# August 31, 2016 – How Prices Get Set

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In the quest to explain something that may be complex into something easily understood, please allow me to reference a recent issue most in the US are now familiar with Â? the shocking rise in price for EpiPens, produced by the Mylan drug company. An EpiPen is a life-saving medicine in injectable form for those suffering a food allergy attack. Since many of the victims are children unknowingly ingesting what to them is poison, Epipens are prevalent in schools and have become a vital part of life for many families.

Shocking and persistent price increases of many hundreds of percent over the past several years for a drug that hasn't changed much had finally reached the boiling point of public and political consciousness and all manner of discussion has erupted. This is not a matter, by any means, limited to Mylan, as there have been many recent cases of skyrocketing prices on a variety of drugs. Having gotten my interest, I was sure that when I looked into the matter, I would discover a case of unbridled greed on the part of Mylan. While I wasn't disappointed by my preconceptions, I also came away with the opinion that it wasn't quite as simple as that.

The whole pricing situation for drugs in the US is extremely complex and involves a wide array of characters, including insurance companies, pharmaceutical distributers and the US government itself, in the form of the FDA and Medicare/Medicaid. The more I looked, the more complex it seemed and that was also the conclusion from all those who seemed most informed. Then it dawned on me what the problem was Â? the price discovery mechanism for drugs in the US was flawed, just as it is for silver and other commodities.

I'm not going to discuss drug pricing because I'm not remotely qualified, but with all the experts on every side agreeing that how drug prices get set is kind of screwy, at least it establishes how prices can get distorted. Why should commodities be exempted? The price of everything in the world has a price discovery process, which is just a fancy way of saying how prices get set. From kids selling lemonade by the cup to the pricing of the biggest ships and planes and parcels of real estate, there is a price discovery mechanism for everything that has a price. All involve the desire by the seller to achieve the highest price possible, balanced by the buyer's desire to pay the lowest price Â? but beyond that, complexity can soar.

In commodities, it is assumed that prices are set by the broad array of consumers and producers on either side, with no one producer or consumer dictating price. Commodity prices are assumed to be set by the myriad countless daily interactions between the world's producers and consumers in a free market atmosphere. And where a big producer or consumer does exert undue price influence, we rely upon antitrust and antimonopoly law to balance things out. That's how commodity prices are supposed to be set.

But something has occurred that has turned the world of commodity pricing on its head. The most shocking element is that while many see it, few recognize how the price discovery process for commodities has been completely upended. At least in the short to intermediate time frame (weeks and months), the usual interactions between the actual commodity producers and consumers of the world have come to matter little in establishing price. Let me be clear, I am saying that what used to set prices and is still thought by most to continue to set commodity prices, no longer sets price over the intermediate time frame. There has been a price setting revolution in some important world commodities.

All revolutions involve a sweeping out of the old and the ushering in of the new. If the price influence of the real commodity producers and consumers has been swept aside, as I claim, then a new force must have taken its place. That new force is the collective influence exerted on price by the traders in the managed money category of the disaggregated COT report and their counterparties (the commercials). So overpowering is the collective managed money/commercial buying and selling that it obliterates any price influence from real producers or consumers.

Not all world commodities have experienced a price discovery revolution, but many have, including not only silver and gold, but also copper, grains and crude oil, the world's most important commodity. The common denominator of the price revolution for commodities is an active futures trading market in which the managed money traders operate. (For what it's worth, most, if not all of the futures markets involved in the price setting revolution are owned by the CME Group, and that's why I zero in on it).

In simple terms, the managed money traders have come to buy and sell futures contracts in such enormous collective amounts that their positions overshadow the amounts produced and consumed in the real world. Even though the managed money traders and commercials deal mostly in derivatives contracts and the prices of such contracts are supposed to be derived from the real world of commodities and not the other way around, size distorts what's supposed to happen.

Under US commodity law, it is illegal for speculators to set or manipulate prices, yet it is easy to document that is precisely what is occurring. Before proving that speculators are setting prices, let me cut to the chase and explain how and why the regulators allow managed money traders and their commercial counterparties to set and manipulate prices. It has to do with speculative position limits and how those limits are determined.

The CFTC has managed to drag its heels for more than five years since the passage of Dodd-Frank and still there are no speculative position limits in gold and silver and other commodities, although long established position limits exist in some markets, notably the grains. It matters little, at this point, whether legitimate position limits ever arrive in gold or silver, because unless the CFTC changes the way it considers the managed money traders, such limits won't limit the managed money traders at all. That's because the agency considers position limits in terms of individual traders only and not in terms of the collective influence of many traders operating as one. Having a position limit, for example, of 5000 contracts sounds reasonable to prevent any one speculator from amassing too large of a position and influencing prices, but what if 100 different traders sought to establish the same 5000 contract long or short position at roughly the same time? In the normal scheme of things, how could a 500,000 contract position not be considered too large and influential on price?

In a nutshell, this is the problem Â? too many managed money traders, all independently owned and run, are operating under the same technical trading signals so as to be, effectively, operating as one entity. I suppose synchronicity holds a place in some forms of swimming, but not in futures trading.  I don't believe any of the managed money traders are doing this intentionally, as I am convinced the collective behavior of these traders works against them in overall performance. Besides, the trading signals for many managed money traders are widely known to be dependent on moving averages and other price changes, as I've written about for nearly forever.

