July 6, 2016 – Turning of the Tide?

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The price fireworks over the July 4 holiday, particularly in silver, were met with an outpouring of commentary and renewed interest. Not only have precious metals prices soared to levels not seen in a couple of years, it's hard for me to recall a time with more input from different voices. It's also hard to believe that it was only six months ago that gold and silver were locked in nearly the opposite situation. So the obvious questions are what happened and, more importantly, what is likely to occur from here?

I continue to believe that the main price driver for gold and silver was the historic positioning changes in COMEX futures over the past six months. Year to date, the now $300+ rally in gold and $6+ rally in silver, were driven by more than 30 million oz of paper gold and 325 million oz of paper silver on the COMEX, bought principally by managed money technical funds and sold by commercials (mostly banks).

In addition, the price rally in gold, in particular, set off significant buying in ETFs and other investment vehicles in which massive amounts of physical gold were purchased and deposited. In six months, nearly 20 million oz of physical gold were deposited into ETFs and COMEX warehouses (11 million oz in GLD alone), further cementing the gold rally. In dollar terms, that comes to $25 billion. The physical flows into silver have been much smaller in dollar terms as less than $1 billion worth of silver (40 million oz) has been deposited in silver ETFs, although there are recent signs that may be changing.

The purchase of so much physical gold has apparently thwarted the usual outcome of an extremely bearish COT market structure causing a big price selloff, or at least so far. Physical metal demand is understandable because it is near impossible to construct a fundamental bear case for gold or silver. I don't think many would disagree over what occurred these past six months, namely, historic COMEX positioning, coupled with massive physical buying in gold ETFs. Now what?

In contemplating what occurs next, it comes down to will the commercial traders succeed in turning price lower and triggering off technical fund selling on the COMEX and, at the same time, cool off ETF demand for physical metal? Up until very recently, history favored the commercials succeeding for the simple reason that they had never lost. Stated differently, the commercials as a whole and particularly the largest commercial traders had never been forced to buy back short contracts in COMEX gold and silver on rising prices.

I've tried to characterize the circumstance in black and white terms in that either the commercials would prevail as usual and drive prices lower or would fail for the very first time. The chance for failure was predicated on the unusually large financial risk the commercials had found themselves in as a result of historically large and concentrated short positions in COMEX gold and silver. Further, the possibility of commercial failure was augmented by a potential double cross by JPMorgan, which has accumulated half a billion ounces of physical silver and perhaps a large physical gold position as well.

To be fair, either outcome, a price selloff or surge, must be considered possible, but recent developments have raised the odds of a commercial failure in which prices surge, especially for silver. I'm still of the mind that we will go straight up or jiggle down one more time before then moving straight up, but it's more important to focus on the facts and figures and reasoning behind the increased odds of something that has never happened before. It has to do with the money game on the COMEX.

On Saturday, I calculated that the combined net-net loss to the commercials as of Friday's close was $1.6 billion. This includes all the realized gains the commercials had taken since the start of the year ($1.2 billion) from the $2.8 billion in open losses in COMEX gold and silver contracts. Through yesterday's close, the commercials' net-net loss has risen to $2.1 billion, largely due to gold's gain yesterday. Since it is too early to calculate for today's price action, I'll hold off on doing so until today's settlement prices are available.

But what I can say now is that through yesterday, the commercials had never been this deep ($2.1 billion) in the hole before in combined gold and silver losses; so in the truest sense of the word, these losses are unprecedented. Since futures trading is a zero sum game, meaning that what the shorts lose, the longs gain (and vice versa), the open profits for the managed money technical funds longs have also never been larger. These large open losses to the commercial shorts makes them both more vulnerable to further losses and more desperate to turn prices down.

Make no mistake – whether the commercials succeed or not is what will determine which way gold and silver prices move in the immediate future. Even if the commercials prevail yet again, and that is far from certain, the tide seems to be turning on the whole COMEX game that has existed for decades. I believe there are a number of factors pointing to changes in the usual business of setting gold and silver prices.

For one thing, it's hard to characterize the current extreme set up in COMEX market structure as being deliberately constructed by the commercials in its current form. After all, who would knowingly dig themselves into the deep hole the commercials find themselves in? What's most unprecedented about current circumstances is that never in the past have gold and silver prices rallied strongly after historic commercial short positions had been established. Yet, for the very first time, prices have so rallied.

It's not possible the commercials intended to be billions of dollars in the hole and the most plausible explanation for why they are so deep in the red is simple miscalculation. And if the commercials have miscalculated to this point, that would seem to increase the odds of continued miscalculation, leading to a total failure which I would define as aggressive short covering on escalating prices. I don't think anyone could conclude that the commercials have the technical funds exactly where the commercials want them to be. At this point, given the positions and overall price levels, the best the commercials could hope for would be to rig prices low enough to recoup their sizable open losses and get out of this jam without being decimated. It's almost impossible to imagine that the commercials deliberately put themselves in a $2 billion hole in order to score billions of dollars of profits in the end.

