March 2, 2016 – More Extreme than Ever

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If there's one thing I really dislike, it is having to talk out of both sides of my mouth. You know, as when an analyst says, I'm short term bearish, but long term bullish. Too often that is an attempt to be proven correct no matter what prices do. But sometimes, having a conflicting opinion may be well founded. It all depends on the facts and reasoning behind the conflicted opinion.

Right now, I am conflicted about the short term direction of gold and silver prices, even though I am more bullish than ever on the long term price prospects for silver. As I'm sure you know, I feel there is only one bearish factor existing for gold and silver and that is the current market structure on the COMEX and as portrayed in the Commitments of Traders (COT) Report.

It is a theme that has recurred for decades that when gold and silver prices are driven higher by concerted technical fund buying in COMEX futures contracts, sooner or later the commercial traders which have sold to the technical funds on the price move higher, succeed in engineering lower prices which induces technical fund selling. In fact, this is the mechanism by which gold and silver prices have been artificially manipulated and what makes it manipulation is that purely paper derivatives trading between speculators should not be how prices are set to the rest of the world.

On the price rally so far this year, the recurring theme of the commercials engineering the technical funds has been fully in force, as COT data have borne out to date. The technical funds have bought 130,000 net COMEX gold contracts (13 million oz) since yearend and the commercials have sold an even more (15 million oz). In silver the technical funds have bought 40,000 net silver contracts (200 million oz) with the commercials selling even more. (The commercials sell to other speculators apart from the technical funds).

The technical fund buying has included both short covering and the buying of new long contracts. In gold, the technical funds bought back close to 70,000 short contracts at a realized loss that I would estimate at more than $600 million and have added more than 60,000 new long contracts that are currently slightly ahead in mark to market terms. In silver, the technical funds bought back 30,000 short contracts at a collective realized loss of around $150 million. Up until now, it looks like the snookering of the technical funds by the commercials appears to be playing out same as it ever was.

With so many COMEX gold and silver contracts having been bought by the technical funds and causing prices to rally, the risk has grown for a sell-off at some point. This is the essence of the market structure analysis, at least as I see it. At the very least, should gold and silver prices decline sharply, there will be no other reason for the decline away from the technical funds being induced to sell by the commercials at lower prices. The COMEX market structure is the only potential bearish factor. Let's face it Â? if silver prices drop sharply, it sure won't be because investors are rushing to dump their metal to raise funds to deposit into zero interest rate bank deposits. It will occur because of futures position manipulation on the COMEX; period.

On the other side of the market equation is a whole host of bullish factors, particularly in silver. So conspicuous have these bullish factors become that should any COMEX-induced manipulation succeed in lowering the price temporarily, it should present an investment opportunity rarely seen. Not only would a selloff Â?clear the decksÂ? of technical fund longs and likely establish excessive technical fund shorting, the new lower price would turn a severely undervalued silver price even more undervalued.

My real concern resides in what happens if the one bearish factor, which has mostly always worked over the years, doesn't work this time? Just to put this in proper perspective, should the one bearish factor – the market structure Â? work yet again in silver, I would envision a $1 to $2 decline, before we embark on an upward journey many times that amount. (In gold, the decline could be $100 to $150 because we are so far above the key moving averages). Therefore, the risk/reward ratio is constructively configured in silver even if the commercials rig prices lower first. But what if the commercials don't succeed in inducing technical fund selling? In that case my concern for sidestepping a sharp price decline, with a certain amount of my silver holdings, would be for naught.

When you drill down to it, there is only one thing that could overwhelm a bearish COMEX market structure and cause prices to rise sharply, instead of falling. That one thing is a physical shortage. I still see a physical shortage as occurring in silver, rather than gold, considering the industrial consumption profile of each. Leaving that aside, a physical shortage in any commodity would overwhelm any paper manipulative attempt to keep the price down. Needless to say, I am extremely focused on any potential indicators pointing to physical tightness in silver that could lead to a physical shortage. (An example is my intense focus on the physical COMEX silver warehouse turnover).

There are a couple of very recent developments in silver that may suggest we are at the cusp of a physical shortage in silver. Please understand that these developments could prove to be false and amount to nothing; but also understand that by the time undeniable indications of physical shortage appear, it will already be reflected in the price and not much use as a potential heads up.

The first development was an unusual surge in the trading volume yesterday in SLV, the big silver ETF. On a fairly nothing trading day pricewise, the volume in SLV exploded to more than 20 million shares, or three times average daily volume. Even though the price of SLV ended 3 cents lower for the day, basically flat, the volume came in late in the day and to the upside, which indicated that the buyers were more aggressive and were the initiators of the transactions, as opposed to the sellers. Now there may have been some other explanation for the sharp increase in trading volume, but I am not aware of what those other explanations might be. I've seen big trading volume in SLV on sharp price rallies and declines, but not on, basically, flat price days.

