No longer Sleepy Silver

Its been a very long time since Silver has traded like Silver - a high beta, higher vol asset, hitting 50c intraday ranges. Thats because the buildup of inventories, following its move to $50 in 2011 kept prices in a sleepy low range. Physical demand was forced to substitute after the price spike and supplies continued to saturate the market given they are rather inelastic to low prices *(its a byproduct of gold and base production).*

Silver prices have under-performed Gold soo starkly the past 2 months (taking the Gold/Silver ratio to 1990 highs of 93), that the market was content in finding excuses why it couldn't keep pace (physically oversupplied, lacking official sector demand, alternative currencies like Bitcoin detracting investment, more aligned with industrial metals which are hurting from a large global manufacturing slowdown etc).However, Silver is up 7% in 5 days, with spot trading over $16. Had Silver kept pace with Gold recently, this weeks rally wouldn't be that conspicuous - - **is this just a long overdue repricing to become more fairly aligned with Gold (currently > $1400) or is this the beginning of cyclical breakout (similar to Golds technical break above $1350)?** A few thoughts…

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SUMMARY:

Overall, we still structurally like a higher Gold/Silver ratio as macro markets navigate the delicate late cycle era. However, we have argued that there will be tactical opportunities in being long Silver, which still holds, despite the ~$1.50 move. This repricing (without the help of base metals or an extension of risk/SPX) shows off that it is still a precious metal, and can play a role as a currency hedge or quality asset, as well as providing relatively cheap optionality on further Gold upside. The physical overhang ensures Silver wont return to its 'wildcat' heydays seen during 2009-2012, but given a world of growing negative interest rates (where fundamental arguments can absolutely take a backseat to a "convincing story" and price momentum), a strong technical close (Silver is required to hold & close >$16 this week) and being relatively under-owned (on AUM basis and versus Gold), the new fairer more "aligned" range (vs Golds >$1400) is $16-18/oz.

The trigger for this weeks move - there was no micro-specific catalyst, but a few considerations:

- **Reflation risk in 2H'19**: Theres been early signs in both US & Chinese macro data signaling some 'reflation risk' into 2H'19. US CPI, jobs no, manufacturing data (Philly Fed, Empire Mfg) & Retails sales have all beat expectations; Chinas Industrial Production, Retail Sales & FAI also beat the street earlier this week. That helped to trigger some short covering in the more industrial precious metals (eg: Platinum & silver), but less so in base metals (Copper), given the base complex remains very mindful of the overhang of the threat of further tariffs. That contrasts with mixed US earnings which have injected a sense of nervousness in the market (SPX is heavy falling below 3000) and thus, should in theory, see safer havens like Gold (not Silver), outperform.

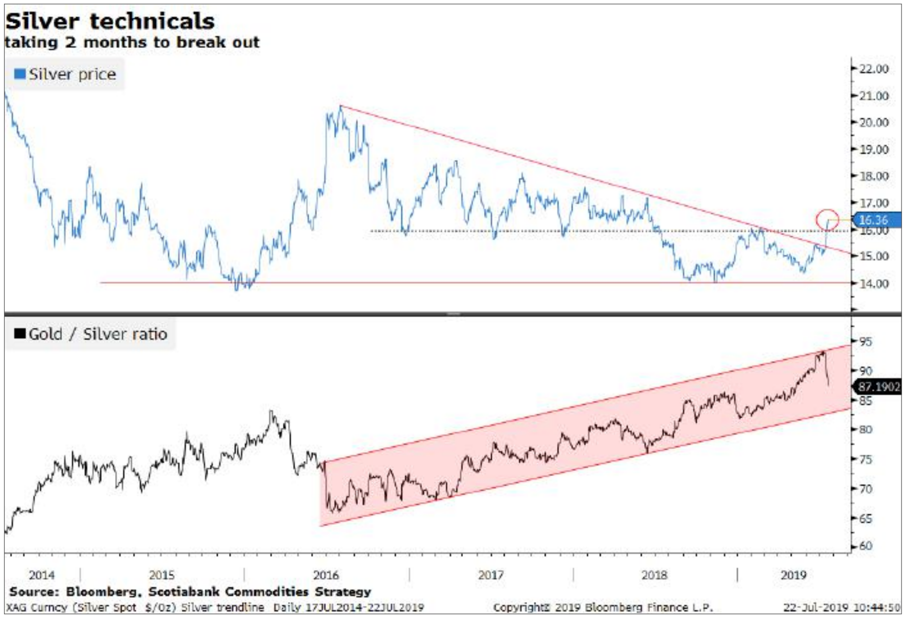
- **Bitcoin: less of a threat now.** The recent lack any significant investment commitment recently has something to do with increase in popularity of alternative currencies; the rise and appeal of Bitcoin et al generally also embodies the structural theme of declining all fiat currencies (when global CBs shift from dovish to super dovish policies), thus they arguably detracts (would-be) retail investment away from silver (more so than Gold) and from other high-beta assets like junior miners. With Bitcoin collapsing and losing 1/3rd of its value this week (as Facebook struggles to convince lawmakers it can create a viable cryptocurrency in Libra), perhaps that allowed Silver to attract its lost usual fast-money participants.

