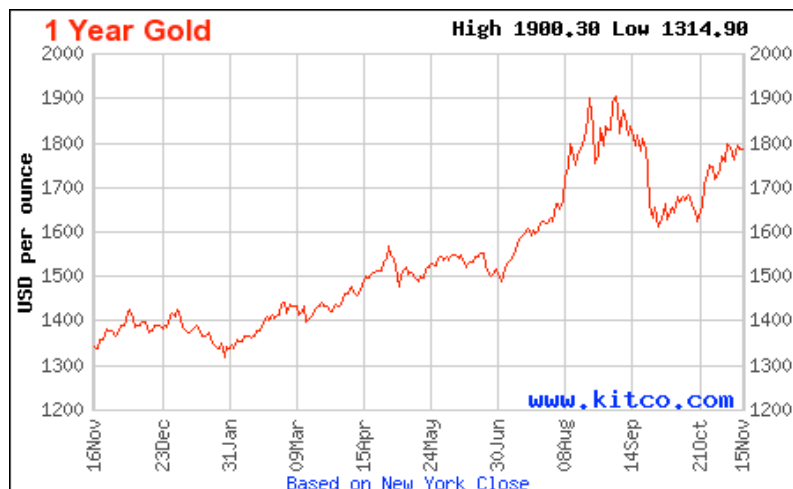


**Silver is Still Undervalued**

After almost hitting a high in April 2011, of \$50 per ounce, silver spot price retreated back to trade around \$35 per ounce currently. In fact, in the last 3 months it has been trading between the \$30 -35 per ounce levels.

Spot Silver: Trading around \$30-35 per ounce levels in last 3 months

In the meantime, gold has been trading on an uptrend; for the last three months, spot gold has moved up, from around \$1600 per ounce to trade around \$1770 per ounce currently (+10%). At the current spot prices, the gold-to-silver ratio is around 52 times.

Spot gold: up from \$1600 to \$1770 per ounce now

Based on GSR, it can be argued that **silver still cheap**.

**Gold-to-silver ratio**

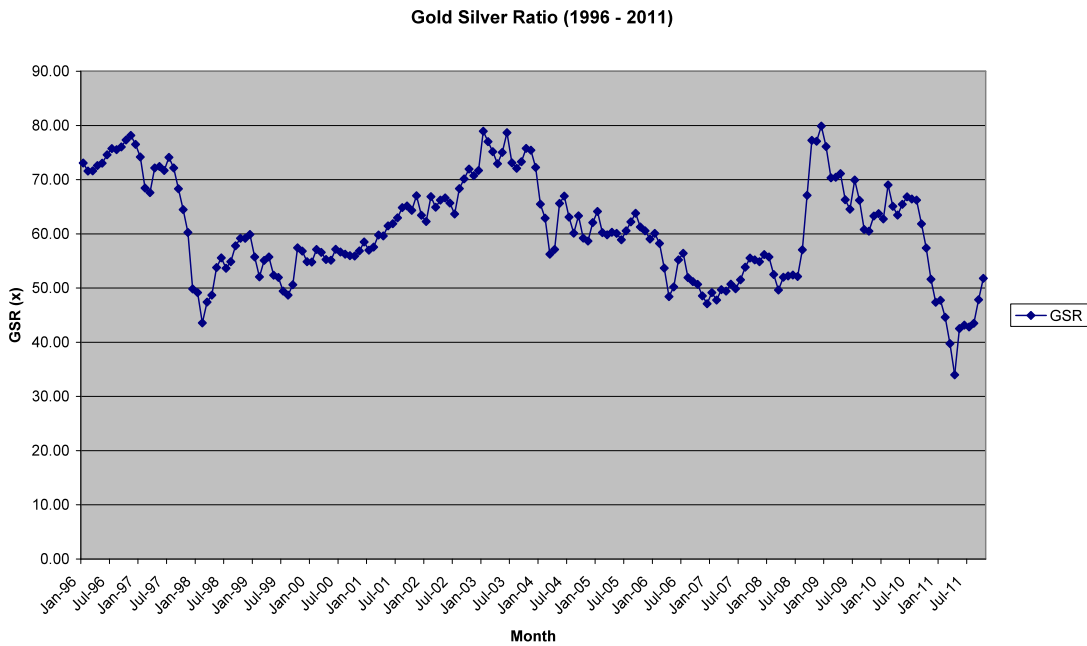
What is the significance of the gold-to-silver ratio (GSR)? It is the proportion of price of gold to price of silver, and is computed as:

$$GSR = \text{Spot price of gold divided by the spot price of silver}$$

For example, if the spot price of gold is now \$1540 per ounce while the spot price of silver is \$38 per ounce, then the gold-to-silver ratio (GSR) is: 40.5 times.

The GSR basically provides us with the *relative price* of 1 ounce of gold to price of 1 ounce of silver. It is used generally for trading by commodities and futures traders; the ratio tells us whether gold is under-or-overvalued relative to silver. GSR is highlighted in many of the writings on gold and has been observed extensively throughout history.

