December 27, 2017 – A Madman’s Playbook

A combination of advancing age and seasonal nostalgia, but mostly the current extremely bullish market structure in COMEX silver and gold prompts me to stroll down memory lane. As a forewarning, this is in no way of intended to lure or suggest anyone to replicate what is, upon the reflection of decades, surely the behavior of a madman.

As Iâ??ve recounted on countless times, more than 30 years ago I developed an unnatural fascination for the metal silver as a result of a challenge given to me by Israel Friedman, a commodity client at the time (actually, Izzy wasnâ??t even my client, but we were both students of the market and conversed in those terms). Izzyâ??s challenge was for me to explain how the price could be so low given the fact that more of it was being consumed industrially than was being produced (this was five years or so after the Hunt Brothersâ?? run to $50 and subsequent bust back to $5). Prices not rising for a commodity in a bona fide long term consumption deficit is an impossibility in a free market.

It took me about a year to come up with the answer, but when I did, it changed my life in ways both very bad at first, but much better with time. My answer to Izzy was that silver was manipulated in price by excessive and concentrated short selling in COMEX futures contracts, mostly by big banks and would be much higher in price when that manipulative short selling was resolved. Since I knew full well that what I was suggesting was a very serious matter, in fact, the most serious matter in all markets, I approached the regulators at the CFTC and the exchanges (the Chicago Board of Trade carried an active silver futures contract at the time, in addition to the COMEX) and everyone else I thought would be interested. In a nutshell, my findings were near-universally rejected, despite my best efforts. This is a story most of you are familiar with.

A story you may be less familiar with is how I thought and acted in investment terms upon making my discovery. To say that I had become a raging silver bull as a result of my discovery that silver was manipulated by excessive and concentrated short selling would be the understatement of all time. I became certifiably nuts about silver, as a result of studying it so intensely in searching for the reason why it was so low in price. Given my background and core competence in derivatives transactions and having amassed what was more capital than I ever had to that point, in addition to constantly pestering the regulators to deal with the blatant silver manipulation, I positioned myself in the manner that made the most sense to me â?? by buying call options on COMEX silver futures contracts.

These option contracts had only been introduced a few years earlier, but were right up my alley, being a way to capture leverage but eliminating the pitfall of unexpected margin calls that comes with straight futures contracts on margin. I was so bullish on silver, then stuck around $5, and convinced it must explode in price that I set out to just keep buying more as already purchased call options expired worthless and not give up. Unfortunately, my strategy worked. Within a year or so of when I started buying out of the money calls on a continuous basis, expecting a price explosion any day, I got what I thought was the start of the explosion in early 1987, when silver more than doubled in price in a number of weeks to over $11.

Call options that I bought for as little as three-tenths of a penny ($15 for a 5000 oz contract) rose as high as $4 ($20,000 per contract) going deep into the money from way out of the money. I had mostly been buying these silver call options for myself, but I had a few personal friends and acquaintances who asked to join along given my enthusiasm (since there were very low commissions involved, I never solicited any of this business). The price explosion and subsequent collapse took an unforeseen toll. One friend went from picking out colors for the new Jaguar he planned to buy with the profits on a $400 option purchase a few weeks earlier (with many tens of thousands of dollars left over), to consulting a psychiatrist a week later when the profits evaporated. The extreme swings in emotions from everyone involved, including myself, is hard to describe. In my case, a $2000 option purchase came to be worth more than $1 million in short order. Unfortunately, it then came to be nearly worthless in even shorter order.

I can assure you that I donâ??t need to be reminded that I should have booked profits and done other things differently, but unless you possess a time machine that I can borrow for a bit, I do believe that I learned some things from that experience 30 years ago. Then again, perhaps not completely, as my involvement with out of the money call options was better in the run up to $50 in 2011, but not the stuff of legend. Call it a learning experience along the lines of it being better to have loved and lost, then never to have loved. I did anticipate the silver price explosion in 1987 and 2011 and was as correctly positioned as possible, but the subsequent price declines, both in degree and time length were underappreciated, even for someone who knew silver was manipulated in price.

