

January 18, 2012 – Look Back/PSLV Offering

Look Back To See Ahead

Forty years is an extremely long time in terms of any person's life; perhaps not so long against the scope of history. The source of my reflection is that forty years ago I began my personal journey in commodities. In 1972, I was hired by Merrill Lynch as a commodity broker trainee. I was 25 years old. While it seems natural for me to look back to that time, I can assure you I was not thinking then in terms of what things would look like over the next 40 years. I felt lucky to have gotten the job and was mostly determined not to wash out and embarrass myself since I had a young family to support and never worked on commissions before.

One thing I definitely was not concerned with was what the level of prices would be 40 years ahead. I was just getting familiar with what prices were then. Crude oil was around \$3.50 a barrel and wouldn't be traded on an exchange for ten more years. Gold was around \$40 an ounce and it was not yet legal for US citizens to own. Silver was around \$1.30 an ounce. In 1972, I did not imagine that oil would be \$100 a barrel today (almost 30 times more), gold \$1650 an ounce (41 times more) or silver \$30 (23 times more). I doubt there were many who made such predictions but I wasn't even thinking in those terms. Please bear with me for a moment as I promise I'm not walking down memory lane just for old-time's sake.

In 1972, the median household income was around \$9000 annually and the median price of a house was \$30,000. A gallon of gas cost 36 cents. Fast-forward 40 years and the median income is around \$50,000, an increase of 5.5 times the 1972 level. The median cost of house is now around \$220,000 or an increase of 7.3 times, while a gallon of gas costs around \$3.50 retail, or almost ten times what it did in 1972.

The first point I would make is that the increase in the cost of a house and a gallon of gasoline exceeded the increase in household income, but not to the extent that crude oil, gold or silver exceeded the increase in household income. Whereas median income rose 5.5 times and houses rose 7.3 times and gasoline almost ten times; that was nowhere near the 30 fold increase in crude oil, the 23 fold increase in silver and 41 fold increase in gold. This makes sense to me in that houses and retail gasoline are more sensitive to household income than are raw commodities. For instance, it is hard to imagine housing prices and retail gas prices completely ignoring what consumers can afford to pay for them. Especially on a shorter term basis, however, crude oil, silver and gold can move in price much sharper and for different reasons other than the growth in household income.

Since the price moves in raw materials (crude oil, silver and gold) are less dependent on household income and consumption than are finished goods, like houses and retail gasoline that means that the next 40 years are likely to reflect what has been witnessed over the past 40 years. How much actually income growth occurs in the US and the world will influence what can be spent on a retail basis. Certainly, I am not suggesting that just because oil rose almost 30 times in price over the past 40 years and silver rose 23 times and gold 41 times, they will rise similar amounts in the next 40 years. But I do think it can be instructive to contemplate if it appears possible for those outsized gains in oil, gold and silver to occur again. Stated differently, if future household income gains as much in the future as it has over the past 40 years, can oil climb another 30 times, or gold 41 times or silver 23 times?

This is speculative crystal ball stuff, but I can't see oil climbing 30 fold, to \$3000 a barrel or gold 41 fold to \$67,000 an ounce in a world where income grows 5.5 times. And if income rises less (as seems likely now) such gains would appear impossible. Strangely, I can easily see silver climbing more than the 23 times current prices to \$700 or even 40 times to \$1200 an ounce over the next 40 years. I know I may not be here to personally witness it, but I can easily imagine it occurring.

Oil going to \$300, to say nothing of \$3000 a barrel would bring about such radical changes in oil consumption and production so as to alter the supply/demand equation to prevent such a price increase from sticking. Gold is different in that it is not widely consumed, except as jewelry. Because gold is primarily held as an investment asset and is not consumed industrially, it has been able to climb 40 fold in price in 40 years, far outpacing the general rise in incomes. With little industrial consumption to begin with, gold's spectacular price rise has done little to curtail what small percentage of it is consumed industrially.

If industrial consumption in gold doesn't play an important part of its pricing equation, then why couldn't it climb another 40 fold to \$67,000 an ounce over the next 40 years? The answer, I believe, lies in how much the world's gold would be worth in such a price rise. The world's total gold above ground stock of over 5 billion ounces (3 billion oz in bullion equivalent form) is worth over 8 trillion dollars at \$1650. At \$67,000 an ounce and assuming no physical build to the total gold stock, the value of all above ground gold would grow to over 330 trillion dollars or more than the all the current assets in the world (said to be \$140 trillion in 2006 by McKinsey & Co). I don't think we are going into a situation where all the world's wealth is held in gold.

