

Executive Summary

- Silver prices are strong and having overcome the 2008 highs at \$21.36/oz, the next upside target is likely to be \$25/oz. This will represent something close to a 50% retracement of the fall to \$3.53 from the high in January 1980 when, on the 18th of the month, Silver fixed at \$49.45.
- Investment demand remains all important as it has in recent years been absorbing the supply surplus. There are some signs that investor demand is slowing.
- Even though the recovery after the 2008 recession has been much stronger and more robust than we thought it would be, we still feel there are downside risks.
- The debt legacy remains a “big unknown” and we feel it might have further negative consequences for the dollar that could lead to a dollar crisis.
- The economic and fiscal uncertainty suggests investors are likely to keep their interest in Silver for some time to come, but watch out in case that changes.

Introduction

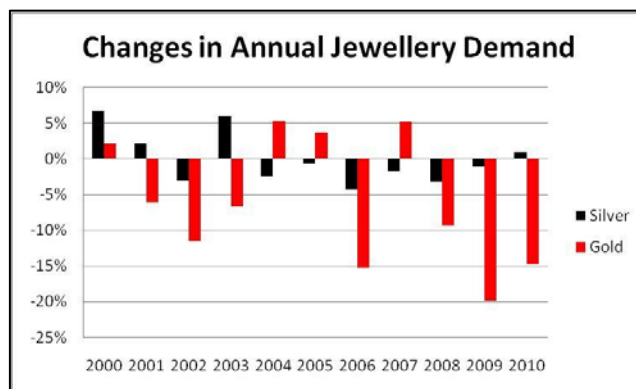
The Silver market promises to be interesting over the next few years as there is likely to be a change-over in the primary driver of demand. In recent years investor buying has been the swing-factor that has driven prices higher, but demand for safe-havens is likely to wane in the years ahead. However, a few new applications for Silver have the potential to become swing factors. In the short term, the global economic situation remains uncertain and there may well be more turmoil in the financial markets before a more sustainable economic recovery gets going. In this case Silver prices have potential to rise further. The longer term outlook for Silver is also interesting with demand seeming likely to undergo a structural change as new technology (including Silver-zinc batteries) emerges, some of which could consume meaningful amounts of Silver. This new technology could substantially reduce Silver’s recent dependence on investor off-take to balance supply and demand. The prospects of this new technology are also likely to make investors even keener to own Silver, although at the moment it maybe too early for them to do so. The biggest risk to Silver’s bull market is if investors start to reduce their exposure to safe-haven investments. Silver has been in a supply surplus since 2003, so a lot of Silver has been bought by investors and now that prices are at levels not seen for 30 years there may be increased interest in taking profits if investors feel that economic growth will provide better investment opportunities elsewhere. The short-to-medium term outlook therefore is very much dependent on how long such investors feel the need to keep, or even increase, money invested in safe-havens. In turn, this will depend on how the global economy performs. New technology promises a new era for Silver, but between now and when this technology takes-off is likely to lead to some wild swings in Silver prices and hence produce numerous risks and trading opportunities.

FABRICATION DEMAND

Fabrication demand covers Silver's use in industry, photography, jewellery manufacturing, silverware and in the making of coins and medals. In 2009, fabrication demand dropped 12% according to the World Silver Survey, with the industrial demand sector falling 20%. The sharp decline hit all sectors other than coin and medal fabrication and came about as recession hit and as fabricators destocked. In late 2009 and in the first half of 2010, demand rebounded as users restocked and consumption recovered. Interestingly, demand has been robust despite high prices. In the second quarter prices averaged \$18.50/oz, which was the highest average quarterly price in over two decades. Demand for coin and medal fabrication has remained strong throughout the 2008-2009 slowdown and is running at around twice the average level of demand seen between 2000 and 2006. As regards to the recovery in total fabrication demand, jewellery and silverware demand are expected to remain relatively flat in 2010 and 2011 as high prices and economic hardship reduce buying interest, while the photographic industry will continue to see a structural decline in demand. This means the main sector leading the recovery is industrial demand, which accounts for some 48% of total fabrication consumption. In 2010, fabrication demand is expected to rise 4% to 23,800 tonnes, still well down from the peak of 26,400 tonnes seen in 2005. In 2011, we expect Silver's use in fabrication to climb, but only by a modest 2%, as economic growth remains depressed in the first half of the year.

