SILVER OUTLOOK Q1 2021: POOR MAN'S GOLD STARTS TO GLIMMER

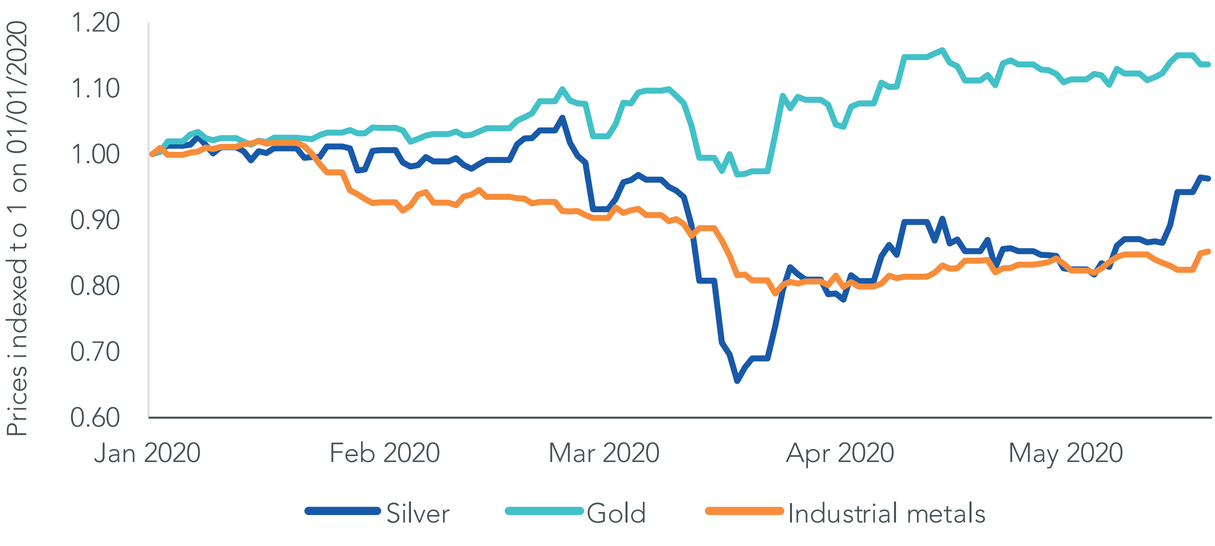
May 2020

Until recently, silver has been laggard this year. It has largely failed to rise in line with gold. However, that is changing. The gold-to-silver ratio, a measure of how cheap silver is relative to gold, has been elevated (i.e. silver has been very cheap) in the past year. While that ratio has been coming down in the past weeks, we don't think that it will return to normal levels in the coming year. However, we think the silver price could rise substantially from US$17.10/oz to around US$26.50/oz by the end of the year before easing to US$21.40 by end of Q1 2021 according to our internal forecasts. These forecasts do factor in headwinds from declining industrial demand. Disruption to supply could pose an upside risk to these forecasts.

More Hyde than Jekyll

Silver's performance this year has been nothing short of disappointing until mid-May 2020 or so. It has behaved more like an industrial metal than a precious metal. Our framework acknowledges that silver is a hybrid metal, but recently its strong historic correlation with gold appears broken.