In 1972, in contrast, the world's then-3 billion ounce total gold holdings were worth \$120 billion at \$40 an ounce. Going from \$120 billion to \$8 trillion is quite a remarkable achievement. Going from \$8 trillion to \$330 trillion appears impossible to me. Please remember, I am not bearish on gold. I just don't see how it can repeat its price performance of a 41 fold increase in price over the next 40 years.

What about silver? Can it possible rise 23 or 40 times over the next 40 years? I don't think that is impossible, particularly in a blow-off caused by a bubble investment mania and an industrial users panic to build inventories. In fact, using the gold template over the past 40 years makes it look more doable. In 1972, there were about 1.5 billion ounces of gold in bullion form (out of 3 billion oz in all forms). Gold was then \$40, more than silver's current price of \$30. Today, there are about 1 billion ounces of silver in bullion form, less than what existed in gold in 1972. The total value of the world's gold rose from \$120 billion in 1972 to over \$8 trillion today, an increase of 66 times. Why couldn't the value of the world's silver bullion rise from \$30 billion today by 23, 41 or 66 times as well?

If silver rose by 23 fold in time or to \$690 an ounce, the total value of the world's one billion oz of silver bullion wouldn't even break the trillion dollar threshold. Please don't misinterpret what I am saying. I'm not predicting that silver will rise by 23 or 40 times, to \$690 or \$1200 an ounce, as I rarely give price predictions, no less fancy numbers. What I am saying is that has occurred in gold already and the conditions in silver are more supportive for such moves than they were in gold in 1972.

In 1972, there were roughly 4 to 5 billion ounces of silver bullion in the world. Due to industrial consumption over the following decades, world silver bullion inventories were depleted and reduced to one billion ounces. Over the 40 years since 1972, gold bullion inventories doubled, from 1.5 billion ounces to 3 billion ounces. The increase in gold bullion levels did nothing to stem the 40 fold increase in the gold price. The 80% reduction in silver bullion inventories over that same period resulted in "only" a 23 fold price increase. I don't think many of the world's investors are aware of these facts. I don't think these investors have studied silver at all.

I think gold is going higher in price for a variety of reasons. I don't think there's a chance it will replicate its 40 fold increase in price over the next 40 years. Considering how little real silver there is in the world, relative to gold, and how undervalued silver has become compared to gold, if any commodity has a chance to climb 23 or 40 times over the next 40 years, that commodity would be silver.

Sprott Silver ETF (PSLV) Offering

A number of subscribers have asked (and rightly so) about the announcement late yesterday that the Sprott Organization is offering new shares in its silver ETF, PSLV. The issuance will be for around \$300 million or more at an offering price of \$13.20 per share. This is part of the \$1.5 billion open shelf offering filed a little ways back.

By my calculations, the amount of silver to be purchased will amount to 9 million ounces to as many as 10 million ounces, depending on underwriter overage allotments. The shares are being sold at a 12.5% premium to net asset value (NAV), namely, the price of silver. This is down from the 25% to 30% premium that existed in the shares prior to the offering (and discussed recently). Thus, the offering has the almost automatic effect of suddenly reducing the former existing premium so that new shares can be sold to investors.

The important takeaway is that a decent size chunk of physical silver will be taken off the market. It's an open speculation as to what impact this will have on the price of silver, both short and long term. My guess is that while it certainly can't be considered negative in any way, there are obvious forces that would prefer to make it look like it has no effect. These forces will do what they can to mute the impact of a fairly large physical purchase. Unfortunately, these commercial crooks may have built up some physical reserves over the past six months or so and may be able to accommodate Sprott's physical purchase without too much difficulty. A couple or a few more similar-sized purchases would have a big price impact, in my opinion.

I hope I'm wrong, but my sense is that Sprott is likely to get fairly quick delivery of whatever silver it purchases so as to avoid a repeat of the delivery delays that occurred the last time it purchased a chunk of silver. Eric Sprott has become an outspoken advocate of silver and antagonist against the silver manipulation and I doubt the suppliers will risk delivery delays to his fund and give him the opportunity to point to tightness. I think that tightness is there, just that the sellers will be able to hide it a bit longer.

The day is soon coming when the commercials will be no longer able to hide the silver physical tightness and Sprott's new purchase will undoubtedly hasten that day. In the interim, the PSLV offering should be taken for what it is, namely, another brick of silver taken from the wall of remaining supply.

I may issue an interim report on position limits and some related thoughts, thanks to some good questions from readers.

Ted Butler

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Silver – \$30.50

Gold – \$1660

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