Intentions aside, the data are clear Â? collective managed money trading is distorting prices like never before. This may not be new news, but what is new is how big the synchronized trading has become. And while I continue to heap scorn on the CFTC for allowing the outsized managed money/commercial trading to infect more commodities than ever, I must acknowledge that it is the agency that invites my scorn by publishing data that can't be denied or misinterpreted.

All this year I have focused on the changes in record extreme market structure in COMEX gold and silver. First record short positioning by the managed money traders at year end at historic price lows, to record long positions at high prices. And it's not just gold and silver, record positioning changes have been witnessed in copper, corn, crude oil and, in fact, most futures markets. That's just a statement of fact. And it's always the same Â? when managed money traders collectively buy, prices go up and when they sell, prices fall. What's different recently is that the derivatives buying and selling has become so large that this has become the sole price setting mechanism.

On Saturday, I commented that the net buying (mostly short covering) of 150,000 net contracts of NYMEX crude oil futures over the past two reporting weeks was why prices rose $8 to $9, a big move for oil. What I didn't expound on was how this was the equivalent of 150 million barrels of oil and the price impact of such a large quantity of crude equivalent bought or sold in two weeks. The world petroleum market is considered in a significant deficit or surplus when daily production or consumption is out of balance by 1 or 2 million barrels. In that sense, the amount the managed money traders bought can be the only real influence on price.

And in terms of the NYMEX crude oil futures market only, the 150,000 net contracts bought by the managed money traders (as prices penetrated the moving averages to the upside) is just as enormous. Not only was the managed money buying the largest category by several orders of magnitude compared to any other trader category, it would not be misleading to say that the managed money category was the only category buying and the other categories were, essentially, selling to the managed money traders. This is as one-sided I have seen a market.

So where am I going with all this? My main point is that the price impact of futures market positioning is not only the prime price influence is silver and other commodities, the positioning has intensified almost beyond imagination. I noticed this futures positioning many years ago as a price influence, mostly because I focused on silver so closely, but there can be no doubt (based upon COT data) that it has become the prime price influence in other commodities as well, certainly including crude oil.

Because managed money/commercial futures positioning is so influential on price, yet being both artificial and lacking in economic substance and legitimacy, I can see no way that it doesn't reach some sort of dramatic climax. This has got to end badly for some. It can't be defended, as is evident in the lack of outrage by the CFTC or the CME to my allegations of malfeasance or worse. It can't be denied, since all my allegations are derived from data published by the CFTC. Most importantly, it can't go on forever, because the effect on price is so artificial and manipulative to continue indefinitely. The question is how it ends.

Just like there was a threshold or breaking point in the price increases for EpiPens before they were rejected, there will come a similar point of recognition by legitimate market participants that managed money/commercial futures positioning is artificially setting the price of many world commodities. Until that point is reached it is foolish to ignore the prime price setting influence, particularly as it grows stronger.

On to developments since Saturday's review. Today was the first notice of delivery day for the September COMEX contacts. As a reminder, September is traditionally an active delivery month in silver, but not for gold. In silver, the standout features are fairly low numbers (257 contracts) of first day deliveries against a decent number (3000) of remaining open contracts, somewhat supportive of tight supply conditions. JPMorgan turned up as a stopper of 31 contracts for its house account, making it the third largest stopper and indicating the bank is still acquiring physical silver via COMEX futures deliveries, but well off its previous pace. Interestingly, MacQuarie Futures was the largest first day stopper of silver contracts (87) for its house account, marking its first instance of issuing or stopping silver contracts. MacQuarie burst on the scene last month in gold when it took more than 2900 gold deliveries, but didn't take any gold deliveries yet in September.

The standout feature in gold was the emergence of JPMorgan as the issuer of all (1773) gold contracts on first notice day, in its house account. This is in stark contrast to JPM taking delivery of gold over the past six months, both for itself and on behalf of clients. In addition to confirming that JPMorgan is the big kahuna in all things gold and silver, the deliveries follow first a sharp buildup in September open interest to over 10,500 contracts as of a few weeks ago and the equally bizarre subsequent reduction to around 2400 contracts yesterday. The facts are as I've mentioned, but what they may mean lies in the realm of speculation, with mine being that JPMorgan originally intended to take further gold deliveries but didn't and turned issuer instead to head off any developing physical gold tightness. (Ironically, a tightness originally caused by JPM).

We have continued to trade below the key 50 day moving averages in both gold and silver for every day of the reporting week, so it would be reasonable to expect a reduction in the total commercial net short position in this Friday's COT report. There seems to have been some pretty noticeable salami slicing (new price lows) and decent drops in total open interest of 15,000 contracts or so in both gold and silver over the reporting week. Therefore, I would expect a decent drop in net commercial shorts, but rather than predicting precise numbers, I am more interested in what I can learn from the new report, particularly in regards to levels of short concentration.

Through today's close, this week's interim $10 drop in gold translates to more than $300 million less of an unrealized loss for the combined commercial open short position, further reducing the open loss from Friday's close to $1.4 billion, the lowest in two months. Likewise, with gold and silver now at the lowest price levels in two months, it's easy to envision further technical fund selling, although I'm more of an observer than predictor.

Seeing how the managed money traders' increasingly sizable positions are having a more pronounced effect on prices of commodities as different as copper, corn and crude oil, makes it difficult to see why the commercials won't succeed in fully liquidating them in silver and gold as well. It's a nutty and artificial way of setting prices in important commodities, almost as nutty as how we set drug prices, but not one of my making. I'm trying to point out how crazy and illegal it is in commodities.

Ted Butler

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Silver – $18.65 (50 day moving average – $19.50)

Gold – $1310 (50 day moving average – $1332)

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