December 8, 2010 – The Great Silver Transition

I had written the following article prior to yesterday's sudden late day silver sell-off. I think it appropriate to comment on that sell-off first. As I indicate in this new article, the silver market is changing, and the cause of yesterday's sell-off is different from ones we've witnessed in the past and is unrelated to the changes I'll write about shortly. You want to be careful about labeling every sell-off in silver as a manipulation, but sudden large moves for no apparent economic reason deserve examination.

I don't sense that yesterday's sell-off was the typical game of the commercials tricking the tech funds into selling, so that the commercials could buy back shorts as the tech funds liquidate positions. That manipulative game appears largely over, as for one thing, the tech funds are not holding big positions and no important moving averages were violated yesterday. Yesterday's sell-off was more like the silver sell-off we witnessed the day after Thanksgiving and closely related to the Â?flash crashÂ? that occurred in the stock market on May 6. I believe it had everything to do with the high-frequency computerized trading that has become common to many markets. I don't believe the spread of this computerized trading is a healthy development for any market. Hopefully, the regulators at the CFTC and the SEC feel likewise.

This high-frequency trading is practiced by a handful of traders using computer programs and mathematical algorithms to rapidly trade in and out of market. Positions are bought and sold frantically with the objective of capturing very quick small profits on large numbers of contracts. It is day trading gone mad. We can deduce it is day trading as the large trading volumes rarely result in meaningful changes in open interest. Because it is day trading, it doesn't add true liquidity to the market, as its supporters suggest, only the illusion of liquidity. Sometimes, the machines take control and things go wrong, like yesterday in silver, or the stock market on May 6. (If my premise is wrong, then something quite intentional caused yesterday's silver sell-off.)

The problem is that this computerized day trading gone mad only benefits two entities Â? the day traders themselves and the exchange (the CME). Everyone else is held hostage by it; including real producers and consumers and investors who are relying on prices created by the day traders. Simply put, the artificial prices created by the computerized day traders would seem to be a violation of commodity law as these traders are setting silver prices and not discovering them based upon actual supply/demand factors in the real world. I can assure you that there were no real silver developments behind yesterday's sudden sell-off.

Because the CME derives income from each trade made, it has no motive to limit this computerized day trading gone mad. It matters little to the CME if many innocent participants, whether they hold COMEX positions or not, are harmed. As long as the CME gets paid for each trade, it could care less what the impact of this out of control trading might be, just like it is not concerned about allegations that silver is manipulated by its leading commercial insiders. Because of these inherent conflicts, it is easy to label the CME as selfish, rotten and corrupt. That it is considered a self-regulatory organization and given any role in the regulation of silver trading is a travesty. The CME always stands in the way of any legitimate market reform if that reform threatens the income from even one contract traded.

What can be done about this? I don't know if it does any good calling the CME corrupt or complaining to the CFTC, but it does no harm. Certainly, erratic and suspicious trading patterns do not foster confidence in our markets. We are all diminished by it. The important thing is what you can do for yourself. As an investor in silver, you must take measures not to be harmed by obstacles placed in your way by the corrupt CME silver shenanigans. You must not lose silver positions because of the phony sell-offs to come and be alert for opportunities to add to positions when they do occur. No margin. Please remember that the long-term silver manipulation (now ending) has been a big advantage to the silver investor. We've seen nothing but a continuous stream of phony sell-offs all the way up from $4 and anyone who avoided silver because it was manipulated made a very big mistake. Like most previous phony sell-offs, I sense this latest sell-off should soon pass.

The Great Silver Transition

There is a transition underway in the silver market of such significance that it is perhaps more appropriate to call it a revolution. This change has been in the making for almost three decades and promises to alter the future price landscape for silver in ways few can imagine. Those who come to grasp the importance of this transformation stand to benefit mightily. Those who miscalculate what is about to occur will have severe regrets. This is a very big deal.

