April 18, 2012 – Excessive Speculation

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Primarily because of high gasoline prices at the pump, increased attention is being placed on what role commodity speculators may be playing in creating those high prices. Just yesterday, President Obama proposed a five-point plan designed to safeguard against excessive speculation and manipulation in energy trading markets. The measures included giving the CFTC the power to set margins, as well as increased funding to boost surveillance and enforcement staffing levels and computer technologies. The President also called for a dramatic increase in the penalties for manipulation. It is thought that increased spending will be difficult in the current political environment and that this was political posturing in an election year.

Certainly, I found nothing to fault with any of the proposals, even with having the CFTC replace the CME as the setter of margins. (Normally, the government shouldn't be setting margin requirements, but anyone would be better than the CME). The economic justification behind futures trading is to allow legitimate producers and consumers the opportunity to lay off price risks to those speculators willing to assume them. The futures markets weren't created to encourage gambling and the founding fathers of commodity law recognized the need to guard against excessive speculation and manipulation. The thought of many millions of ordinary citizens paying more for daily necessities because of the actions of a few speculators should be offensive to all.

But is that what has been occurring in energy markets? Perhaps to a certain level, but the clear telltale signs of excessive speculation and manipulation don't appear to be present. The telltale signs, of course, would include a large concentrated position on the long side. This concentration information is compiled and published weekly by the CFTC in their Commitments of Traders Report (COT). For example, in crude oil futures, the big NYMEX contract doesn't appear to be overly concentrated, with the four largest longs holding a 13.2% net position of total open interest.

Undoubtedly, when important technical price signals are flashed, crude oil futures, like all commodities, can jump or fall suddenly as many technical traders enter or exit the markets simultaneously. In the past, I have suggested a separate speculative position limit be created if too many independent traders are utilizing the same price signals and disrupting price patterns. But overall, it does not appear as if an excessively concentrated long position is behind the rise in crude oil and gasoline prices. As an energy consumer, if I saw clear signs of manipulation in energy prices, I would say so.

Instead, the clear cut signs of excessive speculation and concentration are present in markets away from energy. Of course, regular readers are aware that COMEX silver futures have a concentrated short position consistently larger than any other major market. In the latest COT, the four largest silver shorts have a net concentrated short position of 29.9% and as recently as Feb 28, the concentration was 35.6%. Once spread positions are subtracted from total open interest, the true net concentration in silver climbs even higher. On a true net basis, one trader (JPMorgan) has held a concentrated short position in COMEX silver futures on either side of 25% of the market. In no other market does such a concentration exist.

And it's not just that the big shorts in silver hold an overly excessive and concentrated position in COMEX terms, as the position is also much larger than any other commodity in terms of world production and world inventories. On any objective measurement, there has never been a commodity that has witnessed the degree of concentration and excessive speculation that COMEX silver has on the short side. Yet, when confronted with what is the clearest proof possible of manipulation, the regulators have been silent. I'd like to explore why that is the case.

In large measure, the circumstance of a clear manipulation being present in silver and being ignored by the regulators is due to two factors. One, silver is a small market that doesn't create the widespread political urgency of $4 gasoline at the pump. Two, the manipulation is on the short side, meaning that prices are lower than they would be without the concentrated and manipulative short position. Most people can quickly understand how unscrupulous speculators could buy up available supplies and corner a market, driving prices higher. There have been many examples of such long side manipulations throughout history. But the majority of people would have a difficult time comprehending a short position, to say nothing of a short position so excessive and concentrated that it results in a manipulation. Manipulation, to most people, is strictly a long side possibility.

But law enforcement must not be a popularity contest or otherwise selective. Markets should be regulated as if on a level playing field with no clear advantage being given to one side or to a limited number of participants. That's an additional problem in silver, where the big COMEX short has been identified as JPMorgan, perhaps the most connected of all commercial banks in the US.

As an example of what I am saying, I'd ask you to review a short video interview featuring Michael Greenberger, a professor at the University Of Maryland School Of Law, where he teaches a course on derivatives trading. I don't know Professor Greenberger personally, but his credentials appear impeccable, including a past term as a Director of the CFTC's Trading and Markets Division. From past readings of what Greenberger has had to say, I think he's top-notch and has as firm a grasp on the issues as anyone.

That said, I ask that you review this interview with the filter that he, like just about everyone else, approaches the question of manipulation and excessive speculation strictly in terms of a long side manipulation of energy and food prices. Professor Greenberger is an expert's expert, yet even he falls victim to the prejudice that the long side is the only side in which manipulation can occur. I ask that you substitute or include the short side when watching the video and include the name JPMorgan and silver where the Professor says he doesn't want to name names.
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I think it's mostly good news that people like Professor Greenberger can describe manipulation and excessive speculation sensibly and in detail, but only in terms of the long side and not the short side. My optimism is based upon what should be a brief learning curve. Since there is no exclusion under the law for a short side manipulation, it would appear to be only a brief time before observers like the professor grasp the current circumstances in silver. As I've maintained all along, it's more a question of the real silver story coming out that will bring the manipulation to an end than anything else. Certainly, there has been no compelling rebuttal to the increasingly specific allegations of wrongdoing in silver on the short side. Sooner or later, this will come to a head.

Recent price action has flattened out a bit, which should be of no particular concern to long term silver investors. The key questions are whether the collusive commercials can induce further speculative selling on price breaks and what will JPMorgan do on the next significant price rally. In time, we'll get the answers. I have started to read some increased commentary about the growth in COMEX silver inventory levels to multi-year highs being related to a growing surplus in silver supplies. I think the real story about recorded silver inventories (in COMEX and the various ETFs) continues to be the increased turnover or movement. It is this unusually active movement that has caught my attention for more than a year and it does not look bearish to me. The silver is being brought in because there is a demand for it, not because there is no other place for it to go.

Ted Butler

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Silver – $31.50

Gold – $1640

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