July 15, 2015 – A Reverse Bubble

A Reverse Bubble

Market bubbles are generally rare financial events, usually occurring perhaps once in a generation. For better or worse, the current generation has come to experience more than its quota of financial bubbles. I would define a financial bubble as a market in which large numbers of investors, typically employing borrowed money, bid up the price of an asset well above any semblance of true value until the price collapses due to the same force of universal selling that followed the universal buying that begat the bubble. A bubble always involves the price being bid way to high, followed by almost complete collapse Â? a bubble bursting.

We've become somewhat bubble sensitive in modern times, often affixing the term to almost any market or asset that experiences a sharp rise, whether or not followed by a collapse. I would include as true financial bubbles the dotcom stock market bubble that peaked in 2000, certain sectors of the US housing market in the mid-2000's and what's currently occurring in stock markets in China.

But not all significant price increases, even those which experience price collapses should be considered bubbles if they don't exhibit the true bubble characteristics of near universal participation and over leverage. Other forces can account for great run ups and declines, even if the term bubble is attached to those events. For instance, I don't believe the extreme stock market declines during the financial crises of 2007-2008 was the result of a bubble bursting, but rather a result of genuine financial problems.

Likewise, I still don't view the great silver price run up in early 2011, in which prices rose to nearly $50 from $17 in eight months' time, as a bubble because there was no universal speculative buying and little borrowing based upon futures market data and observable evidence at the time. I know many still consider that price run into 2011 as some sort of a bubble blow-off based upon the extreme price movement, but that move didn't have true bubble characteristics. Yes, silver did go up a lot price wise and then down, but it wasn't a bubble by standard definitions. With the passage of time, I'm convinced we ran up on extreme physical tightness and came down on overt COMEX market manipulation which featured the biggest deliberate sell-offs in the shortest times in commodity history.

Based upon what has transpired in silver over the past four years, I believe that what has been created is a reverse price bubble Â? the opposite and mirror image of what we call financial bubbles. Where a regular financial bubble involves vastly overvalued prices, a reverse bubble features a shockingly undervalued price. Where a regular financial bubble involves vast numbers of participants and reckless leverage, the reverse bubble in silver features just a handful of market participants and little borrowing in the normal sense. And, most importantly, where it's just a matter of time before a regular bubble bursts amid crashing prices, in a reverse bubble it is inevitable that any bursting will cause prices to explode.

Reverse bubbles are so rare that none come to my mind except silver. That's because it's easy to understand how a regular financial bubble comes into existence Â? unbridled collective greed and emotion driving prices to the point of unsustainability Â? the madness of crowds and all that. There's no crowd driving prices lower in a reverse bubble because short selling is not widely practiced and available to the average investor.

Of course, the Â?reverse bubbleÂ? in silver is just another term for the downward price manipulation. Instead of the many pushing prices too high, the few have pushed prices too low in silver. Since neither circumstance can last forever, all that matters in a regular bubble is getting out before the crash; in silver's reverse bubble, all that matters is getting in before the explosion. And when you hold fully paid for silver, getting in too early should not prove paramount in the end Â? better years early than a day late.

With all my talk of a reverse bubble in silver, the price continues to move lower, with new lows being seen today in gold. Speaking of gold, there's no doubt its price has been manipulated by COMEX positioning, although I don't consider gold to be anywhere near as undervalued as silver. Therefore, I would be somewhat hesitant to call gold a reverse bubble as I do in silver. Still, the steady price salami-slicing to the downside has created a market setup that has already set records, not only in COMEX gold and silver, but other CME metals as well.

The biggest difference in the silver reverse price bubble, as well the activities in other CME markets, including metals, crude oil and grains, is the ascendancy of the managed money traders as the leading short sellers in futures markets. Up until a couple of years ago, managed money traders (technical funds) grew very large on the long side of most markets, but not as much on the short side. Before then, the commercials were the biggest factor on the short side.

Very recently (within the past month), we've seen very sharp price rallies in wheat and corn (more than 20%) because managed money traders had built up record short positions and rushed to buy back and cover those shorts on the order of many tens of thousands and even hundreds of thousands of futures contracts. Managed money short covering was the sole cause of the grain price rally. Likewise, we've seen a recent sharp one week drop of $8 in the price of crude oil that can be directly traced to some 40,000 contracts of mostly short selling by managed money traders on the NYMEX.

In many markets, managed money traders are clearly the main price force. This is virtually undeniable based upon the data in the COT reports and leaves aside my contention that the commercials are directing the managed money traders by rigging prices. Importantly, this technical fund (managed money) influence appears to reaching near universal recognition, even by former staunch deniers of the premise of silver and gold prices being manipulated.

The recent sharp jump in grain prices is most analogous to the current setup in silver and gold (and other CME metals). Corn prices had been driven to near multi-year lows precisely because the short position of managed money traders had climbed to the largest level ever Â? around 375,000 contracts (nearly 2 billion bushels). As soon as corn prices jumped above and penetrated the important moving averages, the managed money traders rushed to buy back 250,000 short contracts (in addition to adding 50,000 new long contracts. The combined 300,000 contracts of technical fund buying in corn quickly drove prices more than 20% higher. The same thing occurred in wheat.

