June 29, 2016 – Strange Days

Strange Days

Believe it or not, I picked the title of this piece before today and before I awoke to see silver setting new two year price highs. I had planned to write on several things seeming strange to me, so I suppose silver's price jump this morning only adds to the strangeness. On Saturday, I commented how gold seemed to be dancing around silver somewhat strangely, with gold having had made a number of new highs recently, while silver struggled to keep up. Today, or at least this morning, that's changed.

Still most strange of all is the current extreme disparity between the apparent strong physical fundamentals in silver and gold and the opposite condition in what has been the main price driver, the market structure on the COMEX. Barring some unforeseen surprise in this week's COT report, it looks like the market structure will be at dramatic new bearish extremes in gold for sure and, perhaps, also in silver.

It is not at all strange to witness historic bearish extremes in COT readings as prices hit new highs, because managed money buying (and commercial selling) is what caused prices to move higher. This year's move higher in gold and silver was driven by the largest amount of managed money technical fund buying ever. And it's certainly not strange that gold and silver should be higher this year given the strong physical fundamentals and, particularly in silver, the cheap price. What's strange is that both conditions exist to their most extreme condition ever.

I'll save an update on the latest on the financial scorecard for the massive money game on the COMEX until later and COMEX trading has settled for the day, so let me deal with some items on the physical side of the equation. Tomorrow is the first notice of delivery day for July futures contracts on the COMEX. Normally, July is a month that involves only silver and not gold. Although physical delivery can be made in any calendar month, there are five months in silver and six in gold that are considered Â?traditionalÂ? deliver months, with alternating months for gold and silver and with only December being traditionally shared by both. But, as I have recently observed, there is a very large open interest in the COMEX July gold futures contract, which is strange to say the least. Moreover, the open interest in the July silver contract also looks higher than normal (whatever the heck normal is nowadays).

The open interest in July gold is more than 4700 contracts (as of last night), despite a reduction of a thousand contracts or so over the past couple of days. The large remaining number of open contracts would be strange in its own right, but seems even odder given the extraordinarily large deliveries made in the June gold contract where more deliveries (over 15,600 contracts) were made and in which JPMorgan emerged as the largest stopper, taking almost 11,000 contracts (1.1 million oz) for both itself and a client(s). The natural question is if JPM has the feedbag on for more gold in the July contract? Or will it turn issuer?

The open interest in July silver going into tomorrow's first notice day won't be known until very late this evening, but a reasonable estimate would be for around 7000 contracts or more to be open going into the first delivery day. This would be considered tight, particularly if JPMorgan follows the pattern it has established over the past year and a half and demands the 1500 maximum number of silver contracts it has demanded all along, sometimes getting the full amount, sometimes not.

I doubt there is a gold or silver investor or observer out there that doesn't know that a failure to deliver the amount of physical material demanded by longs will result in prices going boom to the upside. Predictions of a COMEX short squeeze or even a contract default have not exactly been sparse on the Internet for years and the current setup is conducive to additional predictions. Throw in prices at multiyear highs and a short squeeze seems even more likely. Therefore, it is natural to think that today's spurt in prices, especially in silver, seems related to a short squeeze concerning the apparent mismatch going into first delivery day. And perhaps it is related, as we will discover in time, but the theme today is strange days, so let me continue in that vein.

For years, I am sure you have read hundreds of articles discussing the topic of backwardation, or the market configuration in which the nearby months of gold or silver were priced higher than more deferred months. When the nearby months are priced at a premium to more distant months it is assumed that has resulted from there being a scarcity of physical material for prompt delivery. In times of scarcity or shortage, market participants in any commodity will demand a higher price for immediate delivery than a later delivery and such a circumstance would result in premiums of nearby delivery months rising over later delivery months.

Because nothing would reflect severe physical tightness and shortage and the higher prices that would portend than the existence of backwardation, there have been many articles suggesting we were in or about to go into that condition in gold and silver. Admittedly, there have been times when the prices of the nearby months have tightened compared to the back months, but I remember pointing out we never actually achieved true backwardation in COMEX gold or silver. I would define true backwardation as a sufficient enough premium on nearby months of COMEX gold or silver contracts that would make it economically feasible for a holder of physical gold or silver to sell and deliver his metal and simultaneously buy it back cheaper in a more distant month.

For example, I would consider it true backwardation if one could sell a nearby COMEX gold contract for $5 an ounce or more than the next delivery month, enabling a holder to book a certain $5 gross profit (minus costs) and end up with the same material after waiting a short time for delivery. I am ignoring the obvious flaw that if one delivers physical material at a premium price, replacing it at a cheaper price but in a futures contract, it is possible that the contract may default and he who delivered would be left holding the bag. However, I am not ignoring the obvious flaw because it couldn't happen, I'm ignoring it because there has never been an opportunity to do the transaction because true backwardation has never existed in COMEX gold and silver, for all practical purposes. Backwardation in COMEX gold and silver may exist someday, just not until now.

I raise the issue of backwardation for the purpose of pointing out that there exists the exact opposite condition at this time. Instead of a premium of nearby months in gold and silver over more deferred months, as might be expected among signs of physical tightness and surging prices, we have discounts of an extreme degree, where the nearby months are priced very low relative to deferred months. Let me give you an example. Just moments ago, the COMEX July gold contract was officially priced and settled three full dollars less than the next gold delivery month, August. I don't intend to get wonkish or nerdy in describing how a gold carrying charge spread of $3 for one month is extremely wide, particularly in an a era of near zero interest rates and that's why I talked about backwardation first as a means of comparison.