- **Precious: increasingly back on the radar & "whos next" mentality:** With Golds statement repricing (as it internalizes a macro regime shift in monetary policies and geopolitics) all and any exposure to 'precious metals' has become part of the conversation; known investors have recently talked up the prospects of Gold/precious citing "paradigm shifts" ("a good time to ask what will be the *next-best* currency or store-hold of wealth to have when most reserve currency central bankers want to devalue their currencies in a fiat currency system”). Silver simply becomes considered as the next one to go, and becomes relatively cheap optionality on further Gold upside.

- **Fed cutting cycle:** While 25bps cut in July remains the most likely outcome priced by markets, 50bps is not close to being ruled out. Arguably, relatively cheaper high rolling Silver is a better proxy to hedge out 50bp expectations as that would ensure a strong risk-on, $-off environment. However, its worth noting a few lessons from the prior Fed cutting cycles (beginning in 2000 and 2007): Overall, the Gold/Silver ratio strengthened 49% (2000-2002) and 45% (2007-2008) throughout those previous rate cutting cycles, making Gold the preferred longer term investment. However, Silver did outperform in the early stages when the Fed first begun to cut (in 2000-2001, the Gold/Silver ratio fell ~7.5% on slight Silver upside outperformance; in 2007-2008, the Gold/Silver ratio fell >14% on Silver visibly outperforming Gold, rallying 54% in 25 weeks). There is a place for Silver upside in the early stage of late cycles...

Technicals/momentum, positioning and sentiment - a lot, but not everything

- With Gold brushing up into core resistance sub $1440 (before this afternoons breakout!) coyly awaiting its next move, Silver was given the opportunity to extend the key trend line break (yesterday) and test short-term double top resistance at $16.20 (graph 1). Technicals matter, even if sentiment amongst the precious players hasn't quite turned (Silver has been in the doldrums for 6 +years, so naturally theres plenty of skeptics believing this time is not different for a sustained breakout). So, just as the breakout in the dominant GLD ETF (not futures or spot), marked the turning point in Gold spot, so the **SLV ETF close at 15.29 today, above the recent double top, is a constructive development for Silver in helping to re-awaken the asset class for generalists.**



- 312m oz (that is more than half of global industrial demand) was accumulated by all investors over the past 30days. Thats huge and was split between ETFs of +44m oz (largely retail interest) and net COT interest of 268M oz (evenly split between fresh longs of +132m oz, vs short buybacks of 134m oz). Overall, there is capacity for COT to continue accumulating (*recent data holdings show net COT holds 1/6th of peak holdings). And while ETF holdings (of 550m oz) are lofty on an historical basis, on an AUM basis, the market cap of current at ETF holdings is $9bn and more than half the peak AUM of >$20bn seen in 2011. **If precious metals are pricing in a new regime change of easier monetary policies, cold currency wars and fresh political/geopolitical instability, Id argue that investor commitment & positioning also has the ability to 'trade' into new higher ranges. (graph 2)**

