



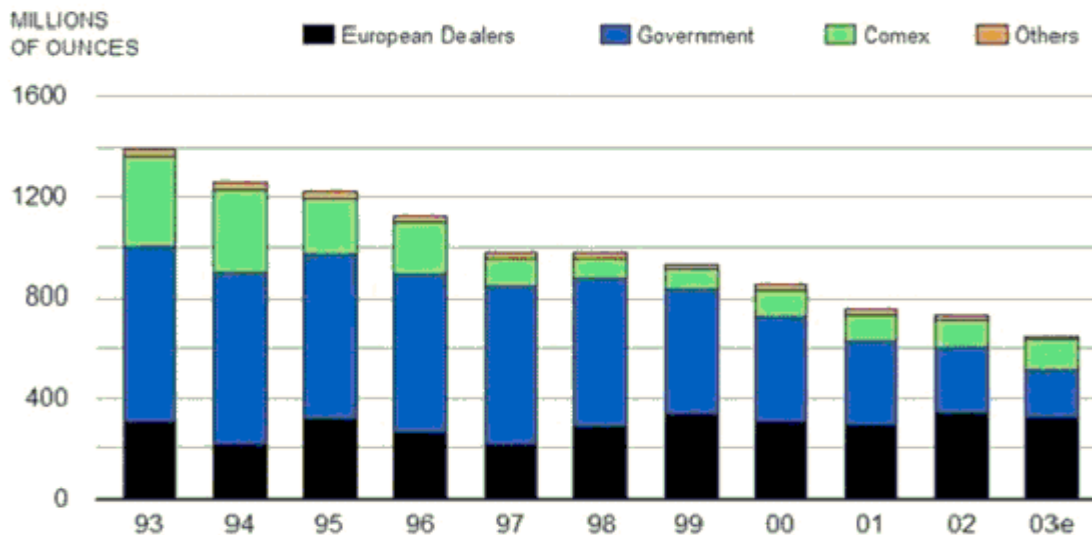
# THE TEXAS HEDGE REPORT

Current Issue: September, 2004

## GOLD WILL RISE, BUT SILVER MAY SKYROCKET

Todd Stein & Steven McIntyre  
*The Texas Hedge Report*  
September 27, 2004  
Courtesy of [www.texashedge.com](http://www.texashedge.com)

We think that silver is a once in a lifetime opportunity to participate in the meteoric rise of a dramatically undervalued commodity. The real story on silver is the massive inventory depletion that has taken place over the last decade as depicted in the graph below. Since 1991, the above ground silver supply has declined from about 1.4 billion ounces to an estimated 600 million ounces (130 million of which legendary investor Warren Buffett may or may not still own from his 1998 purchase). Silver deficits now run between 50-100 million ounces per annum. 130 million ounces and possibly much more of the roughly 500-600 million above ground ounces are owned by investors like Buffett, who have no intention to sell anytime soon. In all likelihood, less than 350 million ounces are available to fill supply deficits at anywhere near current prices. We are running at critically low silver reserves and it is entirely possible that some time in the next few years that silver shortages may occur.



Source: Silver Institute

The only way to bring the supply/demand in balance for silver is higher prices. This is where the dynamics of the silver market become very exciting for silver bulls. Silver has a dual role as both an industrial metal and a precious metal. The majority of silver's

current demand (560 million of 840 million ounces) comes from industrial and photographic uses due, in part, to its high conductivity. The rest of the silver demand is filled in by jewelry, silverware, and coinage. Investment demand in the last few years has been minimal but is picking up as concerns about the U.S. dollar abound. Silver supply is perhaps an even more intriguing situation. 65% of silver mine production is the by-product from copper, zinc, and lead mines. Only 35% of silver demand comes from pure silver mines and from gold primary mines where silver is a by-product. This interesting dynamic sets the stage for a potentially explosive move higher in the silver market.

