industry will consume it, and others will buy for financial gain and protection. Fluctuations in the price of gold primarily arise from changes in demand as annual mine supply is small compared to existing stockpiles; of the same magnitude as the small amount lost or consumed each year. Hence over ground supplies don't change much.

Silver ounces come and go. Unlike gold silver's active chemical properties lend it to practical industrial use that see much of it used beyond practical recovery. The uses for silver in modern industry are growing. It is the best conductor of both heat and electricity, the most reflective, and after gold the second most ductile and malleable element. It is used in photography, electrical applications, particularly in conductors, switches, contacts and fuses. Silver alloys are used in batteries as cathodes. As a bactericide, silver is used in water purification and air handling systems. Silver is also a natural biocide and is very effective against bacterial infections such as MRSA. New products using silver's biocidal qualities are being developed each year; clothing, bandages, toothbrushes, door-knobs (flu-protection), keyboards, the list goes on growing.

Silver is much less rare than gold and as a consequence less effort goes into salvaging and protecting it. Annual mine production and consumption are large compared to existing stock piles, so price fluctuations in theory come from both these factors as well as investment demand.

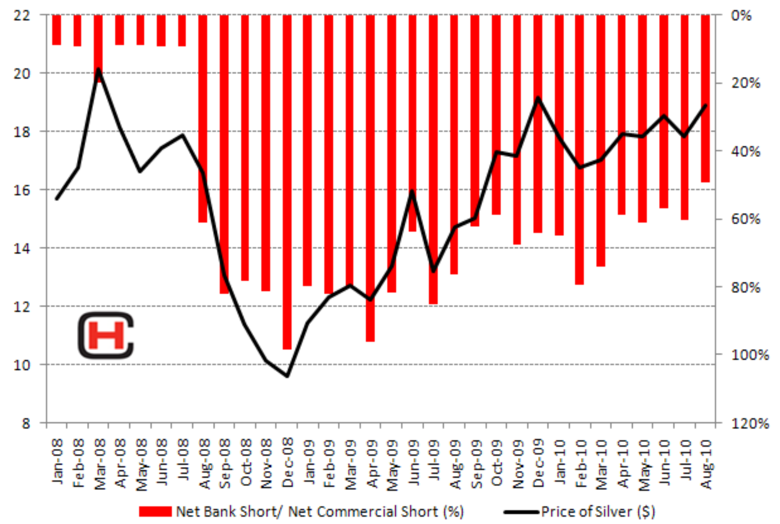
Silver supply demand imbalance

Uniquely silver has been in a multi-decade imbalance between annual "production" and demand from industrial, jewellery and investment. Ted Butler of Investment Rarities Incorporated has become the most ardent silver analyst and has done extensive research into the issues of dwindling stockpiles. His well documented research extended into the leasing market and the existence of huge short positions on Comex (namely among a few large bullion houses) that have been allegedly used to manipulate the price of silver lower for benefit of the "users". This supply of paper silver has undoubtedly arrested the rise in the price of physical silver bullion, as there would appear to be a structural imbalance in supply vs demand, which can only be resolved by a much higher increase in price in order to encourage 'normal' free market forces of supply and demand to interact.

The world annual silver mine output is approximately 650 million troy ounces (average of last decade), with about another 180 million ounces from recycling, and possibly another 100 million ounces from selling from other sources. Industrial consumption is almost 45%, jewellery consumes about 25%, photography is down to about 15%, leaving 15% for investor demand. Investors buy about 100 to 150 million oz. of silver per year, which is barely $2 billion. Yet the BIS estimates that most all of the worlds' banks have $200 billion in 'other precious metal' (i.e. silver) notional value worth of derivatives on the books. This seems somewhat incongruous with the lack of supply. It tends to point to a potentially more sinister occurrence.
http://www.bis.org/statistics/otcder/dt21c22a.pdf

