August 3, 2016 – Center Stage

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Rather than simply repeat how impressed I am with what has developed in the near universal coverage of COMEX related matters and the COT market structure in gold and silver, today I thought I would feature a few specific examples. One article jarred me into remembering something that I had forgotten and the other two featured the COMEX market structure and COT report, but reached conclusions very much at odds with what is presented on these pages.

My main purpose (and likely yours as well) in reading anything related to silver or gold is in the hopes of learning something new or different from what I think I already know. After all, there is never too much one can learn. Generally speaking, it's hard to learn something new when reading commentaries that agree with that which we already believe to be true. Therefore, we are more likely to learn from thoughts contrary to our own, provided the facts are accurate and presented logically.

There is no basic disagreement in the first article I will highlight and, in fact, a subscriber wrote to me asking that I comment on it, after I had already decided to do so. The author is Paul Mylchreest, from ADM in London. You may know of Paul from this Â?Thunder RoadÂ? reports over the years.

http://www.gata.org/files/MylchreestReport-07-25-2016.pdf

Mylchreest's article concerns the current wide spread differentials between the different trading months in COMEX gold futures. I've mentioned spread trading in COMEX gold on a number of recent occasions to explain unexpected changes in total open interest, with my main thrust being that spread trading is of little interest to the long term investor in gold and silver as such trading is highly specialized and generally doesn't have much to do with the direction of gold prices.
I still believe that to be the case, but Mylchreest's article did explain the wide differences between the various gold trading months and provided, once again, a data point in complete conformance with my manipulation premise.

Mylchreest correctly identifies the reason for the historically wide differentials in COMEX gold futures, namely, as an artificial (and illegal) market device solely designed to take money away from those holding long positions in COMEX gold futures (mostly the managed money traders, but including anyone holding long positions) and giving that money to those holding short positions (the commercials).

This is the way this particular scam works Â? by artificially setting the spread differentials in COMEX gold (and silver) futures to historically wide extremes, or steep contango, the commercials force the long speculators at rollover time (when contracts approach expiration) to pay much more for the new contract month they must buy when selling the month approaching expiration. Mylchreest's estimate (which looks correct to me) is that the current artificially wide differentials would cost a long holder (and reward a short holder) who continues to maintain and roll over his long position as much as $24 per ounce annualized. That's $2400 for each gold contract rolled over during a full year. Applied to the roughly 300,000 net contracts held by speculative longs and by the commercial shorts, this comes to roughly $720 million taken out of the longs' pocket and put into the shorts' accounts.

The current overall money stakes are much greater than that (as I'll update in a moment), but $720 million is far from chump change and provides sufficient motive for collusion among the commercials. It's also no coincidence that the commercials, in addition to having financial motive, also have the means and opportunity to skew the spread differentials in their own favor. Mylchreest correctly makes this conclusion and asserts how, when the managed money traders held record short positions back in December, spread differential in gold were at record tight levels which benefited the then commercial longs and punished the managed money shorts.

How is it possible, apart from deliberate spread manipulation that the spread differentials always favor the commercials and always put the managed money traders at a disadvantage whether they are long or short? Is there anything about the COMEX that isn't designed by and for the commercials?

Recently, I remarked how the wide spread differentials between the COMEX gold futures months were in stark contrast to the extraordinary level of deliveries occurring and I kind of left it at that, namely, an unexplained anomaly. Blame it on advancing age or whatever, but I managed to forget how wide carrying charges are detrimental to longs, even though I was well aware of that in a previous life as a spread trader. Thanks to Mylchreest for bringing it all back. By itself, this important data point may not prove everything about the price manipulation that I allege exists on the COMEX, but it fits like a glove with all the other evidence of manipulation.

Based on the belief that we stand more likely to learn from those that disagree with us, allow me to point to two articles in that mold. I think it fair to term both authors as being strong deniers that gold or silver prices have been manipulated. Interestingly, both in these articles and others, I get the strong impression that both authors wouldn't be surprised if prices temporarily sold off, although both would be called long term bulls. Ironically, I'm not in violent disagreement with that. Put it this way, if we do sell off, it will be for one reason only Â? the commercials succeeded in inducing the managed money technical funds into selling; although that's my reason, not necessarily theirs.