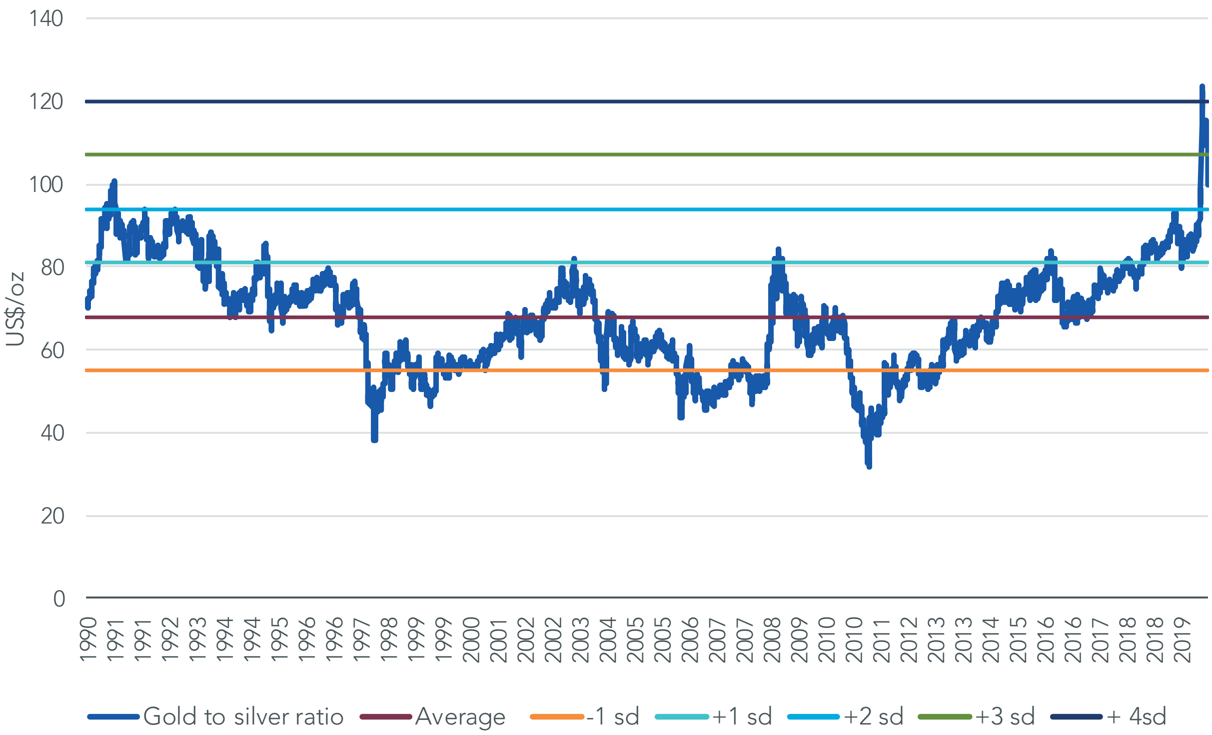
FIGURE 1: SILVER, GOLD AND INDUSTRIAL METALS PRICE PERFORMANCE YEAR-TO-DATE



Source: WisdomTree, Bloomberg. 01/01/2020 to 18/05/2020. Data based on Bloomberg Commodity Index Subindices. The Bloomberg Industrial Metals Subindex includes copper, aluminum, zinc and nickel. ***Historical performance is not an indication of future performance and any investments may go down in value.***

Gold has rallied over 13% this year and silver has fallen 4%[1]. As a consequence, we have seen the gold-to-silver ratio rise to levels unseen before. The higher the ratio, the cheaper silver is relative to gold. At a peak of 122 in March 2020, the ratio was more than 4 standard deviations higher than average. Only on mid-May has the ratio headed below 3 standard deviations higher the average. Either silver is very cheap or there has been a secular change in silver's relationship with gold. Recently, however, silver has started to play catchup with gold. We assume the correlation with its cousin will resume. We believe silver is in the midst of its transformation back to Dr Jekyll after spending so long as Mr Hyde.

FIGURE 2: GOLD-TO-SILVER RATIO



Source: WisdomTree, Bloomberg. 01/06/1990 to 18/05/2020. Data based on London Bullion Market Association PM prices. sd is the number of standard deviations away from the average. ***Historical performance is not an indication of future performance and any investments may go down in value.***

Framework

In "Gold and silver: similar, but different", we argued that silver's price performance is 80% correlated with gold. In our modelling framework, gold price is therefore the main driver of silver price. However, we find the following variables as important drivers of silver price:

+ Growth in manufacturing activity – more than 50%[2] of silver's use is in industrial applications (in contrast to gold where less than 10% comes from that sector). We use global manufacturing Purchasing Managers Index (PMI) as a proxy for industrial demand

[1] In the year to 18th May 2020, based on Bloomberg spot data.

[2] According to data from the Silver Institute.

- Growth in silver inventory – rising inventories signal greater availability of the metal and hence is price negative. We use futures market exchange inventory as a proxy
- Growth in mining capital investment (capex) – the more mines invest, the more potential supply we will see in the future. Thus, we take an 18-month lag on this variable. Given that most silver comes as a by-product of mining for other metals, we look at mining capex across the top 100 miners (not just monoline silver miners)

Gold to reach unprecedented highs

In **"Gold Outlook for Q1 2021: Into Unchartered Territory"**, we laid out our forecasts for gold under two economic scenarios – a V-shaped and U-shaped economic recovery. Increasingly it appears a U-shaped economic recovery is more likely. We use that as the basis for our silver outlook. In the U-shaped economic recovery forecast, we assume the global economy struggles to recover from COVID-19. Facilities provided by central banks and fiscal authorities are heavily utilised and expanded. We could thus see continued policy easing. In this environment, gold may ralliy to US$2200/oz. Regardless of a V or U-shaped economic recovery, in our internal forecast we see gold heading to unprecedented highs. Under the U-shaped economic recovery, it could stay above US$2000/oz for longer.