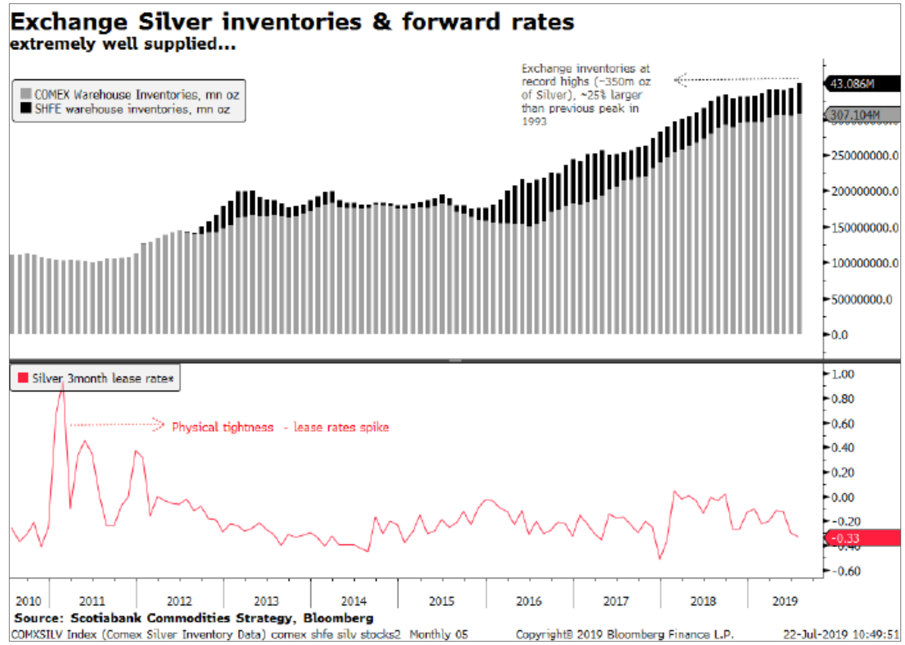
Physical: still saturated creating a heavy overhang

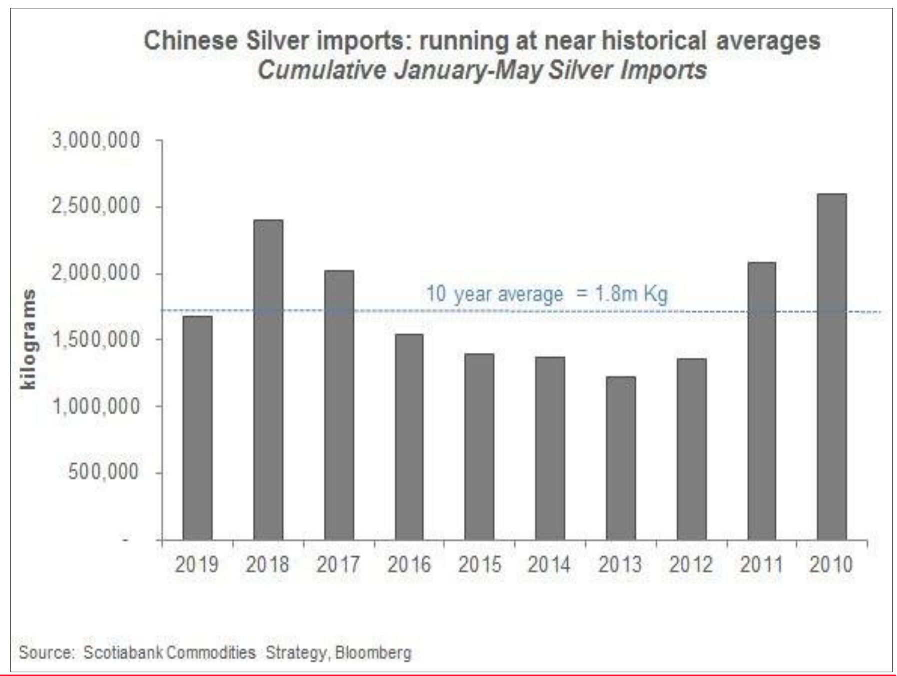
- It hasn't gone unnoticed in physical markets that Silver is very well-supplied. **Current lease rates are near cyclical lows and known exchange (CME + SHFE) inventories are at record highs of ~350m oz.** Graph 3 & 4

- Silver inventories at the SHFE and SGE combined remain at ~ 140m oz (up 35% YTD) and are equivalent to ~9 months of Chinese demand, which also helps to explain why Chinese Silver imports have slowed dramatically vs the same period last year.

- Given Silvers relatively cheap price, total Silver demand hit a 3 year high of ~1bn oz in 2018 (led mostly by physical coin/bar demand in India), YET prices languished below $16 in 2H'18 reflecting the supply overhang. Silver (priced in local INR terms) is still "poor mans gold" vs Gold in INR terms, so demand shouldn't be dented that dramatically on this repricing.

- However, the fact that Silver volatility has blown out, with risk reversals at historical highs, **provides an appetizing opportunity for producers to layer in and is an added risk fresh investor length needs to contend with (**3m 25d calls now demand a overt a 4vol premium to puts, a record high).





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