GFMS: Silver Could be Due for a Correction

By: Dorothy Kosich
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RENO--(Mineweb.com) Is the current interest in silver ETF investment a flash in the pan? Or is the silver ETF investment solid enough to impact silver markets for at least two years?

Or, could silver be blown away by a wholesale shift in commodity prices?

In an interview with *Mineweb* Tuesday, GFMS Chairman Philip Klapwijk said these are the possible corrections for silver. London-based GFMS just completed its 2006 edition of the *World Silver Survey*, which is being published by the Washington, D.C.-based Silver Institute.

So far, mainstream investors, such as pension funds, have only small exposures to the metals mostly through commodities indices. Therefore, silver's investor base remain fairly narrow as of the release of the *World Silver Survey 2006* on Wednesday.

Meanwhile, Klapwijk said a possibility exists "that we could see higher prices" for silver. "That's very much predicated on the view that gold is probably still going to go higher," he explained.

Are the current high silver prices sustainable? Klapwijk responded that--if investors don't continue to buy silver and silver-related instruments, and with the possibility of higher mine production in 2008 and 2009--"I do not think prices at these levels are sustainable."

While the silver ETF demand is pretty healthy at the present time, Klapwijk believes the ETF could create a bit of an overhang. "Let's say it is game over for investors and more mine production comes on, you could see the possibility of a fairly significant price correction at some time in the future," he suggested. In the meantime, however, silver prices could also go higher.

Is the strong demand for silver in the industrial sector vulnerable to a downturn in global economy? According to the *World Silver Survey 2006*, investment and industrial fabrication demand are definitely key indicators of the metal's future in the year ahead. "In a sense, the growth in industrial demand for silver could turn out to be a bit of a weakness because silver demand is increasingly concentrated in the industrial sector," Klapwijk theorized.

While the increasingly variety of silver applications in industrial demand is very good news for silver, Klapwijk asserted that "on a cyclical basis, you could get a downturn. ...We certainly try to point this out that you have this tremendous growth in industrial demand. It certainly helps to sustain silver prices in the face of what has happened to photography. It has blown away the decline in

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photography. But that very success creates a bit of a vulnerability if you have a big downturn in the economy because industrial demand will be negatively affected."

"We have had a year of 10% growth, but we could, very much, have a year of 10% declines. We have had it before," he suggested. "I do not think it is going to happen in 2006, but I would not rule it out in 2007."

FINDINGS

As noted by GFMS, "silver's extraordinary run over the last two and one half years has seen its price more than triple. ...Last year's strong finish has been eclipsed by the strength of investment in the first four months of 2006, which has taken silver close to the $15 level." How much higher can prices go? The answer, GFMS suggests, may be found in how well the new ETF performs.

"Assuming the ETF is successful in attracting investors, at some point, the related build of a substantial near market bullion stock could start to represent an 'overhang,' although this threat might only be realized after silver prices have ratcheted up still further." Klapwijk said this scenario could be interpreted two ways: either people are very interested in and bought a lot of silver. Or because silver is a very near market stock, "given the right circumstances, it represents an overhang ...It's a bit of a threat if it falls."

GFMS determined there is little price elasticity for most areas of silver fabrication demand in the short of medium term. The study found that most industrial uses of silver are also largely insensitive to price over the short run. "However, we would sound a note of caution over the longer-term prospects for an area that now consumes 47% of all fabricated silver. Prices above the $10 level are stimulating the search for alternatives." Klapwijk told *Mineweb* those alternatives could include base metals substitution for silver. "It is totally application and technology driven" as to when and where those substitutions could occur.

Global silver mine production increased 3% or 21.1 million ounces in 2005 to reach a new high of 641.6 million, according to the survey. Primary silver production accounted for 29% of the world total and realized an 8% rise in output, which was attributed to record production at BHP Billiton's Cannington in Australia and Peñoles's Fresnillo in Mexico.

