January 16, 2013 – A Critical Factor

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By many measures, three years is a long time. This is the third consecutive year-end with silver priced at around $30. That's not far from silver's average price during that time, with the price having been $4 lower than this at times and as much as $20 higher in April 2011. Someone not familiar with the real silver story might assume $30 was somehow the right price for silver in the future. It reminds me of the long stretches of years in which silver averaged $4 or $5 per ounce. Someone not familiar with the real silver story back then would have assumed the price would remain below $5 for as far as the eye could see.

Yet the price of silver did not remain below $5 and those investors who came to learn the real silver story and who loaded the boat have been rewarded fabulously over the long term. Likewise, I think there will be fabulous long term rewards for the investors who load up on silver at current prices. The glaring similarity in both cases hinges upon looking under the hood to get at the real silver story and not assuming that the prevailing price will reflect the future price. It's all about learning what makes the silver market tick. That means doing some homework to dig out the facts.

The facts suggest to me that silver is priced well below its true value, despite having climbed sharply over the past decade. More importantly, considering how much silver will be demanded by both industrial consumption and investment demand versus how much supply is likely to be available in the future; it seems only a matter of time until the price climbs sharply. What makes silver such a great potential investment is because the undervaluation is likely to be resolved in the easiest manner possible, namely, with the price rising sharply to correct the undervaluation. If I'm making this sound simple, that's for the good reason that it's not that complicated when you take the time to examine the circumstances.

I think the most important factor in silver is as true today as it was when silver traded at less than $5 ten years ago. That fact is that the amount of silver bullion that exists in total world inventories has remained largely unchanged at a bit over 1 billion oz. Let me be clear in defining silver bullion as the silver that exists in the form of 1000 troy oz bars, with a purity of 99.9% or greater. This is the standard industry grade and form of silver that both industrial silver users and large investors deal in. It is the form of silver that is held in world silver ETFs (exchange traded funds) and that is deliverable on the COMEX against futures contracts. Virtually every modern form of silver was in the form of a 1000 oz bar at some point at a smelter or refiner. Even the massive concentrated paper short position on the COMEX which is responsible for the current depressed price is denominated in contracts based upon 1000 oz bars.

The reason why the amount of silver in the world that is in the form of 1000 oz bars is the critical factor is because the total amount of these bars is not near enough for a world with a population of 7 billion and a total GDP (economic output) of $70 trillion. After all, one billion oz of world silver bullion is only worth $30 billion, which is a pittance in today's world for an asset class that is universally recognized as an investment and is also vital to industry. The reason I focus in on silver in the form of 1000 oz bars is that this is the form which both industrial users and investors will fight over to own in the future. It is that fight that will determine the ultimate price of silver. Big industrial users and silver ETFs will not fight over silver in other forms, simply because not enough silver exists in those forms to fight over (although all forms of silver should also rise when the big guys duke it out for 1000 oz bars).

Please don't assume for a moment that just because one billion oz of silver bullion exist in the world that all that silver is available for purchase. Every single ounce is, obviously, owned by someone and only the owners will decide at what price it will be for sale. Every indicator that I look at suggests that the vast majority of the current owners have no intention of selling their silver except at much higher prices. So when the coming fight for silver between the industrial users and new investors erupts, it will be compounded by a reluctance to sell by existing owners. Only the highest possible price for silver would seem capable of satisfying the forces of new urgent buying and reluctant selling.

My point is that the critical factor is the amount of silver in the form of 1000 oz bars and it should be easy to see why. We've witnessed genuine shortages (delays and temporary unavailability) in various forms of retail silver in the past. For instance, there was a pronounced period of super demand and unavailability of bags of US junk coins prior to Y2K. We've witnessed temporary unavailability of Silver Eagles on several occasions over the past few years as the US Mint ran out of production capacity/blank supply and couldn't keep up with demand. This certainly pushed up premium levels for junk coins (I do hate that term) and Silver Eagles, but had little effect on the price of silver itself. That will not be the case when a shortage appears in 1000 oz bars. That's because the price of silver is based upon the price of these bars. The price of junk coins or Silver Eagles does not determine the price of 1000 oz bars; the price of these bars determines the price of other forms of silver.

Increasingly, I am coming to view the amount of 1000 oz silver bars in the world as the chokepoint in the silver price equation. It encompasses just about everything important to silver, including the coming shortage and the resolution of the ongoing price manipulation. The future story of silver will revolve around 1000 oz bars.

Further, it may be instructive to compare the industry standard form of 1000 oz bars of silver to the standard form in gold, which is denominated in bars of 400 troy ounces with a minimum purity of 99.5% or greater. This is the form of gold mostly held by central banks, gold ETFs and large investors. Because there is little industrial consumption in gold compared to silver, I don't envision a gold shortage inspired by industrial user inventory stockpiling of 400 oz bars, as I envision in silver. Also, a large part of gold investment is for forms in much less than in 400 oz units, all the way down to fractions of an ounce or grams, and that's one reason why I compare all world gold inventories against only silver in the form of 1000 oz bars. In dollars and cents, industry standard 400 oz bars of gold are worth approximately $675,000 each versus $30,000 for an industry standard 1000 oz bar of silver at current prices. The much lower price point for silver per industrial unit will enable more potential investor buying as and when a silver industrial shortage takes hold.