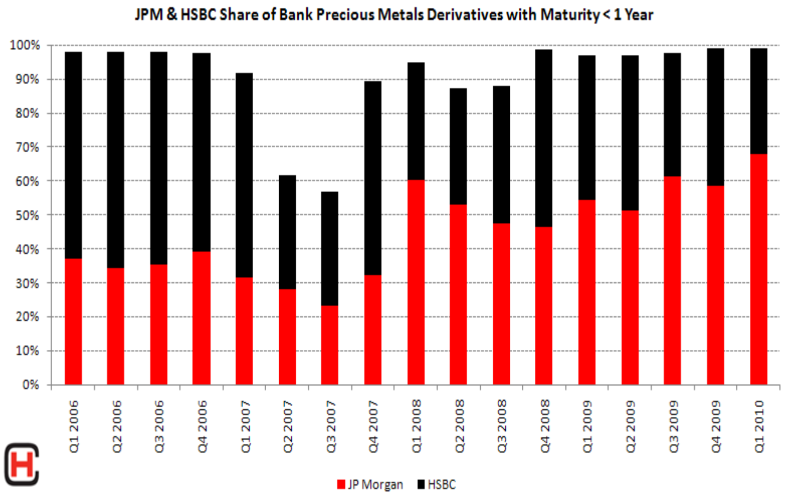
In July to November 2008 silver net US bank shorts rose from 9% to 99% of the Comex commercial net short positions in one shot. Equal to some 27,000 contracts or 30mm tr.oz of silver sold, just prior to a 50% plus collapse in the silver futures price. The issue we and others in the market have with this egregious positioning is that it was concentrated between two commercial banks. Flip such a position around to the long side and regulators would be screaming 'blue murder' and accusations of market manipulation and market 'cornering' would be rife. Remember Bunker Hunt.

Two Banks Net Short as % of Commercial Net Short and Silver Futures Price (observe July 2008 "Commodity Massacre" short activity)



The two commercial banks held 140% of annual mine supply in OTC positions. These two bullion banks dominate the OTC silver market. They range in concentration from 85% to 100% at any one time.

HSBC and JPMorgan % Silver Derivatives (inferred) (average maturity less than 1 yr)



Unwinds of these positions would require more silver than is readily available and will lead to much higher prices as sellers are sought.

The manipulation of this small market has led to low prices whilst a structural imbalance of some note has been growing.

"*What's unique to silver is that it has been in a deficit consumption pattern for more than sixty years, with very low prices over most of that time. That would be impossible for any commodity, except that it has actually occurred in silver. But the very reason it has occurred in silver is the reason I think silver is the best thing to own*".

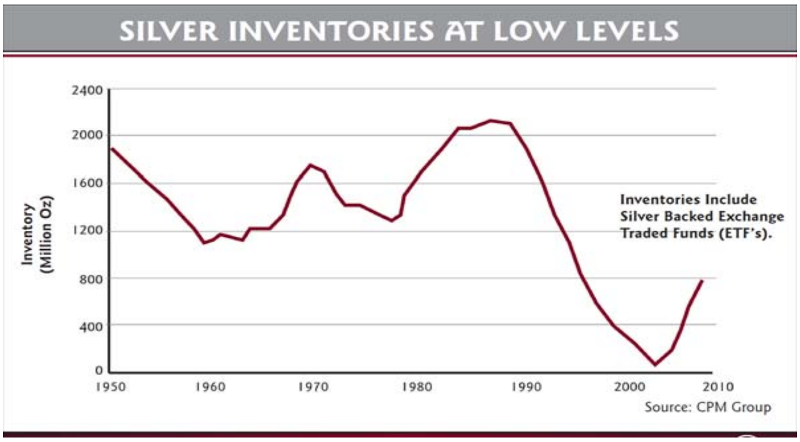
Theodore Butler, Investment Rarities , first mentioned in 1998

The laws of supply and demand dictate that when there is a chronic production shortfall, inventory can only be bid away at higher, not lower prices. Ted argues that most of the inventories consumed over the last 60 years came from government holdings. This amounted to a stupendous 6 to 10 billion ounces, some 100-150 million ounces of silver each year for 60 years. So lets put this in perspective it took 5000 years to accumulative these stockpiles and in sixty, they have gone. Above ground silver is rarer than gold….

As Ted Butler describes it, to look ahead 50 years, it would be appropriate to look back fifty years to gain a sense of perspective. Half a century ago, at the end of World War II, total known stocks of silver amounted to ten billion ounces (with the US government holding 4 billion ounces of that total amount). At that time, we were just entering an era of unprecedented global economic expansion that has lasted to the present. In this era, silver was consumed in a variety of vital modern applications at a phenomenal rate. Today, known stocks of silver have shrunk over 95%, to maybe a half a billion ounces. The nine and a half billion ounce drawdown in total silver inventory, was the result of the persistent shortfall between supply and demand, which continues to this day. Not coincidentally, the current 150 to 200 million-ounce annual deficit in silver mirrors the long-term trend line average. This continuing deficit is remarkable in that there has been decent growth in world production of silver over the past 50 years, but obviously not enough to satisfy the surge in industrial demand.