Jewellery

Jewellery demand only fell 1% in 2009 as harder economic times led to less buying of more expensive Gold and Platinum jewellery, which benefitted Silver demand. However, the main support came from India where, following the drop in price below \$10/oz in late 2008, fabricators started to restock. India's jewellery and silverware demand climbed 50% in 2009. In 2010, Silver jewellery has continued to do well in gaining sales at the expense of Gold, perhaps because Gold prices have returned to record highs, while Silver prices only recently overcome the highs seen in 2008. However, high and volatile prices and continued uncertain economic times are likely to see demand for luxury items remain subdued. We expect more of the same in 2011 as unemployment remains high in Western markets and austerity measures lead to more hardship. Also as India restocked aggressively in 2009, it may be in a position to run down stocks rather than chase prices higher. Over the past decade, Silver jewellery demand has suffered less than Gold jewellery from the adverse effects of rising bullion prices and economic hardship (see chart above). Even though Silver prices are high, there is a bigger profit margin in Silver jewellery than in Gold or Platinum jewellery. Overall we expect Silver jewellery and silverware demand to grow around 1%, in both 2010 and 2011.



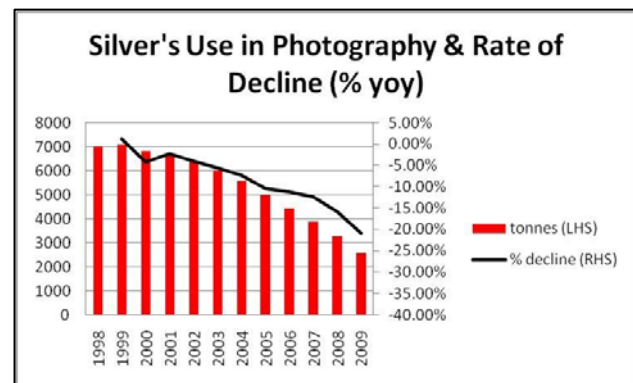
Industrial Demand

Industrial use of Silver as a percentage of total demand slipped to 40% in 2009, two years previously before the financial crisis and the recession it accounted for 51% of consumption. However, at 40% of total demand, industrial demand remains the single biggest consumer of Silver and once economic recovery regains momentum, we would expect industrial use to recovery smartly. The future is also bright for Silver as there are a host of new applications that are gradually making inroads into the market- some more than others. During the years of

strong economic growth between 2004 and 2007, industrial demand was growing at an average of 7% per annum. In 2009, the economic slowdown led to a fall in demand, which was made worse as it went hand-in-hand with destocking and as a result demand fell 20% year on year. By late 2009 and in the first half of 2010, industrial demand started to recover and that fuelled a rebound in Silver demand by industrial end-users. However, the outlook for the second half of this year has deteriorated and may well remain depressed in the first of 2011 as well. In September, the IMF warned that growth in the global economy was likely to slow towards the end of 2010 and in the first half of 2011. Given the stronger growth in H1'10 and with good levels of restocking going on too, we feel industrial demand for Silver in 2010 will show growth of around 11%, but growth will then likely slow in 2011 to around 5%.

Photographic demand

Use of Silver in the photographic industry peaked in 1999 at around 7,000 tonnes and in recent years has been falling at an accelerated pace that became even faster during the recession, see chart. Silver's use in photography is now only 37% of what it was at the peak, however, it still used some 2,600 tonnes of metal last year and a good proportion of this offtake stands to be lost in the



years ahead. The popular belief is that the rate of decline will slow, but with technology evolving so rapidly we expect Silver's use in photography to continue its remorseless decline. Economic hardship might have slowed the conversion to digital x-rays from conventional x-rays, but we would say the pace of conversion will pick-up again. Some of the new hospitals being built in China, of which there are many, might initially use second-hand conventional x-rays but, considering China is building for the future, we would not be surprised if more and more hospitals there start up with digital systems. After the dramatic fall in photographic demand over 2008 and 2009, which averaged 18%, we would not be surprised to see demand from this industry continue its descent by around 15% in 2010 and 2011. This compares to an average annual drop of 9% between 2000 and 2009. A 15% drop in demand would free up some 385 tonnes of Silver this year and 330 tonnes in 2011.

New applications

Silver's new applications are diverse and are being used in health, electronics and renewable energy industries, but many of these new applications including smart tags (RFIDs) and Silver antibacterial applications, use nano-technology with each unit using a tiny amount of Silver. Until these applications have widespread use their impact on Silver demand is likely to take time to be felt. However, some applications, such as Silver's use in consumer electronics, for example in plasma TV / display screens and in solder used in a host of electronic gadgets, do use meaningful amounts of Silver and although demand for these products has been hit by the recession, the recovery is expected to be strong once sustainable recovery is underway.