Years after the 1987 silver price boom/bust I heard a story that was uncanny in its accurate portrayal of how I approach silver with call options when I expect a price explosion (admittedly, most of the time). More than anything else, it shows why most people would be absolutely crazy to consider out of the money call options, but helps explain why a few deranged folks (like me), persist at it. Itâ??s not just the money, but more the intellectual challenge. Anyway, hereâ??s the story I think about almost every day.

Thereâ??s this regular guy, Sammy, whoâ??s retired on a limited fixed income, but who has learned to live within his means (the most important key to financial happiness). Sammy happens to be a horse racing expert, as good a handicapper as anyone, save for one fatal flaw â?? heâ??s addicted to longshots. Sammy knows this is his big flaw and has come to live with it, by limiting himself to one $2 bet any time he goes to the track.

One day, as Sammy is headed out to the track with his egg salad sandwich and thermos of coffee, his wife cautions him not to bet too much. â??Donâ??t worry, all Iâ??m taking is $2, I canâ??t lose muchâ?•. As is his custom, Sammy picks a longshot in the first race that comes in and pays off $90. It turns out to be Sammyâ??s lucky day and he proceeds to parlay his winnings race after race, playing every longshot in every possible combination and perfecta that can be imagined. All told, going into the last race, he puts that dayâ??s entire winnings, now up to an incredible $90,000 on a longshot in the last race that will make him a millionaire many times over. The horse he picks breaks into a late lead, but then fades and loses out by a nose in an official photo finish. Sammy gathers up his thermos and takes the bus home. Upon arriving his wife asks him how he did. â??Not bad, I lost $2, but the sandwich was greatâ?•.

The moral of the story is in the eye of the beholder. In retrospect, Sammy never should have bet everything on each successive race, but then again, had he hit the last race, he would have done everything perfect. Heâ??s certainly in position to try his hand at it any time he wants, based upon his willingness to bet the initial $2 and subsequent winnings. One thing also clear is that most people could and should not try to imitate Sammyâ??s approach and whether the advice is not to bet on horses or longshot silver call options, the advice is sound and I hope you take it that way. On the other hand, I share what I think makes Sammy run, namely, a desire, with limited but truly risk capital, the opportunity of reaching for the stars.

In my case, the initial buying of silver call options is the easy part if the price surges from out of the money to into the money (the price rises above the strike price). Itâ??s even easier if the option expires worthless. Since Iâ??m bullish on silver beyond the expiration date of the options I buy, I have predetermined, just as did Sammy, that if I get lucky and hit the first race, I will be required to roll over all or much of winnings to extend the expiring options time wise (although one can roll up in strike price to extract funds while maintaining a full original position). The whole point in both Sammyâ??s approach and what I think is my silver approach is to get to the position of playing with â??track or houseâ?• money.

Again, this is not intended as an invitation for anyone to trade options and I have zero interest in encouraging, guiding or participating in options trading â?? the image of my friends soaring in spirits with massive profits in 1987, only to have their spirits crushed just as quickly is fresh with me to this day. Besides, no one needs to use options on silver to achieve outsized returns; when silver does go, plain vanilla fully paid for physical metal or mining company shares will knock the cover off the investment performance ball. Then why am I bringing up Sammy and some crazy approach to options? Strictly in the interest of full disclosure.

As I hope I have been conveying for the last couple of weeks, there has been a phenomenal positioning change on the COMEX in silver and gold, my most important price driver. For better or worse, I find myself holding my largest call option position in a very good number of years (in addition to being â??all-inâ?• in normal investment terms). Win, lose or draw, I guess I felt an obligation to reveal that rather than keep it private. Itâ??s certainly not something I would bring up afterwards if the options did happen to come in – sort of speak up now or forever hold your peace. While I would never encourage anyone to buy options, I am encouraging you to hold as much silver on a cash basis as is possible, given the remarkable recent positioning changes and other developments discussed here.

Turning to developments since the weekly review, the continued price strength has been the main feature. Gold prices closed above both its key moving averages (the 50 and 200 day maâ??s) for the first time in about a month on Friday and added to those gains in yesterdayâ??s close for the reporting week and into todayâ??s trading. Silver rose to its 50 day moving average on yesterdayâ??s close and has penetrated it in todayâ??s trading.

