No silver lining as prices take a tumble

By Chris Flood
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The silver market has lost some of its shine with prices dropping 21.9 per cent since mid-March to $16.59 a troy ounce on Wednesday, and further weakness appears likely over the medium term, according to GFMS, the precious metals consultancy.

Unprecedented levels of investor interest had helped to drive silver to a near 28-year high of $21.24 a troy ounce on March 17.

But a five-year rally in which prices soared almost 250 per cent has come to an end with the correction.

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continued from **previous page**

In common with gold, high and volatile prices for silver are having an impact on fundamental drivers of demand, such as jewellery making, which used 163.4m ounces of silver in 2007, 1.7 per cent less than the year before and a seven-year low.

This leaves financial investors to play an increasingly influential role in supporting the market.

"Demand, basically from investors and, maybe, de-hedgers, will have to grow if a price fall is to be avoided," said GFMS in the 2008 **World Silver Survey**, published jointly yesterday with **The Silver Institute**.

The holdings of the **Barclays** iShares silver **Exchange Traded Fund**, which was launched in 2006, have grown to more than 180m ounces of silver, reflecting the critical role ETFs have played in attracting a new generation of investors to all precious metals markets.

The vast majority of holdings in precious metals ETFs are usually considered as long-term investments.

Recent outflows from gold ETFs have weighed on bullion prices and point to a growing tactical awareness among investors who are increasingly prepared to sell some of their holdings in precious metals ETFs if opportunities in equity or bond markets appear more favourable.

Analysts are concerned that investors have bought silver as a play on rising gold or platinum prices and without differentiating between the supply and demand fundamentals of these different markets.

Platinum's use in autocatalysts means demand is underpinned by increasingly strict environmental standards while supply has been squeezed by interruptions to electricity supplies in **South Africa**.

Gold is supported by declining production in South Africa and by its role as a hedge against rising inflation and the declining dollar. By comparison, silver's supply and demand fundamentals appear less compelling.

Silver's use in photography has declined consistently since 2001, shrinking almost 40 per cent, due to the growing popularity of digital cameras.

So industrial applications are an increasingly important source of demand, offsetting the decline in silver's use in jewellery and photography.

Industrial silver demand rose 7.2 per cent to 455.3m ounces in 2007 but GFMS warns consumption is likely to fall this year, mainly due to weakness in the electronics sector. While industrial demand has shown little short-term sensitivity to rising prices, it is increasingly linked to the economic cycle.

On the supply side, mine production of silver has soared over the past four years, rising 11.6 per cent since 2001 to 670.6m ounces last year and a further 6 per cent increase in 2008 is forecast by GFMS.

"The demand from ETF buyers has been almost incredible but it is necessary to gobble up the surplus of metal which is being produced," **Stephen Briggs**, of **Société Générale**, said.

The effect of higher mine output has been offset by a sizeable drop in silver sales by governments and but also by substantial de-hedging by producers who bought back 25.8m ounces of their forward sales last year.

However, GFMS questions whether the favourable dynamics supporting prices last year can be repeated in future.

Philipp Klapwijk, executive chairman of GFMS, expects silver to average around $17 an ounce this year but says that silver prices could head back to $10 an ounce later in the decade.

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