July 29, 2015 – Price Takers and Price Makers

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In the world of basic commodities nearly every market participant, whether a producer or consumer, is a price taker, accepting the general price level prevailing at the time. For example, the individual consumer of gasoline has little choice but to take the price at the pump or go elsewhere. Same with corporate consumers like airlines and other transportation entities. They can hedge and fix their costs, but that hedging must be based upon current prevailing prices. Even large producers like the oil companies must take what prices the market provides, although the largest oil producers, like Saudi Arabia, could set (make) oil prices if it wanted to (at least temporarily).

That's the way it is and should be with world commodities Â? 99.9% of all consumers and producers are price takers, that is, accepting whatever the prevailing price happens to be. Generally, this shouldn't be considered a problem as it dovetails perfectly with our vision of how a free market sets prices through the magic of aggregate supply and demand. Too much world demand and not enough supply, prices have to rise; not enough demand and/or too much supply and prices must fall enough to regain fundamental balance. If that was occurring currently in the pricing of many world commodities, namely, that actual supply and demand was determining price, I would end this article here. But that is not the case.

Oh, it's true enough that more than 99.9% of all world consumers and producers are price takers and not price setters. While that is good in terms of how free markets should operate, their total consumption and production has little to do with how prices of many world commodities are determined; and that is bad. How can this be? How can there be no dominant producer or consumer of world commodities capable of making a price; and still I contend that prices are being set to the point of being artificially fixed?

The answer lies in the fact that a great force is setting (making) the price of many world commodities completely apart from the influence of aggregate actual supply and demand. Seemingly out of nowhere, this great force has come to push aside the price effect of the law of supply and demand and render it as almost non-existent.

The great pricing force that I speak of is excessive speculative positioning in the regulated futures markets, mostly exchanges owned and run by the CME Group. Simply put, speculative futures trading has come to supplant actual commodity supply and demand as the main pricing force. Although such excessive speculation is strictly against commodity law, the primary commodities regulator, the CFTC, looks the other way. Ironically, it is the data published by the federal regulator that proves that excessive speculation is setting prices for many world commodities.

Let me be clear Â? there is nothing wrong with speculation and without it, there would be no functioning commodity market possible. But there is something very wrong when excessive speculation sets prices.

The excessive speculation that I refer to is quite specific Â? it involves only two types of modern day futures traders. One group are the traders in the category the CFTC refers to as managed money and the other group includes commercial traders (mostly banks) which take the other side of whatever the managed money traders wish to buy or sell. And it's even more specific than that Â? I'm only referring to the managed money traders which operate strictly on technical considerations, like moving averages.

In a nutshell, here's the problem Â? because managed money technical traders generally do the same thing (buy or sell) under similar pricing circumstances (buying on rising prices and selling on declining prices), even though each technical trader is operating independent of other technical traders, the net effect is that their collective actions transform them into one massive trader Â? the largest such trader ever known to markets. The price-setting influence the unified managed money traders is having on world commodities is undeniable. Whereas I usually talk in terms of what this collective influence has on silver and gold prices, it has now gone much further than that.

The proof that collective managed money positioning has been the dominate price force in recent moves in corn, crude oil and copper (in addition to silver and gold) can be seen in the data in the CFTC's Commitments of Traders (COT) report. Other commodities are similarly affected by collective managed money futures market positioning, but let me stick to just these five commodities for the sake of brevity.

On the recent 20%+ jump in corn prices (now reversing), managed money traders bought (mostly in the form of short covering) roughly 400,000 net futures contracts in a matter of weeks, or nearly 30% of the total open interest in the Chicago Board of Trade's corn futures market . In addition, that's the equivalent of two billion bushels of corn, nearly 15% of US corn production and the US is the largest corn producer in the world with half the world output. If one trader, effectively and suddenly, bought 30% of an entire major futures market, could there be a more obvious force for driving prices higher?

On the recent $12 plunge in the price of crude oil, managed money traders sold 150,000 net contracts in a matter of weeks. That's the equivalent of 150 million barrels of oil and close to 10% of the total NYMEX crude oil market. If any one trader sold 150 million barrels of crude oil in a hurry, what would the effect on prices be?

On the plunge in copper prices since May 19 from over $2.90 to under $2.40, managed money traders sold more than 66,000 net COMEX copper futures contracts, an astounding 40% of the total open interest. That's also the equivalent of 825,000 tons of copper or more than double the combined COMEX and LME inventories. If one trader sold the equivalent of 40% of a major market in a matter of two months, wouldn't prices drop sharply? (By the way Â? I'm using data from the most recent COT reports).

On the drop in gold prices of $140 from May 19, managed money traders sold 93,000 net COMEX futures contracts (mostly in the form of new shorts) or more than 20% of the entire COMEX market and the equivalent of 9.3 million oz worth more than $10 billion. If one large trader sold more than 20% of the world's largest gold exchange in a little over two months, would you be surprised that prices dropped by 11%?

On the $3 price drop in silver from May 19, managed money traders sold 57,000 net COMEX silver futures contracts (also mostly in the form of new short sales) or roughly 30% of the entire COMEX market, also the largest silver exchange in the world. That's the equivalent of 285 million oz or close to 35% of world annual silver mine production. How could a large trader selling such incredible percentages of both the COMEX and world mine production not send prices lower?

I know that what I just reported on involves trading in futures contracts and not in the actual commodities, but therein lies the rub. Because all commodity producers and consumers are price takers and not price makers, physical commodities are priced off the futures price. Make the price of silver $3 lower on the COMEX and that automatically becomes the price for all silver producers and consumers. It's nuts (and illegal) for pure speculators to dictate prices to real producers and consumers, but we live in a mad, mad world. (Perhaps only until real producers stand up against the madness).