When I speak of gold, I fear that sometimes I come across as gold negative. But that's just because I find silver to be so greatly undervalued relative to gold that it's hard for me not to empathize why silver is likely to outperform gold in the future. Since gold and silver are similar in so many ways and I am speaking of relative undervaluation, nothing (short of the end of the manipulation) could be more positive to silver than a sharply rising price of gold. Or likewise, on a short term basis, hardly anything could be more negative to the price of silver than a sharp decline in the price of gold. Therefore, as a silver investor, you won't find me rooting for gold to decline in price. That doesn't mean, however, that I necessarily accept everything said to be bullish for the gold price to be accurate.

Gold is a unique asset or material, being almost exclusively dependent on investment flows and not on production or industrial consumption for determining the price. Due to the relative absence of gold industrial consumption, more emphasis must be placed on other factors that will influence gold investment sentiment and flows. In this sense, analysis of the likely future direction of gold prices focuses more on announcements and developments that may influence gold investment sentiment than in other commodities, including silver. Since my background is as a commodity supply/demand analyst who looks at the mechanical forces of buying and selling, I look at the developments and announcements in gold somewhat differently than others might. That's a preface for some commentary on the just announced repatriation of some gold reserves by the central bank of Germany back to that country from holdings in France and the US.
http://www.bundesbank.de/Redaktion/EN/Pressemitteilungen/BBK/2013/2013_01_16_storage_plar

Many have been quick to label this announcement as a Â?shock waveÂ? or watershed momentÂ? or that it proves that central banks no longer trust one another. Maybe that will all turn out to be true, but there are less dramatic interpretations for the deeper meaning of the announcement. Gold reserves and where they are held are largely a throwback to World War II, when it made sense to hold gold outside a country like Germany that was devastated by the war. As time has elapsed, the reasons for storing official gold abroad have dissipated. As a sovereign country, Germany is a Â?big boyÂ? and can hold its gold wherever it wants, including moving some or all back home on a time schedule of its own choosing.

There's no doubt that public pressure was behind the Bundesbank's decision, but in the end there is no good reason for the gold not to be returned. Times have changed and the central bank is responding to the change. Let's face it Â? all world governments are pressed to please the will of the electorate and most times there are difficult tradeoffs in accommodating the competing demands on governments. This one was a piece of cake as it involved no monetary cost to please those pressing for the gold's return. If only all demands could be so readily satisfied.

Certainly, on a mechanical basis, the return of gold to Germany involves no buying or selling of gold, just the physical transport. On the surface, the transfer should be price neutral. Please remember, I spend most of my time trying to identify and measure the mechanical aspects as to what moves gold and silver prices, including studying the COT reports and monitoring conditions in the physical silver market. I do that because I believe that is what is most responsible for price movement. On that same metric, the Bundesbank's announcement is a non-event.

Of course, such an announcement can trip off an overall change in gold investment sentiment or collective emotional feeling. I sense there is a widespread feeling among many gold investors that this announcement is significant because it may lead to the discovery that central banks don't hold as much gold as they claim due to the gold being leased out. Perhaps that is true, but I'm not so sure. For one thing, as I've written previously, even if central bank gold is Â?missingÂ? due to leasing, that doesn't mean the gold doesn't exist in someone else's possession. That's because gold is not destroyed by industrial consumption and, therefore, must still exist in some form somewhere. As such, it still could be sold at some point and at some price.

More importantly, I am somewhat suspicious of the amounts of central bank gold said to have been leased out and Â?missing.Â? It's been almost 16 years since I started writing about precious metals leasing on the Internet and, in fact, may have been the very first. http://www.gold-eagle.com/gold_digest/butler414.html A main counterparty in gold and silver leasing/forward selling was always the mining company. Companies like Barrick Gold, AngloGold and Newcrest sold many tens of millions of ounces of gold forward and this depressed the price all the way down to $250. But, as expected by me, the gold miners shot themselves in the foot and eventually had to buy back the shorted gold incurring cumulative losses of tens of billions of dollars and driving the price of gold sharply higher (are you listening JPM?). Now that the miners wised up and quit the leasing/forward selling game it's hard to pinpoint who is involved as a counter party in the massive amounts of gold still said to be leased out by the central banks and apart from the bullion banks. Unless gold jewelry fabricators have committed to many years of total fabrication needs and central banks have been so reckless as to lend the large gold amounts claimed to be leased to users and not producers, the numbers just don't add up to me.

Gold is an asset where the price can be influenced greatly by collective sentiment and emotion and it may turn out that the central bank repatriation does impact the price and reveals much central bank gold to be missing. We'll only know that in the fullness of time. But there's something else very important that doesn't require the passage of time to reveal. You won't be reading any time soon (or ever) that central banks or world governments are considering repatriating their silver reserves for the simple reason that none exist. Since central banks hold trillions of dollars worth of gold, they are free to move, sell or even buy additional quantities of gold. But since they own no silver, they can't sell it or move it. The only thing that world central banks or governments can do concerning silver is to try and buy it. They'll have to get in line behind silver investors and industrial users, but at least they won't have to worry about moving or selling it.

Ted Butler

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Silver – $31.50

Gold – $1682

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