However, other new applications look set to become major users of Silver and growth in these products might even be seen in time to prevent the growing supply surpluses from pushing the Silver price significantly lower. In recent years, demand from the photographic industry has fallen, but demand from investors has increased, but when safe-haven demand wanes once a

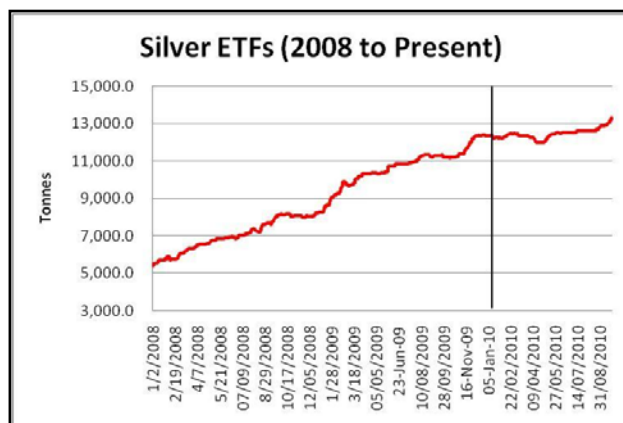
more stable economic recovery gets going, industrial demand is going to have to increase if the large supply surpluses are to be avoided.

Two new applications may become big enough to either soak up the demand investors have recently accounted for, or else may offer a fundamental reason for investors to stay invested. One of these applications is already growing fast, but is still in its infancy, while the other has potential to make significant inroads if the technology is widely adopted. Silver's use in solar cells (thermo-photovoltaic cells), which convert light into electricity, is growing rapidly: it consumed 870 tonnes in 2009, an increase of 30% year on year. Indeed this use of Silver should now be seen as a mainstream industrial use. Current forecasts are for demand to rise to 5,800 tonnes by the year 2020, however, it is uncertain how much of the solar industry is government subsidised and in the current climate of austerity this forecast could change. By comparison, investment demand in 2009 was 4,260 tonnes.

The second potentially large application is Silver batteries. Silver-zinc rechargeable batteries are being considered for the next generation high performance batteries for laptops and mobile electronics. They have the advantage of offering 40% more power and 95% of the primary elements within the battery can be recycled and re-used to make batteries again (i.e. after recycling there is no loss of quality in the material and a closed-loop recycling system could be introduced). Silver-zinc batteries are already in everyday use. These are the small button shaped batteries found in watches and small electronic devices which account for 150 tonnes of Silver demand a year. However, judging by the size of the markets for rechargeable batteries in laptops, as well as laptops and mobile devices, this could potentially become a large growth area for Silver demand. In the future, there may even be a role for Silver as a component in the manufacture of electric cars.

INVESTMENT DEMAND

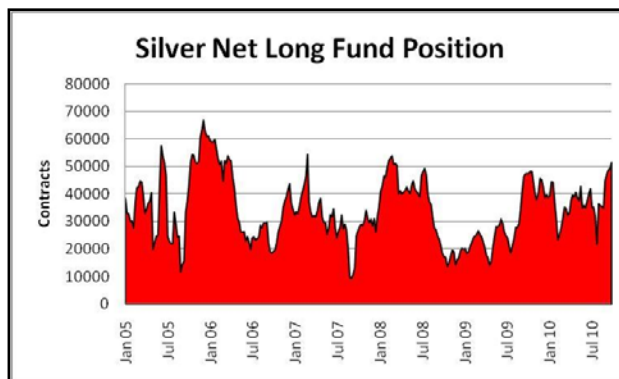
With Silver supply outpacing fabrication demand in recent years, investors' off-take has been critical in driving the overall bull market and the emergence of Exchange Traded Funds (ETFs) have been central in facilitating this growth in investment demand. A slight concern is that although the combined holdings in the ETFs have continued to grow, the rate of increase has slowed in 2010. In 2008, holdings in the ETFs grew 39%, they climbed 49% in 2009, but on a pro-rata basis they are so far only showing growth of around 10% this year (the vertical line on the chart shows the start of 2010). The fact that redemptions up until now have been light is one thing, but new purchases have to be made if the supply surplus is going to be absorbed. If ETF buying does not pick-up soon we will start to get nervous, especially as Gold is setting fresh record highs.



