

# The Lucrative Derivative

R E P O R T

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Welcome to the Lucrative Derivative Report! In this week's recommendation, we discuss the other precious metal, namely silver. Silver has had an incredible run or price rises over the last year, and we examine whether it is overvalued and what trade opportunities this provides.

## Market Summary Commodities (Precious Metals)

### Gold

Opening price: 20,575  
Closing price: 20,180  
Price change: -395  
% Change: -1.92%  
(Prices in Rs per 10 gms)

After a rise last week, gold fell back substantially this week, by 1.92%. The fall was largely driven by a stronger US dollar, and optimistic sentiment that reduced demand for gold as a safe haven. This was the largest weekly fall in six months. Despite this week's fall, overall long-term sentiment appears to be bullish. According to a survey of Industry predictions by the London Bullion Market Association, gold is set to continue its bull run in 2011, reaching above \$1600/troy ounce sometime during the year.

### Silver

Opening price: 46,065  
Closing price: 43,885  
Price change: -2,180  
% Change: -4.73%  
(Prices in Rs/kilogram)

After continual price rises week after week, silver has finally taken a breaker and suffered a significant correction this week, falling by 4.73%. The main drivers for this are the same as mentioned for gold earlier, namely a stronger US dollar and reduced safe haven demand. Part of the reduced safe haven demand is from the fact that most Western economies are cautiously optimistic about growth prospects, yet are not facing inflationary pressures at this time.

Fears over further quantitative easing have also been reduced.

## Market Summary Commodities (Energies)

### Crude Oil

Opening price: 4,034  
Closing price: 4,004  
Price change: -30  
% Change: -0.74%  
(Prices in Rs/barrel)

Crude oil prices have now fallen three weeks in a row. This was driven by a stronger dollar that pushed commodities down generally. Lower stock markets and a weak US jobs report added to further downward price pressure on the commodity. Despite weekly inventory reports showing that oil stocks fell more than expected, the commodity did not respond positively to the news. In USD terms, the price is now below the \$90 mark, and in rupee terms is testing the Rs 4000 mark.

### Natural Gas

Opening price: 195  
Closing price: 201  
Price change: 6  
% Change: 3.08%  
(Prices in Rs/mmBtu)

After a six percent rise the previous week, natural gas continued to climb, rising over three percent this week. Prices were much higher earlier in the week (reaching 209) before coming back down. Natural gas was largely able to avoid the general trend of lower commodity prices this week. This was partly due to weather forecasts indicating that cold weather in the Eastern US and in Europe would continue into next week, and this will increase demand for natural gas.

## Market Summary Currencies

### Dollar

Opening price: 44.81  
Closing price: 45.37  
Price change: 0.56  
% Change: 1.25%  
(Prices in USDINR (rupees/1 dollar))

After being one of the worst performing currencies last week, the dollar was one of the better performing currencies this week. US payrolls data was out this week, indicating that the US gained one hundred thousand jobs (though fewer than expected) and the unemployment rate fell from 9.8% to 9.4%. Throughout the week, economic data was cautiously optimistic, leading to a rise in the dollar. The dollar was also helped due to negative prospects regarding the euro and its debt problems.

### Euro

Opening price: 59.81  
Closing price: 58.93  
Price change: -0.88  
% Change: -1.47%  
(Prices in EURINR (rupees/1 euro))

The euro had a poor week as once again the debt concerns of peripheral European countries were on the forefront of investors' minds. Spot prices came close but were unable to break the Rs 60 mark, before turning lower towards the end of the week. Portugal was in the spotlight this week as concerns grew about their ability to service their debt and reduce their budget deficit. Bond yields in Portugal soared to their highest levels since Portugal started using the euro. The European Central Bank did step in and buy bonds to reduce some of the impact.

### Pound

Opening price: 69.29  
Closing price: 70.04  
Price change: 0.75  
% Change: 1.08%  
(Prices in GBPINR (rupees/1 pound))

After falling for three weeks in the row, the pound rebounded this week and posted a gain of 1.08%. Most of the move occurred in the beginning of the week on positive UK manufacturing data. There is also speculation that the Bank of England will raise

interest rates in the third quarter of this year (instead of the fourth quarter) due to rising inflation, and this has improved sentiment towards the pound.

### Yen

Opening price: 55.06  
Closing price: 54.34  
Price change: -0.72  
% Change: -1.31%  
(Prices in JPYINR (rupees/100 yen))

After two positive weeks for the yen, the currency fell back by 1.31% this week. Much of the fall was a correction for the way the yen has risen over the past few weeks. The yen seemed to be mostly driven by reduced risk aversion in markets on optimistic US economic data. The yen is usually associated with safe-haven status, and demand for that was lower this week. There was little in terms of Japanese economic data that was responsible for the price movement.

*(Opening prices are as of 31<sup>st</sup> December, and closing prices are as of 7<sup>th</sup> January)*

## Recommendation Summary

Position: Short Silver M (or Silver)  
Current Price: Rs. 44,250 (March Futures Price)  
Target Price: Rs. 42,500  
Stop Loss: Rs. 46,000  
Time Frame: Short Term (1 to 3 months)

## Recommendation Rationale

There is no doubt that silver has been one of the best performing precious metals lately. Week after week, prices have been going up dramatically, and silver managed to rise in price even when gold and other commodities were falling. The exception came in the last week, when silver fell by nearly 5% as commodities sold off generally and the dollar rose. However, silver remains near its recent highs even at current levels.

