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Fundamentals Begin to Weigh On Silver

New Mines' Output, Economic Weakness Could Crimp Prices

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Silver has outshined gold -- and most other investments -- this year. But with new mines pumping out the precious metal and industrial demand expected to slacken, analysts are questioning whether the market's affection for silver will stick.

Silver started the year in a dazzling fashion: A 40% ascent pushed it to a 27-year high of $20.685 an ounce in March. It then tumbled 20% in a broad selloff of commodities. Year to date, silver is up 14% to $16.904 an ounce, versus 7.7% for gold.

Investors have maintained interest even since the March selloff. The largest silver exchange-traded fund, **iShares Silver Trust**, increased its silver holdings by 11.7% since silver's March peak, reflecting investor demand, while holdings in **StreetTracks Gold Shares**, the largest gold ETF, declined 12% since gold's peak that month.

Historically, the silver market has been an arena for speculators. A much smaller market than gold, it can stage dramatic swings. And like gold, it tends to move in tandem with the broader commodities markets, which have surged in the past few years.

But there also are silver fundamentals that drive prices. And for years, they've been favorable.

Last year, industrial demand for silver jumped 7.2% to a record of 455.3 million ounces, as a result of its increased uses in batteries, superconductors and other electronic components, according to the World Silver Survey 2008, an annual industry report by GFMS Ltd., a London-based precious-metals consultancy, and the Silver Institute, an industry research group. The robust growth in demand more than offset declines in silver's traditional uses such as photography, jewelry and silverware.

Yet, some analysts expect a hefty surplus may soon emerge. Driven by higher prices, numerous new mines and expansion projects are under way around the world. Barclays Capital estimates silver-mine production will rise 6.5% this year, faster than 2007's 3.6%, causing "the largest surplus in over 20 years."

Meanwhile, general economic weakness may damp demand. Physical demand for silver is estimated to fall 0.5% this year, according to Barclays analyst Suki Cooper, who targets silver's average price at $15.20. "Silver's fundamentals look less compelling this year and are more likely to push prices lower," she wrote in a research note.

Given the expected slowing in industrial demand, "silver's price trajectory is firmly in the hands of investors," wrote Ms. Cooper, referring to the fact that investors influence the supply -- such as through exchange-traded funds that buy bullion as investor cash flows in. But banking on investor demand to prop prices is a riskier strategy than relying on business demand.

Investors who do stick with silver may hope it will revisit highs. Although silver has surged 150% since 2005, it's nowhere near its record of $48.70, reached on Jan. 17, 1980, and the contrast is even greater when accounting for inflation.

GFMS remains positive for silver's prospects "this year at least," according to the silver survey, on the back of a weaker dollar, inflation worries and inflow of money into the commodities sector. CPM Group, a New York-based commodities research firm, expects demand for silver to hold up this year, and its price to average $18.25.

But Brad Zigler, managing editor of research Web site Hard Assets Investor, says gold's harder fall is worrisome for silver. "If silver's price trend catches up to gold's, there's likely to be more redemption."

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