Silver forecasts

We believe in growth terms, silver could outpace gold. Despite being held back by weak industrial demand and rising inventory, silver could rise to US$26.50/oz by the end of this year, which is close to a 55% rally from US$17.10/oz at the time of writing (19/05/2020). It's not enough to bring the gold to silver ratio back to normal levels. In fact, it could still be close to a standard deviation above average. If our Q4 2020 gold forecast of US$2100/oz is right and the gold-to-silver ratio were to go back to normal, the silver price would be over US$30.00/oz. We don't think the ratio will go back to normal in the coming year given the weakness in industrial demand. By end of Q1 2021, silver may weaken to US$21.40/oz, while gold continues to rally to US$2200/oz, thus raising the gold to silver ratio to 102.

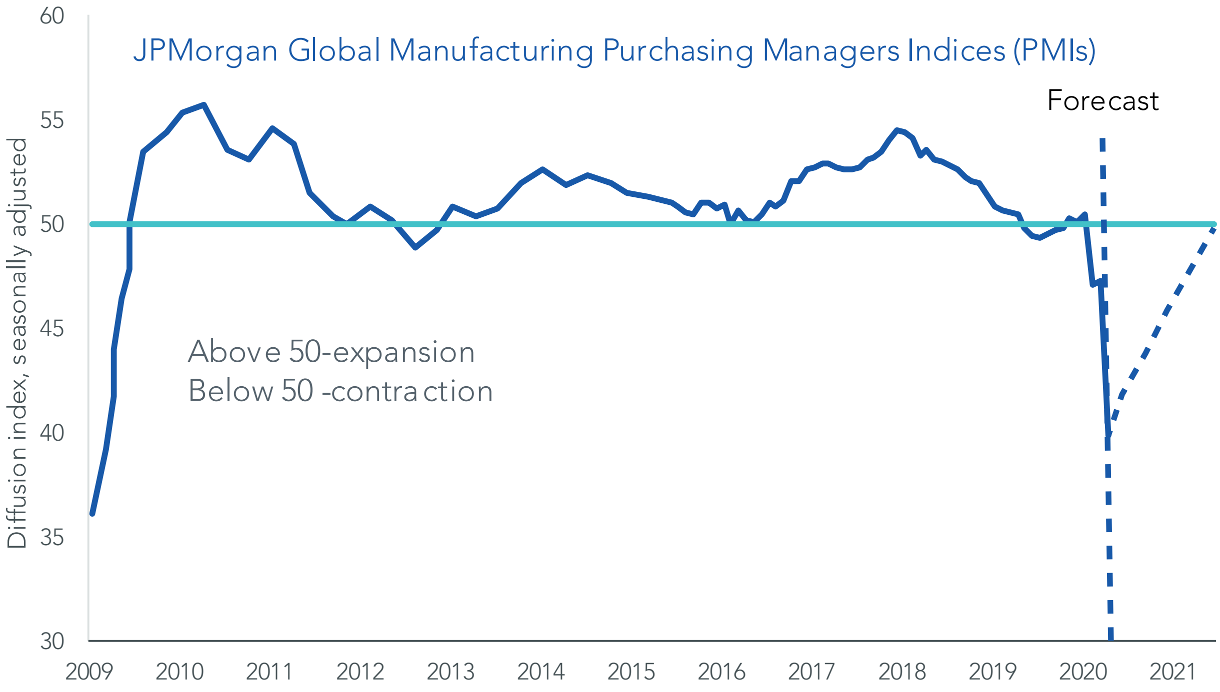
FIGURE 3: WISDOMTREE SILVER FORECASTS

Source: WisdomTree (forecasts), Bloomberg (historic data), data available as of close 19 May 2020. ***Forecasts are not an indicator of future performance and any investments are subject to risks and uncertainties.***

Industrial demand to face a slow recovery

Our forecast for manufacturing Purchasing Managers Indices – our proxy for industrial demand for silver – is for a recovery from today's crisis levels. But the recovery will be slow and may not even rise above 50 (the demarcation between contraction and expansion) in the forecast horizon. That will be a slower recovery than what we saw in 2009, as the lockdown measures can only be eased slowly in the current environment despite all the monetary and fiscal easing potentially driving higher the natural demand for industrial activity.

