

April 23, 2011 – Weekly Review

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I'm sure you will forgive the repetition; another week, another record. The price of silver exploded by more than \$3.50 (8.3 %) to new 31-year highs in a holiday-shortened week. At this pace, I won't have to use the 31-year qualifier soon. Gold moved to new all time highs over \$1500, by climbing \$18 (1.2%) for the week. As a result of silver's stunning outperformance relative to gold, the gold/silver ratio tightened in to under 33 to 1. As I've written previously, changes in the gold/silver ratio do not come close to truly representing just how much better an investment silver has been compared to gold.

Since the start of this year, silver is up 50%, while gold is up 6%. This means an investment in silver has returned more than 8 times what an investment in gold has returned over the past three and a half months. Going all the way back to their respective price lows over the past decade (\$4 in silver, \$252 in gold), silver has doubled gold's return. Similar results occur at most points in between. Despite the remarkable outperformance of silver compared to gold, the facts suggest that outperformance is not over.

Also not over, apparently, is the rash of public commentary that misses the real silver story. I understand the increased attention to silver given its price performance, but I had anticipated a greater awareness of what really was behind it. I'm not complaining, mind you, as it suggests we still have a long way to go. It seems that even those articles that write of silver favorably, still manage to miss the real story. Even the few bullish articles on silver seem to attribute its gains to influences not unique to silver, such as the weak dollar, a flight to quality, the Mid East, etc. But if this were true, one would expect these influences to equally impact a broad range of similar commodities. But that is not the case. Since the beginning of the year, other precious metals like platinum and palladium, as well as other industrial metals like copper, zinc, lead and nickel, have been basically flat, while silver has surged by 50%. A reasonable person would conclude that this would suggest there must have been some unique developments that were specific to silver that would explain silver's singular outperformance. Of course, that's the purpose of this publication – uncovering those unique developments.

Developments in the physical world continue to provide signs of tightness unique to silver. COMEX silver warehouse movements continue frenzied and scream out tightness. Tightness screams out even louder by developments in the big silver ETF, SLV. After expected additions of 4.5 million ounces earlier in the week, 1 million ounces were removed on Thursday. Given the surge in volume and price action in SLV, many millions of new ounces are now owed to the Trust (in addition to what's owed due to the listed short position). That silver is going out when it should be going in is one of the surest signs of physical tightness of them all, as the most plausible explanation is that the silver is just not available.

There continues to be stories circulated about the SLV being a fraud, mostly because JPMorgan is the custodian of the metal. For the umpteenth time, I find these stories to be hogwash. I've come to conclude that nothing will ever satisfy the SLV skeptics. That said, the one legitimate knock against the SLV, namely, the short selling of its shares, is hardly mentioned. The latest figures weren't published yet, but I don't plan to ignore the matter if the short interest in SLV rises again. Aside from that very specific issue, the SLV has been the silver investor's best friend.

The reports of retail silver tightness and product unavailability seem to be intensifying. These reports seem to be specific to silver and not to gold, although there seems to be a pattern of including gold in the stories of tightness. That's not to say physical tightness can't develop in gold, just that there has been no credible evidence of that yet.

This week's Commitment of Traders Report (COT) came in as I hoped, although that was not evident when I first glanced at the report. In silver, there was a slight increase in the total net commercial short position of around 1400 contracts, while in gold the commercials increased their net total short position by almost 13,000 contracts. I had been hoping for a flat commercial position in silver, or even a decline, so at first I was disappointed with the small silver increase. In gold, I had expected more of an increase than was reported. For the reporting week, prices rose by a very hefty \$4 in silver and \$40 in gold, so normally big increases in commercial shorting would be expected.