Not only is SLV the largest silver investment vehicle in the world, it has a direct connection with physical silver in that its shares and the metal are convertible and interchangeable. In fact, it is the share for physical (and vice versa) conversion mechanism that gives SLV legitimacy, in my opinion. Because of its size and conversion mechanism, should an entity or entities begin to buy shares of SLV in noteworthy quantities, it could easily be construed as a means to acquire physical silver.

Since I see no technical trading reasons (moving averages, etc.) for yesterday's huge trading volume, it's even easier to imagine a physical metal motivation. Moreover, if the volume surge does indicate a rush to buy physical metal, given what I perceive as an already tight silver supply situation, it wouldn't take long for that to come to light. Look, I don't want to be the boy who cried wolf about a silver shortage, but I know the silver shortage wolf exists (as was seen into April 2011) and it's just a matter of time before the wolf returns.

The other very recent development is the continued mismatch between the number of March COMEX futures contracts still remaining open and the lack of deliveries to date. I first mentioned this on Saturday and after two additional delivery days, I am even more concerned about a mismatch or delivery crunch. As of the close of business yesterday, there were still more than 3400 March contracts open (or the equivalent of 17 million oz) and only 32 deliveries have been made over the first three delivery days.

http://www.cmegroup.com/delivery_reports/MetalsIssuesAndStopsYTDReport.pdf

Of the 32 silver deliveries made so far on the March contract, JPMorgan has stopped (taken) 28 of those deliveries (or 87% of total deliveries); 15 contracts for a customer or customers and 13 in its own proprietary trading (house) account. Because of the way COMEX deliveries are assigned, it is reasonable to assume that JPMorgan holds a large percentage of the remaining open interest in the March contract (on the long side) for both its customer(s) and itself. This is just another notch on the gun belt attesting to JPMorgan's dominant and controlling role in the silver market. Because of that control, the moment JPMorgan decides that it is time for silver to explode in price that will be the moment silver will explode. It is not possible for me to be more convinced of this statement than I already am.

The question is what does JPMorgan intend for March deliveries (and what connection, if any, the surge in volume for SLV may have)? Since we can't know JPM's intent, we are forced to speculate. I had been thinking there was almost no chance that JPMorgan would allow silver to explode now, since I believe the bank just added 8000 contracts (40 million oz) of new COMEX shorts over the past few weeks and why add shorts if you intend to run silver higher? And JPM could end any delivery congestion in the March contract singlehandedly, by roiling over its and its customers longs to a more deferred month. But maybe my calculations were wrong or maybe JPM has already bought back its added shorts. (We should know when Friday's Bank Participation Report is issued).

I don't want to wade into the conspiracy weeds too deeply, but maybe JPMorgan intends to let silver rip higher and use its recently added shorts to deflect any criticism that it might be behind a silver price explosion by showing that it would never add shorts if it knew silver was about to scream higher. The fact is that JPM has been accumulating hundreds of millions of physical ounces of metal for five years and even if it is short 120 million oz in COMEX futures contracts, it is still net long by a wide margin. And remember there is no public reporting requirement for physical commodities, only futures and derivatives, so JPM could make out to be a victim by being short futures, without the bother of disclosing physical appreciation.

The truth is that I can't know what to expect for sure. I can see silver and gold prices decline sharply and that's why I took some defensive measures recently. But the big volume in SLV yesterday (continuing at a slower pace today), plus the continuing potential mismatch in the March futures deliveries has caused me to add call options today. It might be fair to say that I don't know what to expect and to some large measure that would be true, but only in the short run. I can see a sharp break to the downside based exclusively on the COT market structure. But based upon yesterday's volume in SLV and the continuing potential mismatch in the March delivery process, I can also see prices surging soon if the signs add up to a physical shortage commencing.

While I admit to short term uncertainty, as time evolves the long term case for higher silver prices looks stronger than ever. I suppose that if the long term case for higher silver prices is certain, it is natural to look for short term signs that might signal that the long term has arrived. For today, at least, we can add two more signs.

As far as what to expect in this Friday's COT report, gold prices, while volatile intraday and day to day, were mostly unchanged for the reporting week and total open interest fell by a small amount (5000 contracts). Therefore, I would guess mostly unchanged in terms of the total commercial net short position. Silver prices, on the other hand, took a pretty good spill to the downside and penetrated the key 200 day moving average. As such, I would guess the commercials reduced their total net short position by at least 5000 contracts and possibly more given the 12,000 drop in total open interest for the reporting week. Hopefully, the Bank Participation Report will help clarify JPM's silver short position.

Ted Butler

March 2, 2016

Silver – $15 (50 day moving average – $14.51)

Gold – $1241 (50 day moving average – $1136)

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