FIGURE 4: GLOBAL MANUFACTURING PURCHASING MANAGERS INDICES



Source: WisdomTree, Bloomberg. 05/02/2009 to 04/05/2020. ***Forecasts are not an indicator of future performance and any investments are subject to risks and uncertainties.***

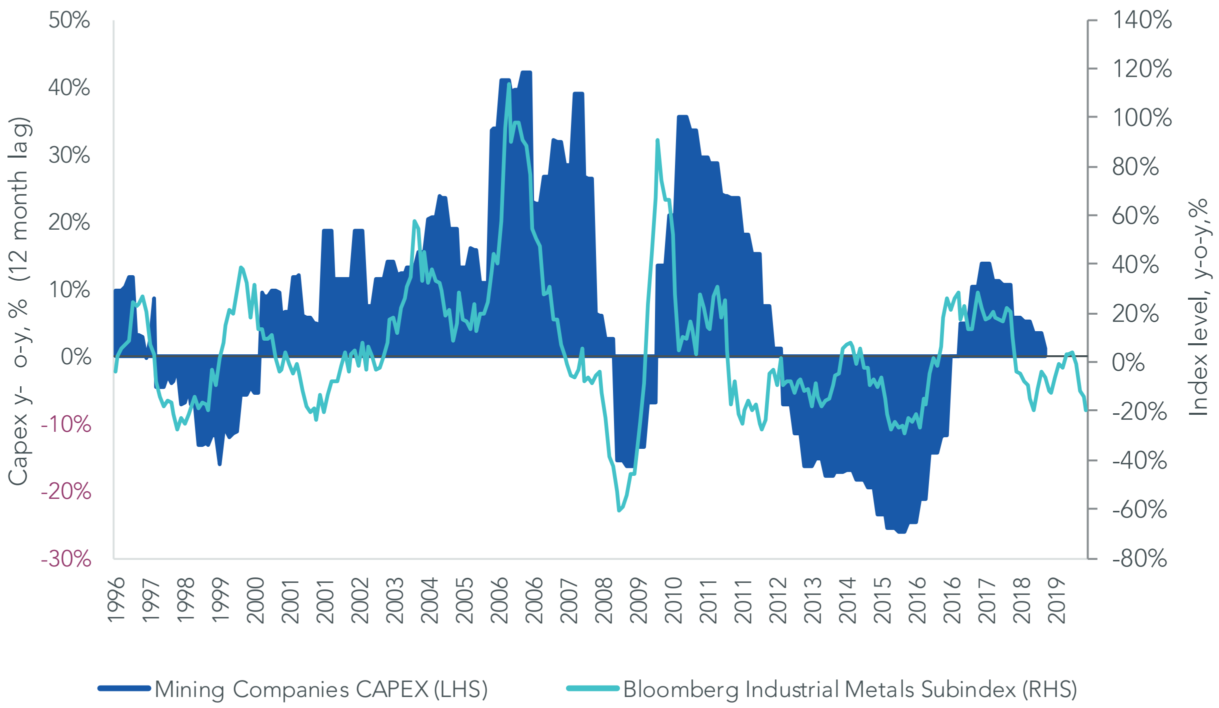
Mining supply could expand

Mine supply of silver has been declining for four years. Declining ore grades at several large primary silver miners, lower silver production at copper mines and notable disruptions at major silver mines were the main drivers.

In our model framework, one of our proxies for supply – the amount of capital expenditure in mines – while having slowed down substantially in recent months, had been rising 18 months ago. In our model, we apply an 18-month lag on this data to reflect the time it takes before an increase in capex turns into a material increase in supply. For now, as we live in the shadow of that rising capex, supply could take some of the potential price gains for silver away.

However, assessing the micro-situation, there is a case for mine supply to decline this year. Due to COVID-19, mining activity has been temporarily suspended in major silver producers including Mexico, Peru, Bolivia, and the Province of Quebec in Canada. So, while in our model framework we point to supply increases being a potential headwind, there is an upside risk to price if the COVID-19 related disruptions take place.