I soon got over my initial disappointment in the silver COTs, as I studied the details. The big 4 (JPMorgan) actually reduced their net short position by 1200 contracts and the next 5 thru 8 largest traders reduced their short position by another 1100 contracts, bringing the combined big 8 short position down by 2300 contracts. The reason the total net commercial short position rose by 1400 contracts is because the raptors (the smaller commercial aside from the big 8) sold 3700 contracts, erasing their previous 2200 contract long position and leaving the raptors short 1500 contracts. (I don't mean to bore you with the details, but many subscribers want to know the math.)

Here's the big picture in this week's silver COT. On a very big increase in price, the big shorts bought back short positions for the second consecutive week. This was what I hoped for. In fact, not in terms of contracts, but in terms of the percent of open interest held by the 4 biggest shorts, this week's net percentage (28%) is the lowest held by them in more than 5 years (maybe longer, but I don't have time to check).

Let me make one quick and obvious point (especially to the regulators). Silver is moving to an extremely high price (from where it was) because the big shorts are no longer selling to manipulate and contain the price. The bigger their short position, the more depressed the price. The more they buy back their concentrated short position, the more the price rises. Anyone (in the Enforcement Division) see a connection here?

Here's another observation. Those traders that we normally associate as being the hot speculative money are usually those in the managed money category (of the disaggregated report) and in the small unreported category. For the past two COTs, as the silver price rose by almost \$5 an ounce, these traders were not net buyers, but net sellers. So all those stories about silver being driven higher by hot speculative buying were just that \hat{A} ? stories. The buyers were primarily the big concentrated shorts. The good news is that these big shorts still have plenty to buy back.

I can't remember where or when, but I know I have speculated previously that after the tech funds and other speculators can't be tricked into selling any more contracts, the big shorts would only have the raptors to buy from. This week's COT is supportive of that premise. With the signs of physical silver tightness present and the buying to the upside by the big shorts emerging, the conditions for a melt up are still with us. Yes, we are at what many would consider the nose-bleed territory of high prices in which a sell-off should be expected, but the actual data rolling in still is supportive of higher prices.

One factor in the melt-up premise is the future behavior of the shorts. It is no secret that the silver shorts have taken a financial beating and history suggests those most likely to panic are those in a financially weakened state. I've pointed out the amount of money the silver shorts have collectively lost as a result of the price increases to date. At Thursday's close, the total net COMEX short futures position of 500 million ounces (net of spreads) is behind \$14 billion in the \$28 rally from August. But numbers alone don't always adequately reflect the emotional and financial predicament of the shorts. And the \$14 billion figure just reflects COMEX net futures contracts. I'm leaving out net COMEX options and OTC swaps and options exposure and the shorts in mining stocks and options. So let me see if I can convey the silver shorts' predicament in a somewhat different manner. As you know, I try my best to present things in different perspectives. There is quite a bit of personal confession here, so try not to hold that against me.

When I first became aware of the COMEX silver manipulation, back around 1985, I got into the bad but logical habit of always maintaining a long out of the money call option position on silver. I knew, or thought I knew, that silver would explode in price one day, although I didn't know, of course, which day. Therefore, based upon my background in the brokerage business, holding a continuous open call option position made sense. Since silver was ultra-depressed in price by the ongoing manipulation, the price of the call options was always cheap. Cheap is not the same as free, so I had to make sure I didn't run out of money and didn't die before silver exploded in price. Unfortunately, because silver remained manipulated for decades, I did run out of money on many occasions. Fortunately, I didn't die in the interim and somehow scrambled to come up with the money time after time. This caused great financial hardship to my family and I deeply regret putting them through it, but I was so convinced about silver that I couldn't help myself. Of course, if I (like anyone) could do it over, I would do it differently, but who has that luxury?

