Ian Williams, chief executive officer and fund manager at Charteris Treasury Portfolio Managers, says now is the time for investors to profit from 'bombed out' silver and metal assets

Silver and gold: 'Bombed out' and uniquely cheap

Gold and silver assets are at acute levels of comparative cheapness, sitting as they are at 50-year extremes relative to other sectors of the global equity market.

The large-cap base metal miners are also trading at extreme levels of relative cheapness, but even they are not as 'bombed out' as the gold and silver miners.

Rio Tinto

Rio Tinto is a case in point. It is a good example of just how cheap the large-cap miners are currently. At a price of £32 a share, the company's stock is less than half the £70 a share it reached in May 2008, just prior to the crash.

All other sectors of the UK equity market have now recovered, or surpassed the previous highs, while the miners languish at their current levels.

Rio Tinto now yields more than 4% against a 10-year gilt yield of 2.8%, having just increased its dividend by 15%. The company is in rude health, despite recent writedowns, which were the result of overexuberant expansion plans in the boom.

It is also expected to greatly benefit from the rally in base metal prices, which looks to have set fair in recent times. This is the cheapest sector of the UK equity market, and that is why these stocks represent the largest overweight position in our own fund.

Gold or miners

Meanwhile, gold and silver assets are trading at even cheaper levels than the base metal miners.

It could be argued they offer the greatest upside potential of all, albeit with higher risk, as the individual companies involved tend to be much smaller than mining giants like Rio Tinto.

Gold shares are obviously dependent on the gold price. So, following the two-year bear market, during which time the price of gold fell from \$1900 an ounce in May 2011 to a low of \$1180 in June 2013, what is the outlook for gold and silver assets?

Firstly, the two-year downward move should be viewed in the context of a previous nine-year continuous upward move, which began in 2002 and 2003.

This previous low, just after the turn of the century, fits in with the 10-year cycle in gold and silver, which sees a major low established in the second or third year of the decade. This decennial cycle bottomed on 28 June 2013, and a sharp rally is expected to be seen over the next few years, in line with the historical precedent established at every previous 10-year cycle low.

"Gold and silver assets are trading at even cheaper levels than the base metal miners. It could be argued they offer the greatest upside potential of all, as the individual companies involved tend to be much smaller than mining giants"

If, for example, we look at the 10-year cycle in silver, we can see the weakest bounce off the 10-year cycle low was in 1993, and this produced a mere 300% increase. Contrast that with 1972, which produced a mind-boggling 36 fold increase – from \$1.50 an ounce to \$49 an ounce before the cycle peaked. The average bounce of this cycle works out at around 700% to 800%, which would take silver from its current \$20 an ounce to around \$150 an ounce.

Any move in bullion on this scale would trigger even greater percentage movements in the shares of the gold and silver mining companies, due to their operational gearing and the extreme relative cheapness of these mining companies. Those companies are not just cheap relative to other sectors of the equity market, but also cheap relative to the bullion itself.

Supply and demand

The supply and demand picture for bullion also looks very positive. Global gold mine output is around 2,200 tonnes net supply to the market, while demand from just two countries (China and India) is expected to account for more than 2,000 tonnes this year and every other year.

Other Asian buyers, Thailand and Vietnam for example, also have a voracious appetite for gold.

The 700 tonne selling by US ETF holders, which kicked in last year, has now dried up. This finite supply of gold onto the market looks to be at an end.

Price rises

It is difficult to see how the excess demand over supply, which is inherent in the market at the current price, can be maintained without a substantial up move in the price. As the effective replacement cost of gold is \$1,500 an ounce (the breakeven rate to build a new mine), no new mines will be built to meet this Asian demand until gold rises far in excess of \$1,500 an ounce.

Therefore this is a somewhat unique opportunity to profit from a bombed out asset class, which offers substantial upside on any bounce-back.

Of the precious metal family, silver is certainly much more volatile than gold, and it can be expected to rise higher and faster in a bull market.

In that scenario, a fund weighted in favour of silver should trigger significant outperformance relative to one laden heavily in gold.