If the Prices of Gold and Silver are Down, Why Are Physical Metals So Expensive?

by Thomas Coulson

In the past week the prices of gold and (to a greater degree) silver have plummeted. Gold was $1,674.50 on March 9. It fell 9% in just 6 trading days. Silver was $17.00 on March 9. It fell a staggering 27% in just 6 trading days. Despite the fact that the spot gold and silver prices are much lower than they were just a week ago, many physical gold and silver products are trading at much higher premiums and sometimes even higher outright prices than they were just a week ago. More interestingly, not all products rose in premium by the same amount. As I will show here, there are particular reasons why this is so.

What Happened?

In the months leading up to the recent time, supplies of most silver and gold were plentiful. Demand was solid; but there was definitely net liquidation onto the market. Price action in gold and silver began to deteriorate. As silver had the most dramatic move, I will focus on that metal in this narrative. Silver breached key support levels. It dropped below $17 on March 10; below $16 on March 12; Below $15 on March 13. As prices fell bargain hunters jumped in to absorb silver at cheap prices and premiums that were still low. Dealer inventories were rapidly depleted. As supplies began to run low; dealers began to raise premiums to reflect that supplies were disappearing faster than they were being replaced; and uncertainty about replacing those stocks abounded.

On Monday, everything changed and chaos reigned. The price of silver fell 12% to $12.77. At such low prices nobody wanted to sell physical silver and many, many people wanted to buy. Supplies of most silver products were already exhausted the past Friday. Whatever silver was available on Monday was sold at high premiums as there was great uncertainty about when more silver would become available and what the price might be when it was available. Confounding the issue was wild fluctuations in the price of silver. Silver spot seemed to be ticking up or down ten to fifteen cents in seconds; making the process of setting a firm price nearly impossible at times. As buying was strong throughout the day, there was also great uncertainty about availability of many products. In this environment, major bullion dealers were willing to continue selling silver for future delivery; but only at much higher prices and without certain timetables for delivery.

Premium differences were extreme for some products. U.S. 90% Silver Coin premiums were about 1.5% during the week leading up to this event. By Tuesday, March 17, 2020, premiums for 90% silver coins ranged from 42% to 60% among major dealers. U.S. Silver Eagles also increased dramatically in premium from 14.8% on March 11 to 58% on March 17. The premium increase for 100 ounce silver bars was the lowest amongst major products (4.2% on March 11 to 19% on March 17).

The premium increase for 90% Silver Coin was more pronounced because it is normally a popular, low premium seller in finite supply. (By definition, no 90% silver coin had been made since 1964 and modern proof 90% Silver coins are generally not considered to be a deliverable form of coin.) Once supplies are off the market, premiums can soar; because no more 90% coin can be fabricated to supply the market. For Silver Eagles, the supply situation was somewhat exacerbated by the fact that the U.S. Mint had run out of production of 2020 dated coins and had no immediate plans to produce new ones. This coupled with the fact that Silver Eagles are popular sellers, also caused the premium to rise significantly. By contrast, 100-ounce silver bars are not so popular as 90% coin or Silver Eagles; so there was more supply available. In addition, 100 ounce silver bars are produced by several companies and supplies can be added to the market in shorter order.

To Recap:

Even though the spot price of silver fell, premiums rose dramatically for many products. These premium hikes varied between products. This was a result of the following factors:

1. Supply-Demand Imbalance

With a dramatic fall in the price of silver (and gold) demand soared and there was no liquidation of physical metal onto the market to balance the demand. Additionally, some products were affected more than others because of supply characteristics such as finite availability (no more could be produced) or production disruptions.

It is very interesting to note the difference in the physical metals markets and the non-physical metals markets like COMEX contracts or ETF's. In non-physical markets, supply and demand are in balance by definition. Pricing is fluid as products are always available on the market at any given time. This is not always so with physical metals. Demand can go wanting when there are simply no sellers at a given price. To compensate for this the premiums rise to the point where holders of physical metals are willing to sell. Holders of physical metals are more purposeful or 'invested' with their holdings and are not so likely to be speculating on short term price movements as non-physical holders might be.

2. Uncertainty

With no new supplies guaranteed to come to market anytime soon, dealers wanted to be compensated for any supplies on hand or in the pipeline because there is no certainty over what price products can be replaced for or when they can be replaced.

3. Risk

The prices of gold and silver were excessively volatile. As metals were ticking up and down by as much as a percent in just seconds, spreads developed on spot pricing and premiums became more pronounced as a mechanism to account for the volatility in the market.

This is not the first time that this scenario has happened. The precious metals markets were quite similar to this during the 2008-2009 downturn. Premiums rose spectacularly with corresponding volatile drops in the prices of gold and silver. Delivery times for physical product stretched out for months for a period. The same thing also happened in April, 2013 when the price of gold broke strong price support to the downside. Premiums for physical metal also rose significantly during the Y2K event from 1998 to late 1999 in the face of overwhelming demand; even though prices of metals were not particularly volatile.

What Should You Do if You Want to Buy Physical Precious Metals?

This situation poses a conundrum for the buyer of physical precious metals. It would be nice to take advantage of metals being 'on sale' but rising premiums make that difficult. There are a few strategies that can be used in this situation.

1. Buy Now Regardless of Premium

If you think that supplies will be unavailable down the road or that prices are going to rise quickly, you may want to lock in a supply of silver at higher premiums and wait for delivery if necessary. If you choose to buy in this situation, be selective and purchase metal that is at the most reasonable premium in order to take as much advantage of cheaper prices as possible. Deal with businesses that have a long track record and are experienced in navigating markets such as these.

2. Wait and Watch for a Better Time to Buy

These situations of high premiums and limited availability are always temporary. At some point, the supply-demand imbalance will be remedied. This can happen if the spot price of silver rises enough to induce sellers into action. It can also happen if the price of silver stagnates at its new lower level or continues to fall. This might convince some 'weak-hands' to sell a supply of metal on the market if they do not believe that prices are going to rise anytime soon.

If the price rises and premiums fall, you may be able to catch a point where premiums have fallen but prices are still relatively low. You will not capture all of the price decline; but you might get some of it. In the second scenario, you will be able to buy your metals at both a low price and a low premium. This would be the best of both worlds. Unfortunately, this scenario might not materialize before prices rise again. There is a risk that you will not be able to buy at a cheap price.

3. Buy Non-Physical Metal and Exchange it for Physical Product Later

You could buy a COMEX contract or ETF metals as a proxy for physical metal. You could then either demand delivery of physical metal at maturity of the COMEX contract or sell the ETF and use the proceeds to buy physical metal when premiums become more reasonable. With ETF's , there is some risk that you could in essence lose premium through ETF management fees if you hold the security long enough, however.