The first, by Steve Saville, contends that there can be no such thing as a commercial failure. He doesn't define what would constitute such a failure, so allow me to offer a simple definition Â? the commercials being forced to buy back previously shorted gold and silver contracts at a loss and the technical funds selling out long positions at large profits.

http://tsi-blog.com/2016/08/there-will-never-be-a-commercial-signal-failure-in-the-gold-market/

While a collective commercial failure has not occurred, to my knowledge, in gold or any other exchange-traded market according to my simple definition, we have witnessed examples of individual commercial traders being forced to buy back short contracts at big losses. In fact, that's what I just reported on Saturday in COMEX gold. The concentration data in the latest COT report clearly indicates that one of the largest 5 thru 8 COMEX gold shorts bit the dust and bought back short positions (roughly 15,000 to 20,000 contracts) in the latest reporting week. There was also the case back in the fall of 2014, when a number of smaller commercials (the raptors) got too long COMEX silver and closed out those long positions at a big loss (I still have my Easter Bunny costume that I threatened to wear should that ever happen). So much for a commercial failing not being possible.

There are a few other things in Saville's article that I would like to address. I agree with Steve that a physical shortage in gold is unlikely given that it is not widely consumed on an industrial basis and that all current production is, by definition, added to above ground inventories. But physical shortage is not the only thing that could cause the commercials to panic on a collective basis in gold or any other commodity Â? it could come down to a simple money game in which enough investment demand emerges to drive prices higher and force the commercials to abandon short positions because the losses and margin calls become unbearable.

I found it fascinating that Savile did illustrate how any industrial commodity could go into a physical shortage and he used wheat as an example. I would have much preferred that he would have used silver instead, as regular readers know that is a familiar theme of mine in comparing gold to silver. In what I would call the key feature or point of disagreement I have with the article is the contention that the commercial shorts are in some way immune from losses to the upside because they are somehow Â?hedged or protected by spread trading.Â? This is also a theme of the last article I will reference, so let me deal with this now. Certainly, spread trading of the kind in the first article above couldn't protect against higher or lower gold prices because a transaction involving a simultaneous long and short position in different COMEX months is market neutral. Therefore, I'll assume Steve meant a spread of a different type Â? say a short position on the COMEX versus a long position held in the OTC market.

This is the issue at center stage Â? are the commercials engaged in legitimate hedging, as some contend, or are they just speculating their butts off, as I contend? Legitimate hedging is the economic justification for why congress authorized commodity futures trading in the U.S. and, accordingly, it is natural to believe the commercials must be hedging. But if you dig just a little beneath the surface, a different picture emerges. The big short sellers are mostly banks, not mining companies, which, I agree, would be the most natural hedgers. The data in the COT and Bank Participation Reports indicate this clearly.

The next usual counterargument is that the banks are merely the facilitators and conduits of miner hedging. In other words, the banks are selling short on the COMEX on behalf of the mining companies. But because there are very strict public accounting rules dictated by the Financial Accounting Standards Board (FASB), all publicly traded mining companies must disclose in a timely manner any hedging. Few if any mining companies have reported hedging and, therefore, the commercials can't possibly be selling on behalf of mining companies.

I suppose that leaves the explanation that the commercials are selling against physical inventories, but it's almost comical to think the commercials secretly held the 30 million ounces of physical gold ($40 billion) and 400 million ounces of physical silver that were added to commercial short COMEX positions since the start of the year. No, the commercials aren't selling short against owned physical positions or on behalf of the miners, no matter how many times this is advanced.

Besides, no one would deny that the managed money technical funds are purely speculating and that their historically massive long position in COMEX gold and silver is a speculative bet and as far removed from a hedging transaction as is possible. This massive net long position must be counterbalanced by an equally massive net short position. The same data source which indicates the existence of the massive net long position also shows the massive net short position. The managed money traders hold the net long position and the commercials hold the net short position.

No one questions who is long and who is short; but instead of simply moving on from there, all sorts of assumptions, mostly false, seek to Â?explain awayÂ? the economic justification of the short side. There's a good reason for that, because no legitimate justification exists. All we're left with is Â?the commercials have to sell to the managed money buyers, otherwise prices would explode.Â? Bingo Â? isn't that artificial price manipulation? If the technical funds are buying too many contracts, causing prices to rise too high or too fast in relation with actual supply/demand fundamentals, then restrict the technical funds by legitimate position limits, not by having a few commercials sell short preposterous amounts. You can call it Â?market makingÂ? if you choose, but I call it an insane and manipulative orgy of speculative bets that has distorted gold and silver prices.