Fast forward towards the end of 2008 and the seizing up of the financial system saw base metals plummet in value. This was down to a combination of deleveraging and lack of available financing for mining companies. Those encumbered with too much debt and ailing commodity prices had to curtail their current mining operations, in some cases to bare minimums, whilst shelving large capital expenditure projects which would bring on new supply in years to come. As over two thirds of silver production occurs as a by-product from copper, zinc and lead mining, silver mine supply into the future has been stymied.

2009 saw such a swift turnaround in copper prices that silver production was a record 709 mm troy ounces. This was 25 million ounces higher than in 2008 and arguably would have been higher had it not been for the crisis. But this is a moot point as we have just outlined. It took thousands of years to build up ten billion ounces, so to create a current surplus of over 2% does not appear feasible with the supply demand imbalance we have. We will caveat; it is exceedingly difficult to ascertain the true levels of inventories, and there is always disparity on the numbers depending on which data collector you converse with. However as can be seen below inventories remain exceedingly low, irrespective of whose data one observes.



Silver inventories have only turned up as assessed by CPM group, because they have included Silver ETFs, such as iShares SLV. This seems odd, as these inventories already existed, and were merely 'transferred' into these vehicles.

In a nutshell- for many decades the world has consumed more silver than it has produced. That has necessitated a draw down of previously produced silver - the existing inventories. **There has never been a situation in any commodity where such conditions have failed to cause a dramatic price increase.**

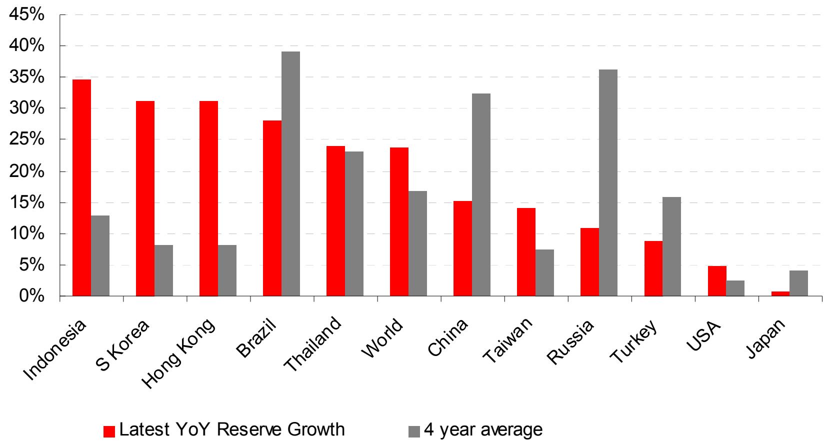
Money velocity rises leads to Silver rise

Hinde Capital rigorously examines collates and archives proprietary economic and geo-strategic data to help provide us with global, national and regional sectoral insights. In 2009 "HindeSight" Macro research was spun off as Variant Perception www.variantperception.com. Variant has in very short order become a respected independent voice. Their growing independent macro research services are widely used by institutional organisations, hedge funds, corporate and family offices.

In their latest August monthly "De Facto QE in Emerging Markets" they discuss that loose liquidity and undervalued emerging market currencies are leading towards excess foreign exchange reserve accumulation and loose credit conditions. Underleveraged emerging markets with higher velocity will continue to benefit from accommodative monetary policies of a developed world beset with high debt and low monetary velocity. At Hinde we employ their analysis and in conjunction with the VP team have drawn some assertions on the relationship between growing forex reserves, increasing monetary velocity and the trajectory for silver. What we have determined is that the macro back drop is also exceedingly promising for silver in the near term.