New production hedging, coupled with the higher silver price used to value option contracts, bolstered a 24% increase in the delta-adjusted hedge book. "The hike in producer hedging was restricted to the options portion of the book, while forward sales experienced a modest contraction," according to GFMS. Hedging by Bema Gold and Apex Silver, related to the financing of Kupol in Russia and San Cristobal in Bolivia, contributed substantially to the increase in producer hedging.

While many would claim that the gold price played a significant role in the strength of silver, GFMS asserted that "there is little doubt that the powerful upward trend in, particularly the copper price, has encouraged investment in silver, More generally, the growing investor interest incommodities as a distinct asset class has benefited the white metal. ...For example, silver has a 2% weighting in the widely followed Dow Jones AIG index."

PRODUCTION

The top five silver-producing companies in 2005 included: Australia's BHP Billiton with 53.8 million ounces; Mexico's Industrias Peñoles with 47.4 million ounces; Poland's KGHM Polska Miedź, 40 million ounces; Russia's Polymetal, 18.9 million ounces; and Mexico's Grupo Mexico with 18.5 million ounces. The top five primary silver mines were BHP's Cannington in Australia, Peñoles Fresnillo in Mexico, Polymetal's Dukat in Russia, Compañia de Minas Buenaventura's Uchucchacua in Peru, and Kennecott/Hecla's Greens Creek Mine in Alaska. The five top producing silver nations included: Peru with 102.6 million ounces; Mexico with 92.3 million ounces; Australia, 77.4 million; China, 64.7 million; and Chile, 44.3 million, according to the silver survey. U.S. silver production reached an 18-year low of 39.2 million ounces. In Africa, Morocco, which is the continent's largest producer, recorded a 10% gain to attain 7.4

million ounces. Silver output in the CIS was reported at 71.7 million ounces with 59% mined in Russia and 36% in Kazakhstan.

GFMS forecasts that growth in mine production is expected to slow this year "with lower output at established mines partly offsetting production at new mines. Only an 1% increase in production growth (6.4 million ounces) is predicted for this year.

Nevertheless, GFMS predicts 2007 growth to be much stronger with production from new mines in Bolivia and Mexico. The survey, however, did not acknowledge the potential risk from Bolivia and, possibly, from Peruvian Presidential elections to foreign-owned and operated silver mines.

The survey found that weighted average cash cost increased by 24% or 67-cents per ounce, "but due to the higher average silver price, cash margins were steady at $4.03/oz." Industry cash costs ranged from a low of 54-cents per ounce at Coeur d'Alene's Cerro Bayo (due mainly to higher gold credits) to $8.37/oz at Galena. Although GFMS acknowledged the hike in cash costs was significant, "producers' simply cash margins were essentially constant, having contracted by just two cents per ounce to $4.03/oz, due to the 10% year-on-year improvement in the silver price."

Aside from possible labor disputes, Klapwijk told *Mineweb* that he does not foresee any substantial threats to this year's silver production. Because silver refining has increased 30% from a decade ago, available refining capacity "is not what it used to be," he noted. Nevertheless, he hastened to add, refining capacity for silver for the foreseeable future has not reached the crisis proportions of base metals refineries, such as copper.

PRODUCER HEDGING

The delta-adjusted hedge book at year-end 2005 was calculated at 76.6 million ounces, equivalent to 12% of global mine production. Through the delta-adjusted hedge book, Klapwijk said the survey tries to determine "what is the real market impact of those reported ounces?" GFMS estimated the delta-adjusted hedge represented an 15.1 million-ounce increase from the position reported at year-end 2004. The nominal global silver hedge book amounted to 128.8 million ounces at year-end 2005. It was composed of 40.6 million ounces of forward and net options of 88.2 million ounces. According to GFMS, the "year-on-year growth was solely due to increased options hedging as the outstanding forward commitments actually registered a modest decline, with sales having fallen by just over 2% year-on-year."

