Revised Edition *Fall, 2019*

Silver for Pennies-on-the-Dollar

Silver is known as "the poor man's gold" because it has nearly always been cheaper than gold. There is approximately 19 times more silver in the earth's crust than its yellow cousin, so it is not surprising that silver is cheaper. Back when both were money, this ratio didn't stray far. It generally took 16 to 25 ounces of silver to buy one ounce of gold. The relationship ended when President Nixon pulled the US out of the Bretton Woods Agreement, severing gold's connection to the US dollar. Since then, it has taken anywhere from 32 to 98 ounces of silver to buy one ounce of gold.

What is surprising is just how cheap silver has gotten in relation to gold. The chart below shows how many ounces of silver it takes to purchase one ounce of gold going back to 2001. **Silver is more volatile than its richer cousin, rising far faster in bull markets and declining much more in bear markets**. Because of this, the gold / silver ratio tends to be inversely correlated to the overall trend in precious metals. It peaks at the bottom of precious metal bear markets and bottoms at the peak of bull markets.

Date Source: FutureSource

In May of 2019 it took 92.50 ounces of silver to buy 1 ounce of gold, making the gold / silver ratio the highest since early 1991. Then it took nearly 98 ounces of silver to buy one ounce of gold and silver dipped as low as $3.50 per ounce. **High gold / silver ratios tend to correspond closely with low silver prices while low ratios tend to correspond with high**

silver prices. The ratio dropped as low as 33 ounces of silver to buy one ounce of gold in 2011. This corresponded with a soaring silver market that topped out at nearly $50 per ounce.

What the gold / silver ratio appears to be telling us now is silver is extremely undervalued vis-à-vis its historical relationship to gold. Silver could be a better bet should the current bull market in gold continue. We expect it will.

Silver Has Been Frustrating For Bullion Holders

The last three years of sideways price action have been frustrating for the bulls. **Silver is unloved and forgotten. But as the chart below illustrates, it is also extremely cheap on a long term basis. This could make the coming months frustrating for the bears.** Bull markets in silver are almost never caused by traditional supply / demand concerns. Investment demand and hoarding are the catalysts of nearly every silver bull. Silver is the "poor man's gold" for a reason: investors tend to buy it because it is a cheaper alternative to gold. This makes its relationship to gold important.

Data Source: Reuters

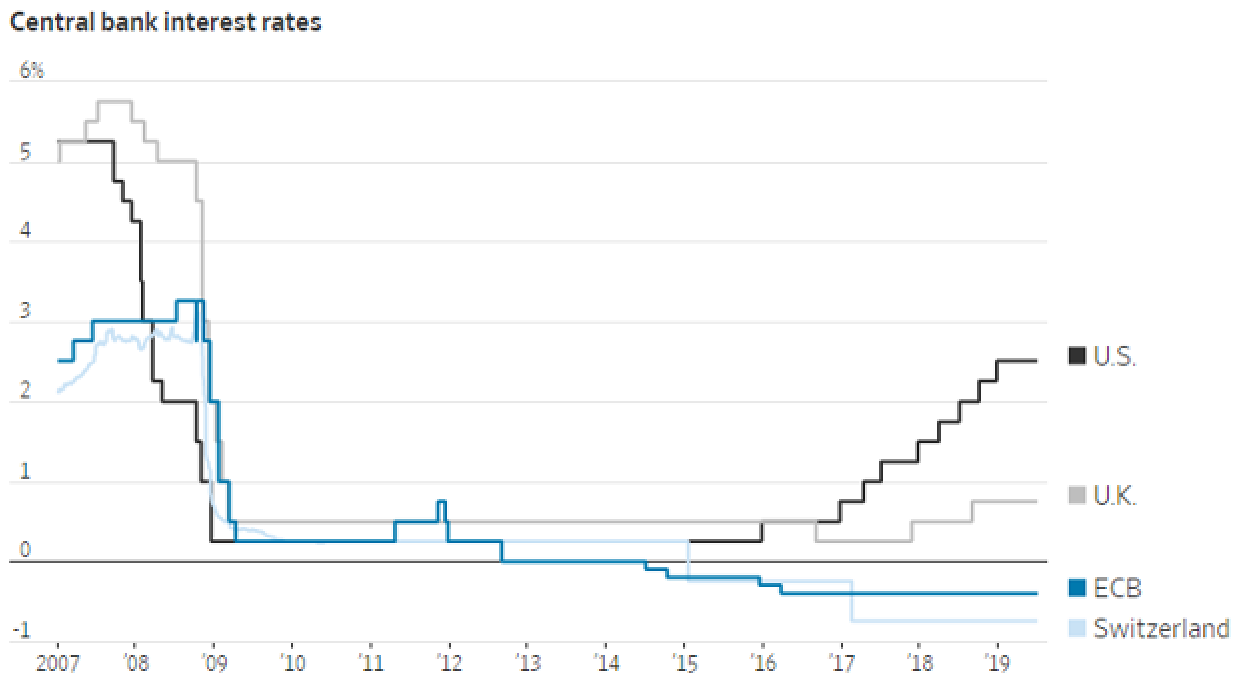
Stuck in a sideways pattern since 2014, silver has been oscillating between support at roughly $14.00 per ounce and resistance at $21.00 per ounce. This turns holding silver into dead money at best. **Investors owning a substantial amount of physical silver are not only paying storage costs, they are missing out on interest to be made in this higher-rate environment. Investors are losing both money and opportunity.**

