

MARKETS AT A GLANCE

Sprott Asset Management^{LP}

Follow the Money

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You know silver's doing well when the commentators start giving it the 'gold' treatment. Silver's recent rise has been so spectacular that it's caught many investors off guard. It's natural to be sceptical when you don't know the fundamentals driving strong performance, and many pundits and commentators have been quick to downplay it as a result - much like they do towards gold when it enjoys a run. Silver is also an awkward metal for them to categorize. Is it a commodity, a monetary metal, or both? And which side is driving demand? If it's industrial demand, that's ok, because that's bullish. But if it's investment demand for silver as 'money', well then that's sort of bearish, isn't it? The fact remains that most commentators have failed to grasp the monetary shifts that silver is signaling today, and in doing so they've failed to appreciate just how high it could actually go.

The financial media's failure to grasp the benefits of precious metals ownership continues to perplex us, and it's not just the commentators who are prone to perpetual disbelief. The sell side analysts are equally as irresolute. According to Bloomberg, the 'expert' consensus silver price forecast for 2011 is \$29.50, representing a 31% discount from the current spot price. This same group of analysts also predicts prices will decline another 25% in 2012 and a further 9% in 2013 to \$20 an ounce. When you consider that the silver price has appreciated by over 21% *annually* over the past 10 years, these forecasts suggest a very dramatic change in the long-term trend. Will this reversal come true? Probably not. These were the same analysts who predicted that spot silver prices would average \$18.65 this year - so they've missed the mark by over 100% thus far.

We don't mean to bash the silver analyst community, and there are several whom we highly respect, but it is important for silver investors to appreciate that these price forecasts are being plugged into financial models that dictate equity valuations. These models are used by traders, bankers, analysts, and portfolio managers to derive valuations for silver stocks and create asset allocations for portfolios. To anyone questioning current silver equity valuations, we would ask: what price assumptions are you using? Of course we as allocators of capital are thankful for this phenomenon, as it allows us to buy our favourite silver stocks on the cheap, knowing full well that the herd will be following behind in due course as those backward-looking forecasts get ratcheted higher.

How can we be so confident that the price of silver will continue on its upward trajectory? Our thesis is premised on the most rudimentary of economic principles – supply and demand.

One of the key indicators that we've been monitoring is the gold/silver ratio. Much has been written about the ratio of late, and we won't go into great detail on the subject, other than to note that the last time money was synonymous with defined amounts of gold and silver, the ratio was set at 16-to-one. In fact, for most of the past millennium, one ounce of gold would have been convertible to somewhere between 10 and 16 ounces of silver - an amount roughly in line with

the relative occurrence of each mineral within the earth's crust.¹ For the better part of the past century, due to the world's abandonment of bimetallism and then the gold standard, the gold/silver ratio has fluctuated widely, twice reaching lows near the 15-to-one mark and a high of 100-to-one back in the early 1990's. The most recent high reached in the latter part of 2009 was nearly 80-to-one. Since then the ratio has been tumbling to where it stands now at 35-to-one – which reflects the incredible outperformance of silver over that time period. In our opinion, this ratio will continue to move lower, driven by nothing more than basic supply/demand fundamentals.

The US Mint, which is the world's largest silver and gold coin manufacturer, recently reported that it had sold 13 million ounces of silver coins and 370 thousand ounces of gold coins on a year-to-date basis.² This means that the US Mint is now selling roughly equal amounts of silver and gold *in dollars* so far this year. Furthermore, bullion dealers like Sprott Money and GoldMoney have confirmed with us that they are now selling *more* silver than gold in dollar terms. For additional confirmation of this investment trend, just look at the flows for the two largest gold and silver ETFs. Investors have withdrawn approximately \$3 billion from the GLD so far this year while the SLV has seen net inflows of \$370 million over the same period. Dollar for dollar, investors are allocating as much if not more money to silver than to gold. And why shouldn't they? Silver is much more of a "precious" metal than the current ratio of 35-to-one would suggest.

To explain, we must first address mine supply. In 2010, the world mined approximately 736 million ounces of silver and 85 million ounces of gold.³ The world also produced an additional 215 million ounces of silver and 53 million ounces of gold from recycled scrap.⁴ Adding both together brings us 951 million ounces of silver and 139 million ounces of gold supply, for a ratio of seven ounces of silver to one ounce of gold.

