August 4, 2012 – Weekly Review

Weekly Review

The daily high price volatility continued in gold and silver, but at week's end prices ended largely unchanged in silver, while gold ended lower by $15 (0.9%). As a result of silver's slight outperformance, the gold/silver ratio tightened in a bit to just under 58 to 1. But make no mistake, both gold and silver remained within the tight trading range of the last three months and silver is still as undervalued relative to gold as it has been in nearly two years. Also not to be mistaken is any notion that either market is being driven by legitimate supply/demand considerations.

There were some very important new developments this week that I will attempt to cover, but one report would hardly be sufficient for full coverage. While the developments were new, they touched on familiar themes including manipulation and regulatory failure. First, let me cover silver in the usual weekly format.

It is repetitive, but still significant that the physical turnover in metal movement in the COMEX-approved silver warehouses continues unabated. This week witnessed turnover that was among the highest in memory, as total COMEX silver inventories declined more that 2 million ounces, to just under 138.9 million oz. Again, I am not so concerned with the total number of ounces, but I am simply amazed at the unprecedented (before a year and a half ago) and persistent silver metal movement. To my knowledge, there is no corresponding movement in COMEX gold or copper or any other metal on any other exchange that compares to this movement in COMEX silver. I am convinced this movement indicates extreme tightness in silver and I am increasingly convinced that it can't stop until we have a silver Â?event.Â?

Despite the day to day price volatility, holdings in the silver ETFs continue to grow slightly, which I interpret as silver investors holding tight and being prepared for the long haul. After the large liquidation (50+ million oz) in the big silver ETF, SLV, following the deliberate take down in price in May 2011, investors have ceased liquidating despite overall rotten pricing. I believe this to be a precursor to a coming revival of silver investment demand. Retail silver demand, as measured by sales of Silver Eagles by the US Mint continues soft, but still remains proportionately way ahead of counterpart Gold Eagle sales. In the short run, wholesale investment demand is more influential on price than retail demand.

One noteworthy development this week was the latest Commitment of Traders Report (COT) which indicated an increase in the headline number of the total commercial net short positions of both gold and silver. I had been expecting some increase in the commercial's net short position, as both markets were higher in the reporting week and traded through important moving averages. But I had not anticipated the particularly large increase in the commercial short position in silver, as trading volumes were fairly tame on the move up in price. Let me cover gold first.

The total commercial net short position in gold increased by a large 19,800 contracts, to 156,000 contracts. But considering the previous week's even larger reduction in commercial shorts, the gold report was rather ho hum and remained in the same range that has prevailed since early May. By category, it was all a raptor affair (the smaller, but very collusive commercials apart from the big 8). The gold raptors' selling equaled the total commercial sales for the week and moved them into a net short position of almost 11,000 contracts. Despite a slight increase in the short position of the big 4, at under 100,000 contracts this concentrated short position is among the lowest in years.

Overall, the gold COT structure remains bullish and is likely more so given the sharp decline in price following the Tuesday cut-off for the COT. It seems that a normal weekly change recently in the gold COTs has been in the 20,000 net contract range. That's the equivalent of 2 million oz of gold, worth more than $3 billion. Seeing as the world only mines 1 million oz of gold in any 5 day period and how the past month's 1 million oz of gold being removed from the big gold ETF, GLD, garnered attention, it should be clear that COMEX paper trading activity has been the clear driver of the gold price. Taking only $25/per oz of profit on 20,000 net gold contracts amounts to $50 million. I would submit that $50 million taken regularly from tech fund traders and other COMEX speculators is plenty of motive for the commercials to continue to collude in manipulating gold prices. Even though the regulators have turned a blind eye towards this short-term gold manipulation on the COMEX, I find it impossible to come up with any other explanation for how the commercials always sell on the way up and always buy on the way down with such uniformity and precision. Can the commercials hit gold near term? Sure, but the overall set up is still bullish.