First, let me offer some background in the form of a review of the silver market before describing the great silver transformation at hand. I'll start by going back to the infamous Hunt Brothers price spike to $50 in early 1980. Bunker Hunt and associates, starting in the early 1970's amassed a massive position in silver and COMEX silver futures contracts. At its peak, the Hunts were said to control 100 million ounces of silver and an additional 100 million ounces in COMEX contracts. Such a large concentrated long position had the effect of driving the price of silver from a few dollars per ounce to $50 ten years later. The manipulation failed when the exchange and government regulators took certain actions to end the concentrated long position. Prices immediately plummeted and entered into a 25 year period of price stagnation averaging near the $5 mark that lasted until 2005.

At the time of the silver price peak of $50 in early 1980, there were approximately 3 billion ounces of silver bullion equivalent in world inventories, which in turn were down from 10 billion ounces at the start of World War II. The 7 billion ounce depletion of world silver inventories came as a result of a structural industrial deficit that existed in silver over that 40 year period. In other words, the world consumed, via industrial and other fabrication, more silver than it had produced over that time period, necessitating the consumption and drawdown of world inventories. The structural deficit continued through 2005, further depleting world silver inventories to approximately one billion ounces, a level close to where they remain today. From 10 billion ounces in world silver bullion inventories in 1940 to one billion ounces today, a decline of 90%. This was an inventory depletion the world had never witnessed. There were two factors responsible for this Â?over-consumptionÂ? of silver. One was the recognition of silver's unique chemical and metallurgical properties, which included being the best conductor of electricity, the best transfer agent for heat, the best reflector of light, as well as a special photographic chemical and superior biocide. Over the past 60 to 70 years, we consumed the heck out of silver in tens of thousands of industrial and medical applications.

But the over-consumption of silver did not rest upon its miracle properties alone, impressive as they are. The second factor leading to the deficit consumption pattern and the destruction of world silver inventories was a manipulation that artificially depressed the price and over-stimulated demand. Prior to 1980, the artificial depression of the silver price was mainly caused by backroom lobbying by the Silver Users Association (SUA) to get the US Government to dispose of its silver stockpile, the largest stockpile in the world. The SUA was very successful and the dumping by the USG went a long way towards depressing the price of silver that stimulated industrial consumption. In the early 1980's, some 20 years before the US ran out of government stockpiles, an additional manipulative force exerted new downward pressure on the price of silver. Actually, two new forces appeared simultaneously; metals leasing/forward selling and excessive paper short selling on the COMEX.

Metals leasing and paper short selling caused many hundreds of millions of ounces of both actual and paper contracts of silver to be dumped on the market, crushing the price. This avalanche of uneconomic selling both distorted the supply/demand equation for silver (increasing demand and constricting production) and set up what I have called the greatest investment opportunity ever presented to investors of all walks. I have made a life's cause (quite unintended) of both exposing the silver manipulation and extolling the virtues of silver as an investment. Now, after 25 years of an accidental journey, I believe the silver market has reached a major transition point. Things will be quite different from this point on.

The transition I speak of will change the silver landscape permanently and dramatically. Quite literally, the transformation will spell the end of cheap silver and the end of the various manipulative schemes that have depressed the price of silver for more than 60 years. Simply put, we are witnessing the transition of silver from a manipulated market to a free market. Nothing could be more profound for the price of silver than this transition. It is something I have anticipated (along with my mentor and close friend, Izzy Friedman) for most of my adult life. I believe that this is the big one. For the record, I'm trying hard not to be influenced by the prediction I made earlier this year that the silver manipulation would end before 2010 was over. But it looks like my timetable will come darn close. What is my reasoning for such a strong statement?