In the four day reporting week thru yesterday, gold rose by more than $20 and silver by 50 cents, adding to gains of the prior two weeks. Thus, it should be expected that we would see some deterioration, or managed money buying and commercial selling in this Fridayâ??s COT report. After all, itâ??s well-known that the managed money technical funds buy on rising prices, particularly when moving averages are penetrated, as was the case in gold. But while I am expecting some deterioration in this weekâ??s report, the standout feature appears to be why there hasnâ??t been much more aggressive managed money buying, particularly in gold, to this point.

I get the sense that up until today, the managed money traders havenâ??t bought near as many gold and silver contracts during the reporting week just ended as would normally be expected. And Iâ??m not sure why â?? maybe itâ??s the holiday season or some other factor that has held managed money buying in check. Donâ??t get me wrong, the lack of managed money buying to this point is the single best thing that could have occurred. Of course, I could be all wet about relatively minor managed money buying being reported in Fridayâ??s report, but the low trading volume and distinct lack of any outward appearance or feel of heavy technical fund buying leaves me inclined to think that gold should not deteriorate by more than 15,000 net contracts and silver by 5000 or so contracts.

Certainly, more managed money buying occurred today, but thatâ??s a matter for the following weekâ??s COT and Bank Participation Reports. As of this reporting week, the standout feature should be the lack of more aggressive managed money buying. Itâ??s almost as if there is something holding back or preventing the managed money traders from aggressively moving to the buy side, although I confess that Iâ??m not sure what that might be. But if itâ??s true that the managed money traders have held back on buying more aggressively, it almost makes me want to buy more crazy options (although I have more than enough and way too many in the event silver prices donâ??t quickly move higher).

The reason it would be incredibly bullish if the managed money traders have held back on the buy side, is that there is no way that they can continue to hold back should prices move higher. At some higher prices, the managed money traders will turn aggressively to the buy side, as they have no choice. Itâ??s not as if they could decide to deliver physical metal, as they would have to secure the physical metal first, something they have never done or appear capable of doing. Likewise, youâ??ve never heard me suggest that the managed money traders would ever take physical delivery when they were extremely long futures contracts, as that was never going to happen. At least it was theoretically possible that they could take delivery if long, but there is no chance they could do other than buy back any short contracts. And there are an unusually large number of short contracts that the managed money traders must buy back in silver, to say nothing about adding new long positions on higher prices.

As I reported on Saturday, in the four reporting weeks ended Dec 19, the managed money traders sold 81,000 net silver contracts, the equivalent of more than 400 million oz on an engineered price drop of roughly $1.50. Through today, prices have rallied by about a dollar, but nowhere near have 81,000 contracts been bought by the managed money traders on the rally, or any number close to that. The fact that prices are now above the average price at which the managed money traders sold on the downswing into the price lows of Dec 12 means all that selling was for naught at this point and leaves the managed money traders particularly exposed to being forced to become aggressive buyers on still higher prices.

So while I got extremely bullish as prices fell into the Dec 12 price lows, the lack of aggressive buying by the managed money traders on the upswing is even more bullish. Let me not beat around the bush â?? the managed money trades are in a highly unique circumstance of having their lungs ripped out to the upside, should the commercials so decide to let prices fly higher. Certainly, this adds to my suspicions that the last trip lower in price was more arranged and deliberate than any prior engineered move. In short, I donâ??t know how the commercials could have set up things better than they have.

I suppose the commercials are capable of delaying the developing rally in gold, silver and platinum, but I am hard-pressed to see why they wouldnâ??t want to ring the cash register loudly by letting prices rip higher to unleash managed money buying forthwith. And while I expect raptor (smaller commercial) selling of their big long positions, Iâ??m more convinced than ever that the coming rally will be decided by whether JPMorgan adds decisively to its silver short positions. I think I know how Sammy would bet.

Ted Butler

December 27, 2017

Silver – $16.75Â Â Â Â Â Â Â Â (200 day ma – $16.98, 50 day ma – $16.68)

Gold – $1293Â Â Â Â Â Â Â Â Â Â Â Â (200 day ma – $1270, 50 day ma – $1276)

Date Created
2017/12/27