Will Silver Prices Rally Soon?

Description

The price of silver has softened by 2.3% since the start of 2014. Yet the price of gold has rallied, spiking a healthy 5% over the same period. This is contrary to the historical correlation that has existed between the two metals, with silver typically following gold. We have seen a key measure of this correlation, the gold-to-silver ratio, continue to widen. The gold-to-silver ratio represents the number of ounces of silver required to buy one ounce of gold.

There are those who argue the ratio should sit somewhere between nine and 19, representing both where the ratio has sat historically and the natural occurrence of silver compared to gold. But with the ratio having topped out at 100 twice in the last 40 years, once in 1980 and again in 1991, it is a fluid measure of the value of silver in comparison to gold.

What do the indicators say about a silver rally?

The gold-to-silver ratio has widened by five points, from 62 at the start January this year to almost 67. But more astonishingly, over the last two years the ratio has widened by 12 points.

There are other indicators supporting the idea of a silver rally.

Global silver supplies have declined since 2010, dropping 9% to 978 million ounces at the end of 2013, yet demand for silver has continued to grow. From 2010 to 2013, physical demand grew by 5%, and over the last 10 years demand has grown a massive 18% to 1.08 billion ounces annually.

There is also increasing demand for silver from India and China. It’s appreciated not only as a store of value and a hedge against inflation but also as an important component in jewelry and many industrial processes. In 2013 alone Asian industrial demand for silver grew 3%, led by China, where a recovery in the electrical and electronics sector drove increased demand. Both economies are expanding rapidly and their demand for precious metals, including silver, can only continue to grow over the long term.

All of these indicators signal silver is set for a healthy bounce during 2014, and has truly entered oversold territory. But there is no guarantee this will become a sustained long-term rally: Better-than-expected global economic growth, the Fed’s unwinding of quantitative easing, and growing Chinese industrial activity are all applying downward pressure to precious metal prices.

Which company is best positioned to benefit from a bounce in silver prices?

Over the last two years, silver miners have been punished by the market, with silver prices plumbing new lows not seen since 2010. For the year to date, **First Majestic Silver's** (TSX: FR)(NYSE: AG) share price has plunged 13%, while precious metal streamer **Silver Wheaton's** (TSX: SLW)(NYSE: SLW) share price has remained flat.

But **Pan American Silver** (TSX: PAA)(NYSE: PAAS) has bucked the trend with its share price jumping a healthy 7% for the same period. This is despite the company's first quarter 2014 net earnings per share falling by a massive 62%.

First Majestic's earnings per share for the same period also fell spectacularly, plunging 74%, whereas Silver Wheaton's dropped by only 35% in comparison.

But it is Silver Wheaton that remains the best option of the three for investors seeking to profit from a rally in silver. This is because it's a precious metals streaming company, which is not required to make the capital expenditures associated with exploration and mine development in order to ensure sustainable production. It also doesn't have to incur any of the operational expenses associated with mining, meaning it has far lower overheads than the silver miners.

This means any significant bounce in the silver price will more significantly boost Silver Wheaton's bottom line than those of Pan American, First Majestic, or other silver miners. It also has another important benefit for investors in that it's capable of remaining profitable at far lower silver prices than any of the miners. which gives it a competitive advantage.

But it does appear expensive compared to the silver miners, with an enterprise value of 16 times its EBITDA, compared to eight times for Pan American and nine times for First Majestic. This ratio is also more than double the EV-to-EBITDA ratio for its peer group, indicating that the market has factored the company's competitive advantage into its share price. However, it is a lower-risk investment than the silver miners.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:AG (First Majestic Silver)
2. NYSE:PAAS (Pan American Silver)
3. TSX:FR (First Majestic Silver)
4. TSX:WPM (Wheaton Precious Metals Corp.)

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