Interestingly, this ratio is very similar to the ratio of available in-situ silver and gold reserves. The U.S. Geological Survey estimates that there are current in-situ reserves of approximately 16.4 billion ounces of silver versus 1.6 billion ounces for gold, or about a 10-to-one ratio.⁵

The case for silver is even more compelling when one considers the ramifications of its dual role as both an investment and industrial metal. Last year, non-investment demand for silver (which includes industrial, photographic, and silverware demand) totaled approximately 610 million ounces.⁶ This represents approximately 64% of primary supply, leaving approximately 341 million ounces to satisfy investment demand.⁷ On the gold side, industrial usage totaled 13 million ounces, or about 10% of primary supply, leaving approximately 125 million ounces left over for investment demand.⁸ So, after netting out the industrial usage the primary supply left over for investment demand is about 2.7 times that for gold. However, if we convert those ounces to dollars at current prices, we're left with \$15 billion worth of silver available for investment versus \$186 billion worth of gold, or a one-to-13 ratio of silver to gold! This means that in terms of primary supply, silver only has 8% of the capacity for investment that gold does despite having equal if not more dollars flowing into it.

Now, it's true that another potential source of supply is the very silver that investors already own - and at the right silver price these inventories of silver and gold bullion may be sold into the market to supplement any supply shortfalls. As we've noted previously, however, due to decades of underinvestment, the amount of silver bullion inventories are actually extremely small, even compared to those of gold.⁹ Recent estimates suggest that reported silver bullion inventories stand

¹ Farchy, Jack and Meyer, Gregory. "Americans feather nests with silver Eagles." (March 29, 2011). Retrieved on April 12, 2011 from: <http://www.ft.com/cms/s/0/fe701e4e-5a1f-11e0-86d3-00144feab49a.html#>

² Unser, Mike. "US Mint Sales: American Eagle Bullion Coins Take Lead." (April 6, 2011). Retrieved on April 12, 2011 from <http://www.coinnews.net/2011/03/30/us-mint-sales-american-eagle-bullion-coins-take-lead/>

³ [Silver:] "Silver Investment the Dominant Driver of a Remarkable 2010." The Silver Institute (April 7, 2011). Retrieved on April 12, 2011 from: <http://www.silverinstitute.org/pr07apr2011.php>. [Gold:] "Gold Demand Trends, Full Year 2010." World Gold Council (February 2011). Retrieved on April 12, 2011 from: http://www.gold.org/about_gold/market_intelligence/gold_demand/gold_demand_trends/

⁴ Ibid.

⁵ "Mineral Commodity Summaries 2011." US Geological Survey (2011). Pg. 66-67, 146-147

⁶ "Silver Investment the Dominant Driver of a Remarkable 2010." The Silver Institute (April 7, 2011). Retrieved on April 12, 2011 from: <http://www.silverinstitute.org/pr07apr2011.php>.

⁷ In our view jewellery demand is considered a component of investment demand

⁸ "Gold Demand Trends, Full Year 2010." World Gold Council (February 2011). Retrieved on April 12, 2011 from: http://www.gold.org/about_gold/market_intelligence/gold_demand/gold_demand_trends/

⁹ See "The Double-Barreled Silver Issue" from November 2010

¹⁰ "Sprott Physical Silver Trust Prospectus" (October 28, 2010) Pg. 38

at roughly 1.2 billion ounces versus 2.2 billion ounces of gold bullion, or roughly a 0.5-to-one ratio.¹⁰ To put that amount in perspective, consider that at present there is only \$52 billion worth of silver bullion/coins and over \$3.3 trillion worth of gold in inventory which could potentially be recirculated into the market. Converting this to a ratio, you get a one-to-63 ratio of silver to gold inventories. So how is silver still priced at 35-to-one?!

All indications lead us to believe that there is now roughly an equal amount of investment flowing into silver and gold on a dollar-for-dollar basis. And although the price ratio of silver to gold has fallen substantially since the highs of 2009, our analysis strongly suggests that this ratio must move lower to restore a fundamental balance between supply and demand. Only time will tell how much lower it will go, but we would not be surprised to see it hit single digits before settling into a more sustainable equilibrium.

What the so-called silver 'experts' neglect to account for in their models and projections is that the fiat money experiment has failed. And in this context, we believe the Market has assigned world reserve currency status to gold - not USD, not EUR, and not JPY. In our opinion, gold's continued appreciation vis-à-vis every currency is assured because the great flight from fiat has only just begun. Like gold, silver also has a long monetary history, and as such, investors are now also buying silver as protection from the ravages of fiat currency debasement. Yet, when compared to gold, it is silver that offers the most attractive value proposition by virtue of the gross mispricing of its scarcity, which, we might add, has existed for many years. Thus, in our opinion, as this new bimetallic standard takes root, silver investors will continue to be justly rewarded with marked outperformance. We truly believe that this is the investment opportunity of a lifetime, and increasingly so, others are taking heed. What is clear to us is that with equal investment dollars now flowing into silver and gold, the current 35-to-one ratio is unsustainable and has only one direction to go: lower.

Sprott at a Glance

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