While silver is classed as a precious metal, it tends to have more industrial uses than its counterpart, gold. Therefore, one would expect that it is not as susceptible to safe haven buying as gold is. However, it is driven by safe haven buying to some degree - so we should expect silver's performance to be linked

both to gold's performance and to the performance of industrial metals.

Let's discuss some performance figures for various metals. All the figures are based on rupee spot prices from the Multi Commodity Exchange, measured from 1st January 2010 until 7th January 2011. Starting with industrial metals: copper is up by 26%; aluminum is up by 10%; lead is up by 8%; and zinc is down by 9%. Industrial metals have generally done well as global economic conditions improved over 2010. On the precious metal front, gold is up by 21%. This is a strong performance, though not as high as the previous year. The price rises in gold are due to safe haven buying and quantitative easing by the US Federal Reserve. Now let's take a look at silver:



As we can see, silver prices have been steadily rising throughout the last year. Since January 1st 2010, silver prices are up by 64%! Silver has outperformed gold and its industrial metal counterparts in quite dramatic fashion. What is the reason for such a large price increase? Well, this is where it gets a bit tricky. There has not been any good fundamental explanation for why silver has gone up so much in price. We know that safe haven demand has a lot to do with it, but that doesn't explain why it has outperformed gold by more than double.

In light of this, we believe silver is overvalued as it has gone up too much in the last year. The fact that silver fell nearly 5% last week is an indication that this market is ready to turn around, and we want to take advantage of possible further falls. Therefore, this week's recommendation is to take a short position in silver.

Let's go on to discuss the risks to the trade. The first risk is that safe haven demand returns to the market

in a big way. If there is significantly bad economic news in the near future, we could see a rise in the price of silver. The second risk is that of the US dollar. If the dollar weakens significantly, the price of silver will probably rise. We believe the risk of additional safe haven demand is low, since much of the safe haven factor is already built into the price. The dollar has a potential to fall, but this should not be too much of a problem as long as the currency doesn't fall too fast.

We had a previous recommendation of a short gold position, which has made a profit but not yet hit its target. We recommend closing this trade out and booking a profit. This is because it is very risky to hold both a short gold and a short silver position at the same time - if safe haven demand increases, it will be bad for the portfolio as both gold and silver will go up together. Since we believe there is more downside likelihood for silver rather than gold, we recommend closing out the short gold position, and taking a new short silver position.

## Trading Mechanics

Moving on to the mechanics of the trade, the execution process is identical to taking a position in any commodity contract. We recommend taking a short position in the Silver M contract, for which the most liquid appears to be the contract expiring on 31st March 2011. For those who wish to trade with a larger stake, they should use the Silver contract. Both Silver and Silver M are liquid.

The contract specifications for the Silver M contract are as follows: One contract is worth 5 kilograms. Prices are quoted in rupees per 1 kilogram, so therefore a 1 rupee move in the price represents a 5 rupee move in the value of the contract. To put this in perspective, a 1% move in the price of silver is worth around 2,200 rupees for the Silver M contract.

For the Silver contract, each contract is worth 30 kilograms. Therefore, a 1 rupee move in the price represents a 30 rupee move in the value of the contract. In percentage terms, a 1% move in the price of silver is worth around 13,200 rupees.

The stop loss for this trade is Rs. 46,000 and the profit target is Rs. 42,250. This may appear to be a wide target, but in reality it is quite narrow because silver is a fairly volatile, relative to other commodities. For this reason, the targets need to be wide. As usual, the

trade should be closed out if either the profit target or stop loss level gets hit, and the trade should remain open otherwise. We can change this later as we see fit.

The margin requirement of this trade will depend on your broker, but expect something it to be around 5% of the contract value. Given the amount we are willing to risk, it will be safe to put up just the margin requirement for this trade.

The timeframe of this trade is short term. Given the volatility of silver, we would not be surprised if either the profit target or the stop loss level was hit fairly quickly.

## Closing Out Existing Trades

This week there is an additional section on existing trades, as we would like to recommend closing out some of the previous trades we had recommended. Even though the profit targets or stop loss levels may have not been hit - we believe the market conditions warrant these moves.

**Short Gold:** We recommended a short gold position on 14th December 2010. Until a week ago the trade had lost money, but in the last week it has turned a profit. We recommend closing out at a profit for reasons described earlier. To reiterate, it is too risky to hold a short gold and a short silver position at the same time. This is because if safe haven demand resurfaces, both gold and silver will go up together and the overall portfolio will suffer. Since we believe silver is more likely to fall than gold, we suggest closing out the gold position, in favor of this week's recommended short silver position.

**Long Natural Gas:** We recommended a long position in natural gas on 26th October 2010. We also reiterated the recommendation two weeks ago. Natural gas has done very well in the last couple of weeks and this trade has turned a good profit. We recommend closing this trade out. Even though it was initially suggested as a long-term trade, the price of natural gas has gone up substantially since the recommendation. Therefore, we believe there may be downside risk to the commodity, so it is best to take profits.

**Short EURINR:** We recommended a short EURINR position on 21st December 2010. We expected the Eurozone crisis to weaken the euro further. It has to a degree, but the rupee has also weakened. As of now, the trade has turned a profit, though not as high as we hoped. Its possible during the time between writing and trade execution the profit could be wiped out or increased, but nonetheless we recommend closing this trade out. We will look for further opportunities to short the euro if the price is right and the debt problems remain.

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