More room for speculators

Although the level of buying by ETF investors has been slow, as discussed in the section above, funds have been active buyers. The net fund long Silver position dropped during the broad market correction in May and again in late July, but it has bounced back with vengeance

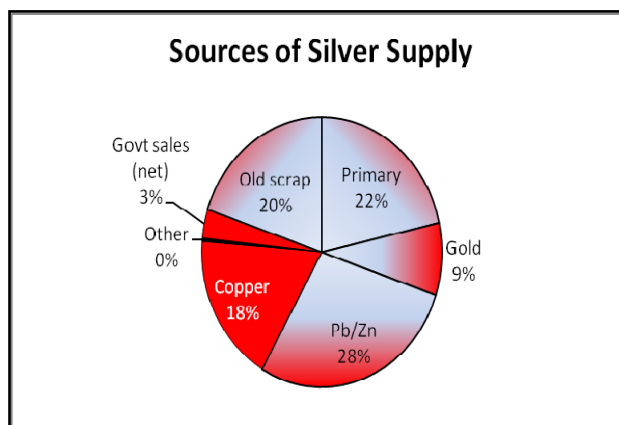
in late August and throughout September. This run up in the net fund long position has happened while both longs and shorts have been adding to their exposure, which suggests increased volatility in the near term as one party is likely to have to throw the towel in. From the most recent dip in the net position, which was seen on 27th July, the longs have increased their exposure from 25,308 contracts to 66,066 contracts, a gain of 161%, while shorts have increased their exposure by 265%. However, compared to previous peaks in the net long position, the present position is still 30% below the 2005 peak. As such, there seems good potential for prices to rise if the situation remains bullish.



SUPPLY

Mine output rose 3.6% in 2009 to a new record of 22,070 tonnes, according to the World Silver Survey, with increases coming from the ramp up in output at new primary Silver mines and at Gold mines(especially in Latin America) as well as from by-product output in China and mine output in Russia. Supply from scrap and official sales declined, which largely offset the increase in mine supply, leaving total supply all but unchanged. Given that prices have generally been trending higher for almost ten years it is not surprising that mine output has been increasing at a steady pace that has averaged 2.1% per annum since 2000. This means that 3,688 tonnes more was produced in 2009, than in 2000.

The sell-off in base metal prices in 2008 threatened mine supply to some extent, but few countries saw a net decline in output in 2009. Australia’s mine output dropped 290 tonnes, Chile saw production fall 96 tonnes and Canadian output dropped 60 tonnes, mainly as a result of strike action and some base metal production cutbacks from 2008 remaining in effect. In 2010 and 2011, output is expected to continue increasing in line with the running average of between 2% and 2.5%, as production continues to be ramped up at new operations and expansions, or restarts are made at existing mines. The main threat to supply would come about if base metals prices fell sharply to levels that prompted production cutbacks. As the chart shows, 28% of Silver mine output comes from lead and zinc mines and 18% comes from copper, but with prices of these metals remaining robust, we feel it unlikely production will be cut. In addition, with 9% of Silver coming as a by-product from Gold mining, we expect output from this sector to continue to increase.



Cash costs of production for primary producers held relatively stable in 2009 and averaged around \$5.23/oz, according to GFMS, while the high cost producers were nearer the \$12/oz level. So with prices back above \$20/oz there seems little chance of primary production being cut and there is every incentive for miners to expand output.

Supply from Scrap

Silver supply from scrap has been falling in recent years as the photo industry has used less Silver and therefore generated less scrap. However, scrap supply is expected to pick-up in 2010 as high prices both in dollar terms and in some key local currencies, such as the Indian rupee, have attracted more old scrap supply to the market. The dramatic rise in Gold jewellery recycling, which is a relatively new phenomenon in developed countries, is believed to have attracted a significant pick-up in old Silver jewellery and silverware recycling too.

With the prospect of higher Silver prices, we expect more scrap to come on to the market, especially from Asia, even though we suspect that there will be solid gains in developed markets too. In 2009, scrap supply fell 292 tonnes, but we believe it may climb 3% in 2010 and 4% in 2011, on the basis that higher prices will attract more old Silver from households. However, should prices start to spike higher, supply from old scrap, jewellery, silverware etc, could pick-up markedly as it did in 1980 when Silver spiked up towards \$50/oz.

