

SILVER OUTLOOK: SET TO RIDE GOLD'S COATTAILS HIGHER

October 2018

Silver has had a disastrous quarter, declining 9%¹. The 'hybrid' metal has come under pressure for several reasons: its 80% correlation with gold has dragged it lower, while the industrial metal sell-off has exacerbated market pessimism towards all metals. Speculative positioning in silver futures has fallen to the lowest level since data became available in 1995. However, looking at the recent price declines of both gold and silver, we believe that the pessimism towards the metals is excessive, and that both are positioned for short-covering rallies. Moreover, silver's deep discount to gold could act as a tailwind if prices turn. Although slowing growth in manufacturing and rising exchange inventory could act as a drag on prices, we expect mine supply of the metal to remain tight. Furthermore, silver's use in electronic vehicles and photovoltaic applications are likely to provide strong structural support for demand over the medium term. Based on our model forecasts, we expect silver prices to rise to US\$16.3/oz by Q3 2019, up from US\$14.2/oz at present.

FIGURE 1: SILVER PRICE FORECAST



Source: Bloomberg, WisdomTree, 29 June 2018 to 28 September 2018 i.e. last trading day of each quarter. **Forecasts are not an indicator of future performance and any investments are subject to risks and uncertainties.**

¹ Source: Bloomberg, WisdomTree, 29 June 2018 to 28 September 2018 i.e. last trading day of each quarter.

Model framework highlights upside potential

Using the framework described in our article *Silver outlook: Searching for a silver lining*, our analysis leads us to believe that silver prices have the potential to rise in the near term, with a recovery in the price of gold being the main driver behind our silver price forecast. Having said that, other drivers of price in the framework, namely exchange inventory and manufacturing activity growth, could possibly act as constraints.

Deep discount

Right now, silver is trading at its deepest discount to gold since 1993². Silver has a strong correlation to gold (close to 80% over the past 20 years), but tends to be more volatile, rising more during rallies and falling more in sell-offs. If gold makes a recovery, which we believe it will (see *Gold outlook: upside correction overdue*), we expect silver will rise that bit more – albeit with a lag.

FIGURE 2. HISTORICAL GOLD-TO-SILVER RATIO



Source: Bloomberg, WisdomTree, 28 February 1990 to 21 September 2018. **Historical performance is not an indication of future performance and any investments may go down in value.**

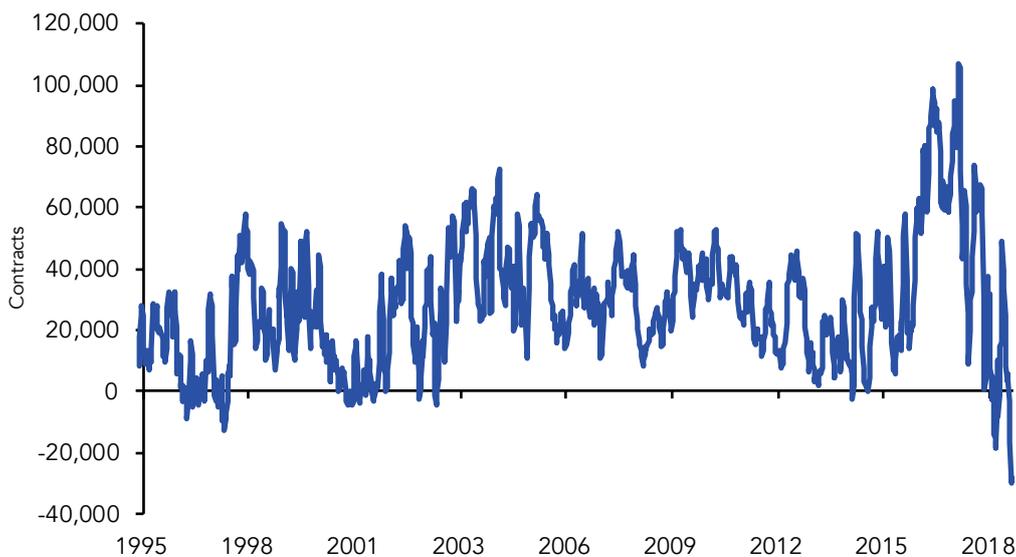
Because silver is a hybrid metal, and has both cyclical and defensive traits, it is often a forgotten asset class. Developed market equity benchmarks such as the Dow Jones Industrial Average and S&P 500 Index posted all-time highs in September 2018, and as a result, investors have lost interest in hybrid metals such as silver. In fact, a sell-off in industrial metals has cast doubts on all metals with industrial traits (more than 50% of silver's use is in industrial applications, in contrast to gold, where only 10% is used in industry). However, we believe that industrial metals are oversold, because the market has focused on demand falling as a result of burgeoning trade-wars, without giving much thought as to how supply chains will be impacted. An upward price correction in gold and industrial metals could act as a catalyst for a rise in the price of silver.

² Source: Bloomberg, WisdomTree, 28 February 1990 to 21 September 2018.

