

September 9, 2015 – The Coming Silver Shortage

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From the very beginning of my epiphany 30 years ago about a silver price manipulation on the COMEX, was the unavoidable conclusion that if prices were artificially depressed as I believed, then at some point a physical shortage must develop. If the price of any commodity were set too low for too long a period of time, then the dynamics of the law of supply and demand would eventually crimp supply and encourage demand to such an extent that a physical shortage must develop and end the manipulation.

I was never much of a geopolitical or monetary analyst or even a conspiracy theorist, as my background and interest was always in commodity supply and demand analysis. As such, I knew that the most potent force for driving prices higher was an actual commodity shortage. If there is not enough of a commodity to meet demand, then the price must go to whatever high level is necessary to satisfy demand. That is a primal market force few would argue with.

What drew me to silver in 1985 was that its price appeared to be too low and not in conformity with credible evidence that more silver was being consumed than was being produced, which necessitated a steady drawdown in world silver inventories. In trying to reconcile these two conflicting circumstances – low price in spite of current demand being greater than current production – I stumbled on concentrated short selling on the COMEX and, much later, leasing. The discovery only convinced me more that this must end with silver in a pronounced physical shortage; as excessive COMEX paper short selling and the uneconomic dumping of actual metal (leasing) couldn't last indefinitely or invalidate forever the law of supply and demand.

The long term consumption deficit in silver did end, after being in force every year since WW II, but not until 2006, more than 20 years after my discovery about manipulation. But the damage to world silver inventories had already been done and to this day, world silver inventories are down more than 90% from where they were at the start of WW II. In 2006 silver finally crossed the \$10 price barrier convincingly on its way to \$20 in 2008 and nearly \$50 in 2011. That was a much longer period of time than I ever envisioned and the subsequent grind down in price since the peak was also more than I ever envisioned. But at least my unshakable belief that a physical shortage is the most potent upward force possible in a commodity held true, because the price peak in 2011 was a result of a developing physical silver shortage. True, a sharp deliberate price takedown nipped that developing shortage in the bud by disrupting growing investment demand, but there is nothing to suggest that can be arranged permanently.

When I speak of a coming silver shortage or the close call in early 2011, I am referring to a shortage in the prime wholesale form of silver — industry standard 1000 oz bars. There is a current pronounced shortage in retail forms of silver, as has occurred previously over the past few years, but by definition such a retail shortage only impacts the premiums on individual forms of retail silver, not the price of 1000 oz bars (upon which the premiums are based).

That's not to say that there isn't some connection between a retail silver shortage and a wholesale shortage. For one thing, we are talking about the same substance, just in different forms. But more important than that is the highly unique nature of investment demand in this commodity. Both retail and wholesale silver demand is based upon investment demand. In the case of retail forms of silver, demand is 100% investment demand, while wholesale demand is only part investment demand (although investment demand is the "wild card" in wholesale demand).

Which brings me to the main point about a coming wholesale silver shortage. Of all the basic commodities that are consumed, be those commodities, oil, copper, corn or any other commodity, only silver has the kicker of investment demand in addition to the utilitarian consumption demand it shares with all other commodities. This doesn't apply to gold, simply because so little gold is consumed industrially that virtually all demand is investment or jewelry demand. As such, while gold can go to any price buyers and sellers agree on, since it isn't industrially consumed, it's hard for me to see how it could go into a genuine commodity shortage.

With all consumable commodities, whenever a shortage occurs, invariably that shortage owes its origins to some type of supply side disruption. Examples include a crude oil shortage coming as a result of a unilateral cutback in OPEC production, or a weather induced crop failure or some unforeseen restriction to production. Years ago, I was involved in a big orange juice play as a result of an unexpected freeze. The other day I read in the Wall Street Journal of a shortage in glass for new skyscrapers brought on by many glass manufacturers going belly up in the real estate crash.

One reason it's rare for an industrial commodity shortage to develop primarily from the demand side, as opposed to the supply side, is that commodity demand usually doesn't spike with no warning. The per capita consumption of coffee, for instance, is not likely to change as radically as the supply side in the event of a killing frost in Brazil or Columbia. Therefore, disruptions to the supply side of any commodity are more likely to occur than disruptions on the demand side.

That is not the case in silver and this is the key premise to an eventual physical shortage. Simply put, the highly unique dual demand feature in silver – vital industrial commodity and universal investment asset – gives silver something not present in any other commodity, the possibility of a demand surge capable of creating a physical shortage. I suppose silver could also be subject to a supply side disruption, just like any other commodity; but only silver has the potential of a demand side disruption as well.