FIGURE 5: MINERS CAPITAL EXPENDITURE GROWTH



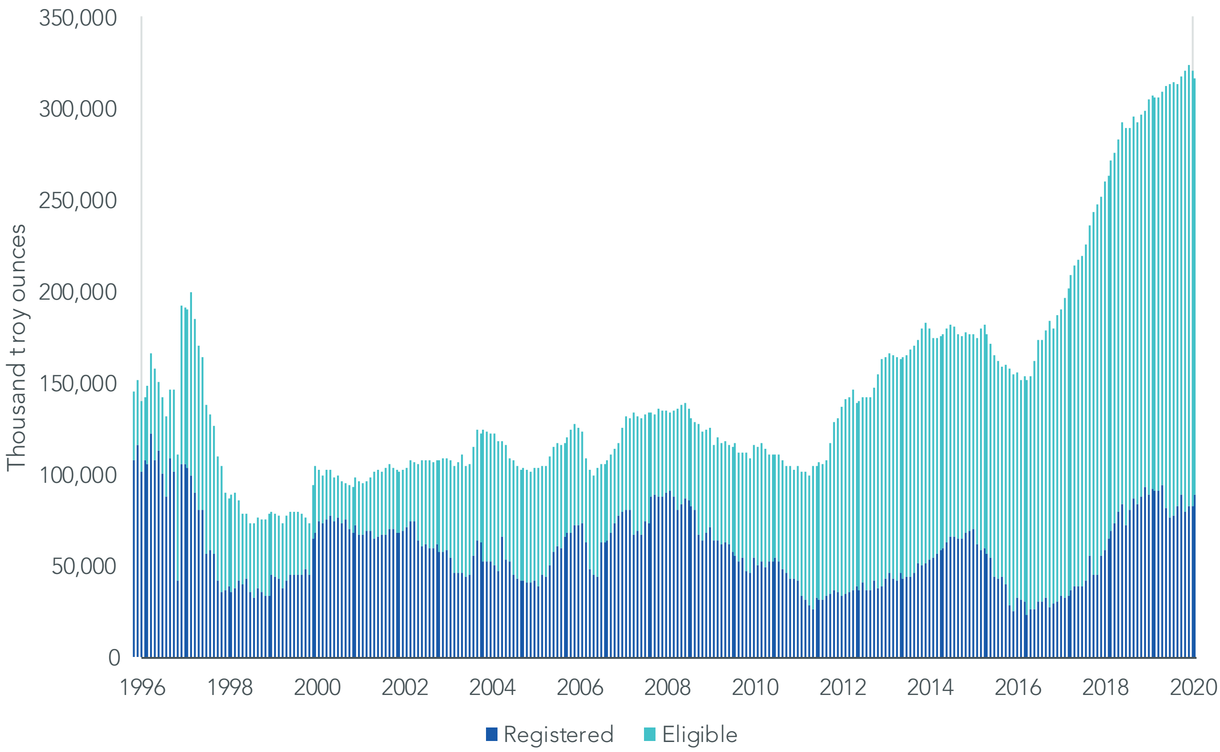
Source: WisdomTree, Bloomberg. Data available as 18 May 2020. ***Historical performance is not an indication of future performance and any investments may go down in value.***

Silver exchange inventory rising

Turning to another supply indicator – silver inventory – we are handicapped by the poor data in global inventory and so we rely on futures exchange inventory as a proxy. Futures exchange inventory has been rising relentlessly in the past few years. Although that is hard to square with the falling mine supply in recent years, it does help account for the relatively weak prices of silver.

We should note that there is a distinction between registered and eligible inventory. Eligible means the metal meets exchange's requirements but has not been pledged as collateral against a futures market transaction. Registered means the metal meets requirements and has been pledged as collateral for futures market transactions. Eligible can easily be converted into registered, and that is why we look at the aggregate. However, most of the gains have come in the form of eligible rather than registered. That could simply be the choice of warehousing more in COMEX warehouses rather than other warehouses. Nevertheless, the greater source of visible inventory has had a price dampening impact on silver. We expect this to continue as a headwind against prices.

FIGURE 6: SILVER INVENTORY



Source: WisdomTree, Bloomberg. Data available as 18 May 2020. ***Historical performance is not an indication of future performance and any investments may go down in value.***

Although silver faces some headwinds from declining industrial demand and potential supply increases, its correlation to gold should act a strong tailwind. While silver's correlation with gold has been poor in recent months, it does appear in the past few weeks that it is regaining. We could find that our assumption on supply increases based on the model's treatments of capital expenditure increases is misleading. Mine supply may, in fact, remain tighter due to COVID-19 restrictions. So, the risk for silver price could be to the upside.

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