

Feb. 10, 2010 – Falling Into Place

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The recent price smash has set up one of the most promising opportunities in silver in my memory. Not only was the price taken down almost \$4 from recent highs, creating a 20%-off discount price, the internal structure of the market has improved dramatically as well. This is a double-barreled gift to investors. Yes, I know these price drops can be terrifying (and maddening). And no, I can't guarantee you that we've seen the absolute bottom. But that's not the important issue, which is that we are looking at a great set-up.

Let's face it, we went down in price for one reason and one reason only, so that the commercials could trick the technical funds and other leveraged speculators into selling these traders' long positions. This is what enables the commercials to buy back shorts and other commercials to acquire long positions. This is the process I have written about and studied for more than 20 years. It is the basic analysis of the Commitment of Traders Report (COT). On the one hand, it is wrong because it shows that the paper COMEX futures market is setting the price for silver and not the real physical market. That is not the way the futures market is supposed to work. On the other hand, it is reality and we must put it to proper use. Not only was there no net physical selling by silver investors during the sharp sell-off, signs are emerging that the physical shortage has drawn closer. This sell-off was all a paper affair. And it did rearrange an awful lot of silver paper.

Data from the last two weeks' COT, plus an extrapolation from last Tuesday's cut-off indicate a thorough cleansing of speculative long positions in COMEX silver and gold futures contracts, perhaps among the most extreme on record. Thanks to the detailed data in the disaggregated COT, the technical funds have reduced their net long position by 25,000 contracts or more over the past three weeks (we should know for sure in this week's report on Friday). That's the equivalent of 125 million ounces of silver, a stupendous amount. Just to put that number into perspective; it is more than what investors have been acquiring annually in all the world's silver ETFs over the past four years. The equivalent of a full year's buying, dumped in three weeks' time. It's no wonder prices fell like they did.

But there is a limit to how many contracts the technical funds can and will sell. Once that limit is reached, the market is at a bottom. That's the basic premise behind my COT analysis. It's not the price action itself; it's what causes the price action. The commercials' snookering of the technical funds is what moves the price. The data show that has just occurred in a big way. Is it all done? I think so. Like horse shoes and hand grenades, you just have to come close enough. Even if we still will make a new price low, I feel confident we will be higher than current prices soon enough.

In essence, it comes down to two questions. Are the tech funds cleaned out? I think yes, or nearly so. But we must look beyond that. The most important question is – will the big shorts sell short again on the next price rally? The answer to this question will determine whether we gain a few dollars or a few tens of dollars on the inevitable next price rally. More than ever before, I think the next rally could be the big one, precisely because the big shorts may refrain from shorting more. Why? For a number of reasons.

First, it looks like conditions are really getting tight in the physical markets, both retail and wholesale. On the retail side, the US Mint just can't keep up with the extraordinary demand for Silver Eagles. This has been the case since my good friend and silver mentor, Izzy Friedman wrote about them two years ago. <http://news.silverseek.com/TedButler/1196788997.php> The inability of retail investors to purchase Silver Eagles is prompting a rush towards other forms of silver, causing general tightness in retail forms of silver. The suddenly lower price of silver is no doubt contributing to this tightness as well. It is logical to buy something you want that has been marked down. No dealer that I am aware of has reported net selling of silver by their customers.

On the wholesale front, there have been no signs of widespread selling of physical silver. The big silver ETF, SLV, has actually recorded a gain in holdings over the past week, despite the sharp sell-off and extraordinary volume on the big down days. Likewise, other silver ETFs have recorded increases in holdings, such as the Swiss version, ZKB. This should prove to you that all the selling in silver has been of the paper variety on the COMEX.

Markets operate on fear and greed. Fear is a short-term emotion, greed is long-term. You just can't stay in a constant state of fear. Sharp price declines induce the fear of further price declines. Once prices stop falling, fear quickly subsides. As that fear subsides, the attraction of the new lower prices stimulates greed and buying demand. I think we're close to that now. Growing investment demand for physical metal, both retail and wholesale, at the new lower and attractive price levels cannot be satisfied with paper short sales on the COMEX. I think the big commercial shorts know this as well. That argues against them selling heavily short again.

Likewise, we are clearly in an environment where big banks speculating in markets away from their core responsibilities is garnering attention from the highest levels, including the President of the United States. If ever there were a time that was hostile to the thought of a big bank speculating excessively, that time must be now. And what could be a more excessive and reckless speculation than the largest historic short position in a vital industrial material close to being in a shortage situation?

Throw in a proposed meeting by the primary regulator that may shortly address the very issues of excessive speculation and position limits and concentration on the short side of silver, and you wouldn't seem to be painting a picture for increased manipulative silver short-selling.

Taken all together, I have rarely seen this combination of potential circumstances before. The only dry powder that should be held is that which is being saved for the rainiest of days, or that final thump to the downside, should it come. For me, I'm still all-in, with recent additional purchases of out-of-the-money call options (primarily on SLV). This is definitely not meant as a recommendation to anyone not already a battle-scarred and grizzled speculator, just as a demonstration of how I feel about current circumstances. It is said option buyers lose 99% of the time. You should only think of options after you have had a thorough mental examination (something I have managed to avoid to date). Stick to real silver investments purchased with non-borrowed funds. You'll be glad you did.

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