Fool's silver?

Posted by Colin Barr

March 28, 2011 6:35 am

The price of the poor man's gold has doubled over the past year, putting it at a 30-year high. How long can it keep going?

The rally puts silver up 21% this year at a recent $37 and change – a level it hasn't seen since the Hunt brothers tried to corner the market in 1980. Responding to surging interest, the Chicago Mercantile Exchange recently **raised margins** on silver, forcing those who are financing their holdings to chuck in some more cash.

Taking off?

Not that a mere margin adjustment is likely to stop the momentum in the most volatile precious metal.

"Silver gets untethered and it can just skyrocket," said Tom Winmill, who runs the Midas fund that buy stock in gold and silver producers. His Midas Perpetual Portfolio fund owns shares in both the SPDR Gold (**GLD**) and iShares Silver (**SLV**) exchange traded funds. "It could go anywhere from here now."

Why is silver so hot when gold is up just 1% for the year? Winmill says traders are crowding into the thin market for silver in a way not seen in years.

Like gold, silver benefits from the perception that irresponsible central bankers are intent on dooming paper currencies – a view that endures even as policymakers in Europe consider rate hikes and the Fed approaches the end of its unpopular bond-buying program.

But unlike gold, silver trades in a relatively thin market where prices are apt to spike when sentiment is positive and plunge when it isn't.

Even at the elevated prices prevailing now, the annual output of global silver mines is worth just $27 billion or so, says Winmill. That's the size of a good-sized but certainly not giant public company, such as, say, Dell (**DELL**). That means there is a small doorway for a huge number of people to squeeze through when silver gets hot.

"Imagine having the entire world speculate on what's going on at that one company," says Winmill. "That's what's going on lately in the silver market."

The surging silver price has spurred interest not only in the markets for silver itself but also in the shares of the more speculative precious metals producers. Winmill says a good way of measuring the level of eyes-closed betting on metals appreciation is to look at stock-trading volume on the TSX Venture Exchange.

It's a Canadian market that specializes in companies that have sold shares without ever having turned a profit, and whose shares accordingly trade in the Canadian pennies. A favorite name in recent months has been Seafield Resources, a gold mining company that has accumulated a deficit of more than $6 million since 2003.

Average daily volume on the TSX Venture was around 160 million shares in July, a level Winmill says suggests little speculative activity. But with the Fed announcing its plan to support the economy at all costs the next month, volume went through the roof.

Volume approached 200 million shares in August before surging to 320 million in September, 360 million in October and November and 390 million in December, according to TSX data. It hit 458 million shares last month, of which Winmill says, "We are way up in frothyville there."

Sell signal?

Silver's rally has been so determined, and the gold price so lackadaisical, that it now takes just 39 ounces of silver to buy an ounce of gold (see chart, bottom right). That's half as much as at the ratio's recent high during the 2008 financial crisis and the first time in more than a decade it has taken fewer than 40 ounces of silver.

Some precious metals obsessives say you should trade into gold at 40 and into silver above 60. Trading based on ratios is a notion Winmill dismisses as "witchcraft." But at this point all bets are on, so why rule anything out?

"We could have significant upside from here in silver, but I don't think assuming that is a very good idea," Winmill says. "You'd might as well go to Aqueduct."

Also on Fortune.com: