

Executive Summary

- Silver has had a very volatile year so far. Prices all but reached the 1980 high - they peaked at \$49.81/oz after rallying 88% from the January low. Since then prices have dropped to \$26.06/oz, but have now recovered to around \$34/oz.
- Given this volatility investors' confidence has been hit, funds have cut their exposure by 70%, although ETF investors' holdings only dropped 13%. If Gold prices mover higher, there is now plenty of room for funds to buy Silver again.
- The fundamentals for Silver remain bearish as net of investment, the market remains in a supply surplus. Investor sentiment therefore remains crucial.
- We feel investors will continue to want to monetarise Silver as a means to preserve wealth and protect against currency debasement and financial risk.
- As we are bullish for Gold we are de facto bullish for Silver and as the latter can out run Gold there are likely to be some interesting trading opportunities in Silver.

Introduction

The Silver market has lived up to its reputation as being a volatile market as prices became increasingly erratic in 2011. After climbing above \$20/oz in September 2010, prices accelerated higher and then went exponential between February and April. Prices spiked up to \$49.81/oz, dropped back to \$32.22/oz in May, they rebounded to \$44.24/oz in August, before slumping again in September to \$26.06/oz. They have since returned to around the \$34/oz area. Increased volatility has not surprisingly unnerved those active in the market, especially speculators, although the longer term investors have generally held their nerve. Dips have provided fabricators and investors the opportunity to restock, but with the economic climate deteriorating there now seems to be a lot of uncertainty as to what lies ahead. In many ways we are surprised the dire situation in Europe has not led to more safe-haven buying, but the fact Gold has been slow to pick-up safe-haven demand since the September sell-off, means Silver has been left without a leader. As we move towards year-end, Gold is looking firmer again so there is a good chance Silver will follow. A quick solution to the debt debacle in Europe is unlikely and there is every risk of contagion. The US budget deficit also needs to be cut and China seems to have its own credit issues. Given this, we think recession looms in the West and with it a period of deflation is likely. As such, we think 'cash will be king' in the months ahead, but we expect investors will want to hold bullion as a form of cash as a safe-guard to just holding fiat money.

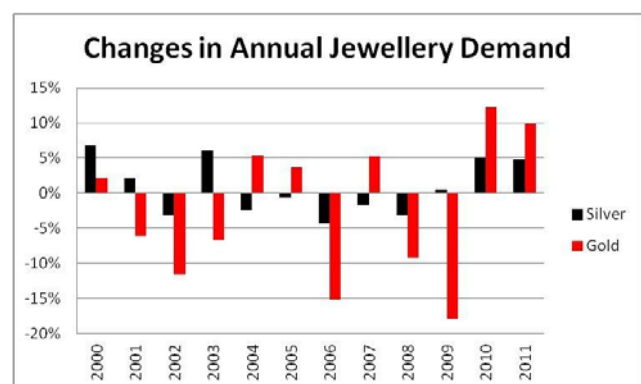


FABRICATION DEMAND

Fabrication demand covers Silver's use in industry (55%), photography (8%), jewellery manufacturing (19%), silverware (6%) and in the making of coins and medals (12%). In 2010, fabrication demand climbed 13 percent, according to the World Silver Survey; this followed an 11% drop in 2009. The rebound in demand in 2010, was the first year-on-year gain since 2007 and showed the extent of the market's recovery after the 2008-2009 recession. Growth was seen in industrial applications, jewellery, coins and medals, but fell in photography and silverware. In 2011, the combination of continued economic recovery in the first half of the year has no doubt seen these strong trends continued, although the spike up in prices would have dented demand briefly. However, the sharp pull back in prices will have given consumers a restocking opportunity. Consumers have become more cautious in the second half of the year about a double dipped recession and with the outlook for 2012 looking difficult, we feel fabrication demand will slow again.

Jewellery

Jewellery demand climbed 5% in 2010, as the global economy recovered from the slowdown seen in 2008 and 2009. Not only did outright demand recover, but apparent consumption was also boosted as fabricators switched from destocking to restocking. As Gold prices climbed from one record high to another, demand for Silver jewellery picked-up as it won market share from Gold and the PGMs.



The main support came from Asia, where demand grew strongly in China, Indonesia and Thailand. In China, economic prosperity has been a major factor in driving demand. What was surprising is that apparent demand fell in India, but we feel this is an aberration and reflects destocking rather than a fall in consumption. Indeed, demand for fashion jewellery in India seems to be gaining momentum and as fashion jewellery tends to be cheaper and lighter in colour, it gives Silver an advantage over Gold and the PGMs. As the economic outlook for 2012 remains depressed, we feel Silver jewellery will continue to win market share from other more expensive precious metals and as such, demand should hold up relatively well in 2012.

Industrial Demand

Industrial use of Silver is the exciting area to watch as there are numerous new applications for Silver that have potential to make a big difference to demand – in time. Many of these new applications are using nano-technology so use tiny amounts of Silver per application, but they have potential to be used extensively. In addition, because the amount of Silver per application is so small, demand is likely to remain price inelastic. These new uses include solar power, medical applications and smart tags (RFIDs). In 2010, industrial demand climbed around 20% on the combination of the Western world recovering from recession, organic growth in emerging markets and as industry restocked. The recovery in this sector meant industrial applications accounted for 46% of Silver consumption in 2010, this was up from 43% in 2009. Two years before the financial crisis and the recession, ie in 2007, it accounted for 50% of consumption. In the years ahead, we expect Silver's industrial use to grow as a percentage of total demand. During the years of strong economic growth between 2004 and 2007, industrial demand was growing at an average of 7% per annum, we expect to see similar, if not higher, growth rates in the years ahead. However, for the rest of 2011 and for 2012, we expect

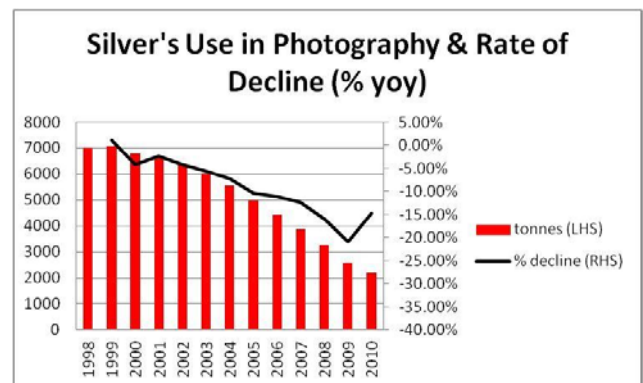
industrial demand to suffer in line with the global slowdown. For 2012, we would look for growth of around 2 percent, with new applications driving growth and offsetting slower growth from the more traditional industrial uses such as electronics and photography.

Solar power – Photo voltaic (PV)

The adoption of solar power has taken off and that is boosting demand for Silver. In 2010, Silver demand from this industrial sector soared 70% to around 1,500 tonnes – this equates to around 5% of total Silver consumption and was up from 870 tonnes in 2009. Solar power tends to be subsidised by government grants, but is being applied to both commercial and residential properties, as such the potential for organic growth is huge. As this is a relatively new industry, it is very much in its start-up phase and therefore is likely to see strong growth over the next few years. Silver is used in the PV industry in the form of Silver paste, which in turn is made from Silver powder. The US and Japan are the largest Silver powder manufacturers.

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 a fast pace. Silver's use in photography is now only 32% of what it was at the peak, however, it still used some 2,200 tonnes of metal last year. In 2010, photographic demand for Silver fell 8%, which was a smaller than expected drop and the reason for that seems to be due to the market for x-ray machines. Most medical establishments



where possible are using digital x-rays, but they are prohibitively expensive so as medical care expands in the developing world, medical establishments are often opting initially to install second-hand conventional x-ray machines and this is keeping photographic demand for Silver alive. As such, the rate of fall in Silver's use in this industry might start to level out as we expect further economic hardship will delay the switch over from conventional x-ray machines to digital x-ray equipment. Overall, we would expect photographic demand for Silver to drop at a rate of 10 percent per annum, which is slower than the average drop of 18% during 2008 and 2009, but more in line with the average annual drop of 9% between 2000 and 2009.

New applications

Silver's new applications are diverse and are being used in health, electronics and transport/packaging. 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 that was noticeable in the strong rebound that was seen in 2010. However, as we move back into a slower growth environment, demand for these products is likely to slow again.

Another new application that looks promising and has potential to become a major user of the metal is Silver –zinc batteries. These rechargeable batteries are being considered for the next generation of 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 market for rechargeable batteries in 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-zinc batteries in electric cars, which would drive up Silver demand considerably.

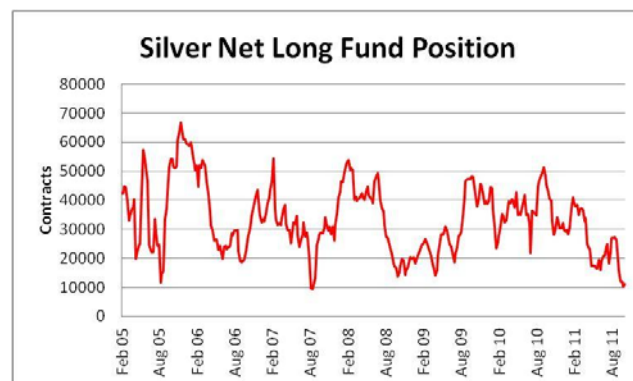
INVESTMENT DEMAND

ETF investors have generally remained committed to the Silver market. In April, the increase in margins needed to trade the futures markets, triggered a profit-taking sell-off and that led to redemptions in the Silver ETFs. Before the sell-off in price, the peak in ETF holdings had been 15,632 tonnes, seen in mid-April - holdings dropped to a low of 13,576 tonnes in mid-June, a drop of 13%. However, since then the ETF position has climbed to 14,415 tonnes. Even though this is still below the peak, generally it suggests that long term investors have not lost their faith in Silver. Interestingly, throughout the 2008-2009 sell-off in asset classes, Silver ETF investors were steadfast. Given increased concerns over the fate of the euro and the potential for more quantitative easing (QE) in the US, which could further debase the value of the dollar, we feel investors will increasingly look to monetarise bullion as they seek to protect themselves from the turmoil in the financial system. Needless to say, given the supply / demand surplus, investing in Silver is a confidence game. We can understand why Silver prices can still go up as there are trillions of dollars worth of paper-based financial instruments that have little intrinsic value. So if investors' confidence in these paper assets falls, then the demand for assets with intrinsic value will no doubt rise. However, at some stage confidence in the financial system will return and then investors will want to move out of safe-havens and return to more traditional forms of investments. When that happens, there is likely to be a flood of Silver returning to the market and prices will correct accordingly. But we do not see that happening anytime soon.



Speculators' holdings near long term lows

Although the level of buying by ETF investors has generally held up well, the same can not be said for the funds. The net long fund position (NLFP) in Silver has dropped significantly. We feel investors were hurt during the price correction in April and the volatility has made them wary about returning. However, the deteriorating economic outlook will also have reduced the appeal of holding Silver as industrial demand is likely to suffer if the West moves

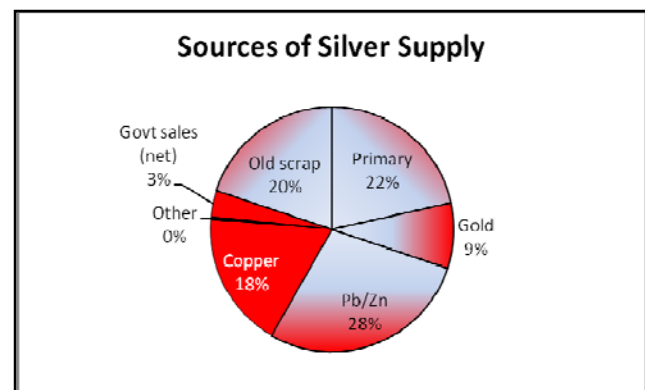


back into recession. That said, we feel that Silver still has a role as a monetary asset and would not be surprised if broad based currency weakness - on the back of the EU debt situation, quantitative easing in the US and further wrangling over how to cut the US budget deficit, did not boost demand for Silver as an alternative monetary asset. A look at the chart of the NLFP shows from such low levels, a strong rebound has often followed.

SUPPLY

Silver supply comes from mine output (70%), scrap (20%), forward producer hedging (6%) and net government sales (4%). Surprisingly the biggest change to supply came from producer hedging that reached an estimated 1,900 tonnes in 2010, whereas in preceding years producers had still been de-hedging.

Mine output rose 2% in 2010 to a new record of 22,889 tonnes according to the World Silver Survey, that was after a 5.3% gain in 2009. Output from primary Silver mines continued to expand, but output at some polymetallic mines dropped as ore grades declined and as some producers targeted higher grades of base metals to take advantage of the strong base metals prices. Mexico became the world's largest producer of Silver, overtaking Peru in the process, while China remained the third largest producer. Most of China's Silver mine output is a by-product from its lead-zinc and copper mining, all of which has been growing rapidly in recent years. In 2010, the break down of global Silver supply showed 28% coming from lead-zinc mining operations, 22% from primary silver mines, 18% from copper mining, 11% as a by-product from Gold, 20% from scrap and 3% from official sales. In 2011, the main increases are expected to come from increased by-product output from lead/zinc mines.



Supply from scrap has been strong in recent years as the high price has attracted metal back into the market. The move up towards \$50/oz earlier in the year is expected to have led to a significant increase in scrap supply and as we expect Silver prices to rechallenge the highs in the months ahead, we feel scrap supply will remain high.

Base metal prices have turned lower in 2011 as the outlook for economic growth has deteriorated. We are somewhat surprised by the speed of the price retreat in lead and zinc and now feel that it will not be long before prices of those metals fall to levels that prompt production cutbacks. With 28% of Silver mine output coming from lead-zinc mines and 70% of Silver coming from mining that means 20% of total Silver supply comes from lead-zinc mines. As such, if there are production cutbacks then Silver supply is likely to be affected. With copper prices still well above its marginal costs of production, we would be surprised to see any loss of Silver mine output from this source as we do not expect to see copper production cutbacks.

Supply from Scrap

Silver supply from scrap had been falling up until 2009 and that was mainly the result of less Silver being used in the photo industry. However, the tide has turned and scrap supply is at record levels. In line with the various commercial schemes to encourage people to scrap old Gold jewellery, there has been a marked pick-up in the amount of Silver jewellery and silverware being scrapped – this is especially so in the US, India and in Europe. Scrap supply from China also climbed, but that was more a result of higher prices encouraging recycling of Silver waste from the photographic industry. This ties in with reports that as better healthcare was rolled out into the less developed parts of China over the past decade, they installed conventional x-ray machines, rather than the considerably more expensive digital x-rays equipment. In addition, film based cameras and single-use disposable cameras are still widely in use in China. As we expect bullion prices to rise further, we expect supply from scrap to continue to grow. Whereas record high Gold prices may have already attracted much of the old Gold out of the ‘woodwork’, we imagine that supply of old Silver jewellery and silverware will remain quite price elastic.

Government stocks continue to fall

In 2010, net government sales from stocks are estimated to have increased to 1,390 tonnes, up significantly from the 426 tonnes sold in 2009. As has been the case since 2007, most of the official sales have come from Russia. We are somewhat surprised that Russia is selling Silver as it is an active buyer of Gold for its foreign exchange reserves and we would have thought Silver would complement its Gold holdings. Since 2006, China seems to have stopped exporting Silver in quantity and although its electronics and solar panel industry have grown significantly since then, which might account for the fall in government sales, we also feel that they may well be holding on to their Silver to diversify their foreign exchange reserves. Overall, we would not be surprised if government sales start to trend lower again in the years ahead, as Silver becomes more monetarised.

Balance

The Silver market has been in a supply surplus since 2004 so above-ground stocks have accumulated – estimates put this at around 15,000 tonnes. The emergence of the ETFs in 2006, have absorbed much of the surplus as the ETFs hold around 14,415 tonnes of metal. However, the market remains in a surplus and that is likely to remain the case until the handful of new industrial applications become large consumers of Silver. This means that ongoing investor interest is crucial for the longevity of Silver’s bull market. Although the long term outlook for Silver demand is good, there is a high chance that between now and the time when the market balance returns to a deficit, investors will want to rotate their investment money out of Silver and into assets that offer a better return. In the short-to-medium term, we feel the potential for currency debasement and deflation, plus the need for a safe-haven against developments in the financial markets, will keep investors’ interest alive, but we feel there is no room for complacency and once the West starts to get its debt, budget deficits and any latent inflation under control, we should expect large scale disinvestment.

Technical

The accelerated rally between August 2010 and April 2011 seemed unsustainable, so it was not a surprise prices corrected, although the severity of the correction was a shock. However, the fact prices held above the long term up trend line is constructive and with prices back above the former retaining line that runs along previous peaks and above the 52 week moving average, the chart looks potentially bullish again. Needless to say, there is a lot of overhead supply

above \$35/oz and that runs up to the August peak at \$44.24/oz. This may take considerable time to erode. The stochastics have recently crossed higher again and the slow line of the stochastics is at a relatively low level - this suggests that the rally may well have further to run and we would target the \$40/oz level. It would take a move above \$45/oz again to open the door for a challenge of the all time highs above \$50/oz. There seems little point forecasting how high prices might go as we have seen how overbought prices can become - as the Q1'11 rally showed. That said, we would not be surprised to see Gold reach \$2,280/oz and if we take a Gold/Silver ratio of 1:44 (which we could see again in a bullish environment), then that would suggest a Silver price of around \$52/oz. On the downside we would expect support at \$28/oz, \$26/oz and then at the long term up trend line, which at the time of writing is around the \$23.40/oz area.



Conclusion and Forecast

The situation in Silver remains very interesting in that the market continues to be in a supply surplus and that is likely to be the case for the foreseeable future. Given the high level of stocks around in Silver it does take a leap of faith to be bullish, but we do feel that Silver is well positioned to follow in Gold's footsteps as a hedge against uncertainty and an alternative to paper money, which if we are heading for a period of deflation might become all important.

Although there are new applications for Silver that are likely to become large consumers of the metal, we do not feel these new uses will cause the market to move into a supply deficit for a number of years still. This means that the investment boom currently driving prices higher is likely to run out of steam before the more bullish fundamentals take over. As such, we need to have contingency plans ready for when the investment bull-run ends. When it does, then disinvestment of Silver is likely to flood the market with metal and prices are likely to tumble.

However, while concerns over the West's financial system persist, the market is likely to remain broadly bullish for Silver as a complement to Gold. Both markets are relatively small, so there is room for both of them and Silver provides a cheaper entry point for those who can not afford to buy Gold.

Investors' interest will remain crucial. ETF investors have cut their Silver holdings by 13%, but given the extent of the correction in prices that is not too alarming. The funds have slashed their net long position, but if those remaining are in for the long term, then there is now plenty of room for more speculative fund buying to return.

Overall, we think Silver prices may well have another run higher as, along with Gold, we expect Silver to become more monetarised as investors seek protection against currency debasement and upheavals in the financial system. We would not be surprised to see \$45/oz, or even \$52/oz at some stage. However, Silver could experience some very volatile conditions and that could entail retests of support down into the \$28/oz to \$26/oz level, or even a spike down to the up trend line should another broad market sell-off be seen. Although we have

allowed for further corrections, we feel prices will run higher again before investors finally feel confident enough to liquidate their safe-haven positions and Silver prices undergo a deep correction.

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To obtain additional information on ScotiaMocatta products and services, call one of the offices listed below.

CANADA**Toronto**

Scotia Plaza
40 King Street West
Box 4085, Station 'A'
Scotia Plaza
Toronto, Ontario
M5W 2X6

Andy Montano

andy_montano@scotiacapital.com
Tel: 1-416-866-7835
Fax: 1-416-866-6897

UNITED KINGDOM**London**

201 Bishopsgate
6th Floor
London
EC2M 3NS

David Wilkinson

david_wilkinson@scotiacapital.com
Tel: 44-20-7826-5931
Fax: 44-20-7826-5948

UNITED STATES**New York**

One Liberty Plaza
165 Broadway
New York, N.Y. 10006

Tim Dinneny

tim_dinneny@scotiacapital.com
Tel: 1-212-225-6200
Fax: 1-212-225-6248

MEXICO**Mexico City**

Bldv. M. Avila Camacho #1,
Piso 11
Col. Chapultepec Polanco
Colonia Polanco 11560
Mexico

Jose Maria Tapia

jose_tapia@scotiacapital.com
Tel: 52 55 9179 5142
Fax: 52 55 5325 3527

INDIA**Mumbai**

91, 3rd North Avenue
Maker Maxity
Bandra Kurla Complex
Mumbai 400 051

Rajan Venkatesh

rajan_venkatesh@scotiacapital.com
Tel: 91-22-6658-6901 (Direct)
Fax: 91-22-6658-6911

New Delhi

Upper Ground Floor
Dr. Gopal Das Bhavan
28 Barakhamba Road
New Delhi 110001

Prem Nath

prem_nath@scotiacapital.com
Tel: 91-11-2335-8789
Fax: 91-11-2335-9342

Bangalore

25/2 S.N. Towers
M.G. Road
Bangalore 560001

Mahendran Krishnamurthy

mahendran_krishnamurthy@scotiacapital.com
Tel: 91-80-2532-5325
Fax: 91-80-2558-1435

Coimbatore

Classic Towers
1547 Trichy Road
Coimbatore 641018

Shankara Subramanian

shankara_subramanian@scotiacapital.com
Tel: 91-422-2304-489
Fax: 91-422-2301-596

HONG KONG SAR

21st Floor, Central Tower
28 Queen's Road Central
Central
Hong Kong

Alice Lam

alice_lam@scotiacapital.com
Tel: 852-2861-4778
Fax: 852-2573-7869

SINGAPORE

1 Raffles Quay
#20-01, North Tower
One Raffles Quay
Singapore, 048583

Swee Kiang Teo

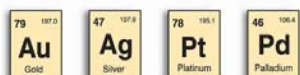
sweekiang_teo@scotiacapital.com
Tel: 65-6536-3683
Fax: 65-6534-7825

UNITED ARAB EMIRATES**Dubai**

302, Precinct Building 03
Dubai International Financial
Centre
Dubai
UAE

Pramod Mohan

pramod_mohan@scotiacapital.com
Tel: 971 4 371 1555
Fax: 971 4448 4640



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