

August 17, 2016 – Silver Rocket Fuel

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I thought it would be appropriate to revisit a long held silver premise of mine. In fact, this one goes back more than 30 years and came about from my epiphany in silver and endless conversations with my silver mentor and good (and long lost) friend, Israel Freidman. I've held this premise for so long that I can't pinpoint its actual origin or whether Izzy came up with it or me. Now that I think it over, it had to be Izzy's idea because it is more rooted in his unique life's experience, including first hand observation about how people react in the face of genuine shortage.

While it would take years for Izzy to fully accept the mechanics of the silver manipulation (my COMEX positioning version), there was never any doubt in his mind that the price of silver was artificially depressed – that's why he challenged me to come up with the explanation for silver's low price in the face of a structural consumption deficit. In any event, our daily conversations revolved around two things – what was causing the low price and what effect the low price would eventually bring about. Not much different from today where the topic is either price control on the COMEX or when the forces of actual supply and demand will assert control.

The premise in question is the coming physical silver inventory buying panic by industrial users and fabricators. I know there are many reasons advanced for why silver prices should increase dramatically in time and I have covered more than my fair share of those reasons on these pages. But there has always been one main reason for me – an inevitable physical shortage. Embedded in that physical shortage thesis is how delivery delays will affect silver user behavior. It's not the shortage itself that will cause silver prices to explode, but what the users will do when the shortage hits. That's the real rocket fuel.

I've used the term "rocket fuel" in the past to describe the type of aggressive buying that must occur when the managed money technical funds get heavily short in COMEX gold or silver futures. This was last seen at the end of last year when managed money traders held record short positions on the COMEX. The first leg of this year's rally (\$200 in gold and \$3 in silver) was due to that managed money short covering rocket fuel type buying. I'm speaking of a different type of rocket fuel buying today, not the buying of paper contracts on the COMEX, but the panicky buying of physical material by companies that need that material in their manufacturing processes and without which the user must stop production.

The paper contract buyer is motivated by speculative profit or loss, whereas the physical user buyer is motivated by the fear of interruption of the continuity of the business operation. Any silver user which encounters a long enough delay in the actual delivery of metal will panic at some point to secure prompt delivery by any means possible, including buying more than needed to ensure against further delays. This results in less physical metal being available to other silver users and exacerbates the shortage.

Another important distinction between paper and physical rocket fuel buying in silver is that the commercial crooks on the COMEX can sell short virtually unlimited amounts of paper silver, but no one can create physical silver in unlimited quantities. No doubt some users may also buy futures contracts as prices rise for protection, but if the buying motivation is driven by physical delivery delays, then it will be physical metal sought.

What the silver users will do when faced with delays in deliveries of actual metal is what most people do when faced with the sudden deprivation of a necessary or highly desired item. In other words, buying demand intensifies, driving prices higher and further straining already limited supplies until prices get so high so as to exhaust all the demand. This a price blow-off situation of historic proportions which, by definition, occurs only once in decades or longer. Silver prices will fall back sharply from whatever the ultimate price peak may be, but the peak will likely be remembered forever. I think the ultimate challenge for silver investors is to say goodbye to silver as close to the coming blow-off peak as possible (or at least as close as possible while we still inhabit this world).

Many observers speak of sharply higher silver prices to come, but most usually in the context of such a move occurring in gold as well. However, few speak of an industrial user buying panic in gold and for good reason. Since gold is not consumed industrially as heavily as is silver (or other commodities), it is hard to envision a gold user buying panic. Gold (and silver) can certainly move higher on investment demand, but only those commodities which are industrially consumed can experience an industrial users buying panic. Silver is both industrially consumed, like every other commodity aside from gold, but also different from other commodities and aligned closely with gold as an investment asset; hence silver's unique dual demand profile.

Since I have held the silver user buying panic premise for more than 30 years, it's fair to ask when the heck this panic will occur. Unfortunately, analysis is different from prophesy and to pretend to know precisely when any inevitable result will occur is beyond human capability. On the other hand, there have been a number of developments that have occurred over the past thirty years that strongly support the user buying panic to come in silver. One is the industrial user buying panic in palladium in the early 2000's.

Very long term readers may remember several articles I wrote about the user buying panic in palladium both when it occurred and afterwards. Because it illustrates so clearly what will unfold one day in silver, please allow me to summarize the palladium industrial user buying panic.

Like silver, palladium is a precious metal and primarily a metal industrially consumed, as are other precious metals, like platinum and rhodium. In fact, the only precious metal not widely consumed industrially is, of course, gold. And while there is certainly some investment in palladium and platinum, investment demand makes up a very small percentage of total demand. In every practical sense, gold and silver are the only true choices for precious metals investors.

Palladium is used primarily in catalytic converters in motor vehicles to curb exhaust emissions, making the world's automobile manufacturers the largest users. Palladium prices were just above \$100 an ounce in early 1997, having fallen from a peak of the historic peak of \$200 two years earlier. By 2001, the price of palladium had surged more than ten-fold from the lows to \$1100 an ounce. During that same time, 1997 to 2001, the price of platinum moved higher, from \$400 to \$600, and the prices of gold and silver were deader than a doornail and flatter than a pancake. The ten-fold surge in the price of palladium was unique and specific to that metal.

Over the four year run in palladium prices, participation in the leading palladium derivatives exchange, the NYMEX (owned by the CME Group now, also the owners of the COMEX), shrunk greatly, effectively approaching zero, as trading volume and open interest almost disappeared. I mention this to make the point that the explosion in palladium prices had little to do with futures market speculation because there was so little speculation on the exchange. So if speculation or investment demand was not responsible for the palladium price surge, then what was?