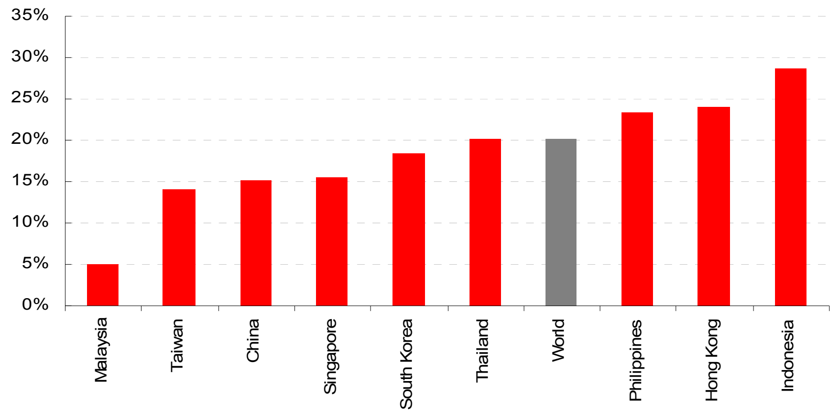
When foreign exchange reserves are accumulated, they represent an expansion in central bank balance sheets. (Of course, some of the reserve accumulation can be sterilized, but this is only happening partially at best.) **Excess reserve accumulation is acting as a massive de facto form of quantitative easing.**

Global Foreign Reserves Growth



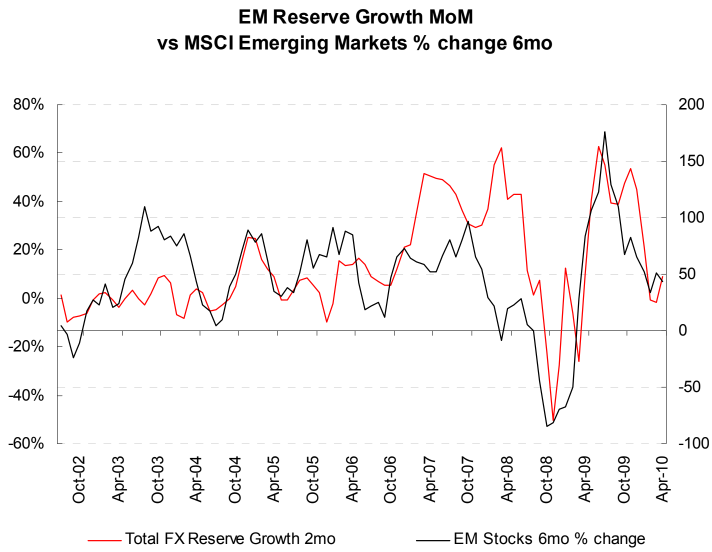
Source : Variant Perception

Reserve Growth, YoY, Asia EM



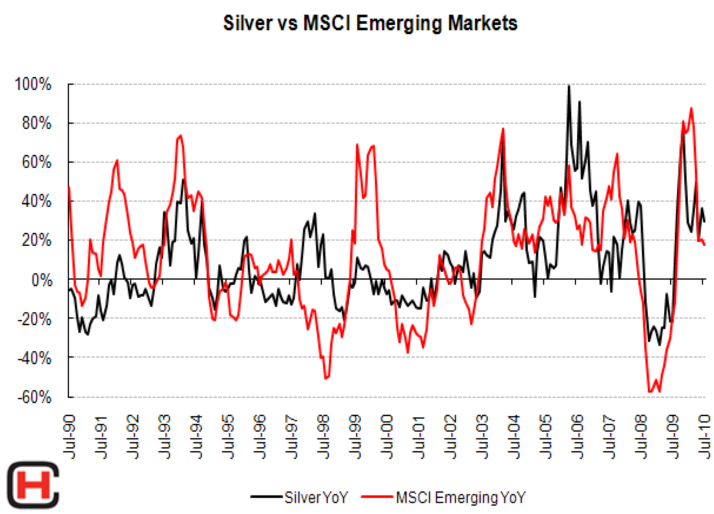
Source : Variant Perception

Continued reserve accumulation can lead to inflationary pressure, over-investment, complications in the management of monetary policy and misallocation of domestic banks' lending and asset bubbles. As the following chart shows, there is a high correlation between reserve growth and emerging market stock returns.



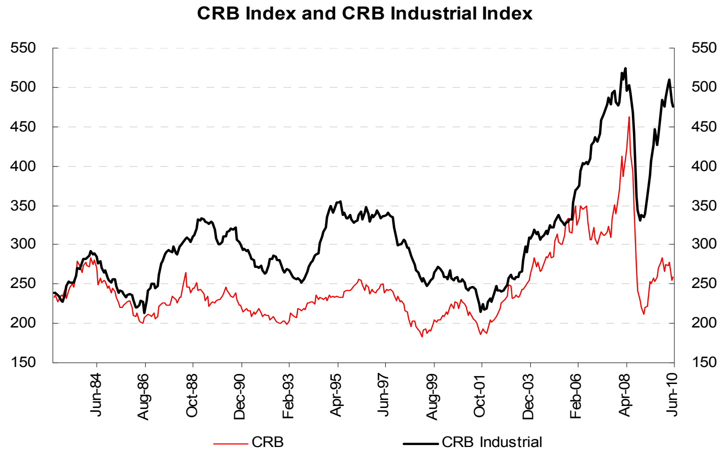
Source : Variant Perception

As EM reserve growth has continued in recent months we expect the MSCI continued outperformance to Western stock markets to support silver prices. Silver has a strong correlation with the MSCI Emerging markets:



