Nov. 17, 2009 – Extreme Speculation

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Recently, I have raised the possibility that silver trading might be terminated on the world's largest silver exchange, the COMEX (The Commodity Exchange, Inc.), now owned by the CME Group, which in turn is the largest futures exchange in the world. I hope everyone realizes that this is an extreme speculation on my part, and that the likelihood of such an event must be considered remote. Still, I am somewhat haunted by this possibility and I would like to share the reasoning behind my concern. Even if my fears never come to fruition, I feel I would be doing a disservice to subscribers by not fully airing the subject.

Any cessation of trading of COMEX silver would be a very big deal indeed. It would send shockwaves of unprecedented proportions throughout the silver world. It's not hard to imagine shockwaves extending beyond silver. That's because the COMEX is the most important pricing mechanism for silver. All silver pricing throughout the world emanates from the COMEX. In this day and age of instant electronic price and news dissemination, any interruption of trading on the COMEX would have immediate and profound implications.

The COMEX has evolved into the dominant silver trading venue over the past half century and sits at the pinnacle of the silver trading world. Some would argue that trading in the OTC or LBMA markets are bigger, but my long time analysis suggests otherwise, particularly now that strict regulation appears probably in the OTC market. Ask yourself this Â? if the COMEX did suddenly stop trading silver, where would most silver trading take place? I don't have a good answer to that question even though I have thought on it long and hard. I do know that any COMEX silver trading halt would be a shock to the silver system.

The main reason for my recurring thoughts that silver trading may be terminated on the COMEX someday is because that exchange is at the heart of the silver manipulation. If we are closer than ever to witnessing the end of the long-term silver manipulation, as I believe, it must mean an end the extreme concentration on the short side of COMEX silver futures. But the concentrated short position in COMEX silver futures is so extreme, that it is hard to imagine how it can be resolved in an orderly manner. The most recent data from the CFTC indicate that one US bank, JPMorgan, now holds 200 million ounces net short in COMEX silver futures, fully 40% of the entire net short position on the COMEX (minus spreads). As I have previously written, JPMorgan accounted for 100% of all new short selling in COMEX silver futures for September and October, some 50 million additional ounces. You have not seen anyone refute those findings, nor is it likely that you will.

So extreme is JPMorgan's silver short position that it cannot be closed out in an orderly fashion. How could such a large position be closed out quickly, or otherwise, without strongly disturbing the market? If it could be closed out, it is reasonable to assume it would have already been closed out or greatly reduced to avoid the allegations of manipulation it raises. It's not like the banks are presently universally loved and admired. The intent of anti-concentration guidelines and surveillance is to prevent the precise monopoly that JPMorgan has amassed on the short side of COMEX silver. Having erred egregiously in allowing this concentrated short position to develop, the CFTC is stuck with coming up with a solution to disband it. There is no easy solution.

Further, it is not just JPMorgan's 200 million ounce COMEX silver short position that threatens the continued orderly functioning of COMEX silver trading. As extreme as JPMorgan's position is, there is a total true net short position of 500 million ounces (100,000 contracts) in COMEX silver futures. Try to put that 500 million ounce short position in perspective. It equals 75% of world annual mine production, much higher than seen in any other commodity. This makes claims that the COMEX short position represents a legitimate hedge of mine production a lie. The total short position represents almost 100% of the total visible and recorded silver bullion in the world, and 50% of the total one billion ounces thought to exist. These are truly preposterous amounts. By comparison, the net total short position in COMEX gold futures, admittedly no slouch in the short category, represents a little over 2% of the gold bullion that exists (45 million oz total net COMEX short position versus 2 billion oz). When it comes to the amount of real material, or mine production, in the world backing up the COMEX silver short position, the word Â?inadequateÂ? takes on new meaning.

Because of the extreme mismatch between what is held short on the COMEX and what exists or could be produced to be potentially delivered against the short position, a very dangerous market situation exists. It is this dangerous situation that haunts me and causes me to contemplate a closing of the COMEX silver market. It has to do with what I see developing in the silver physical market and by putting myself in the other guy's shoes. The other guy, in this case, is Gary Gensler, chairman of the CFTC.

It seems to me that there may be real stress in the wholesale physical silver market. All the factors I look at, including flows into ETFs, the shorting of SLV, the decline in COMEX silver inventories, the strong retail and institutional investment demand in silver, the now growing world industrial demand, etc., suggest tightness and the potential for a silver shortage like never before. This, in essence, is the real silver story. In spite of a large and growing concentrated short position, the price of silver suggests that it is the manipulation that is under stress. At some point, a physical silver shortage will destroy any amount of paper short selling. We may be very close to that point.

When the silver shortage hits, the price will explode. On this, there is no question. Industrial users, at the very first sign of delay in silver shipments, will immediately buy or try to buy more silver than they normally buy, in order to protect against future operation-interrupting delays. This is just human nature. The world has never experienced a true silver shortage ever, so the price impact is clearly unknown. I'll try not to overstate how high I think the price will go in a true silver shortage and how quickly it will occur, so that I don't sound too extreme. But the price move will give new meaning to Â?highÂ? and Â?fast.Â?