But what if there was a way to keep upside exposure to silver without the costs of storing and insuring it? What if you could also earn interest on the side – even in a "worst case" scenario? We'll explore such a strategy later in this report and show you how **it's possible to "rent" silver for pennies on the dollar, freeing up capital to earn risk-free interest**

elsewhere. But before we get to the strategy, let's take a look at why silver is so cheap, both an absolute basis and in its relationship with gold.

Why Is Silver So Cheap?

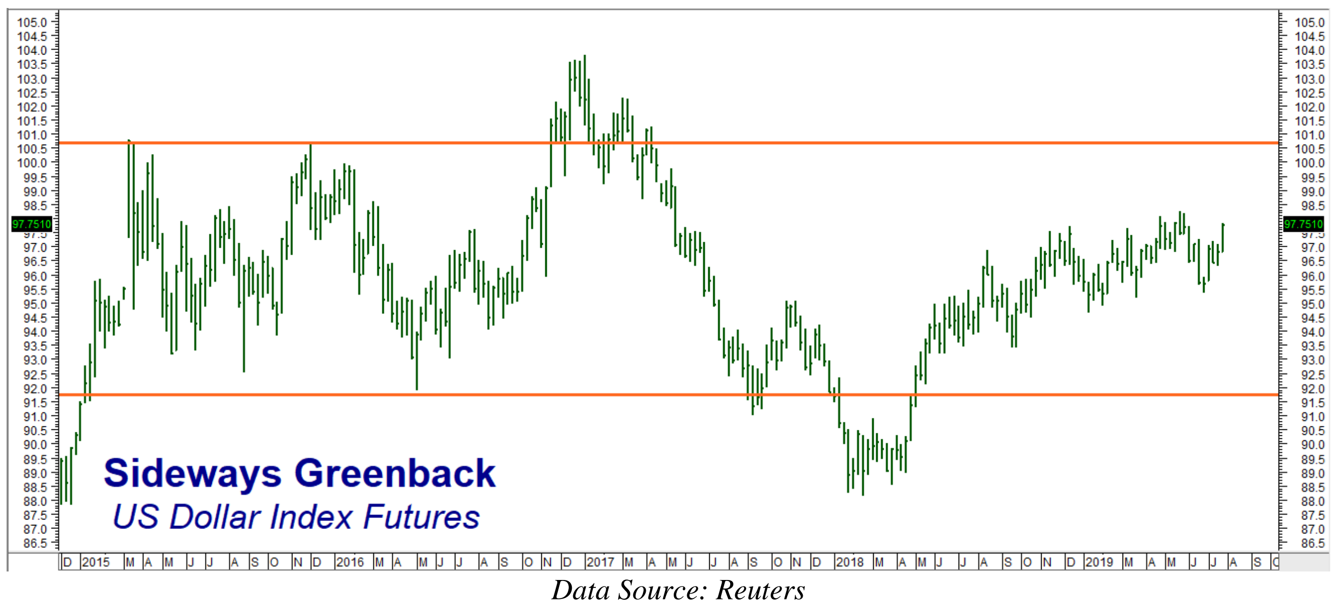
It starts with higher relative interest rates in the US. As the chart below illustrates, central bank interest rates in the US are much higher than those in most of the developed world. Higher relative interest rates increase the opportunity cost of holding physical silver and gold (which earn no interest). Higher interest rates in the US also help to prop up the US dollar. Capital will chase the highest returns.