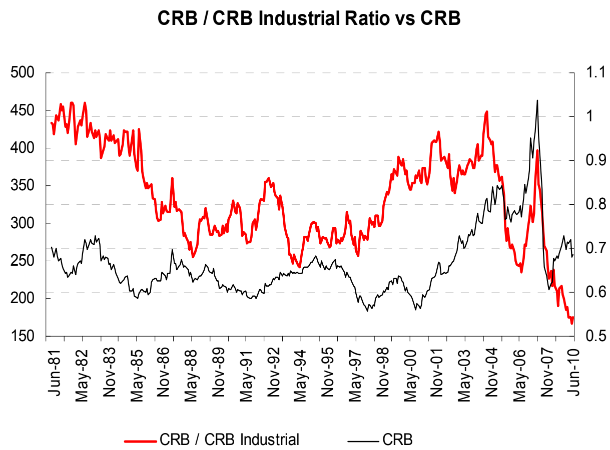
Exchange traded commodities are very cheap

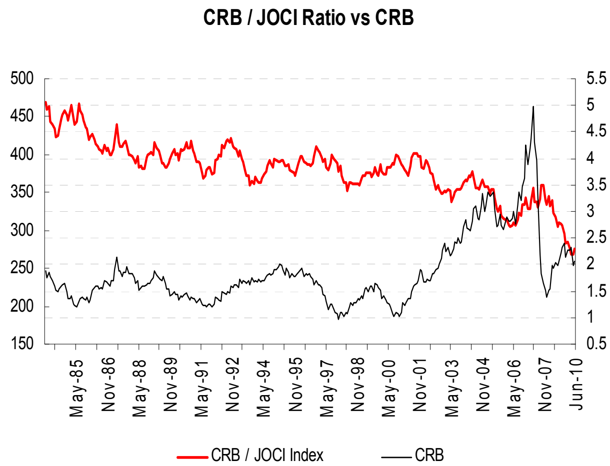
VP have highlighted before that exchange traded commodities are cheap. Industrial commodities that are not exchange traded are not far from their all time highs, and they barely sold off during the earlier sell-off in risk assets through April to June.



Source : Variant Perception

The ratio of the CRB Index vs. the CRB Raw Industrial Index is at all time lows, indicating significant undervaluation. The CRB Raw Industrial Index is driven by fundamental demand and not speculators, while the CRB Index is driven by speculators. (The Raw Industrial Index includes things like copper scrap, lead scrap, steel scrap, tin, zinc, burlap, cotton, print cloth, wool tops, hides, hogs, lard, steers, tallow, butter, soybean oil, lard, print cloth, rosin, and rubber.) The Raw Industrial Index contains no energy inputs, so is not driven by higher oil. VP also look at the JOCI Index which includes many non-exchange traded commodities (for example burlap, steel, lead, tin, nickel, hides, rubber, tallow, plywood, red oak, benzene, ethylene, etc). They both present a similar picture.



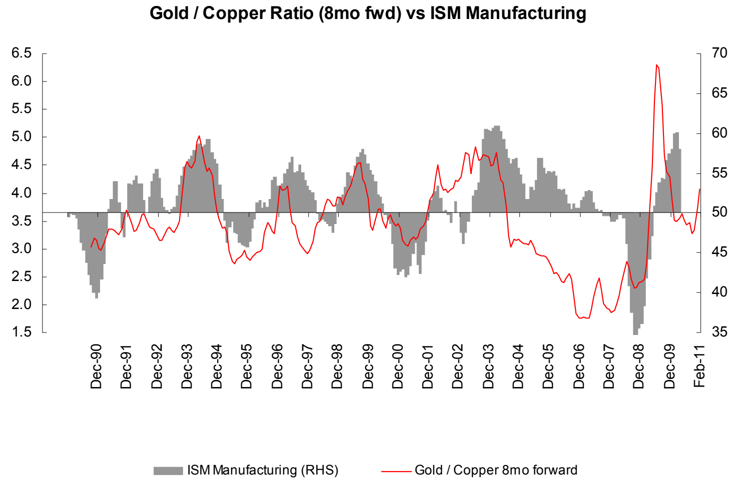


Source : Variant Perception

The charts could not be clearer. Exchange traded commodities have never been cheaper relative to non-exchange traded commodities.