The amount of the increase in the total commercial short position was the surprise in silver, not that there was an increase. The commercial net short position grew by a very large 5,900 contracts, to 21,400 contracts. This is the largest level of total commercial net shorts in three months. What accounted for the large increase? Clearly it was the two-day upside penetration of the 50 day moving average in silver during the reporting week. This was an upward penetration of the 50 day moving average for the first time since January. Even though volume was relatively low on the days of the penetration, it resulted in a massive contract shift because the 50 day is perhaps the key moving average and it had been so long since the last upside breakout. Just to be clear, I am not sanctioning or condemning such technical trading (although as I grow older, personally I think it is insane for grown men and women to base investment decisions on such mechanical indicators). My prejudice aside (and I do know and respect many competent technical traders), there should be no doubt that moving average penetrations result in big changes in market structure and price. Real supply and demand? Forget about it.

By category, the silver raptors sold around 4200 of their long contracts, which reduced the raptor net long position to 19,400 contracts; still a large position. The big 4 (read JPMorgan) added more than 3000 short contracts, increasing their concentrated short position to 33,100 contracts, the largest level since April. The 5 thru 8 largest shorts bought back 1300 contracts, tending to confirm my suspicions that a tech fund or two may have slipped into what normally is a commercial-exclusive club. One thing that was definitely confirmed in this COT report was that the tech funds that had recently gotten historically heavy on the short side do run like scared jack-rabbits on higher prices. In the disaggregated report, nearly 3800 short contracts in the managed money category were bought back.

Undoubtedly, the price weakness in silver immediately following the cut-off resulted in tech fund selling (both long liquidation and new short selling) and commercial buying. By how much I don't know, but we did penetrate the 50 day moving average sharply to the downside on Wednesday and Thursday and that is a prime technical selling signal. On an historical basis, the COT structure in silver is still very bullish, although we must be prepared for the instantaneous and crooked silver price smack downs due to HFT manipulation which the incompetent or complicit regulators at the CFTC refuse to confront.

I'll try not to make this a rant, but the most disturbing aspect to this silver COT report was the increase in short selling by the big 4 and JPMorgan. I think the 3000+ contract increase in the big 4 category was all done by JPMorgan and JPM's short position is now 18,000 contracts, as of the cut-off. It might be a bit less now as a result of the price weakness after the cut-off, but we'll recalibrate after this coming Friday's Bank Participation Report. Even if JPMorgan did not account for the entire 3000 contract increase, the alternative explanation is that they recruited a collusive partner in one of the remaining big 4. (Hey, your Honor, we didn't do it all by ourselves, we took on a partner in crime during the week in question).

As I indicated last week and numerous times before that, a major key to future silver prices is the behavior of JPMorgan. I don't relish any legal dust up with the likes of JPMorgan (or the CME Group) because I know I don't stand a chance, but they are the main manipulators of the price of silver. But the fact that they may have added 3000 contracts to their already bloated short position is criminal. Without the sale of these 15 million equivalent ounces, the price of silver would have gone much higher to attract additional (raptor) selling. Whenever a single trader exerts that much dominance and influence on price, the word used to describe it is manipulation. I don't know what JPMorgan intends, but what they did during this reporting week proves, at a minimum, that they are manipulators.

The 5900 net commercial contracts sold in the reporting week is the equivalent of approximately 30 million ounces of silver. Let's try and put this amount into perspective. Over any five day period, the world produces by mining around 10 million oz. So the change in COMEX paper positions was three times all the silver mined in the world at the same time. On a price move of roughly a dollar during the reporting week, 30 million oz of paper contracts were bought by speculators and sold by commercials on the COMEX. The economic purpose and justification for futures trading is to facilitate legitimate hedging by real producers and consumers. But how can there be legitimate hedging taking place when the paper contracts bear no connection, either price or quantity wise, to what is occurring in the real world of supply and demand?