Some say that the definition of insanity is doing the same thing over and over again and expecting a different result. I stipulate to being certifiable when it came to buying silver call options, always expecting the next purchase to be the big one. But I underestimated the power of the silver manipulators in maintaining the duration of the scam for as long as they did. While I never put too much into any one call options purchase, the cumulative impact of two decades' worth of purchases amounted to an embarrassingly large total loss. That past personal experience made it difficult for me to even suggest that any subscriber should consider buying call options some six months or so ago. That's why, when I did so, I was careful to characterize it as throwing money away and how you had to be crazy to even consider it. I wasn't interested in seeing anyone go through what I had gone through. Yet, I knew the logic was there. It's also why I always preached buying physical silver for cash and not to speculate on margin (I'm devout believer in the Good Book of do as I say, not as I do).

The good news is that my cumulative options loss of two decades has been offset by many times in the rally since August. (Although I am mindful of Kenny Rogers' sage advice in *The Gambler* "never count your money when you're sitting at the table. They'll be time enough for counting when the dealing's done."). If you think this is intended as a story of personal redemption, you would be wrong. I'm not that full of myself. My point is completely different. My point is about the (call options) shorts.

Call options, like all derivatives contracts, are composed of a long and short holder; a buyer and seller. The cost or price of the option is called the premium. The buyer pays the premium and the seller receives the premium. The buyer can't lose more than the premium he pays for the option. If the underlying asset makes a big enough move up within the time life of the call option, the buyer can make many times what the premium originally cost. If not, the buyer loses what he paid and the option expires and becomes worthless. That's what I did in silver, over and over.

The seller of the call option gets to keep the premium that the buyer pays if the buyer's bet doesn't pan out in time. But if the buyer guesses right and the price of the underlying asset does rise sufficiently, the seller may be liable for an amount much greater than what was originally collected. (Please remember I am trying to keep this simple). In many ways options are like insurance. The policy holder pays a (small) premium to the insurance company to collect a large amount in the event of an accident or death. The option sellers, in accepting the buyers' premium, function as an insurance company and agree to pay out big amounts in the event of an unusual price event. I guess the big difference is that most people don't look forward to collecting from an insurance company because that means something bad has occurred. In buying call options, the buyer is looking to collect from the get go. Option sellers, like insurance companies, would prefer to never pay out.

The problem for the silver call option sellers, and the point I am trying to convey, is that they had learned over the two-decade life of the silver manipulation that they never had to pay the silver call option buyers anything. Because the price of silver was controlled (not necessarily by the option sellers themselves), the sellers took in the buyers premiums and never had to pay out any claims. A business that only takes in money and never has to pay out anything is a very good business indeed. On this, we would all agree. But, in reality, there are very few such businesses. Unfortunately for the silver call option sellers, they came to believe that they owned such a business and let their guard down. I believe that they came to be complacent and assumed they would always be able to take in silver premiums from the buyers and never have to pay out. Those days, which did exist for many, many years, are now over.

I believe the silver call options sellers have received a shock to the system with the recent sharp rise in silver prices. After decades of easy street and easy money, the tables have been abruptly turned. It's said that you learn more from adversity and failure than you do from success; that when life is too easy, you become less prepared for dealing with difficulties. Where there was always only money coming in from the option buyers, there is now sudden and massive money going out. My personal financial turn-around is only a drop in the bucket for what the silver option sellers are collectively experiencing. If they are not panicking, it is only because they are already dead (financially). Who are the silver option sellers? They range from individuals to large financial trading companies.

The only real solution for the remaining silver option sellers may be to quit the business completely and buy back or neutralize their open exposure to a further rise in silver prices. This would put powerful upward pressure to the price of silver. What I have tried to convey today is that it's not just the amount of money the silver option sellers have lost and how quickly that has come to pass, but also the emotional state they must be in presently. After twenty years of everything going your way, it's a rude awakening that has befallen the silver call option sellers. It is this emotional state that greatly raises the risk of a melt up in silver prices. Make no mistake – silver call option sellers are silver short sellers, whether they considered themselves that or not. To repeat – the financial and emotional stress to these short sellers is such that it increases the odds of a silver price explosion.

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Silver – \$46.50

Gold – \$1504

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