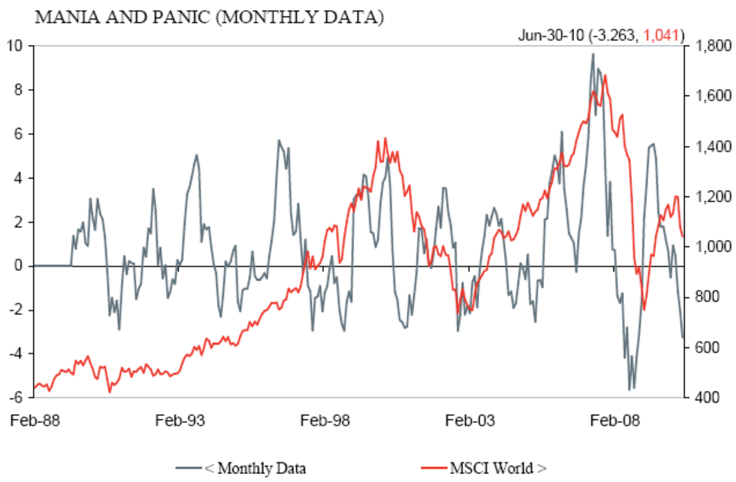
VP has followed a framework of observing leading indicators in trying to determine if 'deflation' or a double-dip recession is on the horizon. They wrote in a recent monthly that they believed the world was experiencing a mid-cycle slowdown, similar to that seen in 1994 and 2004. "The momentum of growth has peaked and our forward looking indicators have peaked, but they are still positive and pointing to continued growth ahead."

The gold/copper ratio is one such leading indicator VP look at (it is an intuitive real world measure of excess liquidity). It gives an advance read on ISM manufacturing. After a huge surge, followed by a sharp slump, it has started to tick up again. The new orders to inventory ratio has also picked up again over the last few months.



Source : Variant Perception

Over the summer concerns about a European banking crisis helped push sentiment to very negative levels. The VP Mania and Panic indicator, which measures risk aversion and risk taking globally, shows that only during the crash in October 2008 had the indicator been lower.

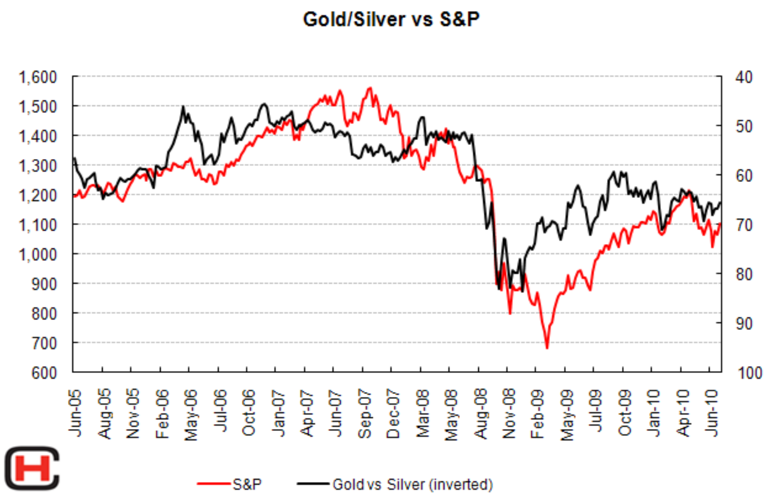


Source : Variant Perception

Extreme sentiment in western stock markets, undervalued exchange traded products including silver and a turning up in the gold/copper ratio suggest the precious metals complex will rise substantially in short order under a surfeit of monetary reserves that is originating primarily in the West but accumulating in the East and on other developing nations' balance sheets. We observe the Gold silver ratio closely.