My point is that the current circumstance of the more distant months of COMEX gold and silver being progressively more expensive than the nearby month suggests the opposite of backwardation and, therefore, the opposite of the tight physical situation that backwardation infers. In other words, the current spread configuration across the board in COMEX gold and silver suggests that more than ample physical supplies are available to anyone desiring physical delivery on the COMEX. Just about everything I look at suggests a greater physical tightness than ever in gold and silver, yet what has been the premier indicator of tightness, the spread configuration on the COMEX is screaming the opposite Â? almost to the point of suggesting physical gold and silver are falling from the sky, like rain. Strange days indeed.

I must confess to smelling a rat and that maybe the spread differentials quoted on the COMEX are not exactly kosher and are being deliberately set wide to send the misleading message of physical oversupply. Certainly, my suspicions of manipulation on the COMEX isn't new and after manipulating silver prices for decades, how much of a leap would it be to manipulate spread prices, which most observers never even look at. Then again, any professional metals trader could take physical delivery at wide current spread differentials and achieve interest rate returns greater than available in traditional interest rate vehicles of similar short durations. Because the current spread differentials in COMEX gold and silver futures are strange compared to signs of physical tightness, I thought it might be interesting to mention. However, I still believe the resolution of the giant poker game on the COMEX will dictate the near term direction of gold and silver prices.

One other thing I found somewhat strange was the increase in COMEX gold margin requirements announced by the CME on Friday, increasing minimum margin requirements for gold futures contracts by about $1000 to $6050 per contract. What I found strange was in how little the margin increase was in terms of current price volatility and the extremely large number of total open contracts. The new minimum margins come to little more than $60 per ounce of gold, an amount that was exceeded in Friday's trading.

http://www.kitco.com/news/2016-06-27/CME-Group-Increasing-Margins-For-Comex-Gold-Futures.html

The whole purpose of margins is to protect the broker carrying the account and the exchange (clearinghouse). If the brokerage firm hasn't secured sufficient margin from the customer in the event of sudden adverse price volatility to the customer, it is the brokerage firm that may be left holding the bag (an unsecured debit). With sudden pronounced price volatility and a record open exposure in COMEX gold and silver, current margins look on the lean side to me, but obviously not to the exchange. I can easily see a $6050 margin requirement on a gold contract worth close to $133,000 becoming insufficient in a hurry if price volatility intensifies.

I have a suspicion that COMEX gold margins, despite this increase, are being held low in order to aid the commercials who hold record short positions and are most damaged by increased margins as prices rise. In addition, should prices suddenly selloff, I wouldn't be particularly surprised if margins were raised more aggressively to the downside, as occurred in the infamous silver takedown in May 2011. I guess I'm just a suspicious guy when it comes to the COMEX Â? I wonder why?

COMEX trading just ended for the day session (around 1:30 PM EST) and since this is the settlement basis for tallying the day's losses and gains for the purpose of establishing open equity and margin calls, let me update the ongoing results in the great COMEX gold and silver money game.

On Saturday, I calculated that the commercials were out a collective $200 million from yearend in combined realized profits and unrealized losses thru Friday. That was based upon a $1.2 billion realized gain and an open unrealized loss of $1.4 billion on the 35 million gold ounces (350,000) contracts I estimated the commercials were net short on Friday at gold's closing price that day of $1320. I calculated the average price the commercials were short gold came to around $1280. For this week's COT, I'm sticking to earlier guesses that the new report will show about a 40,000 net contract increase in commercial shorting for gold and while I'm more unsure in silver, I would look for an increase of several thousand contracts in commercial selling

Today, gold closed around $1325, up five dollars from Friday's close, meaning that the commercials are underwater by an additional $175 million. Up until today, it has been mostly a money game involving gold, but today silver took a pretty big jump relative to how it's performed recently. Considering that the big gold COMEX shorts are largely the big shorts in silver as well, the 50 cent+ jump today adds to open commercial losses. Since I believe JPMorgan holds a massive physical long position in silver, I don't see how it could ever get hurt on an upside move in the price of silver.

If I remove the 120 million oz or so that I believe JPMorgan is short in COMEX silver futures contracts (24,000 contracts), the net commercial short position in silver looks to be around 350 million oz (70,000 contracts) ex-JPM. The 60 cent rise since Friday's close in silver would add another $200 million to the commercials' collective unrealized loss, to a bottom line $1.8 billion. I've been deducting the $1.2 million realized gain since the start of the year from unrealized losses and to remain consistent, doing so would now indicate the commercials are collectively net $600 million underwater on that basis through today.

This is about the commercials' most negative mark-to-market this year, perhaps exceeded only by $100 million or so at the end of April. But there is no question that the size of the short position has increased materially, at least in gold, and with such a large short position, the stakes to the commercials have never been higher. There is no magic number that will signify a full pants down end to the manipulation, but it is fairly certain to say that every $60 higher from here in gold will put the commercials another $2.1 billion in the hole and every $3 higher in silver will add another billion dollars to that, along with dollar for dollar mandatory cash margin call requirements. To say that the stakes are high would be an understatement.

Therefore, I am still unsure how this gets resolved in the short term, although I am fairly certain that I have characterized the game properly. Longer term, it's always been a no brainer Â? silver is cheap and destined to move much higher. The only question is at what cost to the commercials, the COMEX and the regulators.

Ted Butler

June 29, 2016

Silver – $18.38 (50 day moving average – $17. 06)

Gold – $1325 (50 day moving average – $1264)

Date Created
2016/06/29