December 10, 2011 – Weekly Review

Weekly Review

Amid almost incomprehensible intraday price volatility, the price of gold and silver fell for the week. Gold finished the week down $36 (2%), while silver declined by 45 cents (1.4%). As a result of silver's slight outperformance, the gold/silver ratio tightened in a bit to around 53.1 to 1. Silver still appears to me to be greatly undervalued to gold and the switching of gold positions to silver appears warranted.

I use the word incomprehensible to describe the daily price changes because I know the price volatility cannot be explained in terms related to normal supply/demand factors. Gold does not normally fluctuate $40 to $50, nor silver by a dollar or more, in a very short time frame with little direct news. This being the case, I also know this volatility is unnerving to most investors and observers. Therefore, it is important to try to understand the cause behind the great volatility. Clearly, the volatility can be traced to the relatively new trading mechanism of computerized High Frequency Trading (HFT), chiefly encouraged by the CME Group to enhance their trading fee revenue. Simply put, the unnerving price volatility would not exist were it not for HFT activities.

In a very real sense, many markets, including gold and silver, have been overtaken by the rise of day trading computer robots and algorithms. On a typical day, more than 90% of all trading volume on the COMEX is conducted by HFT programs. This has been acknowledged by the markets' prime regulator, the CFTC. It is easy to demonstrate that this HFT activity is day trading by changes in daily open interest. Therefore, this trading is of no real benefit to legitimate hedging or price discovery. In essence, all this HFT activity is only to the benefit of the few traders involved in it and all other market participants, including legitimate hedgers and the vast bulk of outside investors, are held captive by it. Barring regulatory intervention, all the long term investor can do is to steel himself against the irrational daily price volatility and use it, where possible, to his advantage (such as buying on extreme price declines). Day-trading induced price volatility, as much as it unnerves us, will not influence long term price trends.

Conditions in the wholesale physical market still appear tight in silver. Movement into and out from the COMEX silver warehouses is still frantic on a daily basis. This week, amid the continued great turnover, the total level of COMEX silver inventories has climbed to 110.5 million ounces, the highest such level in a year. I continue to maintain that the total level of inventories is less important than turnover activity, and the actual movement itself suggests tightness. There have also been deposits of more than 2 million ounces into the big silver ETF, SLV, over the past few days, although I would not be surprised if some of that comes out as a result of Thursday's high volume sell-off. Finally, sales of Silver Eagles from the US Mint picked up, after a very weak November. In my opinion, the physical market activity stands in stark contrast to the price shenanigans on the COMEX, highlighting the disconnect between paper trading and real supply and demand.

The changes in this week's Commitment of Traders (COT) and monthly Bank Participation Reports were not radical and in line with general expectations. There were sufficient enough price rallies during the reporting week in both gold and silver to have expected an increase in the total commercial net short positions in each. As a result of Thursday's high volume sell-off after the cut-off, I would imagine the commercial net short position to have decreased in both markets.

In silver, the total commercial net short position increased by around 1800 contracts to 22,500 contracts, but still very much within the range since September. The raptors (the smaller, but highly collusive, commercial traders apart from the big 8) accounted for all the selling and then some, as they sold 3700 contracts, reducing their net long position to 14,000 contracts. The big 4 (read JPMorgan) bought back 1200 contracts and the 5 thru 8 largest traders bought back around 700 contracts. In conjunction with the Bank Participation Report, it appears to me that JPMorgan's concentrated short position is still in the 15,000 contract range, very much in the lower extremes they have held since 2008. The silver COT structure remains in the very bullish set up it has been in since the late September intentional take down in price.

In gold, the commercial net short position increased by 8,000 contracts to 201,500 contracts. Unlike in silver, the four largest traders increased their formerly low net short position by around 5,000 contracts and the 5 thru 8 next largest traders by another 2,000 contracts. The gold raptors sold the balance. Whereas only the raptors sold in silver, all three commercial categories sold in gold. The gold COT structure looks neutral overall.

Last week, I mentioned a concern I had that the gold raptors might look to rig gold below the 50 day moving average to induce speculative long liquidation. We did see some of that since the cut-off and may see more, since gold is riding just a couple of dollars above the 50 day moving average on Friday's close. I dislike making short term price predictions, so take this instead as an explanation in advance if the commercials do succeed in driving gold lower at this time. If we do move lower in gold it will be solely due to the commercials rigging the market lower in order for them to buy whatever the commercials can force the technical longs into selling. Of course, there's no guarantee the commercials will succeed in their usual manipulative games.