Both the European Central Bank (ECB) and Switzerland have negative interest rates. This means investors are literally paying these central banks for the privilege of holding their money. In July the ECB announced its intention to lower rates even further, making the dollar even more attractive versus the British pound, the euro and the Swiss franc.

A strong dollar impacts silver because it takes fewer of them to buy the same amount of silver. Silver may have declined versus the dollar – but it has soared in Turkish lira, Russian rubles, Iranian rials and Argentine pesos as those currencies have collapsed due to financial mismanagement, US sanctions, or a combination of both. Add in an attractive bull market in American stocks, and it's easy to see why the poor man's gold gets no respect.

However, many of the factors behind silver's malaise are showing signs of change. Let's start with the US dollar…



Data Source: Reuters

The Federal Reserve has raised interest rates numerous times while Europe kept theirs at a negative yield. One would have guessed that the widening gap between American interest rates and Europe's would have sent the greenback rocketing higher. But that didn't happen. The dollar went nowhere. It has been oscillating between 100 and 90 since 2015 and is trading right in the middle of this range as we write this.

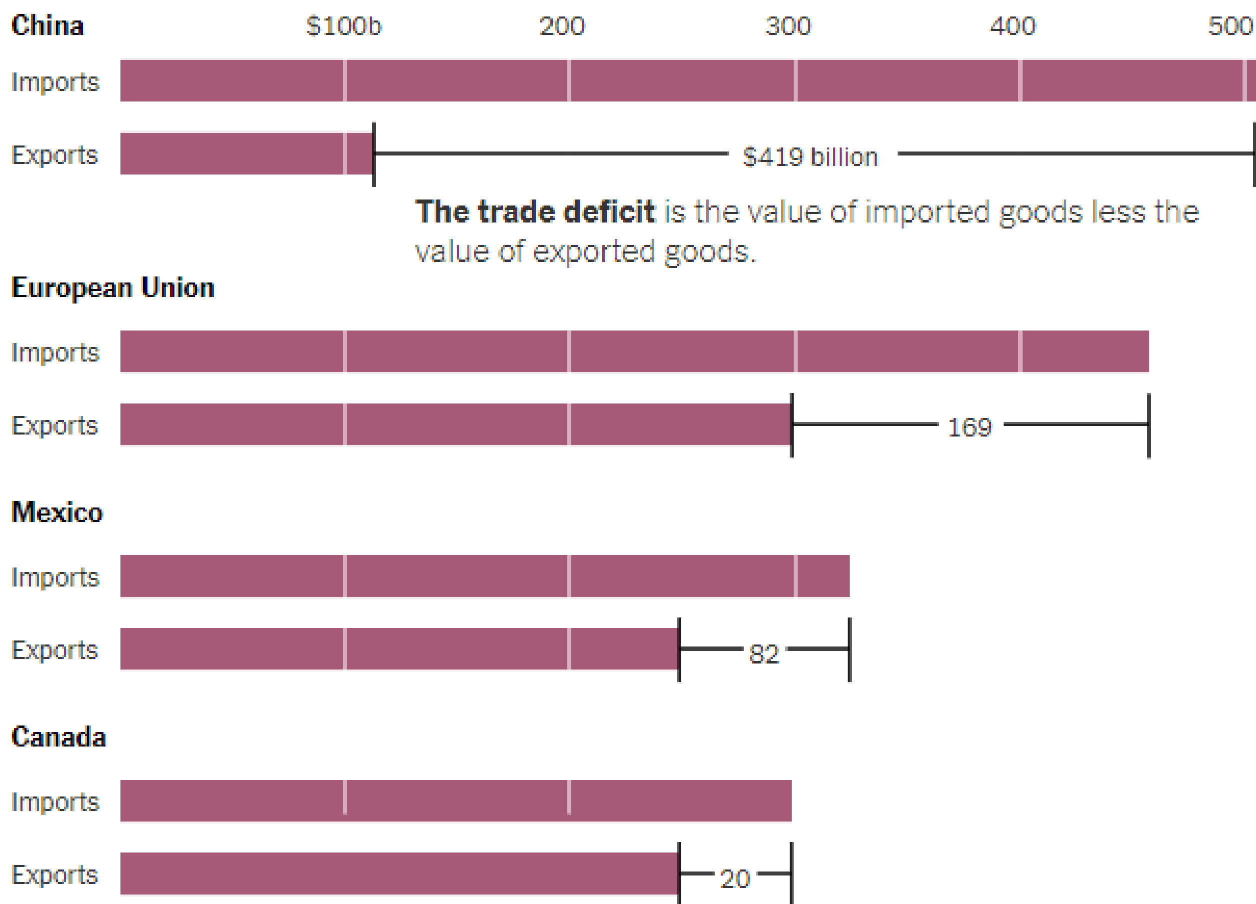
What is holding it back? The Trump Administration has been clear on its preference for a weaker dollar. The Fed now appears to be playing along, announcing its intention to begin reducing interest rates this year despite the strong American economy and record-setting stock market. Could their goal be to match Europe's easing and avoid further appreciation of the dollar? We think so.

