July 25, 2010 – Cocoa and Silver

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On Sunday, July 25, the New York Times featured a front page story on the big cocoa purchase by a hedge fund trader on the London Cocoa market. http://www.nytimes.com/2010/07/25/business/global/25chocolate.html?_r=2&hpw (free registration required). This story has been making the rounds in the mass media for the past week or so.

Here's a quick summary of the NY Times story. The trader, an experienced cocoa market participant, took delivery of a large amount of cocoa beans, some 240,000 tons, or 7% of the annual world production. Such an amount, the story states was, Â?Â a big enough amount to sway prices.Â? Big cocoa users are up in arms and complaining to the exchange that the purchase represented a market corner and would leave prices subject to a short squeeze. My sense is that short sellers are using the media to bring pressure on the big hedge fund trader to abort his buying for their own selfish interests. But for the sake of argument, let's assume that the trader is attempting to manipulate the price of cocoa higher.

Surely, if a position of 7% of world production is enough to influence price, then a position four times larger would sway prices even more. Yet, over the last two years, the CFTC has reported in its monthly Bank Participation Report that one or two US banks have held short the equivalent of 25% to 30% of the world annual production of silver on the COMEX. My guess is that it is just one US bank, JPMorgan, which accounts for almost all of this concentrated short position, as a result of its takeover of Bear Stearns in 2008. In fact, there has been an active investigation into this very issue by the Enforcement Division of the CFTC for almost two years. Let's hope we are not at the half way mark of the investigation.

If a cocoa manipulation is under way, it is occurring in London and not in the US, outside the jurisdiction of the CFTC. Importantly, CFTC data indicates no serious concentration, long or short, on the US cocoa market. Unfortunately, this same data indicates an extreme concentration on the short side of COMEX silver. For the NY Times and others to highlight the cocoa story on a London exchange and not a more extreme silver story seems unfair and unbalanced. After all, US commodity law does not distinguish between a long side and a short side manipulation. Nor does it distinguish between manipulative activities by a hedge fund or by a bank acting as a hedge fund. Lastly, what makes the actions of the US bank(s) more serious is that at least the hedge fund trader paid for his cocoa beans and owns them. The biggest silver short, JPMorgan, has sold and committed to deliver a quantity of silver, 150 million ounces, that seems impossible to fulfill. That makes the situation more dangerous in silver, as it raises the specter of default. The 8 largest short traders on the COMEX have committed to deliver more than 305 million ounces, or more than 40% of annual mine production. (According to the most recent Commitment of Traders report).

If the NY Times and others imply that holding 7% of the world production of a commodity would artificially influence prices, why are they not also implying that holding 25% to over 40% of world production short would influence prices even more? If holding 7% of the world production of any commodity is worthy of the front page, is not holding a short position many times larger a story that is news fit to be printed?

A few words on the most recent COT report. As I indicated in my King World News interview, there was a big improvement in silver and gold for the week and over the last three weeks, especially in gold. Interestingly, almost all of the 75,000 net contract improvement in gold over the past three weeks came by the smaller commercials. It's pretty unusual when the big 4 and 8 largest gold shorts hold their positions in the face of big technical fund selling. I don't write too much about these smaller commercials (raptors) in gold, but their behavior over the last three weeks merits commentary.

Basically, the gold raptors (the commercial traders other than the 8 largest commercial traders) increased their net long position from less than 3,000 contracts on June 29, to almost 70,000 contracts on July 20. In effect, these smaller commercials absorbed almost the entire technical fund selling over the past three weeks of declining gold prices. The 70,000 contract long gold position that these raptors hold is among the largest on record. It is my speculation (first advanced privately to me by Izzy Friedman) that the biggest gold short, led by JPMorgan, has recently sold short futures contracts representing a chunk of gold that the IMF hasn't been able to sell yet. Perhaps JPMorgan did reduce its proprietary gold short position, but the amount represented by a sell hedge by the IMF camouflaged the reduction.

What does this mean? The overall COT setup is still very bullish for both silver and gold. But the emergence of the gold raptors being so heavily long suggests a specific outcome ahead. Please bear in mind that I am speculating here. We know that the commercials, both the big 8 and the raptors always sell on the way up in price and buy on the way down. Having bought almost 70,000 contracts in the past three weeks, the raptors can now be expected to sell those contracts on higher prices, when the next price rally emerges. These raptors will sell as the technical funds buy, first as the moving averages are penetrated to the upside and as further new price highs are established by tech fund buying. Again, this is the rhythm of the market. 70,000 contracts (or more if the raptors first add to these longs on lower prices) can be absorbed by a $50 to $100 rally in gold prices, by my estimates. After selling these contracts up to $1300 or so, the raptors and the big 8 will be able to maneuver gold prices lower again, all things being equal.

But the situation in silver is different. There, the raptors only appear likely to sell 5,000 to 10,000 contracts or so, maybe more if they decide to go short on much higher silver prices. (The silver raptors have not been net short in a couple of years). I don't think JPMorgan will increase noticeably its silver short position from this point on. I don't think raptor selling in silver will cap a price rally in silver, like is probable in gold. Therefore, it is my expectation that while we should witness a decent gold rally shortly, the silver rally will be a lot more than decent.

It is important to remember that the most significant issue of the day, position limits, is very much an issue specific to silver. Sometimes that gets overlooked. The issue of position limits in gold is not as important. If the CFTC decided to impose position limits in gold at somewhere near the current 6,000 contract accountability level, it would appear reasonable to me. Certainly, I am aware of no other level being openly suggested in gold. In silver, however, the current 6,000 contract accountability level is absurd. All the facts surrounding silver demand a position limit of 1500 contracts and the disallowance of the current phony hedge exemptions granted to JPMorgan and others. My point is that any true enactment of legitimate position limits will have a profound impact on silver and not much of an impact on other commodities, including gold.

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