February 19, 2011 – Weekly Review

Weekly Review

The price of gold and silver rose strongly on the week, with the gain in silver especially noteworthy. Gold rose by $31 for the week, its third consecutive gain, while silver exploded by $2.60 to a new 30-year high. Importantly, the gold/silver ratio tightened in to a 27-year low water mark (under 43) favoring silver. I'll spare everyone the lecture on switching gold to silver, except to note that anyone who did so at any point in the last quarter century is ahead for having done so. Heck, I was only 37 years old the last time the ratio was at current levels and had yet to discover the silver manipulation. Talk about a long time ago.

Conditions in the physical market still appear tight for silver. The rapid turnover (in and out movement) in the COMEX silver warehouses still looks intact and we remain at historically low total COMEX silver inventory levels. The feedback from the world's mints that produce silver coins is that they are still struggling to meet demand. Silver deposits into the big silver ETF, SLV, have resumed with inflows totaling almost 5 million ounces over the past seven trading days. The surge in volume in SLV trading on the big up days on Thursday and Friday strongly suggests that several millions of additional silver ounces are now owed to the Trust. Undoubtedly, this is putting extra pressure on the silver shorts and adding to overall physical tightness. For the time being, this is strictly a silver phenomenon, as inflows into the big gold ETF, GLD, are still lacking.

The flashing neon sign on silver tightness, however, still remains the unusual spread price movement between the various delivery months in COMEX silver futures contracts. On Friday, the market closed in official backwardation for the first time in history, with the nearest delivery months commanding the highest price on the board and the farthest delivery months commanding the lowest price. This price configuration is generally accepted in the commodities world as being indicative of very tight physical market conditions. A quick review of Friday's official settlement on the COMEX will display the configuration in simple terms. Look under the Â?settleÂ? column.
http://www.cmegroup.com/trading/metals/precious/silver_quotes_settlements_futures.html
Merely on a comparative basis and not to pick on gold, a quick glance at the gold settle column will confirm there is no hint of backwardation in the gold market. Maybe that will occur someday, but there is no sign of that yet.
http://www.cmegroup.com/trading/metals/precious/gold_quotes_settlements_futures.html

With first notice of delivery day for the big March silver contract coming on Monday, Feb 28, it will be instructive to monitor the spreads over the next week and how much the open interest in the March contract gets reduced before that date. The key question is if a higher than normal number of contracts remains open into the March delivery period. If a larger than normal number of contracts stand for delivery, as is suggested by the move to backwardation, then the question becomes can the shorts come up with the physical goods to meet the extra delivery demand. If they can't, the market could react violently to the upside.

Ever since the silver spread price earthquake occurred on January 19, there has been no obvious explanation for why the silver spreads have changed so much. The most plausible explanation is physical tightness, but it is very unusual how the backwardation developed from that date. I have been talking about the growing signs of tightness in physical silver for quite some time, but I am unaware of any specific catalyst that caused the sudden spread price movement on January 19. Over the past month, the cumulative change in the silver spreads has been truly unprecedented. From January 18 to yesterdays close, for example, the widest time span from the nearby March 2011 contract to the most distant December 2015 contract has swung in price by almost $1.75. No telling for sure what will happen from this point, but such a swing in spread prices in silver were thought by many to be impossible not too long ago.

Now that we have moved into official backwardation, I would remind you that there is no way of determining how far the backwardation might extend. I can tell you that a common belief held by both Izzy Friedman and myself for the past 25 years is that one day we could witness an eventual silver backwardation measured not in pennies difference between various futures months, but by many dollars per ounce. If this does occur, the impact on the price of silver would be beyond dramatic. Not to overstate the situation, but in many ways the price gains to date in silver actually look muted given the spread changes so far. The spread price changes are definitely ahead of the flat price movements at this point.

The latest Commitment of Traders Report (COT) was a mixed bag. The total net commercial short positions increased in silver and gold; silver by 3900 contracts and gold by 8700. Importantly, the largest 4 shorts in silver only accounted for 1200 contracts of the increase, allowing for the possibility that JPMorgan did not increase its short position and that the other three traders in the big 4 category were the sellers. In gold, the big 4 actually decreased their short position 1600 contracts, despite the 8700 contract increase in the total net commercial short position. I find it encouraging that the largest 4 traders in silver and gold are not taking the lead behind the increase in the commercial total short position.

This week's COT featured a big increase in silver total open interest, with a jump of more than 11,000 contracts in silver in the reporting week. Since the commercials Â?onlyÂ? increased their net short position by 3900 contracts (almost 20 million ounces), a big part of the total open increase is explained by a marked increase in spread positions. Given the unusual spread price changes in silver, this big increase in spread open interest promises to increase spread volatility, particularly as we get closer to the actual delivery period for March.

Most of the commercial selling in the big price rally from the price lows near the end of January has been to due to the smaller commercials (the raptors) selling out long positions. In silver, the raptors have now sold out all their long positions and have ended up net short by a small amount (900 contracts). This is the first time the silver raptors have been net short in four years. My sense is that these raptors won't increase their silver net short position by a large amount. If true, this suggests no heavy selling pressure from this group of traders from this point on. Considering the price move through Friday, anyone short silver has experienced financial stress and the possibility of some of these short traders throwing in the towel must be entertained. Coupled with the possibility of delivery tightness, it adds potential pressure for a continued upside price move. Now that gold has crossed the important 50-day moving average, more buying could come into gold, exerting price pressure to the upside in gold which may add sympathetic buying pressure in silver.

Of course, now that silver prices have advanced as far as they have, we must be prepared for increased price volatility. That means sharp price movements both up and down. But if we do get a manipulated sell-off by the commercials looking to liquidate the tech funds who have come onto the long side (as expected), it shouldn't last long, although it may be sharp. However, the odds have also increased that silver could really get uncorked to the upside, especially if demands for physical silver intensify on both the COMEX and in the SLV and other ETFs. Considering the financial punishment accruing to the shorts and the overall tightness in physical silver, the ingredients for an upside price event are in place. The advice to silver investors remains the same Â? hold on for what may be the ride of a lifetime. Sharp sell-offs are painful, but stepping aside to repurchase at lower levels has been difficult at best. Being largely out of an historic silver price move higher might prove to be a lot more painful than enduring sharp temporary sell-offs.

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Silver – $32.50

Gold – $1387

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