Whatever the reason, the dollar hasn't budged despite Mario Draghi and the European Central Banks decision to dust off their bond-buying Quantitative Easing (QE) operations and reinforce Europe's already-negative interest rate environment. **The US dollar should be soaring in this environment, but it isn't. Something is holding it back.**

Exploding Trade Deficit Could Spur Action on the Dollar

What is certain is, despite negating its bull market and five-year sideways drift, the dollar is still too strong to put any kind of dent in the trade deficit that has plagued the US for decades. **The trade numbers for 2018 are in, and they are not pretty.**

"America's trade deficit in goods with the rest of the world rose to its highest level in history last year as the United States imported a record number of products, including from China, widening the deficit to $891.3 billion and delivering a setback to President Trump's goal of narrowing that gap." New York Times, March 6, 2019



The problem with tariffs is they reduce China's demand for American goods at the same time the strong dollar encourages Americans to purchase Chinese goods, even with tariffs. If President Trump wants a "win" on trade, he is going to need to campaign harder for a lower dollar. A lower dollar is bullish for commodities in general, and for silver in particular.

Silver Has a Split Personality

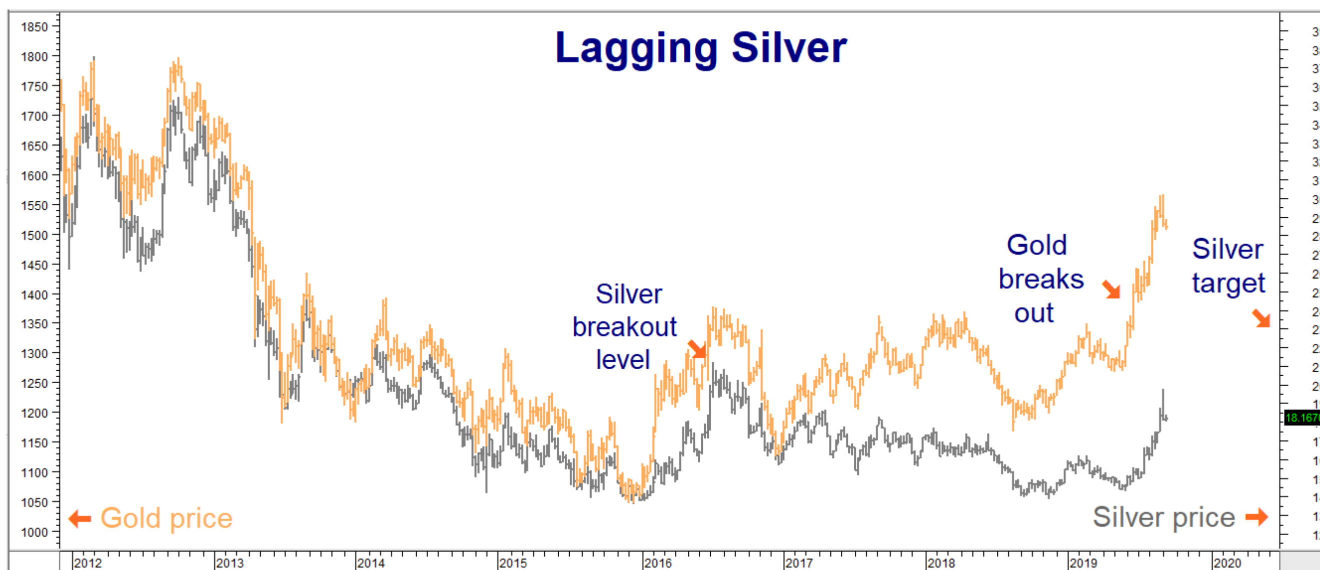
Unlike gold which is basically seen as a financial metal because of its history as a store of value, silver has a spilt personality; it an industrial metal as well as a financial metal. How investors see it nearly always determines its fate. It tends to do poorly when viewed as the

former and to do well when viewed as the latter. This split personality makes silver hard to value.