Short-covering rally possible

Sentiment towards silver has been poor recently, as has sentiment towards gold. Pessimism towards silver has been more extreme, with speculative positioning in silver futures having fallen to the lowest level since the data has been available. Yet we believe that short-positions will need to cover at some point, and short-covering activity tends to exacerbate price gains. This could potentially set in motion a rally in the price of the metal.

FIGURE 3. SILVER FUTURES SPECULATIVE POSITIONING

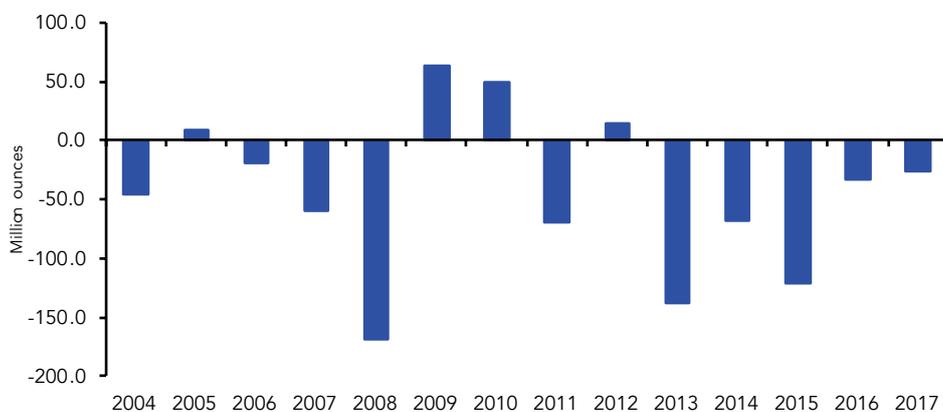


Source: Bloomberg, Wisdom Tree, data available as of close September 2018. **Historical performance is not an indication of future performance and any investments may go down in value.**

Silver is likely to remain in a supply deficit

Silver has been in a supply deficit for the past five years. We believe it is likely to remain in a supply deficit this year, as the mining sector is still operating in the shadow of the dearth of capital investment from 2013 to 2016.

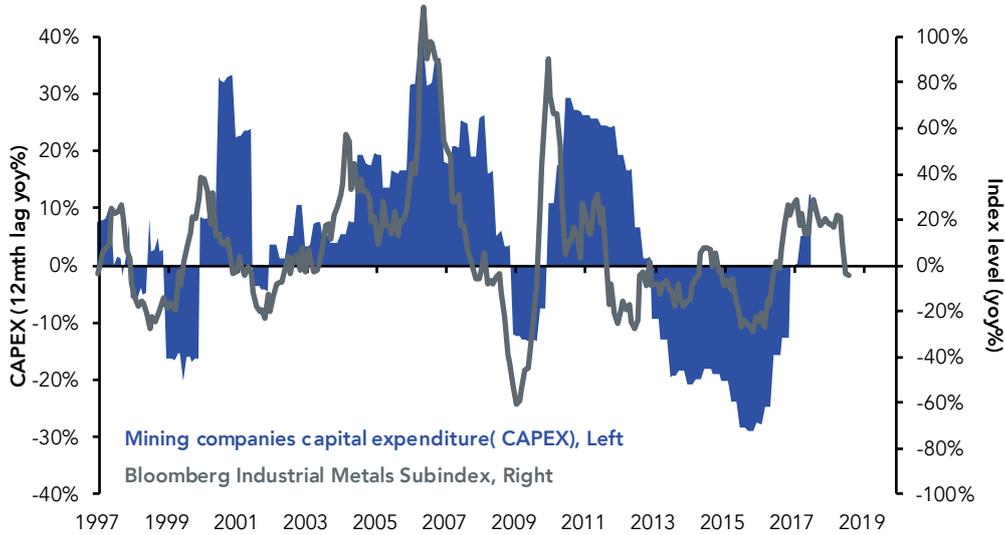
FIGURE 4. SILVER'S SUPPLY-DEMAND BALANCE



Source: GFMS Thomson Reuters, Silver Institute, WisdomTree, data available as of close 12 June 2018. **Historical performance is not an indication of future performance and any investments may go down in value.**

Capital investment has been growing over the past year, but given the lag between increased investment and increased quantities of the metal being mined (18 months in our model framework), we don't expect any significant new supply in our forecast horizon.

