January 4, 2012 – Just Warming Up

Silver Is Just Warming Up

There is a feeling among many that silver may have played itself out with its price performance in 2011. From less than $18 in the summer of 2010 and $27 in January 2011, the price of silver surged to almost $50 in late-April, up more than ten-fold from where the price had been ten years earlier. Few investments performed better than silver. A series of sharp and deliberate sell-offs has now brought the price to under $30 again. This has led many to conclude that silver's best days are behind it. I would suggest that the facts point to a different conclusion, namely, that silver is just warming up for what should be much higher prices to come.

I can understand why many would assume that the run to almost $50 in April might mark a top for silver, as did the run to $50 thirty years earlier. After all, $50 is somewhat of a special number in silver history. But it is ironic that most of those proclaiming that the silver move is now over never expected silver to hit $50 before April 2011. Besides, when one objectively dissects the reasons behind the most recent move to $50, the conclusion reached is that the price of silver still has a long way to go higher. Someday, in the not too distant future, we will likely look back at $50 as wishing we could once again buy at such a cheap price.

The first fact to consider is that on last year's run to $50, no big silver mania developed. I know that many assumed and proclaimed, by virtue of price alone, that silver was in a bubble of sorts and that there must have been widespread and unbridled speculative buying that caused prices to run so high. But that assumption is not borne out from the facts. Of course, any market that doubles or almost triples in less than a year is bound to attract its share of momentum-type buying and investors attracted by price movement alone. Silver, by virtue of its price movement did attract some pile-on buying; but the public data show no signs of a genuine bubble or investment mania. What data?

The first data series documenting no big speculative buying as being behind the surge to almost $50 last year is published weekly by the US Commodity Futures Trading Commission (CFTC), the federal regulator of commodities trading. On the run up in prices last year, the CFTC data clearly indicate that excessive speculative buying was not the cause of the price surge. Instead, the actual price peak was achieved due to short-covering by commercial interests who had bet wrong on lower prices and bought back short positions in an effort to limit losses. On the big move up in silver prices last year, speculators held less than their usual long positions. US Government statistics clearly indicate no big speculative buying in the futures market as being behind the move to $50.

The second public data indicator that there was no speculative buying mania in silver last year is in the recorded holdings of all the world's physical depositories of silver, in the form of Exchange Traded Funds (ETFs) and other silver investment vehicles. There was relatively little buildup in the world's investment holdings of silver from year end 2010 to the peak in prices four months later. Yes, there was net buying of physical silver, but the buying was minimal, especially when compared with previous silver investment buying over the five prior years. A key ingredient required for a bubble is missing; there was no notable leverage present in silver into the price peak. Additionally, not one well-known hedge fund star was ever reported to having bought silver into the price peak.

If all the data indicate no big speculative buying surge, either in the paper futures market or in the physical market, then what the heck caused silver prices to surge to near $50? As I alluded above, there was some short-covering by commercial traders into the peak, but even that was not the main factor behind the run up. The simple answer and my main point is that there was no standout overall buying, either by speculators plowing into the market or by short-covering. Instead, the silver market had become so tight in early 2011, due to the cumulative effect of previous investment and industrial demand, that silver had reached the breaking point and was on the verge of truly exploding in price by the end of April 2011. Faced with financial and perhaps legal ruin should silver prices surge uncontrollably beyond $50, the big silver shorts on the COMEX, led by JPMorgan and in concert with the exchange itself (owned by the CME Group), resorted to their own emergency measures on May 1 and began driving prices sharply lower on that Sunday evening by an initial $6. Their intent was to cause what long investors that were in the market to panic and sell. To aid the short sellers, the exchange quickly instituted a series of margin increases, further pressuring long investors to sell.

The desperation tactic by the big silver shorts was successful, as silver prices quickly fell by more than 30% in a week to the low $30's. After recovering to over $42 by the summer, the same sudden takedown maneuver was deployed again by the big shorts in late September when price fell 35% in three days. And we just witnessed another orchestrated takedown in late December when prices were pushed below $27. Lost to many, there is a common denominator in all the deliberate silver sell-offs this year that points to dramatic new price highs for silver in the future. The common denominator is that the commercials have been super-aggressive in buying the sell-offs. This concerted buying has set the stage for new highs in silver.

The big commercial silver shorts had a near death experience when the price approached $50 in April. They were at the end of their rope and needed to do something in a hurry. That's why they rigged prices lower; so that they could buy and save themselves. These well-connected commercials knew, perhaps for the very first time, just how tight the silver market had become and how close we were to a profound physical shortage. The key is that the silver shortage wasn't caused by excessive speculative buying or a bubble or a mania. The extreme tightness and near shortage in silver was as a result of the gradual and cumulative impact of normal investment buying over the past five years. There is nothing to suggest that the long term and steady silver investment buying has ended.

Because there was no bubble or mania in silver, there was no bubble to burst. The orchestrated takedowns of the price by the big commercial interests were simply so that these commercials could buy and rid themselves of silver short positions. That's done now. That means that the silver market is now in the best possible shape. It's important to remember that the silver investment buying infrastructure is more advanced and fully-functional like no other time in history. As little as six years ago, there were few avenues for the world's investors to purchase silver. Today, silver ETF's and other investment vehicles stand ready to handle any amount of investment flow into silver. That greatly increases the probability that these investment flows will overwhelm the physical silver market at some point (just like it did around April 2011).

What lies ahead for silver is exciting. While we have not witnessed a bubble in silver yet, we will some day. The silver story and the dynamics of the market are too compelling for an investment mania not to emerge at some point. If anything, speculative sentiment has been completely wrung out from silver, clearing the way for speculators and investors to enter the market with a vengeance. At some point, enough of the world's industrial silver users will panic as prices climb and attempt to build physical silver inventories. This user buying, something that never kicked in during the run to $50 will create a silver shortage, the likes of which never witnessed before. It seems that the big commercial interests have come to learn the real silver story and they appear to want no part of the short side again. The major pressure of selling has passed and the way seems clear for higher prices. By the time the next chapter in the silver story plays out, $50 could look cheap. As always, it's mostly about trying to keep things in proper perspective.

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Silver – $29.40

Gold – $1610

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