Quite simply, the game has changed. The influence of paper trading on the COMEX, and in particular the dominance of the big concentrated short sellers, has ceased to be the dominant pricing force, except on a very short-term basis. Please think about this for a moment. For the past 25 years it has been my strong conviction that the COMEX had set the price of silver for everyone in the world. Instead of following (discovering) developments in the real world of silver supply and demand, the COMEX was dictating the price to the real world, like the tail wagging the dog. This is clearly illegal under commodity law and was the basis for my never-ending appeals to the CFTC. I stand by every allegation I have ever made. But things do change, and I believe that is now the case in silver. I don't think the COMEX can or will set the price of silver much longer, for a variety of reasons.

Among those reasons is that, thanks to the Internet and mass mailings by Investment Rarities, the COMEX scam became widely known. It became common knowledge, for instance, that JPMorgan was the big COMEX silver short seller. As sophisticated as the silver manipulation may be, repeated explanations helped to make it understandable. The recognition of a crime in progress by many is not conducive to it remaining in force. Throw in the timely appointment of a new chairman at the CFTC which has resulted in a remarkable transformation at that agency, and the silver manipulation's days were numbered.

If the COMEX's dominance over the price of silver is at an end, then what will now be the new price-setting force? The answer is what it should have been over the past 25 years, namely, the physical silver market. No longer will paper trading control prices; we are transitioning to the sanity of real supply and demand setting the price of silver. Although this is as it should have been all along, this transformation is such a radical change, that it will still be a shock to the silver price system. Its impact is already obvious. The recent moves to new highs are mostly centered on conditions in the silver physical market. To be sure, short covering and regulatory developments will still exert a strong influence on silver prices, but circumstances in the physical market will exert the strongest influence of all.

It is vital to grasp the significance of the transition from COMEX price-dominance to the physical free market world we are entering, if one hopes to navigate the exciting silver future ahead. If one doesn't recognize that the structure of the market has been radically altered, it will be difficult to comprehend and deal with the dramatic price changes ahead. Those who look at the sharp price gains to come with Â?old eyesÂ? will be left confused and not in position to capitalize on the larger gains to come. Those who recognize that it is a growing silver physical shortage that is driving price will be quick to mentally adjust to the large price gains and take them in stride.

If there is one key point I would try to impress on you about this silver transition, it is the often-repeated lesson from my gifted silver mentor Izzy. That lesson was the extreme pricing that comes with an actual shortage of an item in demand. Like most important lessons learned well, Izzy's came from actually experiencing profound shortages of basic items in his native Romania during the Nazi occupation. The lesson was that price knows no bounds in an extreme shortage. This is something, fortunately, that most of us have not experienced, so it is hard to fully comprehend. Because of my great respect for him and his repeated lectures on the subject, I believe I came to as close an understanding of the shortage pricing concept as is possible without replicating the actual deprivation caused by war. I can tell you that when you contemplate deeply what the impact can be on silver in a genuine shortage, your thought process begins to short-circuit because the price possibilities become too extreme.

In turn, over the years, I have often attempted to replicate Izzy's lesson with articles describing shortage pricing and availability because of hurricanes and gas shortages and other modern day examples. The one thing we always agreed on was that the downward price manipulation must result in a shortage at some point. Of course, while we never knew exactly when the silver shortage would arrive, we did know it would be very quick to intensify once it appeared. And that it would shock the world. I may be jumping the gun a bit, but the signs of a silver shortage appear clear to me. The large price gains and the clear evidence of relentless demand and delays in silver shipments are a strong signal. Plus, you know you shouldn't expect an engraved notice in the mail announcing the official start of the silver shortage. This is one of those things you need to jump the gun on a bit so as not to miss it.

It's hard to predict the very short-term price direction of anything in normal times. That becomes even harder in extraordinary times. Therefore, I would suggest you try to refrain from short-term prognostications on the price of silver. Instead, try to imagine the unprecedented circumstance of the world coming to grips with a genuine physical shortage of an item that heretofore had never been in a shortage in history. Try to imagine and position yourself for such an unusual circumstance, as I can assure you that those prepared, mentally and financially, will fare better than those who don't see it.

Ted Butler

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Silver – $28.92

Gold – $1394

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