Matarin Capital

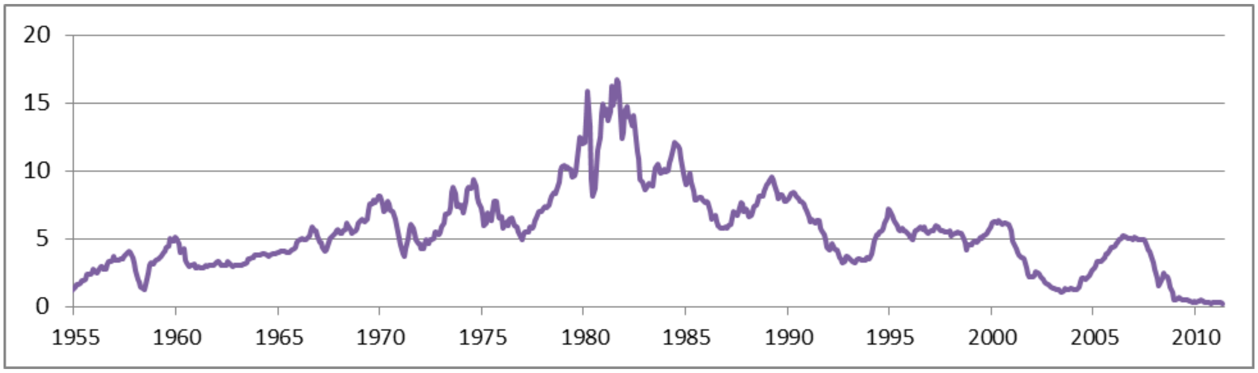
Investing with Insight and Integrity

Silver

May 2011

Signs that speculative capital are exiting the markets are increasingly there to be found by those who look: small cap stocks have stumbled in their rally versus large, the VIX, which hit its one year low on April 25th, has crept up 24% in the following week, and crude oil, which hit its 1-year high on April 29th, dropped almost 13% in a single trading day. A flight to quality is evident in other areas of the market: 3-month Treasury Bills have yielded as little as 0.005% this week, while 1-Year Treasury bills offer only 0.17%, a remarkable all-time low in the history of available Federal Reserve data, beginning in 1953.

1-Year US Treasury Bill Yields (%)

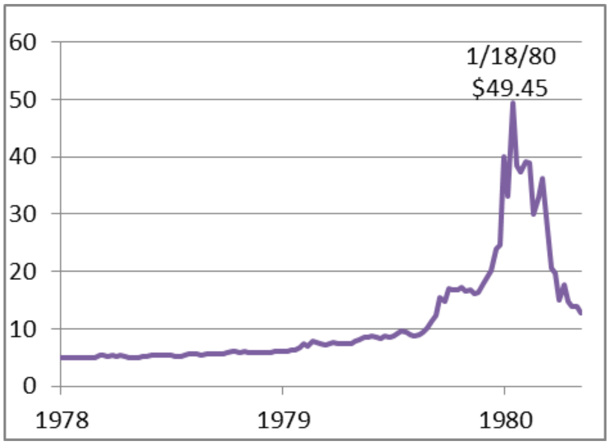


But perhaps no asset class demonstrates the story of the current pressure on risky assets more vividly than that of silver. After the metal's amazing rise from a low of $8.96 on November 20, 2008 in the wake of the financial crisis, to a high of $48.54 on April 28th, silver prices have fallen by 28% in 5 days. The signs of overheating were clearly emerging before the collapse, with the strongly positive trend in prices accelerating, trading volumes accelerating, and with small futures traders (more likely to be speculative hedge funds) buying silver contracts at an increasing rate with large institutional investors increasingly selling. Finally, in order to crowd out speculation, on April 25th, the Chicago Mercantile Exchange began a campaign of increasing the margin required on silver futures from $11,745 to $21,600 (an 84% increase) in a series of hikes over the course of two weeks. The reaction in the silver markets has been dramatic. After a 28% fall, prices continue to fall in the aftermarket, at the time of writing.

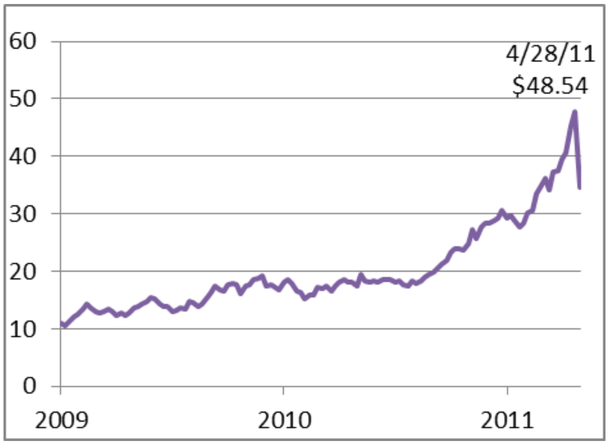
Many will compare current markets with the most notorious event in silver futures history: the failed attempt of the Hunt brothers to corner the silver market in 1980, which is the last time that silver saw prices close to $50. Their efforts too, were thwarted by the intervention of market regulators.

Silver Prices (US$)

Rise and Fall of the Hunt Brothers



Beginning of the End for 2011 Speculators?



[1] Comparison of non-reporting longs to non-commercial shorts in the weekly CFTC Commitment of Traders Report

Are there potentially similar negative catalysts on the horizon for other markets? The change in margin requirements for silver futures represented a change in the cost of leverage which decreased liquidity in the market. If banks become less generous with their margin capital, just as the Chicago Mercantile Exchange did last week, then investors in highly leveraged markets should exercise great caution. At Matarin, the catalysts that we'll be watching are related to central bank tightening around the world. In the U.S., although the Federal Reserve has signaled that rates won't be raised for an extended period, the end of QE2 and other monetary tightening measures (such as the potential for increasing the interest rate being paid on the deposits that banks leave with the Federal Reserve) could have a similar effect.