The big news this week centered on developments in the MF Global bankruptcy mess and the highly visible congressional hearings, including public testimony by the former MFG CEO, Jon Corzine. Other big news concerned the CFTC's role in the MF Global affair, with particular emphasis on the role of Chairman Gary Gensler. Let me discuss MF Global first.

I have been stunned that in the six weeks since MF Global's bankruptcy filing on Oct 31, that around $1.2 billion in missing segregated customer funds has not be found or accounted for. This is unprecedented, especially considering the round the clock examinations by government and private sector investigators. There has never been such a circumstance of customer losses or lack of explanation in any previous financial firm bankruptcy, including Refco, Bear Stearns or Lehman Brothers. Perhaps we will wake up soon to discover just where the money went, but in the interim I'm starting to suspect a different explanation.

Earlier this week, an article appeared which set off a possible explanation for the missing MF Global customer money, concerning the issue of re-hypothecation. http://newsandinsight.thomsonreuters.com/Securities/Insight/2011/12_-_December/MF_Global_and_the_great_Wall_St_re-hypothecation_scandal/ This is a complicated matter that I will try to explain in as simple terms as possible. We all know that the financial system is highly leveraged. In particular, financial firms such as MF Global as among the most highly leveraged of all, by a factor of 30 to 40 times real capital. Assets are pledged and borrowed against and then re-pledged and re-borrowed against repeatedly. When trouble strikes, the borrowings on top of borrowings can collapse like a house of cards that the structure truly represents. The excessive re-pledging of assets is a common modern theme at the heart, for instance, in the European sovereign debt crisis. I suspect this re-hypothecation may be behind the MF Global mess.

Let me give you an example from a childhood game of my very early years, musical chairs. In this game, a limited number of chairs (say nine) are arranged in a row and a slightly larger number of children (say ten) walk slowing around the row of chairs as music is played. The children must keep moving around the chairs as the music plays, but as soon as the music stops, the children must rush to sit on a chair. The one child who must come up short when the music stops is eliminated and one more chair is removed after each round of music until the game is played out. It looks to me that the missing customer money at MF Global is similar to the game of musical chairs, but with a very evil twist.

Just like there are never enough chairs in the children's game, there are also never enough real assets behind any re-hypothecation financial structure. All such financial structures are inherently defective as money sloshes and re-sloshes around giving the appearance of plenty, but as soon as the music stops, someone is going to come up short. Unlike the children's game, the music can play on for many years and even decades in financial circles, as no one is interested in having the music stop. As time goes on, everyone, from participants to regulators and auditors, becomes convinced the re-hypothecations are sound and trustworthy. Then, if the music does stop (as it stopped at MF Global), everyone is shocked and confused and tries to figure out where the money went. In reality, the money was missing all along, except that no one noticed, or wanted to notice.

I think this may be what has occurred at MF Global. The financial structure at the firm was based upon growing re-hypothecations that grew so large and complex and lasted long enough to look sustainable. After six weeks, if there were another explanation, I believe it would have emerged. It may explain the congressional testimony this week by its former CEO, Jon Corzine. I had thought privately that Mr. Corzine would take the Fifth and refuse to testify as it would surely incriminate him. Instead, he professed under oath that he did not know how so much customer money could be missing. I am certainly not defending him, nor am I condemning him; I don't know enough to do either. I am always reluctant to follow a mob, whether that mob is out to lynch or to worship. I'm more interested in drilling down to the facts to learn the real story to guide my future behavior and what I write for subscribers.

Even if the MF Global mess was as a result of re-hypothecation gone mad, I do see a very evil aspect to it. In the children's game of musical chairs, the child eliminated after each round is random and not prearranged. In the case of MF Global, the game was rigged from the beginning to screw the customers. How can I say that? I can say that because of all the participants in the game of re-hypothecation, only the customers didn't know there was a game or that they were at risk. All the real players in the game of the re-pledging of and re-borrowing against assets, such as JPMorgan and other large financial firms, knew at all times where the chair was that they would sit in if and when the music stopped. These big financial crooks always maintain strict control of what is in their best interest and pull those assets at the first sign that the music has stopped, no matter what is right or fair. Some may call that good business, but I call it evil.

What makes it evil is the environment we are supposed to be dealing in. MF Global customers did nothing wrong and were led to believe that they were protected, due to the regulatory structure. Instead, the regulatory structure looked the other way when the music stopped, as a few financial giants were given preference to first claims on remaining assets at the expense of tens of thousands of innocent customers.

