CPM Group

Market Alert

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Seasonal Strength; A Possible Silver Bull Trap

Silver prices have shown a bit of strength since they dipped below $30 on 4 January. The actual price increase has been relatively muted, but the modest increases have combined with marketing hype to re-ignite bullish sentiment toward silver on the part of some investors.

There indeed has been some seasonal strength in investment and fabrication demand pushing prices higher over the past two weeks, and there are some other factors that could push prices higher later in February. These factors are relatively minor, however, and do not necessarily represent convincing justifications for expectations that prices will rise significantly higher on a longer term basis. They tend to be seasonal, and occurring in an environment of mixed economic activity overall probably are not sufficient to push prices much over $33 in the next week or two, and $34 - $36 over the next few months.

Silver marketing types are talking about silver shortages, but there is no real evidence of this. The U.S. Mint has run out of silver blanks (blanks are coins before they have been stamped or treated) in the face of the traditional January surge in Silver Eagle purchases. Meanwhile, there has been ample metal in good delivery bar form to meet a surge in silver purchases via exchange traded products, and at Comex-registered depositories.

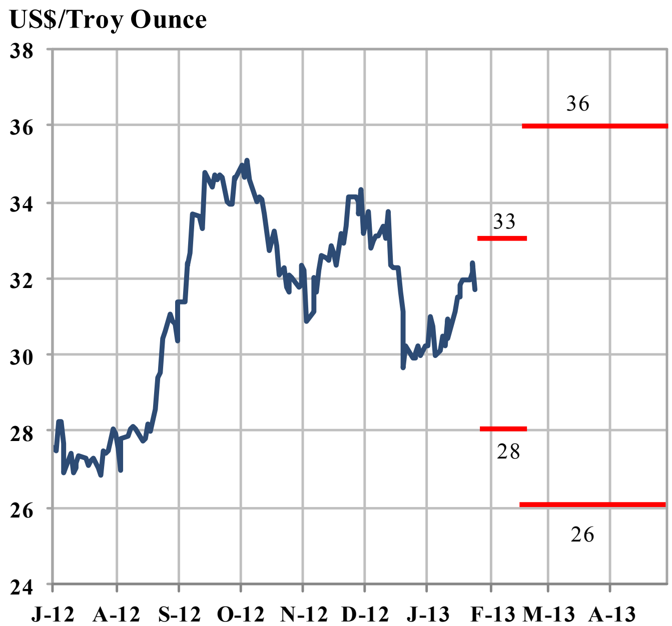
The conclusion is that while there are some positive factors in play that could push prices higher, possibly in the second half of February that are in no way related to any theoretical shortage of the white metal and that are short-term in nature. Once those factors dissipate, a decline in silver prices may occur. **In this environment, silver prices might decline back toward $28 - $29 in the next couple of weeks. Silver might then move higher, toward $34 - $36, before dropping back in the second quarter.** The hype that pushed silver prices higher in April 2011, only to see prices plunge in early May of that year, may serve as a good model for what is occurring in silver right now, although the price moves are not expected to be nearly as exaggerated as they were then.

The Silver Shortage Myth

Silver is produced in 38 countries at 242 mines and is present in 3,863 known deposits around the world. Silver is mined mostly as a byproduct of gold and base metals, which often means it is produced independent of its price. As of 2012, 51 billion ounces of silver have been unearthed since the year 1500. Of those 51 billion ounces, 24 billion ounces, or 48%, may be lost. This still leaves 27 billion ounces of above-ground stocks known to be in the form of jewelry, silverware, and decorative objects or investment-grade bars and coins.

The location of a significant portion of this above-ground supply is at least somewhat known today. Approximately 90% of the 27 billion ounces of above-ground stocks is held by individuals in the form of jewelry, silverware, and decorative objects. The balance is in the form of investment products. This 2.8 billion ounces of investment grade silver, or 2.8 years of annual supply, can further be delineated between exchange traded product (ETP) holdings, coins, exchange inventories, and unreported silver bars. Silver ETP holdings account for 640 million ounces, or 23%, of the 2.8 billion ounces held by silver investors. Coins could account for as much as 8%, or 217 million

Nearby Active Comex Silver Futures Settlement Prices Projected Through April 2013



Seasonal Strength; A Possible Silver Bull Trap (con't)

ounces, of this total. Comex silver inventories makes up about 5.5% of above-ground investment quality silver. The remaining 63% of above-ground investment-grade silver is held by individuals and is unreported. **This equates to 1.7 billion ounces of unreported silver available in the market to investors.** It should also be noted that the silver held by ETPs, in coin form, and stored at exchange warehouses also is theoretically available for sale.