SUMMARY of the most important Gold Silver ratios

As Ferdinand Lips (of 'Gold Wars' fame) writes, the Gold Silver ratio makes for one of the most fascinating questions of monetary history, and also one of the most mysterious. This ratio was at 10 in antiquity, by the Modern Age it was at 14. By the eighteenth century governments tried to stabilise at 15, but without success. In the nineteenth century the ratio was completely destabilised as it raced towards 60 and then back to 16 by the First World War 1930 and at the height of the Great Depression it hit 100 and this decade appears to have stabilised at 55 to 60; an anomaly in light of all we have written about here.



- 90 Was the ratio of silver to gold when the price of an ounce of silver was at a low in 1991. With one ounce of gold one could buy 90 ounce of silver. **In recessions the spread widens.**

- 51 Was the average ratio of the price of gold to silver in 2007. **In boom time the spread narrows.**

- 17 Was the gold / silver ratio at the time of the record gold and silver prices in 1980. Bunker Hunt corners the market.

- 15 Was the official ratio of gold to silver during the great period of Bimetallism, 15 ½ for France (1803), 15.68 for the USA (1800), 14,29 for England (1806)**.**

- 12 Was the gold/silver ratio in Antiquity in Rome.

-12.5 Was the ratio in Greece at the time of the death of Alexander the Great in 323 BC.

The ratio of production and reserves of gold and silver:

- 13 Is the ratio of world production from 1493 to 1931. For this 400 year period 13 times more silver than gold was produced.

- 8 Was the ratio of silver to gold production in the world in 2006. What is being said is that eight times more silver than gold was produced in 2006.

- 7.64 It the ratio of all production of gold and silver during one century (1900-2003). In the 103 year period, there was 7.64 times more silver than gold produced in the world.

- 6.4 Was the ratio of the ground reserves of silver to gold in 2000.

Source: Dr Thomas Chaize

Despite silver's intrinsic properties as an industrial element, it was once money. Silver began to lose its status as money starting in the late 1800's, as nations stopped using silver, and started using only gold as money. Over 100 years of this "demonetization" has caused a serious drop in silver's value, and this trend is about to be reversed as investors re-learn that silver is a great store of value because of its intrinsic monetary properties. As paper money continues to waver, the neglect of silver's use as money will end. Once again, silver will be valued based on other measures of value, such as a day's wage, or a tighter ratio to gold; real money. If silver exceeds its historic value, due to this scarcity - from its importance in electronics and nanotechnology - then perhaps a silver dirham, a silver quarter, or a silver dollar will be worth far more than a day's wage, as it once was.

If you don't believe silver won't be considered a monetary asset then think again. Malaysian state Kelantan have just re-introduced gold dinar and silver dirham coins as an alternative to Malaysia's currency, the ringgit. http://blogs.ft.com/beyond-brics/2010/08/13/malaysia-looks-to-ancient-alternative-currency-gold/ . Likewise and perhaps of more significance is the second wave of precious metals liberalisation in China. At the beginning of August China's PBOC (Chinese central bank) announced its intent to support overseas investment plans by investments in and financially backing for "large scale" bullion companies. Recall China held on to a silver standard throughout the Great Depression, many years after the rest of the world demonetised silver.

http://online.wsj.com/article/SB10001424052748704499604575407000318191996.html?mg=com-wsj

http://www.bloomberg.com/news/2010-08-03/china-plans-to-help-bullion-producers-expand-overseas-central-bank-says.html

Long term silver fundamentals imply a substantial re-rating of silver will happen, but this was first highlighted at the beginning of the decade and as yet remains highly undervalued. When such assets are so undervalued one has to maintain a core allocation. However as Fund managers, we also have to look for prudent times to increase (or even reduce) such holdings. We look for inflection points on nearer term horizons to adjust allocations higher. Right now we believe is that time.

Although the current gold/silver ratio at 65 looks to be the mean of a severe financial crisis and boom time, we believe this will become the upper band (cheaper end) of the spread. At this point in the monetary cycle we envisage the silver spread narrowing to nearer 50 or tighter this fall (on overshoots) in line with the surfeit liquidity that similarly buoyed markets in 2007 despite the on set of subprime mortgage issues. Should we see more monetisation of silver then this spread will narrow dramatically and sooner.

We believe the near term catalysts for an outperformance of silver are a pick up in monetary velocity (notably Asia), a potential cessation to excessive 'manipulative' silver Comex shorts by a very concentrated number of bullion banks (namely two), positive seasonals, and a trend ready silver bullion market. We believe the narrowing in the gold silver spread will be based on a superlative break out to nominal new highs. The coming silver bullet just may be approaching faster than we could imagine.

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