This can be seen in the current shortage of many retail forms of silver. It's not that the US Mint has suddenly reduced its production of Silver Eagles, having produced more over the past five years (200 million) than it did over the first 24 years of the Bullion Coin Program (150 million). The Mint has already produced more Silver Eagles this year than in any year to this point; yet there is a shortage of Silver Eagles. Clearly, the shortage in Silver Eagles is as a result of surging investment demand and not any disruptions on the supply side.

But wait – we're told that surging investment demand for retail forms of silver is a whole different animal than surging investment demand for 1000 oz bars. Is it really? I don't think so. While I would agree that a sudden surge in investment demand for physical ownership of soybeans, crude oil, copper or live cattle is highly unlikely, it seems to me that such a surge in investment buying in 1000 oz bars of silver is not only inevitable, but has occurred previously. Certainly, anything that has occurred before makes it possible to occur again, particularly in the case of silver where all the circumstances that I monitor indicate an investment surge is more likely to occur than ever before.

It's important to define – shortage. The first definition appearing on Google is a situation in which something needed cannot be obtained in sufficient amounts. In the free market, when a commodity goes into a shortage the price is bid higher until it is available to those willing to pay more than others. This is particularly true for investment assets because potential buying is not limited to those using commodities in their usual day to day businesses.

Silver's dual demand means just that – it is demanded by those who need it for industrial and other purposes and by those who want to hold it as an investment asset. Silver's dual demand profile has a multiplier effect on demand, something no other commodity has to any practical extent. When investment demand for 1000 oz bars of silver surges, as I believe is inevitable, industrial and other fabrication demand for silver doesn't go on holiday until the investment demand subsides. Dual demand means both remain in force at the same time.

Against the dual demand for silver is situated a dual source of supply — the net new supply of metal mined and recycled and the supply made available from existing inventories. The true amount of “new” silver is that which is available for investors after all other industrial and other fabrication demand is met. This “left over” amount is no more (by my calculations) than 100 million oz annually, or in dollar terms at current prices, no more than \$1.5 billion annually. It's important to note that new silver supply becomes available on a day to day basis as it is taken from the ground and refined; whereas demand knows no daily limitation. As far as “old” silver, of the 1.3 billion oz of silver in the form of 1000 oz bars, the percentage available for sale near current prices is very small (as is the case in everything).

The important point is that the investment side of silver's dual demand can explode at any time (as has recently been seen in retail silver), while the supply side is much more constrained and will only expand with time and at much higher silver prices. And the age-old collective human trait of jumping on the investment bandwagon when prices of investment assets move higher would seem to guarantee that investment demand for silver will increase as prices move higher.

So, on the one hand we have potentially exploding investment demand for 1000 oz bars, given that this is the form offering the greatest current relative value and is what the COMEX and world ETFs are denominated in and what industrial users will rush to when the shortage becomes apparent and their deliveries are delayed; and on the other hand we have a very limited potential supply. This is the stuff of which constitutes a potential historic shortage.

If the coming silver shortage is as inevitable as I suggest, then why hasn't it occurred yet? The short answer is that COMEX futures trading has come to so dominate the price of silver (and now other commodities) that the surest sign of a physical commodity shortage, a rising price, is blunted. The price of silver is not depressed because of a surplus of real metal, retail or wholesale, or a lack of physical demand, it is depressed by a surplus of derivatives contracts. In essence, the artificial price emanating from the COMEX is short-circuiting the true functioning of the law of supply and demand.

What it comes down to is how much longer the COMEX-orchestrated price can delay the physical silver crunch and shortage to come? I don't have the answer, but I am confident that this is the right question. I am also confident that once a wholesale physical silver shortage kicks in, that shortage can't be further contained by derivatives trading and most likely will have to burn itself out the old-fashioned way — by allowing the market to discover the true clearing price. The trick, of course, is to be positioned before the physical shortage is reflected in price.

Since the trading week has been shortened by Monday's holiday, there is not much to report on in the way of new developments, other than to note that the more important indicators, such as Silver and Gold Eagle sales, COMEX silver warehouse movements and deliveries against the September silver futures contract, continue to indicate strong retail demand and wholesale tightness. I'll save an update until Saturday.

Ted Butler

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Silver – \$14.60 (50 day moving average – \$14.96)

Gold – \$1107 (50 day moving average – \$1126)

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