Stockpiles of gold held in warehouses and by central banks are fairly easy to calculate. Gold tends to stay put. Stockpiles of aboveground silver are nearly impossible to pin down due to industrial demand. Gold may be 19 times rarer in the earth, but some estimates peg aboveground gold as 5 to 7 times more abundant than silver. Surprisingly enough, industrial demand rarely determines the price of silver while investment demand nearly always does.

Investors seek out silver as a cheaper way to take advantage of rallies in gold. Silver is not as liquid as gold which means each rush of new buying has an outsized effect. This lures even more investors into the market in a positive feedback loop that causes silver to rally faster and further than gold in well-established bull markets. The same dynamic works in reverse in precious metal bear markets.

The more silver becomes as an alternative to gold, the higher it tends to go on a percentage basis. This is why the gold / silver ratio is so important. It tells us exactly where this dynamic is at any given point in time. "Lagging Silver" (below) is another way to look at the relative price dynamics of gold and silver. It illustrates the recent price histories of both in the same chart. Gold's price is on the left. Silver is on the right.



Data Source: Reuters

Notice how closely gold and silver tracked until early 2017, and how much they have diverged since then. Gold broke out of its 5-year trading range in late June and appears to be consolidating for a move higher. Silver still has a long way to go to do the same. This tells us that until very recently, the market was viewing silver as an industrial metal.

Silver's relative underperformance vis-à-vis gold coincides almost precisely with the first shots fired in the ongoing trade war with China. Tariffs nearly always cause a global slowdown. Industrial metals suffer in slowdowns. But things may be changing. Silver took out old swing highs two weeks ago for the first time since May 2017. This is even more impressive when you consider that it had virtually no help from the dollar. Could the poor man's gold finally catch up to its richer cousin? It needs to clear $21.22 to break its sideways pattern. We think it will.

Silver Has Lots of Catching Up To Do

Two scenarios could cause silver to soar. **The first is a continuation of the powerful rally in the gold market.** Silver is tethered to gold and like a rubber band stretched too far, could snap back once investors believe the rally in gold is for real. As the chart above illustrates, the poor man's gold certainly has a lot of catching up to do. Gold has already broken out of its 5-year trading range. Our $23.00 per ounce target could be just the beginning should silver do the same.

The second catalyst for a "catch-up" silver rally could be a truce in the American-Chinese trade war. While the outlook seems bleak, political considerations caused by a potential slowdown in either economy could be enough to force both sides into a face-saving agreement. Silver could make up a lot of ground on gold should both scenarios play out.

Silver needs to build on the progress made in July and August. Note the similarity of the current price action to the last bullish pop that began in December of 2015. As we mentioned earlier, **a series of closes over the 2016 high of $21.22 per ounce would be a bullish development, setting the stage for an assault on our first upside target of $23.00 per ounce.** (See chart below.) However, we would not rule out some near-term corrective price action first. We believe it could provide a great opportunity to establish or add to bullish positions.

Data Source: Reuters

The strategy below is designed to give RMB Group trading customers upside exposure to silver for a lower cost and risk than purchasing the metal outright, freeing up capital to generate a return somewhere else.

Use COMEX Call Options to "Rent" Silver for Pennies-on-the Dollar

The options we are going to use are the 5,000 ounce COMEX silver options. Each option covers 5,000 ounces of silver, making each 1 dollar move worth $5,000 and each 1-cent move worth $50 in the underlying futures contract. Buyers of silver call options pay money, known as a *"premium",* for the right but not the obligation to be long silver futures at a specific price for a specific period of time. **Call option buyers are not buying the market; they are merely buying the right to be long that market. When you buy a call option, you are essentially "leasing" the right to profit from higher silver prices.**

The key phrase is "but not the obligation." Should silver decline or fail to rally before the option expires, the option buyer will simply not exercise the right to buy the futures contract. **All the silver call option buyer risks is the premium paid (plus any transaction costs).**

Silver call option sellers receive money in exchange for the obligation to sell silver futures for a specific price for a certain timeframe. Notice how this definition is the exact opposite of call option buyers. Think of it this way: if you are an employer, you pay money to your employees. This gives you the right to tell them what to do. As an employee, you receive money from your employer, obligating you to do what your employer tells you. Options work the same way.