FIGURE 5. CAPITAL EXPENDITURE GROWTH

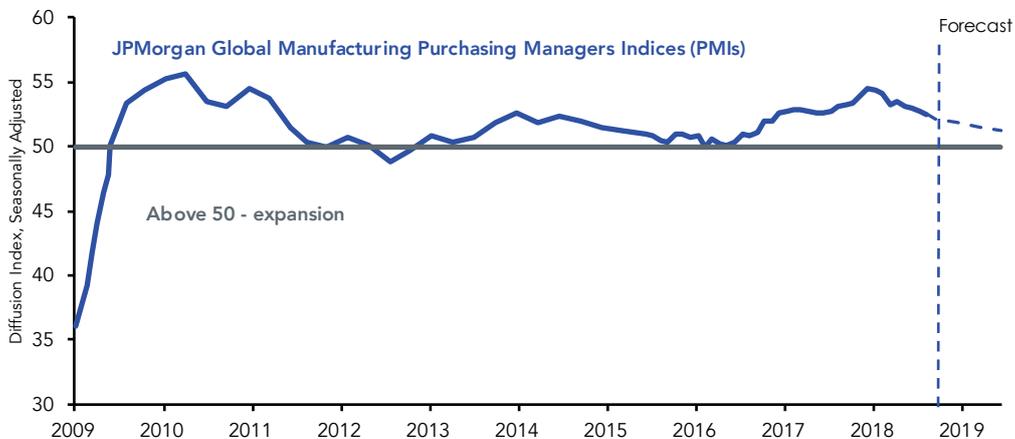


Source: Bloomberg, World Bureau of Metal Statistics, WisdomTree, data available as of close 19 Sept 2018. **Historical performance is not an indication of future performance and any investments may go down in value.**

Slowing manufacturing growth could cap gains

In terms of the gold-to-silver ratio, we don't expect the ratio to return to its historical average in our forecast horizon, as there will be some limitations. Although Global Manufacturing Purchasing Managers' Indices are above 50 and likely to remain above 50 (indicating growth in global manufacturing), they are declining, which indicates that the pace of industrial economic growth is moderating.

FIGURE 6. GLOBAL MANUFACTURING PURCHASING MANAGERS' INDICES

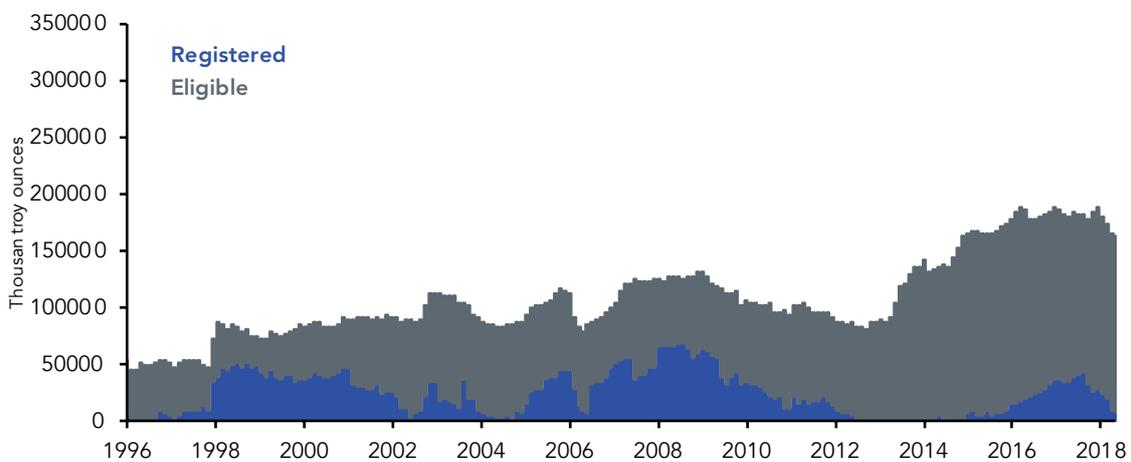


Source: Bloomberg, WisdomTree, data available as of close 21 September 2018. **Historical performance is not an indication of future performance and any investments may go down in value.**

Silver exchange inventory is rising

Analysing silver exchange inventory levels, we have continued to see inventory increases. With silver in a supply deficit, this suggests that inventory outside of exchanges is not rising and therefore, we doubt that overall silver supply is rising. In fact, much of the gains in inventory are of the ‘eligible’ kind, where the metal meets the exchange warehouse’s criteria in terms of purity and weight, but warrants have not been written to indicate that the metal is available for delivery on a futures contract (i.e. it is not registered). So, the rise in exchange inventory could be function of warehousing choice rather than a sign that there is excess inventory. For the purpose of our framework we view inventory increases as silver-price negative, but caution that we could be overly conservative here.

FIGURE 7. SILVER INVENTORY LEVELS



Source: Bloomberg, WisdomTree, data available as of close 21 September 2018. **Historical performance is not an indication of future performance and any investments may go down in value.**

Structural support for silver

Although we only expect silver to recover the ground it lost earlier this year within our forecast horizon, over the medium term we expect more from the metal. As we mentioned in Silver outlook: Searching for a silver lining, there may be a number of structural changes that have not been picked up by the model. Growing silver demand in automobiles and photovoltaic applications could be key catalysts for upward price movements.

CONCLUSION

We believe that silver is likely to ride gold’s coattails higher when a recovery in precious metals takes place. A short-covering rally is also likely given the level of short activity that exists at present. While the covering rally may drive silver’s price temporarily higher than our forecast of US\$16.3/oz for the end of Q3 2019, there are some constraints that could cap price gains, namely decelerating manufacturing growth and rising exchange inventory. Our medium-term view on silver is constructive, although it falls outside of our model framework.

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