We believe silver will do well, even if we are wrong about the economy's weakness to come. In a strong economic scenario, a resurgent industrial and electronic demand should propel silver demand higher, creating 50-100+ million ounce annual deficits, which should force prices significantly higher as inventories are depleted. Even better for silver would be the weak economy scenario, which we believe is destined to occur. In that scenario, silver's unique supply characteristics could cause a very large price increase. As strange as it may sound, zinc, copper, and lead prices are the primary driver of silver production in the form of by-products. Zinc, copper, and lead are base metals used in broad ranges of industrial production applications. These base metal mines (65% of silver mine supply) will produce more silver when the economy is doing well and less when the economy is struggling and base metal prices are depressed.

In a weak economic scenario, you could see many base metal producers shutter production and as a consequence, the world silver supply would decrease. At the same time, a weak U.S. economy may lead to a weak dollar, which spurs investment demand for both gold and silver due to the monetary nature of the two precious metals. In such a scenario of declining silver production and rising demand, the price increase required to bring on material amounts of silver supply could be quite large. To quote Warren Buffett, "and because...demand is...relatively inelastic, we don't think [that the] price change required to reestablish an equilibrium between supply and demand would necessarily be minor."



Both gold and silver have long been neglected commodities, but we believe they are still in the early stages of a secular bull market for precious metals. We think that gold could again challenge its early 80s highs of 800 bucks an ounce. But, as

bullish as we are on gold because of its constrained mine production and the continued debasing of all fiat currencies (particularly the dollar), **we believe the move up in silver could be several times higher than gold.** And in what we believe is a very unlikely scenario of the economy and the dollar doing well in the next few years, silver will hold up much better than gold because of the tightness in supply/demand and its industrial nature.

We appear to have another catalyst coming in 2004-2005 to drive the silver price higher. A silver ETF (Exchange Traded Fund) is in the works of being introduced. A gold ETF is slated for late 2004, and once it is done, the Silver Institute intends to follow suit. Estimates we have seen floated of up to 200 million ounces in demand seem quite possible to us (you have got to remember just how difficult it has been for individual investors to buy, transport, and store silver in the past).

The chart to the right shows the net asset value for the 10 largest U.S. ETFs. It is illogical to think that a gold or silver ETF might have anywhere near the investment interest of the S&P 500 or Dow or even the Russell 2000. That said, we do not think that the investing public's demand for the "Russell

<b>Ticker</b>	<b>Index Tracked</b>	<b>(in billions) Net Assets</b>
SPY	S&P 500	\$ 43.3
QQQ	NASDAQ 100	\$ 21.2
IWV	S&P 500	\$ 8.4
EFA	MSCI EAFE (foreign large blend)	\$ 7.2
DIA	Dow Jones	\$ 6.9
MDY	S&P MidCap 400	\$ 6.5
EWJ	MSCI Japan	\$ 4.4
IWM	Russell 2000	\$ 4.0
VTI	Wilshire 5000	\$ 2.9
IWD	Russell 1000 Value	\$ 2.7

1000 Value" index is extremely high yet it has \$2.7 billion in net assets. Why couldn't a gold ETF have investment demand at least high as the Russell 1000 Value Index? And why couldn't a silver ETF be perhaps one third the size of a gold ETF? At that rate, the silver ETF would be \$900 million in size and at a current price of \$5.56 an ounce that would chew up roughly 160 million ounces of silver (about two years worth of annual supply deficit cushion gone). The great thing about a silver ETF is that we do not think that it would drain much demand from other silver assets, but rather be additive as individuals who didn't take the time to buy silver in the past (because of the hassle) can now push a button on E-trade and own silver. If the silver ETF takes off, all of the sudden you might have less than a year's above ground supply to fill the deficit and there is no practical way that additional mine supply can come on-line that quickly. Throw on the uniquely bullish fundamentals of silver itself and it is easy for us to be bullish on the grey dog when everyone else seems to be so bearish.

September 27, 2004

Todd Stein & Steven McIntyre

Texas Hedge Report

Todd Stein & Steven McIntyre are internationally known analysts and editors of *The Texas Hedge Report*, a market newsletter that highlights under and overvalued securities in the equity, bond, currency, and commodity markets

For more information, go to <http://www.texashedge.com>