Some commentators insist that the commercials are always just hedging, but that claim is not possible during this reporting week. It's clear that the buyers were mostly technical speculators covering shorts and the sellers were either commercials taking paper profits (the raptors) or JPMorgan capping prices by adding big new shorts. Certainly the speculators and the raptors were not hedging and, if you use some common sense, it's clear that JPMorgan wasn't hedging either. What mining company is looking to lock in prices that are almost 50% lower than peak levels of a year ago? What this COT report confirms is that there is very little legitimate hedging taking place in COMEX silver (or gold) as it is impossible to construct a legitimate hedging explanation given the data in the COT. Let's call it as it is, namely, that the COMEX silver market is a scam to set the price of silver between two warring sets of leveraged paper speculators, one of which is termed commercials. Worse, the chief speculator and manipulator hiding behind the commercial label is a systemically-important US bank protected by FDIC deposit insurance. Worst of all, the scam is made possible because of an inept federal regulator (the CFTC) that refuses to fulfill its main function of ending price manipulations.

The point here is simple Â? since the COMEX is not coming close to fulfilling its most basic function as authorized by Congress, why is it allowed to exist? Not only is there little legitimate hedging talking place in COMEX silver (and gold); the phony paper setting of price is extremely harmful to the interests of real silver producers and investors. If the COMEX were to shut down or be shut down, the price of silver would explode as the shorts would be hard pressed to replace their manipulative selling elsewhere. That's not a reason to close the COMEX; the reason to close the COMEX is because it is not facilitating legitimate hedging as is required by commodity law.

In another stunning development for the financial world, the big electronic stock market maker, Knight Capital, roiled the markets when it entered an errant computer software trading program and lost $440 million in 45 minutes. That comes to $10 million for every minute the faulty program remained in effect. Although not widely known outside trading circles, Knight is no pip-squeak and accounts for more than 10% of all stock trading volume. It was revealed that Knight is also a clearing member of the CME Group, having purchased Penson Financial two months ago for around $5 million and gaining stewardship of Penson's $400 million in customer commodity funds on deposit. Regulators from the CFTC and the CME were reported to be monitoring the situation closely. One would hope so. I know that both regulators must be doing everything possible to prevent another ruinous loss to innocent customers at a commodity firm gone bust. I sincerely hope that past performance by the CFTC and the CME in such matters (MF Global and Peregrine Financial) is not repeated in the case of Knight Capital

Perhaps the very last thing the financial world needs at this time is yet another scandal involving electronic trading gone bad or the sudden loss of customer funds, as these are investor confidence destroyers. While it is too soon to know the specific fallout from the Knight debacle, the time is long overdue for taking the right steps in terms of prevention. As is always the case, you can't fix a problem unless you recognize that a problem exists.

Electronic High Frequency Trading (HFT) gone screwy is a visible symptom of the problem, but the real problem goes deeper than that. The HFT involved in Knight's case was completely unintentional, while the HFT involved in the deliberate COMEX silver takedowns is as intentional as is possible. Since this is a publication primarily devoted to silver market analysis, I will speak of what I believe to be the underlying problem as it relates to silver.

I know I have been a super-critic of the CME Group, owner and operator of the COMEX, but the electronic trading mess at Knight leads me to conclude that I haven't been critical enough. The real problem at Knight is that it shows that the markets have become a Planet of the Machines. Computer bots, algorithms and fraction of a second trading have become the rule of the day. What's wrong with having machines dominate stock market trading is that it has nothing to do with the stock market's reason for existence, namely, as a capital raising and investment medium. I know the algo and HFT traders proclaim how they are increasing liquidity, but hyper day trading and cancellation of orders does little to enhance genuine liquidity and nothing to aid long=term investment and capital formation. Let's call it as it is Â? HFT is all about gaming the system in a manner never intended. Only the short term traders involved in it benefit, along with those collecting the excessive fees charged for this frantic and overall harmful speculation. That's where the focus turns to the CME Group.

Just like HFT activity has nothing to do with the real purpose and functioning of the equities markets, it also has nothing to do with the economic justification and purpose of the futures markets, which is to facilitate legitimate hedging. So how did we get to the point where the machines have captured and distorted our vital stock and commodity exchanges? This core problem developed when the exchanges were converted into for-profit public corporations and not organizations of mutual seat holders. By converting our important exchanges into corporations with a profit motive and then allowing further consolidation via merger is what created the mess we are in, to the point as one wag termed it, Â?we must kill HFT before it kills us all.Â?