Most disturbing in this week's congressional hearings was the lack of drilling down to the real culprit in the MF Global debacle. At the heart of the mess lies the CME Group, the true masters of spin and political connections. Whether it was re-hypothecation at the heart of the MF Global mess, or whether another smoking gun emerges, the CME was the frontline regulator and must be held responsible. The CME walked away from MFG customers despite their repeated former claims that they were responsible for no customer ever having lost a penny as a result of a clearing member failure. Now, the crooks at the CME have the nerve to claim that they had a great record up until MF Global and that these things happen. Talk about spin. All the CME has done is make a phony pledge of $550 million to MF Global customers that they have no intention of paying. At the root cause of this problem is still a conflict of interest. You can't have a for-profit entity allowed to make regulations and have oversight over itself.

I know many seem to be rushing to judgment, particularly on a personal basis. Aside from Jon Corzine, who may in fact be found to have violated the law, the person who has been most reviled in recent events is the chairman of the CFTC, Gary Gensler. It's no secret that I have long held Gensler in special light, calling him the greatest chairman in CFTC history on many occasions. So it's only right that I directly confront the virulent criticism he is now facing. In my close observation of recent events, I have uncovered my own rare and negative criticism of the man, aside from continuing complaints that he wasn't moving fast enough against the silver manipulation. Before I get to my criticism, let me review the criticism of him from others.

Much of the recent criticism of Gensler relates to his former employment at Goldman Sachs and, in particular, any previous relationship he had with Jon Corzine who was head of Goldman during Gensler's last years there. Some are trying to spin his past employment and possible relationship with Corzine as directly related to the MF Global debacle, including the Wall Street Journal, in another scathing editorial on Gensler today. The Journal points to meetings the two held with staff in person and in teleconferences, as well as a wedding of mutual friends both attended. Aside from the wedding, all previous meetings between Corzine and Gensler were recorded on the CFTC web site, a government in the sunshine practice first initiated by Gensler himself.

I find much of this criticism of Gensler to be highly offensive and nothing less than character assassination and guilt by association. Since when is it right to condemn someone solely for where they worked 15 years ago or who they may have worked with, without some direct connection offered? Those who resort to such innuendos should be ashamed of themselves, most particularly the Wall Street Journal. To suggest that Gensler showed any inclination to favor Corzine in the MF Global mess is preposterous and opposite to what the record shows. My reading of the rule change that Corzine was opposed to during the summer that was restrictive to MF Global's use of funds had Gensler alone as pushing for such restrictions, with little support from any other commissioner. It's amazing how history can be revised to suite one's position. It is equally amazing how Gensler has been skewered along partisan political grounds in the congressional hearings to date and likely to come next week. Gensler recused himself in the investigation of MF Global only after Republican Senator Grassley demanded he do so. Now he is being attacked by other Republicans for having done so.

The fact is that much, if not all, of the criticism against Gensler has little to do with the stated reasons being given. There is a deeper meaning to the criticism; it has to do with financial reform in general. Specifically, it has to do with Dodd-Frank and the restrictions it and Gensler intend to place on the large financial firms, most emphatically JPMorgan and the CME Group. As I have written previously (Oct 1, 2010 in the archives), Gensler has been designated as Banking's Enemy Number One. That alone suggests a motive behind the attacks. It is obvious that the attacks on Gensler are largely designed to weaken his approach to minimize the influence of the big financial firms over the markets. This is a deadly serious game and the long knives are out in Washington and elsewhere for Gensler. In my opinion, the attacks against Gensler are an attack against true financial reform.

The bad news is that those attacks have been effective, in my opinion. Gensler has not come off well under the relentless personal attacks and accusations, particularly in congressional hearings. He has appeared tentative and weak under the barrage of insults heaped upon him by congressmen and senators. He was, obviously, not prepared for it. This leads to my rare negative criticism of him on those same grounds. What makes Gensler so good is his intelligence, his grasp of the important elements, his moral compass and his ability to arrive at a consensus on contentious issues. What detracts from these essential qualities is his inability to date to fight back when insulted or confronted with lies. Few of us would encourage our children to be overly hostile to others; but neither would we advise our children to not stand up to bullies. As distasteful as it may seem, sometimes you just have to fight back.

Gensler needs to fight back, both for his and our sake. He needs to stand up to the financial bullies, especially JPMorgan and the CME; otherwise we can kiss genuine financial reform goodbye. I appreciate that fighting back may not come easily to him, but he must transcend that for a much higher cause Â? finishing the financial reform battle that he started and that won't be completed without him. Let me repeat the specific advice I have offered previously. The CFTC must sue JPMorgan and the CME for manipulating the silver market. And it must do so immediately. It may not even matter if the Commission prevails in court; what will matter most is if the agency stands up to these market bullies and crooks.

Ted Butler

December 10, 2011

Silver -$32.25

Gold – $1712

Date Created
2011/12/10