The cause of the ten-fold increase in palladium prices was industrial user stockpiling of the metal in the fear there wouldn't be enough metal to go around. To this day it is thought that the Ford Motor Company was the chief palladium buyer as it sought to immunize itself against delays in physical deliveries by building sufficient physical inventories. Once Ford finished buying, palladium prices fell below \$200 by 2003. I'm sure there were other price forces at work over this time, but if Ford and other industrial users hadn't moved to build up physical inventories of the metal, there would have been no ten-fold rise in price.

Over the years, there have been many instances of industrial shortages in other metals, including nickel, copper and zinc. In every case, some industrial consumers contributed to the inevitable price run up, although probably not to the extent of Ford in palladium. My point is that industrial user attempts to build inventory at the first sign of delivery delays are normal human behavior. How secure would a purchasing agent's job be if the entire plant had to cease operations due to the lack of a single material/component? Because there were so many, it's not possible to count all the conversations I had with Izzy about this over the years, long before the real life occurrences appeared.

Industrial company purchasing agents or logistics officials are, at the core, human beings. Who among us wouldn't rush to fill up the gas tank or buy extra supplies that we know from experience will be long gone when hurricane warnings are issued? Those types of shortages are known to likely be temporary; but when a shortage occurs in an industrial commodity, there is no way to judge its longevity, so that begets even greater user stockpiling.

Aside from the capability of any industrial or consumable commodity to go into a physical shortage exacerbated by user stockpiling, there is one special characteristic specific to silver that sets it apart from all of its fellow industrial commodities, namely, that it is a timeless primary investment asset as well. This is the essence of silver's highly unique dual demand profile that exists in no other commodity.

Palladium is a precious metal, first discovered 200 years ago, but it is not a primary or timeless investment asset and there is no evidence that broad investment demand drove it higher by ten times into 2001. Nor is there any evidence that investment buying drove any other industrial commodity shortage over the past couple of decades. I'm not saying some big hedge funds didn't play around at times, but such entities didn't create the shortages themselves.

Silver is different in that it is a primary investment asset. Certainly most, if not all reading this article own silver in some form (I would hope). This is a specialized service, but silver is available for investment in more forms than just about any other asset, including the ability to hold it in its most elemental form \hat{A} ? as metal in hand. And silver certainly has a history, in terms of time, second to no other asset, including gold. My point here is that there are many who recommend the purchase of silver and silver related assets for a wide variety of reasons, as mentioned previously. Most do so independent of the premise of the coming industrial user buying panic.

But whatever reasons investors rely on for buying silver, in no way do those reasons negate the industrial user panic buying premise. That's the beauty of silver's dual demand profile — one has nothing to do with the other. Silver investors have different buying motivations than do industrial users. But they do share one commonality — the commodity itself. Silver investors seek to have their investment grow in value and industrial users seek a continuity in business operations, but they end up doing the same thing — buying silver.

And not only that — both investors and users will likely end up buying the same type of silver — industry standard 1000 oz bars. That's because that's the form of silver in futures trading and in exchange traded funds (ETF's) and the form the users will rush to buy when delivery delays appear. Not coincidentally, this is also the form of silver that determines the price. Therefore, as and when a physical shortage develops in silver, not only will there be a rush by investors (attracted by the rising price) and a rush by users to build inventory, the rush will be centered on one specific form, silver in 1000 oz bars.

Excluding the premise of a user buying panic, there are many calling for silver to exceed \$100 or \$200 in price for a variety of reasons, which is five to ten times the current price. But when you include the user premise, it turbocharges or multiplies those expectations. Palladium ran up ten times in price in four years on user panic buying. Silver ran up ten times in price in little more than a year in 1980 and by that amount in 2011 from six years earlier, not on a user buying panic, but on investment demand both times. If we do experience a user inventory buying panic in silver, accompanied with an investment surge, shouldn't the price implications be magnified? Therefore, shouldn't those expecting silver to rise without considering the user buying panic, adjust their targets upward?

We'll see how it plays out, of course, but industrial shortages and user buying panics are facts of life, as are investment-led surges in silver. We've never experienced an investment boom and user buying panic in silver together, but there is little I see that can prevent it. When, not if it occurs for the first time, the roof will surely come off for silver prices.

There haven't been many notable developments since Saturday's review. The central point remains how and when the current extreme market position in COMEX silver and gold gets resolved. Will the commercials finally end up, for the very first time, buying back short positions to the upside in price and at great loss or will the technical funds be induced to sell on lower prices, allowing a more graceful exit for the commercial shorts?

Timewise, we have raced upward in the moving averages, particularly the 50 day variety, so it wouldn't take much of a downward thrust to see if the technical funds will begin to sell and there is no reason to believe that should take very long to uncover. But COT considerations are not time sensitive and the proximity of the 50 day moving average offers little insight into to how it will play out.

My principle daily focus is still on the changing fortunes on the collective financial scoreboard for COMEX futures positioning, the most meaningful measure available. At today's publication time, gold was up about \$11 for the week, while silver was about unchanged, pushing the commercials' unrealized loss up by around \$350 million from Friday's level of being \$2.5 billion in the hole. Of course, the commercials were briefly underwater by an additional \$350 million or so at yesterday's price highs, before prices sold off.

I don't have any strong expectations for Friday's new COT report, given the rather choppy price action during the reporting week ended yesterday. I will be looking to pick up on any unusual changes, considering the extreme nature of the current market structure.

Ted Butler

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Silver – \$19.73 (50 day moving average – \$19.15)

Gold – \$1347 (50 day moving average – \$1319)

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