- The long-term GSR is generally accepted to be around 14 to 16 times, but
- It has been as high as 80 times and as low as 32 times (between 1996 to 2011) – see chart below.
- **Gold-silver ratio (1996– 2011): As high as 80 and as low as 32 times**



Source: [www.gold.org](http://www.gold.org), [www.silverinstitute.org](http://www.silverinstitute.org) (London fix)

Now, with spot gold trading at around \$1770 per ounce, and applying a GSR of 16 times (which is generally accepted as the long term ratio), the price of silver should be closer to \$110.62 per ounce; that would mean a huge upside of 225% from current levels of \$35 per ounce!

And, if gold were to hit \$2500 per ounce as predicted by some punters, the price of silver should be \$156 per ounce (assuming GSR of 6 times). That would mean a whopping 360% gain from current levels. Hence, with GSR currently at 52 times, it appears that silver is trading at a steep discount (i.e. it is still cheap), and any re-rating upwards could see its prices moving even higher.

But, what are some of the factors that would cause the silver price to be re-rated upwards? There were two commentaries on silver recently that shed some light to the true state of silver's supply and demand scenario, which many have argued is heavily distorted. In other words, the shortage in the physical silver market is not reflected in the paper silver pricing; and eventually they argue prices will have to catch up.

Firstly, The Silver Institute released a report on 16 November 2011, entitled *The Silver Investment Market – An Update*, which forecasts world silver investment will reach a record high total of \$10 billion in 2011, representing a 66 percent increase over the \$6 billion posted in 2010. Findings from this report include: the outlook for silver prices is bullish for the remainder of 2011 and into 2012, silver investment has become a key area of the global silver supply/demand balance and since the beginning of 2008, global Exchange Traded Fund (ETF) holdings have grown by 364 million ounces (moz), to 577 moz on October 31, 2011. While these recent developments are certainly good news for silver, it also highlights the inconsistencies that exist in the silver markets.

Essentially, demand for silver from ETFs in 2008 in was only around 213 moz, and in the last 2 years it added a staggering 364 moz ounces. This happened when silver supply hardly grew at all; supply from mines in 2009 was only 718 moz, while in 2010 was only 735moz (according to the Silver Institute). Eric Sprott, Chairman of Sprott Asset Management, commented about this scenario in his speech at the Munich Precious Metals Conference recently<sup>1</sup>. He said that “there are disparities between the physical market and the paper silver market...in terms of supply and demand, the upward pressures on silver price from demand growing much faster than supply are not being accurately reflected.

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<sup>1</sup> 4<sup>th</sup> November, Munich, <http://www.goldmoney.com/video/sprott-turk-munich.html>

A 900 million ounce silver supply simply cannot cope with a 380 million ounce increase in demand and maintain current prices". (Here, the 380 moz demand Sprott is referring to, is the demand from ETF as reported by the Silver Institute to be around 364moz). Is it possible that the statistics from the Silver Institute is somewhat inaccurate or distorted? The definition for World Investment consists of two components; new bullion sales and implied (dis) investment, the latter is a balancing item and a proxy for net investor demand on physical silver (incl. from ETFs). In other words, they do not actually measure the demand for physical silver from investments but its merely the difference between what is observed, i.e. what is supplied by the mines and scrap, and less the demand (from sources other than physical investment demand). Our contention is that as a result of this, silver should really be higher than what is reflected in the spot prices today. Eric Sprott also explains that investment sales of silver are 50 to 1 in volume compared to gold and that this means a *decreasing gold/silver ratio*. This supports our argument that the current GSR of 52 times is probably to high, and over time it should revert back to the long term average of close to 16 times; hence, the price of silver should be much higher than what it is today.

The second reason that silver prices should move upwards is related to the shortage of physical silver supply. Although this is not acknowledged but users of silver such as mints have at one time or another reported this. Further, coupled with the strong demand for silver coins this year, and next year as predicted by the Silver Institute report, the situation can only get worse. All the major mints in the world have reported record sales: in 2010, sales of bullion coins grew by around 1/3 to an estimated 12moz (includes the Maple Leaf, Kookabura, etc) while sales of U.S Eagles have also hit a record 34 million coins. The number of Eagles coin for next year is expected to be even higher, at 41 million. Indications of shortages to come can also be seen as news of China cutting its export quota for silver hit the markets. Silver exports from China, the world's largest economy, are expected to drop this coming year as domestic demand from investors is expected to surge. And, in a market that has seen significant price volatility, these reduced exports could bolster prices of the white metal, say analysts. According to a statement from China's ministry of commerce, the 2012 export quotas for silver from the Asian country have also been reduced by 5%. This amounts to a cut of 283 tonnes in its 2012 silver export quotas from 5,670 tonnes in 2011. Roughly, 70% of China's silver demand comes from the industrial sector. Analysts say shipments are also set to decline with customs data showing a drop in exports. Chinese customs data showed export growth falling more than expected in September, while import growth also declined. What is intriguing is that despite the news of possible slowdown in China's domestic GDP (its third-quarter gross domestic product was up only 9.1% from a year ago, slowing from 9.5% growth in the second quarter and 9.7% growth in the first), its export of silver is still being cut.

This could possibly indicate that despite the likely slowdown in domestic consumption, China is not taking any chances with its supply, preferring to keep some of it, for own internal use rather than exporting. A bullion retailer was quoted as saying "Silver prices have been volatile of late. Like rare earths, China is also cutting exports of silver. Less exports mean tighter markets everywhere else,".

Given these developments, one can only expect silver prices to be higher next year.

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