Please remember, I am only talking of the price impact of the industrial users scrambling to secure silver supplies for their operations. This has always been my Â?doomsday machineÂ? future silver price event. I am not speaking of new investment demand or short covering. Users, anxious to keep their assembly lines running and their workers employed will care less about price and more about availability and actual delivery. The users will buy with an urgency and reckless abandon rarely witnessed. That the price explosion caused by user buying will destroy the shorts is beyond doubt. So certain and devastating will be this destruction, that you must start asking questions as to what the regulatory reaction is likely to be. This is where you must try to put yourself in the other guy's shoes. When the industrial silver shortage hits and prices explode, what would you do if you were Chairman Gensler?

The question of what you would do if you were him is also a question of what you can do. Certainly, Chairman Gensler will not be able to secure adequate physical supplies to satisfy a world-wide silver user inventory buying panic. That price fire must burn itself out. But, it appears to me that he might be able to take some fuel away from the fire by trying to eliminate the additional potential panic buying of 500 million ounces worth of short covering that exists on the COMEX. A shut down of COMEX silver trading will eliminate any panic short covering. It will open up a Pandora's Box of other consequences, no doubt, but it will eliminate panic futures short covering. This is not about choosing solutions from a long list of attractive alternatives. This is about choosing from a very short list of decidedly unattractive solutions. The CFTC certainly has the power to order such a market shut down.

Please understand, I am not advocating or recommending such a COMEX silver shutdown. In fact, this possible event is something I have worked hard to cut off for 25 years. My background is in futures and it pains me to see the current extreme situation, despite all my best efforts to end the silver manipulation. The possibility that COMEX silver trading may be terminated at some point is the direct consequence of the long term manipulation. If the manipulation did not exist, the possibility that COMEX silver trading might be halted would not exist. But the silver manipulation is as real as rain and so is the possibility of a COMEX silver shutdown. What does this mean for you?

First, any COMEX silver trading halt will cause the price of silver to explode, all things being equal. All things, most likely, will not be equal, as other events will be driving silver prices higher at that time. But the closing of COMEX silver trading will be a unique bullish factor on price. That's because the principal mechanism of the silver manipulation, the unlimited short selling of paper futures contracts, will suddenly no longer exist. Silver prices will surge when the yoke of manipulative short selling is lifted. In addition, many long holders whose paper futures positions were eliminated will be forced to buy other forms of silver that would include real physical purchases, including ETFs. This will also exert a very bullish impact on price.

I've been asked how such a potential COMEX silver shutdown might take place. I think the model would be patterned after the Maine Potato default of the mid-1970's. All contracts were closed out and settled at an arbitrary price. Longs and shorts alike were credited or debited at that price, relative to their original purchase or sale price. The scary thing is that the mechanical aspect of such a shutdown is really quite a simple thing to accomplish. I would be very surprised if the regulators have not been discussing such a possible outcome.

Those holding COMEX silver certificates stored in exchange-approved warehouses should not be affected. Those warehouse receipts are separate and distinct from futures trading. If anything, such receipts should grow in value, above and beyond the price increases in other forms of silver. I don't see anything particularly troubling to holders of COMEX warehouse receipts or other forms of physical silver in the event of a closing of silver futures trading on the COMEX. True, you may not be able to tender those receipts against a futures contract, but there should be such high demand for those receipts, in the event of a COMEX shutdown, that a sale should be easy to arrange.

The real losers in a COMEX silver trading halt would be the long holders. There is no nice way of putting it, so I won't try Â? these holders will be royally screwed. How bad the screwing will be will depend upon what the arbitrary close-out price will be. Perhaps the price will be high enough so that it may not appear at first that the longs were cheated at all. But the real screwing will become obvious in short order, after any trading halt is enacted. As silver prices soar after a possible COMEX shutdown, closed-out longs will be deprived of profits that should have accrued to them. I guess there's no way to get the paper shorts off the hook by not cheating the paper longs.

What can the long COMEX silver futures holders do about the possibility that this extreme speculation of mine might come to pass? As always, common sense is the rule of the day. My speculation is so extreme that it is important to remember that it may never happen. I hope it doesn't come to pass. But it wouldn't hurt much if long COMEX holders took some precautions, particularly those whose silver holdings exclusively or predominantly consist of COMEX futures and options contracts. Take out a little insurance. Don't have all your silver eggs in the COMEX basket. I know that the attraction to holding COMEX contracts is the extreme leverage they afford. As I said, that's my background. You can't get that leverage in holding pure physical; even though that's the most secure way of participating in a silver price explosion. If leverage is your goal, maybe try some leverage with ETFs or mining shares, or options on either. Please understand where I'm coming from. I'm not telling anyone to immediately abandon all COMEX positions, just if you are very heavy there, try diversifying a bit. How bad would it be if you got shut out of the coming silver move due to an abrupt closing of silver trading on the COMEX? How bad would it be if I had these real fears and didn't share them with you?

Although it has long been a consistent theme of mine, the case for owning fully paid for physical silver has never been more compelling. Even if my fears of a COMEX silver shutdown never come to pass, I just Â?knowÂ? that the surest winners in the coming silver price explosion will be those who own real silver for which they paid cash on the barrel head. Sometimes it pays to keep it simple.

Ted Butler

November 17, 2009

Date Created
2009/11/17