The Silver Part of the Strategy

We will combine buying COMEX silver calls and selling COMEX silver calls to create the silver part of our strategy. As we write this, December 2020 silver futures are trading at $18.60 per ounce. That makes each 5,000 ounce futures contract worth $93,000. Our upside target on silver is somewhere north of $23.00 per ounce. What we want to do is buy a December 2020 $20.00 call option and *simultaneously sell* a December 2020 $23.00 call option.

The "bull call spread" described above pairs the right to buy 5,000 ounces of silver at $20 per ounce with the obligation to sell 5,000 ounces of silver at $23 per ounce As of the close on September 9, 2019 the December 2020 $20.00 silver calls we want to buy cost roughly $7.850. The $23.00 silver calls we intend to sell closed at roughly $5,500. Buying the $20.00 call while simultaneously selling the $23.00 call makes our net cost $7,850 minus $5,000 or $2,850. This (plus transaction costs) is the most we can lose on this trade if silver fails to rally past $20.00 prior to the expiration of our December 2020 COMEX silver options on November 24, 2020.

Let's say silver rallies to or above our target. We could exercise our right to be long at $20.00 per ounce. Since we have a corresponding obligation to sell silver at $23.00 per ounce, the most our spread would be worth is the difference of $3.00 per ounce. **$3.00 times the 5,000 ounce contract size is $15,000.** We are expecting more corrective price action after silver's most recent run-up, so we expect to get this trade a little cheaper.

> **Bull Call Spread In Silver --** consider placing an order to buy December 2020 $19.00 COMEX silver calls while simultaneously selling an equal number of December 2020 $22.00 silver calls for $2,500 or less. We're looking for silver to rally above $23.00 per ounce prior to option expiration on November 24, 2020.

The CD Part of the Strategy

Since our option trade only costs us $2,500, we can now take the $90,500 we didn't have to spend on physical silver and invest it in a safe, interest-bearing investment like a CD. As we write this, the best rate for an 18-month CD on Bankrate.com is 2.55%. Eighteen months of interest at 2.55% on $90,500 is roughly $3,390. By pairing this CD with the bull call spread above, you've essentially created your own silver-backed CD. It's like earning interest on your silver.

You've also lowered your total risk. Subtract the $2,500 cost of the trade (assuming silver does not rise above $20.00 per ounce) from $3,390.00 in interest from your CD and the worst you can do is collect $890 in remaining CD interest, even if silver fails to rally or goes south. You are still ahead – although not as much as you would have without the silver position.

Compare this with purchasing silver outright. Not only do you have to pay markups on your initial purchase, but you also have to pay monthly storage costs. Worse still, you forfeit the interest you could have made in a safe investment like a CD. Let's say silver doesn't rise. Combining the purchase of a CD with a bullish silver option play leaves plenty of cash to re-enter the market, hopefully at a lower level.

Prices will have changed by the time you read this, but you should be able to construct a similar strategy as long as 18-month CD rates remain above 2.00 APY. RMB Group will work with you to match the silver part of the strategy with market conditions. If you are an RMB trading customer, please contact your personal broker for the latest.

Note: If you don't have an RMB Group trading account, you can contact us using the phone numbers below. You can also go to our website at www.rmbgroup.com and set up an account online. Please be advised that it is up to you to handle the CD part of this strategy. Buying CDs is easy: www.bankrate.com is a good resource for the latest yields. **You can also**

execute the silver part of the strategy without buying a CD. In that case, the most you can lose is the cost of the bull call spread plus your transaction costs.

Please be advised that you need a futures account to trade the markets in this post. The **RMB Group** has been helping its clientele trade futures and options since 1991 and are very familiar with all kinds of option strategies. Call us toll-free at **800-345-7026** or **312-373-4970** (direct) for more information and/or to open a trading account. Or visit our website at www.rmbgroup.com.

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The RMB Group

222 South Riverside Plaza, Suite 1200, Chicago, IL 60606

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