November 10, 2010 – Another Takedown Attempt

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One can contemplate and predict volatility, but it's always quite different actually experiencing a day like yesterday in silver. In little more than a couple of hours straddling the COMEX traditional close, the price plummeted almost three dollars after setting a new 30 year high of over $29. Volume was off the charts, probably setting records that may last for quite some time on the COMEX and in the big silver ETF, SLV. Let me give you my overall assessment of silver after yesterday's dramatic volume and price volatility. While I can't tell you what will transpire over the next few days, the long-term picture has been greatly improved by yesterday's developments. Details in a moment.

First let me address a development that many of you have asked me about Â? the rise in margins for COMEX silver futures announced yesterday by the CME Group, Inc. I had been expecting such a margin increase. I had written about it on Oct 19 (third paragraph from the bottom). There has been a lot written about this margin increase and some of it is a bit off-base. Margin increases should not be automatically bearish for the price and as such should not be feared. (Personally, I would prefer silver margins be raised to 100% of contract values for a variety of reasons). But this increase in silver margins was very much intended to have a bearish effect on the price of silver by the CME Group. Please let me explain.

The real scandal in this silver margin increase was not that it occurred, but that it took so long to be enacted. Over the past three months, the price of silver increased by around 50%. Yet the exchange never increased margins once. That was irresponsible. The reason the CME didn't increase silver margins over this time was because to do so as prices were rising would have put more pressure on the shorts, something the exchange wants to avoid at all costs. The CME is almost totally interested in protecting the interests of the big shorts, like JPMorgan, who are the most important members of the exchange. The exchange would never do anything against the interests of its most important constituents, unless it had a gun to its head. But if the price of a commodity rises sharply, the exchange knows it must raise margins, which is a function of price and volatility.

Since raising margins becomes inevitable in a price rally at some point, the exchange does the next best thing Â? it times the margin increase so that it comes when it is least likely to hurt, and maybe help, its big constituent member short holders. That time is always best when the price makes a sudden reversal down after a big climb. This way, the margin increase actually hurts the longs and benefits the shorts, as the reversal to the downside swings the financial tide against the longs temporarily. In other words, had the exchange done what it should have done and raised margins on the way up, that would have hurt the shorts, something the exchange would never do. By timing the margin increase just after a price reversal to the downside, the exchange helps the shorts. This is the dirty trick I referred to in my Oct 19 piece.

This is also an example of why I refer to the CME Group as operating a criminal enterprise, as I've seen them pull this dirty trick numerous times in the past. What's particularly infuriating and illegal is that the exchange is designated under commodity law as a self-regulatory organization (SRO). That means the CME Group is supposed to do things on a fair and even-handed basis, not cater to the selfish interests of its most important members. The phrase that comes to mind when describing how the CME fulfills its regulatory obligations is like letting the fox guard the hen house.

The CFTC and Congress made a very big mistake when they turned over so much regulation to the exchanges years ago. There is so much of a conflict of interest in what the exchange does in its regulatory role, that it's a no wonder they are opposed to the new Dodd-Frank reform law. Let's face it – the CME is a for-profit organization interested in its own profits and the welfare of its members. Faced with a choice of doing the right thing or padding its pockets, what do you think it would choose? That's why they are fighting the CFTC tooth and nail over position limits and every other issue that may infringe on its own interests. That's why the CME can pull the dirty trick of timing margin increases to suit the big shorts.

The good news is that the CME has become brazen in pulling dirty tricks and fighting the new law. To me, it shows weakness and desperation. I think the silver wagons are circling this dirty exchange. The margin increase timing dirty trick is a short-term ploy. It's not something that impacts the market beyond a few days at most. Once the late-entering margined longs are flushed from the market, the impact on the silver price passes. The flushing of leveraged longs is a short-term phenomenon. After it passes the market is actually strengthened.

Lost in yesterday's high-volume intentional flush out were some incredibly bullish developments, particularly on the wholesale physical side. COMEX warehouse inventories decline over a million ounces, thereby almost confirming my recent speculation about silver coming from there to partially satisfy demand from the new Sprott silver ETF. We had an additional massive inflow into the SLV of 3.6 million ounces, which had nothing to do with yesterday's almost unbelievable volume of close to 150 million shares. My sense is that there are many millions of silver ounces still owed. This is confirmed by the almost 13 million share reported short interest in SLV (I think there are additional millions of shares shorted on an unreported basis). Retail silver demand is extremely strong as well. This all adds up to silver physical supply being extremely tight. Paper short sales cannot control that for long.

Also lost in yesterday's volatility is the relentless march towards regulatory reform and resolution. I don't think the new top cop at the CFTC's Enforcement Division, David Meister, will look the other way when confronting the silver manipulation. Very soon we will be into the position limit discussion in earnest, despite the howls of protest from the CME. I'm told that the number of lawsuits now filed against JPMorgan and others for silver manipulation is up to nine. These are no minor matters.

This week's review will be sans a COT analysis as the report will be delayed until Monday, due to tomorrow's Veteran's Day holiday. Even when the report is released, it may not show all the improvement I anticipate, due to reporting deadlines. My sense is that the COT structure is great, as small shorts liquidated on the rally and JPMorgan and the other commercial crooks liquidated on the sell-off.

All in all, silver never looked better. If you told me I would have said that, at $27+ silver, back in the days of $4 silver I would have never believed you. That's why you must not lose silver positions in the volatile times to come. To do that, avoid margin. If you must speculate, do it via call options, which incidentally, has been the single most profitable approach you could have taken over the past several months. How long the current sell-off may last is anyone's guess, but mine is not very long.

Ted Butler

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Silver – $27.20

Gold – $1395

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