The Gold-to-Silver Ratio Widens: Is it Time to Buy Silver Miners?

Description

Gold has rallied sharply to be trading at well over the psychologically important US$1,200 a mark, although it is still down by 7% for the year to date. Surprisingly for many investors, gold's poor cousin silver has failed to keep pace having lost 15% for the same period. This has caused the gold-to-silver ratio, which measures how much silver is required to buy one ounce of gold, to widen significantly in recent months.

Almost 84 ounces of silver is needed to purchase an ounce of gold compared to only 75 ounces a year ago. The ratio is well above its average over the last 100 years, which analysts claim to be around 55 ounces. This indicates that silver is heavily undervalued relative to gold.

As a result, many fans of the white metal claim that now is the moment for investors to boost their exposure to silver. Because many silver miners have fallen sharply in value over the last year to see the **Global X Silver Miners ETF** down by 25% many believe that now is the time to acquire quality silver mining stocks. While there may be some historical validity to those assertions, there are growing signals that the gold-to-silver ratio and the relationship between the two precious metals may not be as important as it used to be.

Now what?

A key issue is that silver, unlike gold, possesses considerable utility, which means that a whopping 59% of all physical demand for the precious metal comes from industry, whereas in the case of gold that demand only amounts to a paltry 8%. This means that the price of silver is unlike that of gold, which is fundamentally a precious metal is subject to industrial consumption of the metal.

There are emerging concerns that global economic growth is slowing because of rising trade tensions and firmer oil. Already, the International Monetary Fund (IMF) recently downgraded its 2018 forecast world GDP growth rate by 0.2% to 3.7%. Global money managers are also becoming pessimistic about the economic outlook. According to a survey undertaken by Bank of America Merrill Lynch, more than a third of respondents expect economic expansion to slow heading into 2019, while 85% believe that global growth is in its late stages, meaning that a downturn could be on the way.

Those demand pressures are being magnified by growing supply. Despite overall silver demand declining sharply over the last decade, mining supply has expanded at a solid clip to be 24% higher in 2017 than it was for 2008. All of these factors are combining to suppress the white metal's value, indicating that silver's traditional closely correlated connection to gold is deteriorating.

So what?

For the aforementioned reasons, the gold-to-silver ratio appears to hold significantly less relevance than it has in the past and silver is not as heavily undervalued as some pundits claim the ratio indicates. Even claims of silver trading at US$14.60 per ounce, it is below the cost of production for many primary silver miners, meaning that they will shutter uneconomic operations thereby curtailing supply, appear to be incorrect.

Historically weak silver prices have not led to lower mine production. In 2015, when silver averaged US$15.68 per ounce, supply from mining was 5% greater than it was in 2017 when its annual mean price was US$17.05 per ounce. There are many reasons for this, but key is that many miners because of substantial by-product credits from gold and base metal production are reporting exceptionally low AISCs.

For the first half of 2018, **Pan American Silver Corp.** (TSX:PAAS)(NASDAQ:PAAS) reported AISCs of US$6.71 per silver equivalent ounce produced, which is less than half of silver's market price. While this includes by-product credits, it is unlikely they will fall significantly in value even if silver remains weak, as gold and base metal prices are firm and higher than they were when silver last slumped to below US$15 an ounce.

Another important aspect is that around 70% of all silver produced is a by-product from extracting other metals such as gold, zinc, lead and copper. With gold trading at over US$1,226 per ounce, bolstering the profitability of an industry where the marginal cost of production is estimated to be at around US$1,080 an ounce, gold miners are focused on boosting production to take advantage of higher prices.

A similar phenomenon is underway among base metals miners regardless of the recent downturn in lead, zinc and copper prices. This is because prices are still well above the lows experienced during the last base metals slump meaning those miners are determined to bolster cash flows from greater metals production.

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Author
mattdsmith