Certainly, I am not attacking the profit motive and it is hard to find fault with a for-profit corporation, like the CME Group, seeking to increase its profits. The problem is that some things, like national defense and the public administration of law and order, are not designed to operate on a for-profit basis. Certain aspects of the US's stock and commodity exchanges are hurt and not helped by the profit motive. The conflict involving market regulation versus diminished profit is the most obvious. Would the CME ever do anything of a regulatory nature if it infringed on its profits? According to the public record, the answer is no.

The CME's (and all other exchanges') profits come mostly from trading fees on contracts traded. It's not complicated; the more contracts traded, the more profit. By converting to a for-profit corporation, the CME's main objective automatically became a quest to increase trading volume at any and all cost. As one of the very few beneficiaries of HFT, the CME has done everything in its power, which is considerable, to encourage as much HFT as possible. While understandable from the CME's profit perspective, the frantic and manipulative HFT is negative to the interests of the more than 99% of market participants hurt by HFT. In a normal world, something that harmed 99% of the participants and only benefitted less than 1% of participants would seem to come under fire, as have HFT activities. However, because the guys in charge at the CME benefit from the crooked HFT, the 99% are ignored.

Other instances specific to silver arise. What if one of the biggest contributors to the CME's bottom line was involved in a serious wrongdoing, like market manipulation; would the CME have the incentive to crack down on the manipulation if it meant its bottom line would be hurt? If there's another reason why the CME has not cracked down on JPMorgan's obvious manipulation of silver, I'd like to hear it. Ditto for the CME standing by while the commercials collusively rig the silver market when one considers who is getting paid (by trading fees) for all the excessive paper trading. Calling this silver manipulation a CME-inspired racket is appropriate.

And it's not just that the CME is conflicted into looking away from the silver manipulation because it's good for its bottom line; it's much worse than that. Because the CME is focused only on the bottom line profit, it has affected the greater public good in truly harmful manner. After decades of bragging about a great track-record of insuring the safety of customer funds, the quest for ever-increasing profit allowed that record to be demolished. Up until MF Global, there was an implied guarantee of customer fund safety by the CME. When the MF Global crisis hit, the CME took one look at what backing their implied guarantee would do to their profits and promptly reneged, perhaps the worst thing possible in the world of trading and standing by one's word. The CME, having established its word was worthless in MF Global, did the same weasel act with Peregrine Financial. I think it's a safe bet that the CME won't be helping the customers at Knight/Person either. That's the problem with a pure profit motivation, other formerly important considerations are brushed aside; like integrity and market regulation. It also explains how the CME Group can ignore the allegations of an ongoing silver manipulation because dealing with it would hurt their bottom line.

If I am correct in identifying the problem, the solution is simple Â? let the CME continue to seek only profits, but strip away from them the functions not related to the bottom line, like any and all regulatory responsibilities. By taking away the CME's self regulatory organization (SRO) status and clearing out the dead wood at the CFTC, there is a chance to rescue some very important financial institutions. Allowing a continued regulatory role for the CME in any way only insures that the machines will kill us all.

If I sound too negative, don't let that fool you. This Knight trading disaster and the increasingly obvious silver manipulation and the sick role of the CME and JPMorgan in just about everything they touch is encouraging precisely because it is becoming more widely known. There's a well-established history of change coming only after enough people get fed up with what's around them. The real irony is that the news as it relates to silver is better than ever. I've not seen a single instance in the recent news that should make anyone sit up and decide to liquidate silver holdings. Instead, the news of more firms in trouble, screwy electronic trading and regulatory failure only enhance the lure of real silver. The last thing the recent news flow should suggest is a move away from silver. I can't tell you what the crooks at the CME and JPMorgan have in mind in the short run, but in the long run they look like toast to me. What doesn't look like toast is silver.

Ted Butler

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Silver – $27.75

Gold – $1605

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