Where I do agree with Saville is when he says that a collective commercial failure is rare and could be of the financial end of the world variety. Aren't those the type of possibilities which should be discussed the most?

The last article by Bob Moriarty from 321gold also contends that the bullion banks are not the short sellers on the COMEX, but mining companies instead, based upon the category classifications listed in COT reports. As always, Bob is personally insulting to anyone who disagrees with him (is this trait somehow coming from the water supply?), but I refuse to respond in kind. He refers to those espousing the manipulation premise as Â?scammersÂ? and I suppose he believes that I started petitioning the CFTC and the COMEX 30 years ago about the silver manipulation because I intended to deceive people about it three decades later. Let me take the high road and just say that I am grateful Bob is writing about the COT report more than ever.

http://www.321gold.com/editorials/moriarty/moriarty080216.html

However, as to the question whether the banks are the big short sellers or are mining companies instead, just because the COT category says producers, merchants and processors, etc. does it exclude the banks. JPMorgan is clearly classified in the producer, merchant, processor/user category, but that doesn't make it any less of a bank. Further, a simple glance at any Bank Participation Report, which uses the same source data as the COT reports, will confirm banks, both domestic and foreign are the largest short holders in COMEX gold and silver compared to any other type of trader. I would assume that Bob wouldn't knowingly state and restate something he knew to be factually incorrect and can only assume he is unaware of the Bank Participation Report. I intend to send a copy of this article to Mylchreest and Saville out of professional courtesy, but don't have Moriarty's email address. If anyone has it, please send it to me or forward this article directly to him (then stand back). Thanks in advance.

Onto the most recent market developments and my running financial scorecard of the great contest unfolding on the COMEX between the technical funds and the commercials. Strictly on the numbers, through yesterday's settlement prices on the COMEX, the commercials' total collective unrealized loss on the short side of gold and silver, widened by nearly $600 million from Friday's close to roughly $3.8 billion. This is the largest combined open loss the commercials have ever held in COMEX gold and silver and is critical for that reason alone. Today's slight decrease in price at settlement time (1:30 EST) brings only minor relief to the commercials (by about $250 million from yesterday's close)

As a reminder, my back of the envelop calculations assume an average shorting price of $1285 for gold on an average of 32 million oz and an average shorting price in silver of $17.20 on 350 million oz (after subtracting 150 million oz to adjust for JPM's paper short position on the COMEX due to its 500 million oz physical long position). Most of commercial short position in gold and silver, moreover, is tightly held among only 8 traders or so, making the concentrated nature of the short position particularly dangerous. That danger was evident in the case of the big gold short which bit the dust in the last COT report.

Since the commercials are now underwater by the largest amount ever, my sense is that their backs might be up against the wall and it's more critical than ever what happens next. Another $50 higher in gold and $2 higher in silver would put the commercials deeper in the hole by an additional $2.3 billion, bringing total unrealized losses to over $6 billion. Since the commercial short position is almost fully-held by 8 traders, that would bring the average loss per trader to $750 million. Never have the stakes been this extreme.

Because the stakes are so high and because a collective commercial failure would have implications beyond profound, it is difficult to imagine it occurring. Yet such a failure must be considered not only possible, but only one of two possible outcomes. Either the commercials succeed in turning prices lower and inducing significant technical fund selling or they will be forced to buy back to the upside for the first time in history. And on top of everything else, more continue to become aware of the game and the stakes, as evidenced by my reference to three different articles today.

Perhaps I'm imagining this, but the critical nature of the circumstance and the financial stakes may be behind what may be a slight easing in delivery demands on the current COMEX August gold delivery. I'm only speaking of the last couple of days, but there appears to be more voluntary liquidation of open August contracts as opposed to the new contracts created after first notice day in the June and July gold deliveries. There was also some liquidation in the non-traditional September gold contract following nothing but open interest additions until the past two days. My sense is that the commercials taking delivery in the August gold contract, specifically JPMorgan and its client(s), may be backing off a bit. Then again, this is a dynamic situation and changes by the day.

As far as this Friday's COT report, the safe bet is more technical fund buying and commercial shorting, based upon price action during the reporting week. However, considering the extreme numbers of contracts on both sides, we have to be coming to a point of resolution sooner rather than later. Of particular interest on Friday will be the new Bank Participation Report.

Ted Butler

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Silver – $20.47 (50 day moving average – $18.40)

Gold – $1358 (50 day moving average – $1295)

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