Who are these traders that move in lockstep and hold such a dominant role in setting commodity prices? And why are the regulators looking the other way as managed money technical traders evolve into the unquestioned price makers that the data indicate? The answers to these questions have to do with gradualism and not wanting to admit to a problem that should have been rectified long ago.

First off, no one managed money technical trader is responsible for setting prices; but when many different managed money traders do the same thing at the same time, the collective effect is price making and distortion. As a whole, managed money traders control upwards of $300 billion in assets devoted to futures trading. They even have their own powerful lobbying organization, which like any such organization fights any attempt to restrict their activities, even if their collective activities undermine the integrity of our markets.

https://www.managedfunds.org/

And as for the CFTC, it has denied so often that there is anything amiss in the silver market that there is no chance it can admit to anything I allege under any circumstances. Unfortunately, because the CFTC is afraid to even discuss this issue, now the silver manipulation disease has spread to most markets controlled by the CME Group. That's too bad, because there is a simple solution to the problem of collective managed money trading making the price that all consumers and producers of world commodities must take. (For the purpose of this article, I'm leaving out my contention that the commercials are tricking the managed money traders into and out from futures positions, as that's a separate issue).

The solution (as I've maintained for years) is to treat the managed money traders who are buying and selling in unison as the one trading entity that they are effectively functioning as. There is no question that these traders are speculators and, therefore, there is no question that they should be treated as a single speculative entity and be governed by a single collective speculative position limit.

No one speculative trader would be allowed to buy or sell 10%, 20% or 40% of any commodity market in a short period of time and neither should a small group of traders, trading in lockstep, be allowed to do the same. Remember we're talking about a very small number of managed money traders, close to 30 or 50 traders in most markets. Why should 30 or 50 purely speculative CME traders be allowed to set the price for the millions and even billions of world participants who must then take the prices dictated to them?

On to developments since Saturday's review. I was so anxious about Friday's COT report that I overlooked the new short interest report for stocks which was released late Friday. I've gotten away from predicting what this report might indicate and that seems wise now, since I never would have predicted the sharp increases reported in the short positions of both the big silver ETF, SLV, as well as for the big gold ETF, GLD. As of the close of business July 15, the short position in SLV grew by 8.2 million shares to more than 21.7 million shares (ounces) and now represents a significant 6.4% of total shares outstanding. In GLD, the short interest grew by 4.6 million shares to 14 million shares (1.4 million oz) or 6.1% of total shares outstanding.

http://shortsqueeze.com/?symbol=slv&submit=Short+Quote%99

While 8.2 million oz is the equivalent of Â?onlyÂ? 1640 COMEX silver contracts, it is not an insignificant amount of silver, particularly considering is it a lot more Â?realÂ? than COMEX contracts overall. In trying to explain (to myself) why such a large increase, I've settled on the two most plausible explanations that came to mind. One, there was no choice but to short shares of SLV, particularly on the fairly sharp four day rally within the reporting period, because actual metal simply wasn't available for deposit. Two, the new short sellers were influenced by overall price weakness and the explosion of negative commentary, especially on gold.

If either explanation is close to the mark, I can't help but conclude either wholesale conditions are tighter in silver than even I imagine or speculative traders who shouldn't be short are now heavily short. While I dislike seeing any short position in these two highly unique securities, I can't help but interpret the increase as constructive. Time will tell.

As expected, the US Mint announced sales of Silver Eagles this week after a three week suspension of sales due the sellout announced on July 7. On Monday, the Mint announced it had sold a little over 1.3 million Silver Eagles which was half the amount I had privately expected, using what I had estimated to be the Mint's daily production capacity of 130,000 coins per day (7 day week). To say I was disappointed with Monday's report would be an understatement. Fortunately, yesterday's update from the Mint eliminated any disappointment as it indicated another 1.2 million coins sold, with the two day total darn close to the 2.6 million coins I expected (20 days X 130,000 coins).

http://www.usmint.gov/about_the_mint/index.cfm?action=PreciousMetals&type=bullion

Previously, I speculated that the intent behind the Mint's suspension of sales for 3 weeks, instead of selling coins daily as they were produced, was to cool off demand and allow the Mint to get ahead of the curve and get off the rationing mode. If my speculation is close to the mark, then it would appear the Mint has been unsuccessful to date in cooling off demand. What I can't tell at this time is JPMorgan's role, aside from the bank cleaning out the Mint in June and early July and kicking off the surge in retail demand that resulted from the Mint's sellout on July 7.

Reports from the retail front indicate demand for silver has remained strong and I'm inclined to believe that this week's sale of Silver Eagles may have been pure retail. There has also been remarkable increase in demand for Gold Eagles, but I don't have a strong handle on where that demand is coming from. It may be a plain vanilla surge in retail demand, but that argument is undercut somewhat by the lack of demand for shares of GLD or in similar gold investment vehicles. In any event, I'm not ready to abandon just yet my premise that a big buyer may have emerged for Gold Eagles, similar to the big buyer I have sensed in Silver Eagles over the past few years.

The intent of today's article on price takers and makers was to restate in the simplest terms possible what is a very complicated and serious problem in the pricing of world commodities. But just because I refrained from discussing how bullish is the current market structure in silver and gold, please don't interpret that omission as indicating that both aren't locked and loaded for the upside, regardless of very short term price action.

It's hard to imagine a further big improvement in this week's COT report, considering the bullish extremity of the current COMEX market structure, but price action during the reporting week that ended yesterday suggests additional commercial buying and managed money selling. And given just how bullish the setup has grown, neither have I abandoned my thoughts that this may still be the last great such setup.

Ted Butler

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Silver – $14.75

Gold – $1096

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