Along those same lines, it doesn't seem plausible that the phenomenal demand for physical gold in world ETFs was fully anticipated by the commercials. There was no evidence, for example, at the start of the year that the commercials held vast amounts of physical gold that they were seeking to unload. To the contrary, commercial net short positions in COMEX gold (and silver) were at extreme lows. If the commercials were expecting big physical buying in gold, they wouldn't have rushed onto the short side so early and aggressively.

I believe the massive and, largely, unanticipated demand for physical gold this year not only adds to the premise of commercial miscalculation, but holds special potential significance for silver. As I indicated earlier, surging physical ETF investment demand has largely been confined to gold, but could and may be developing in silver, based upon price and volume patterns in silver ETFs, including the largest, SLV.

It's kind of remarkable that $25 billion worth of gold has come into world ETFs over the past six months, while less than a billion dollars' worth of physical silver has come into the world's silver ETFs. Not that gold isn't the larger market, but there are other instances where the dollar demand for silver comes close and sometimes exceeds the dollar demand for gold, like in sales of Eagles from the US Mint. While gold did outperform silver pricewise earlier in the year, more recently silver has outpaced gold in the performance department. I can't help but think that if silver is doing so well despite the lack of physical demand compared to gold this year, what the heck will silver do when physical investment demand kicks in, as is almost certain at some point.

In fact, that's always been the prime component for my investment case in silver Â? the likelihood of a physical shortage. Now, more than ever, does the potential for a physical silver shortage exist. And while I have been amazed at the quantity of physical gold that has flowed into the ETFs this year, to this point the lack of big deposits in SLV and other silver ETFs leaves intact the possibility that no big quantities of physical silver are available to the market near current prices.

Since it has been a while, let me outline the silver shortage premise. First off, I am referring to a coming shortage in the form of silver that matters most Â? 1000 oz bars. Shortages in supplies of Silver Eagles or smaller bars of silver have gotten to be somewhat of a regular affair over the past few years, but do not directly impact the wholesale price of silver. The wholesale price of silver is determined by 1000 oz bars, because they are the industry and investment standard.

Apparently overlooked by many, is the tiny amount of 1000 oz bars of silver in existence. The entire world supply of verifiable 1000 oz bars in existence (including ETF and COMEX inventories) is just under 900 million oz, to which I would add 500 or 600 million oz in unrecorded 1000 oz bars (of which I believe JPMorgan holds the majority). Let's call it 1.5 billion oz, worth around $30 billion, compared to known gold in all forms of 5.5 billion oz, worth $7.5 trillion. In dollar terms, there are more than 250 times more gold than silver in the world. Common sense would suggest if there is going to be a shortage, it would likely occur in a commodity where inventories are small to begin with.

But like most investment assets, including gold, very little of what exists is truly available for sale at any point in time. That's because relatively few sellers exist at any time in any asset or investment, usually amounting to no more than 5% or 10% of the total of any asset and sometimes much less. In silver, the 1.5 billion oz in the form of 1000 oz bars, probably has an actual availability of no more than 100 million oz. In other words, no more than $2 billion worth of silver could be bought at any time (say over a month or so). I noted earlier that less than $1 billion of silver in 1000 oz bar form had been bought by ETFs over the past six months.

But we live in an investment era when many billions of dollars could flow or change direction at any time, almost instantly. Should the smallest amount of money get directed towards silver, say 10% of what flowed into gold ETFs over the past six months or $2 billion, it would likely absorb and exceed the amount of metal available. In addition to sending prices higher, sudden investment demand would disrupt the entire silver supply chain and lead to the Â?doomsdayÂ? effect in silver Â? an industrial user inventory buying panic.

It would work like this. Investment demand for 1000 oz bars of silver, either through ETF demand or COMEX deliveries, triggered by higher prices (silver is up more than any other commodity or asset this year), triggers further investment buying until the supply of available 1000 oz bars are temporarily exhausted. But because 90% of silver demand is earmarked to industrial or total fabrication demand, the investment buying surge will result in growing delays in delivery of 1000 oz bars to users. This will cause those users denied timely delivery to behave like any industrial consumer when faced with the shortage of any vital commodity, namely, to not only buy, but buy more than usual, adding to the physical shortage.

Certainly, regular readers know I have held this industrial user buying panic premise from the beginning and while we came close to physical shortage in early 2011, my premise has yet to fully blossom. Not only do I see my premise playing out, I believe the first stage, investment buying, may have begun or, at a minimum, is set to begin, based upon recent buying in SLV. The recurring image in my mind is that the coming silver user buying panic is like the great white shark lurking just off the beach. It doesn't matter until you cross its path, but when, not if, investment buying depletes the available supply of 1000 oz bars, industrial users will bite the silver market like never seen.