The only rational conclusion an objective observer could make is that managed money selling in corn and wheat first drove prices lower and then managed money buying drove prices sharply higher. It's easy to make this more complicated, but for what purpose? That this is not the way regulated commodity markets are supposed to function goes without saying. The regulators should be ashamed for having let our markets, once the envy of the world, sink to this perverted level.

But instead of harping on that regulatory failure now, let me instead outline some specific price guidelines for how I see the current historic managed money short positions in silver and gold playing out. First, I do think we have seen or are seeing the price lows for silver and gold being established currently. That's due to the record managed money short position already being at record levels which suggests the bulk, if not all, of the managed money shorts being in place. Certainly, with a current (temporary, at least) retail silver shortage in effect and clear signs of tightness in wholesale silver as well, no one would suggest actual supply/demand fundamentals are driving prices. Of course, if more new managed money shorts can be lured into silver or gold ahead, prices go a bit lower and I look like a jerk for a while longer.

But sooner or later, silver and gold prices will penetrate the important moving averages (now just under $16 in silver and just over $1200 in gold). Not only is this eventual penetration mathematically guaranteed to occur (some combination of moving averages coming down and prices moving higher in time), based upon past results and the methods by which managed money traders operate, we can quantify how many contracts these traders will buy.

In silver, as and when $16 is breeched to the upside for more than a few trading days, it can be reasonably calculated that upwards of 60,000 net contracts will be bought by the managed money traders (technical funds), including 45,000 short contracts bought back and covered and 15,000 new long contracts being added. In COMEX gold, if prices trade above $1200 for more than a few days, it appears a minimum of 80,000 contracts (short covering and new longs) will be purchased by managed money traders and possibly a lot more.

The 60,000 silver contracts that will be purchased by managed money traders, since it represents 300 million oz of equivalent silver, is particularly noteworthy. That's close to the amount I allege JPMorgan has acquired in actual silver and close to 40% of annual world production. I recognize this is paper silver, not actual silver, but I would point out that JPMorgan took more than four years to accumulate its hoard of silver, whereas the technical funds will buy that amount in weeks, if not days, once the moving averages are penetrated.

I can set the parameters of the coming rally in silver and gold in terms of how many contracts the managed money traders are likely to buy and the circumstances by which they will buy (moving average penetration), but there are some things I can't know. One is the exact timing of the moving average penetration to the upside, but that's less important in the scheme of things (although I did top off my options position today replacing those expiring as worthless, with my wife's permission, meaning I think the time is at hand).

But the most important unknown is how aggressive the counterparty commercials will be in selling into what I contend will be 60,000 contracts of managed money silver buying and 80,000 contracts of gold buying. Using the past experience of the pattern of the ever diminishing rallies of the past few years and the recent experience in grains, I see a worst case situation of a $2 to $3 rally in silver and an $80 to $100 rally in gold from current prices. Remember, that's worst case and not the reason I hold and advocate silver.

This is always a case of the number of contracts bought by managed money traders and sold by the commercials being more important than the price. If, on a rally above $16 in silver and $1200 in gold, future COT reports indicate net buying of 60,000 silver contracts and 80,000 gold contracts by the managed money traders, it will be hard to remain as bullish in the short term as I am now. But the determining factor will be the number of managed money contracts purchased and at this moment, no such contracts have been bought.

If the worst case is a rally of $2 or $3 in silver and $80 to $100 in gold from close to current levels, what's the best case? The best case, at least in silver, is if the commercials don't sell all of the 60,000 contracts that the managed money traders look set to buy on a decisive upside penetration of the moving averages. And, most particularly, whether JPMorgan joins in with the other commercials, most of which are long, and begins to expand a short position which I believe is currently low or nonexistent.

I'm not a mathematician, but I see this as a clear mathematical equation. It's a given that the managed money traders will buy 60,000 net silver contracts on a decisive penetration of the moving averages and that buying will exert upside pressure to price. The variable is what the commercials will sell. If the commercials sell all 60,000 contracts (with JPM joining in) as aggressively as the managed money traders buy, we may be lucky to see $17 silver. But if the commercials sell some significant number less than 60,000 contracts, upside price targets will expand notably.

For instance, if the commercials sell Â?onlyÂ? 40,000 net silver contracts when the managed money traders are seeking to buy 60,000 contracts, the unsold 20,000 contracts should have a profound upward impact on price; simply because the managed money traders will keep raising bids to complete their buying. Admittedly, the commercials have always provided the exact number of contracts needed to be bought by the managed money traders in order to cap and control upside price moves and it would not be unreasonable to think that will occur again.

But when you put this whole thing on fast forward and try to imagine how this crooked game will end; it will likely end when the commercials don't provide the sufficient number of sell contracts to fully match managed money buying. Considering all the new circumstances in silver, such as tight retail and wholesale markets and that JPMorgan is massively long actual silver, why not now?

Of course, there are other potential outcomes, such as the commercials and other speculative longs panicking and selling out to the managed money traders at much lower prices (like occurred last October. But history suggests that's a long shot outcome and will only delay the mathematical equation I just described. And considering what just transpired with the managed money traders in grains, where they had no ability to deliver and could only buy back short positions (same as in silver, gold and other metals), recent events suggest it is only a matter of time and price before they also buy back to the upside in silver and gold. Again, how much upside is more dependent on the how aggressive the commercials are in selling, than how aggressive the managed money traders are in buying.

Ted Butler

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Silver – $15

Gold – $1147

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