Some market participants and observers will look at Comex inventories for insights about the amount of silver available to the market. This indicator however is insignificant in several respects. First off, it is widely understood that only 1% to 2% of futures are settled through physical delivery. The futures market is not the primary conduit for physical supply. The balance is settled in cash. Historically, since the early 1990s, total Comex silver futures open interest has averaged 4.4 times the amount of metal stored in Comex warehouses. Since 2005, this average was 5.1. On 22 January, open interest was 4.7 times larger than Comex inventories.

Conspiracy theorists tend to try to get their listeners to think about extreme scenarios. One popular silver market scenario is the potential upside of silver prices if every investor in the world were to demand delivery of their silver from the Comex, ETP issuers, banks, and other companies that hold silver for clients. Such an unlikely phenomenon would obviously push prices higher, but each investor has a unique threshold and agenda. If one investor bought silver at $20, that investor may be tempted to sell if prices reach $40. Even if prices are expected to move higher, that investor may opt out of a market, in which he realized a 100% gain, in order to avoid further risk. The extreme scenarios concocted by silver marketing groups and conspiracy theorists should never be the basis for rational investing in an asset, for numerous reasons. For one thing, with the example here, it would suggest that each and every investor has the same objective and time horizon, and that there are no sellers in the market whatsoever. This is why every bubble has burst, because at some point, those buyers become sellers.

Above-Ground Investment Grade Silver Available to the Market
Million Troy Ounces

	Value	Percent of Total
ETPs	639.6	23.3%
Coins	217.0	7.9%
Comex Warehouses	151.0	5.5%
Unreported	1,742.2	63.4%
Total	2,749.8	

Source: CME Group, ETP issuer websites, Bloomberg, mint websites, CPM Group
January 24, 2013

U.S. Mint

The U.S. Mint ran out of 2012 Silver Eagle bullion coins on 17 December. This triggered even heavier than usual demand when the 2013 coins went on sale at the start of January. The Mint then ran out of 2013 Silver Eagle bullion coins, shortly after its 7 January 2013 release date, on 17 January.

Some marketing hypesters have interpreted these temporary sales suspensions as indicative of a shortage of silver. **In reality, however, these temporary disruptions to Silver Eagle bullion coin sales are indicative of shortages of Silver Eagle bullion coins, not of silver.** Each year, the Mint allots a specified amount of its blanking capacity to silver. In some years, it underestimates demand. In other years, it overestimates demand. Last year, the Mint saw a spike in demand ahead of the fiscal cliff talks, particularly in November. It was unsuccessful in adjusting its production schedule of silver bullion coins during that time. The shortage of 2013 coins was simply a ripple effect from the shortage of 2012 coins last year. The surge in coin demand between 7 and 17 January included some pent-up demand for 2012 coins, after the program ended on 17 December when coins sold out.

Conclusion

All of this talk about a shortage of silver supply is irrational and not supported by readily available market data. The increase in reported inventories this year so far actually argues against a silver shortage theory. Silver ETP holdings are up 20.6 million ounces and Comex inventories are up 2.8 million ounces since the start of 2013, as of the release of this commentary. In the case of silver ETP holdings, there was a 19.4 million ounce increase on 16 January, most of which came from an increase in SLV holdings. There were no disruptions reported in delivering this metal.

To further argue against this point, consider that the market lost about three million ounces of annual mine production due to the temporary closure of Hecla's Lucky Friday mine in the United States last year. That mine is now com-

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ing back online and is expected to deliver two million ounces of silver to the market in 2013. Further to the point, this loss of supply had no material impact on prices last year. Silver prices averaged $31.17 in 2012, an 11.7% decline from the previous year.

Silver prices could very well head toward $34 - $36 between now and March, ahead of the Comex silver March futures delivery period. Seasonal strength in prices and demand may lift prices. Potential for higher Indian demand for silver, a result of the increase in gold import duties from 4% to 6%, also could be positive for prices in the interim. There often is an elevated level of congestion in the market ahead of the Comex March futures contract expiry, a result of seasonal demand strength. Should a run up in prices occur before this period, silver prices could drop shortly thereafter, possibly toward $26.