In fact, this is the main difference between gold and silver. Gold is not an industrial commodity. Because silver is an industrial commodity, both world inventories and current production have been and are reduced by industrial demand. Very few recognize just how much this has depleted world silver inventories and available current production. World silver inventories are down more than 90% from 75 years ago and only 10% (100 million oz) are available from current production for investment in 1000 oz bars. It will take much higher prices to balance supply once investment and user demand kicks in. This is the case for $100 and higher silver. Not the end of the world as we know it, just the ignition of investment demand and user inventory buying.

That's what makes the current set up so intriguing and dramatic. At precisely the same time 8 commercials have never been short so much silver on the COMEX (nearly 500 million oz), higher prices have put those traders more deeply underwater (in combination with gold) than ever, while those same rising prices threaten to ignite an investment stampede. It's as if one were deliberately chumming the waters off shore to excite the great white shark of user inventory buying.

Gold and silver prices have settled for the day and despite finishing off the highs, the price gain at settlement time (1:30 PM EST) indicates a further $400 million increase in the collective commercial loss for gold and silver. That puts the bottom line loss since yearend up to $2.5 billion by my back of the envelop calculations, once again the most ever. Even more stunning is the quickness in which the commercial losses developed. Only five weeks ago, the commercials were net-net ahead for the year by around $1.5 billion, meaning there has been a turnaround in the collective commercial position in COMEX gold and silver of upwards of $4 billion.

These are big numbers in any event, but when you distribute the turnaround and assign losses by the actual number of commercial traders holding short positions, the numbers become quite dramatic. COT data indicates only 8 traders hold the entire commercial net short position in silver (nearly 500 million oz) and 8 traders in COMEX gold hold 86% (28 million oz) of the 33 million oz total commercial record net short position. The $4.5 billion turnaround in commercial financial results over the past 5 weeks comes to many hundreds of millions of dollars per trader. Not all of the $4 billion collective commercial negative turnaround needed to be deposited as additional margin, but at least half did.

I've removed JPMorgan from my calculations of ongoing commercial losses, as I believe the bank holds so much physical silver and perhaps enough gold to offset losses on COMEX short positions. Here's an interesting thought Â? at current silver prices, JPMorgan is now close to even on the 500 million oz of physical silver I claim that it started buying 5 years ago and above $30 an ounce. Previously, I calculated that JPM had an average price of around $20 an ounce and I think I remember dismissing concerns that the bank may be underwater by as much as $6 per ounce or $3 billion back when silver traded at $14. Perhaps the real lesson is that if an average price of $20 is good enough for JPMorgan, it should be good enough for anyone.

But the circumstances surrounding JPMorgan are very much different from that of the other commercials. Because JPM holds so much physical metal, it is immune from damage to the upside. That cannot be said of the other commercials who appear to be taking it in the teeth. And, of course, it is the difference at the core of the double cross premise. Should JPMorgan not join in with the other commercials as short sellers of last resort, it's hard for me to see how the commercial short selling scam in COMEX silver and gold doesn't unwind.

Considering the price volatility in silver, I'm surprised that the CME hasn't raised margin requirements yet. I think I know why the CME hasn't raised silver margins and that's because as prices are rising (as has been the case in silver) any increase in margin requirements hurts the shorts and not the longs. That's because longs profit as prices rise and silver has risen enough that longs have enough open profit to meet any additional margin requirements without having to deposit additional funds. Those same rising prices have been causing the shorts to come up with additional margin on a daily basis and any increase in exchange margin requirements would force the shorts to put up even more. Since the commercial shorts are of more concern to the CME than the longs, the exchange has dragged its heels in raising margins.

What the crooks at the CME prefer to do is to wait for a turn in prices lower and then raise margins so that the shorts can use developing equity from falling prices to cover any increase in posted margins and the longs are the ones who have to come up with more money and not the shorts. It's an old dirty trick last employed in the great silver smack down of May 2011. The remarkable feature is that the CME hasn't been able to employ this trick yet because silver prices hadn't made a turn down through today's close. But expect these crooks to do so as soon as they can.

Finally, five weeks ago, in the weekly review of May 28, in response to a note from a subscriber about copper, I mentioned that the price was likely to rise to perhaps $2.25 to $2.30 since the technical funds were excessively short at the then current price in the low $2's. Since then and thru Tuesday, copper traded up to just under $2.25 as more than 40,000 net contracts were bought by the technical funds over the past few weeks. Copper prices have slipped since Monday and the COT structure is more neutral than anything else and, accordingly, I have no opinion on copper based upon COT readings. I also commented on the dollar index looking constructive from a COT standpoint and at least the dollar hasn't been smashed. I mention this because the COTs seemed to have worked as usual in copper, but that is not the case, at least so far, in gold and silver.

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Ted Butler

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