"In delta-adjusted terms, the steep change in the silver price towards the end of last year had a marked impact on the valuation of the contracts and hence the implied delta against the outstanding options positions," GFMS explained. "Despite an increase in the nominal value of purchased put contracts ...the delta hedge against the purchased puts actually declined by 55% year-on-year (as the puts moved further out, or out-of-the-money)."

SILVER INVESTMENT

Implied net investment in silver-related financial products rose to 47.5 million ounces in 2005. "Over the last two years, there has been substantial growth in activity from mainly institutional investors in silver futures, and especially last year in over-the-counter market instruments," the study said. During 2005, silver investment demand tracked movement in the gold price. However, during the first four months of this year, "an important factor was speculative buying ahead of the launch of the much-awaited silver exchange traded fund," which start trading on April 28th.

Although the silver ETF is structured similarly to the gold ETF, GFMS asserted that "the potential impact of the iShares Silver Trust on the silver market could be (and, in fact, has so far proven to be) significantly more dramatic than the one gold ETFs have had on the gold market."

"The most important reason for this is that the silver market is not nearly as liquid," according to the survey. GFMS estimated that identifiable silver stocks at year-end 2005 were 607.9 million. At the end of April 2006, the estimated value of this available metal was priced at $8.2 billion. "Due to this relative lack of readily available metal, the movement of a substantial quality of silver bullion from unallocated into allocated form (which is essentially what the silver ETF translates into) could easily lead to a very tight market, as manifested by higher silver leasing rates and a rise in the metals prices," GFMS suggested.

The survey estimated that as of May 11, 2006, the ETF had accumulated 62 million ounces of silver. Meanwhile, lease rates rose from a 12-month average rate of 1.81% in 2005 to 6.7% as of May 4, 2006.

The bulk of investor activity in silver has come from institutional investors, with a subsidiary role played by a limited pool of high net worth individuals. "Small private investors have so far had little impact on the market, although there is arguably some scope for that to change in the future given silver's recent spectacular and widely publicized advance and the launch of the ETF, which has provided a more efficient vehicle for the retail investor in silver," GFMS declared.

However, the ranks of the institutional investors thus far have comprised more speculative plays, such as hedge funds, commodity trading advisors and some banks' proprietary traders. "Mainstream investors, such as pension funds, have only a miniscule exposure to the metal, mostly through investments in commodity indices and the like."

Nevertheless, speculators apparently have become increasingly fonder of the silver metal. Total silver futures volumes for 2005 on the Comex reached 5.5 million contracts or 27.7 billion ounces, an 11% gain over 2004. Total turnover in silver options for 2005 revealed an 11% year-on-year increase, although only 1.1 million contracts were registered. GFMS surmised that "fund activity in Comex silver futures was on average higher in 2005 than in 2004."

Silver is generally borrowed to fund short selling or producer hedging and to provide liquidity for efficient functioning of the physical market. GFMS estimated that the lending/borrowing market reached an estimated end-year volume of 322 million ounces. Among the factors contributing to the increase in silver borrowing was the rising price and private volatility encouraging fabricators to manage their exposure. The survey suggested that consignment-related borrowing probably increased for stocks destined for the Indian market.

BULLION

The survey suggests that identifiable silver bullion stocks fell by 117.9 million ounces in 2005, part of which may be related to the 39.7 million-ounce increase in lending. "Furthermore, it is possible that some of the bullion that was released from identifiable sources was moved to non-identifiable stocks held by private individuals and non-reporting institutions," according to the survey.

GFMS estimated that government silver stocks totaled around 206 million ounces at the end of 2005. In 2005, net sales came to 68 million ounces, with the vast majority coming from Indian, China and Russia.

For further information concerning the silver survey, go to *www.silverinstitute.org* to obtain copies with North America or *www.gfms.co.uk* for inquiries in other countries.

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