Government stocks continue to fall

In 2009, net government sales from stocks totalled 426 tonnes, which was down from 858 tonnes in 2008 and an average of 2,040 tonnes seen between 2001 and 2007. Sales were therefore 58% lower in 2009, than the recent average. An absence of government sales from China and India and lower sales from Russia accounted for the lower level of stock disposal. Given that India and Russia are buying Gold for their strategic reserves it seems they may be holding on to their Silver too. Likewise, although China might not be looking to diversify its reserves by buying Gold in the open market, it may well be accumulating bullion from domestic producers. Given the trends in official sales in Gold and Silver in 2010, we expect government sales from stocks to continue to decline in 2010 and 2011. It is now estimated that government stocks had fallen to 1,906 tonnes at the start of the year. Although accurate data on government holdings are hard to come by, if the figure now stands around 1,800 tonne level, then the large burden of 23,000 tonnes that was overhanging the market in 1997 has been severely depleted and is likely to limit sales going forward. For 2010 and 2011, we expect sales to drop around 200 tonnes.

Balance

The Silver market swung from a supply deficit to a surplus in 2003 and has remained in one since. What's more, the surplus has been escalating, which makes it even more surprising that prices have performed the way they have. This has happened because strong investment demand has soaked up the surpluses. In recent years, the high level of ETF buying has managed to absorb the net of total supply less fabrication demand, even when fabrication demand has fallen. Another supply surplus will be seen in 2010, but that has not stopped prices rising further and with yet more 'oversupply' forecast for 2011, you have to wonder when investors will slow their buying, let alone start to liquidate what they already hold. Cumulatively, since 2003, the implied physical surplus is estimated at around 11,700 tonnes.

Technical

After strong gains in 2009, Silver prices corrected in early 2010, but then ran higher again between February and May. Prices then consolidated in a symmetrical triangle until late-August when they broke higher. The count on the triangle was for a \$2.70/oz move and a target of \$21.50/oz which has now been reached. If you draw a line along the tops since February 2009, then that line is now around \$24.80/oz, which has been hit, but prices have since pull back from that line, suggesting it is a valid resistance line. In the year ahead it would not be

surprising to see prices extend into the \$25-\$27/oz range. This is approximately the area that corresponds to a 50% retracement of the fall back from the historic highs near \$50/oz, in 1980. If prices were to continue to rise strongly, the 61.8% retracement level would be around the \$32.25/oz level.



Conclusion and Forecast

The situation in Silver remains very interesting in that the market continues to be in a supply surplus but prices are rising strongly. On the surface, the rally in Silver looks quite vulnerable but the economic and fiscal outlooks suggest there is still room to remain bullish and there are also some exciting potential developments in industrial demand, namely solar cells and Silver-zinc batteries. The time-line of various events is therefore going to be all important. If sustainable economic growth is seen sooner rather than later, then there is likely to be significant investor long liquidation that is likely to lead to a tumble in prices. However, while concerns over economic recovery remain in place then the markets are likely to continue to be concerned about governments' fiscal policies, their debt burden and methods they will use to try to correct the economic malaise. If the economic uncertainty drags on long enough for demand from new technology to become meaningful then Silver prices could stay up in a higher trading range.

Investors' interest will remain critical. Demand from ETF investors has slowed so far in 2010 and that is a worry as continued high investor off-take is needed to absorb the supply surplus. Given the economic uncertainty, the potential for more quantitative easing and concerns over the dollar, we would not be surprised to see investor demand pick-up again and in that case we could see Silver's rally continue. However, if investor interest remains subdued then it will likely make investors nervous and in turn that would increase the risk of a correction.

In the near term, there is a risk of a deeper correction in equities and industrial metals as the rebounds in these seem to have run ahead of the economic fundamentals. A correction in equities and industrial commodities would likely cause a pull back in Silver prices too. However, we think the secondary reaction would see more safe-haven buying, especially if another period of economic weakness forced the US to take steps that further weakened the dollar.

Overall we think the longer term outlook for Silver has improved as new technology looks set to provide new areas of significant consumption, which in turn is likely to see Silver prices trade at a higher price. In the short-to-medium term we feel that the economic climate will keep safe-haven demand strong and that could see prices rally further - we would not be surprised to see \$27/oz at some stage. However, Silver could experience some very volatile conditions before the new industrial applications become a reality, if investors feel confident enough to liquidate their safe-haven positions. In this case prices could drop sharply and a return to around the \$17.00/oz level would not be surprising.

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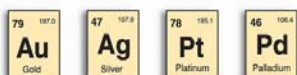
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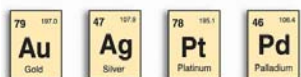
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