

## November 12, 2014 – Actions and Reactions

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Most often, as history is being made, few can see the full perspective of the era that will develop after time has passed. That's particularly true in our modern era, which is made more complicated by the level and growth of the world's population and that population's cumulative advance. Add in technology and things move so fast that we rarely appreciate the full consequences of all the new processes and developments we seem to be bombarded with daily.

This is especially true in modern trading markets, where technology, new trading vehicles and an unimagined amount of investment capital have created opportunities and consequences not envisioned a few decades, or even a few years ago. However, not all consequences are intended or beneficial.

Another fact of the modern era is that the degree of occupational specialization has never been more varied than anytime previously. Such incredibly varied occupational specialization makes it difficult to judge general history as it is being made. After all, it takes time and effort to remain proficient with one's own occupation nowadays – be it doctor, lawyer, or mechanic – how many areas can one be expert in?

Quite by accident and circumstance, almost 45 years ago, I began an occupational specialization in futures trading. I didn't have much choice – I felt lucky to be hired by Merrill Lynch as a commodity broker trainee – and it was learn and succeed or find another occupation. Necessity being the mother of incentive and invention, a lifelong interest in the futures market took hold and blossomed, even though it has been decades since I've been a broker. In fact, it was my background in futures which led to my interest and involvement in silver and to my perspective when considering other markets.

A little while back, I commented that I believed the big drop in the price of crude oil, by far the most important commodity in the world, was set off by futures positioning on the NYMEX and other derivatives trading exchanges. Specifically, I concluded that selling by technically motivated traders over the past few months was most responsible for the sharp drop in the price of crude oil, as well as the not coincidental price drops in silver, gold, copper, palladium and platinum. I gave the documented quantities of contracts and equivalent amounts of material that were sold and can do so again on request.

While a few commentators and analysts pointed to the derivatives market as influencing crude oil prices, most assumed and concluded that prices dropped and have continued to decline because of changes in actual supply and demand. Because of my imbedded futures market perspective, I still maintain that the trigger for the crude oil sell-off was NYMEX positioning; although I fully concede that there have been actual supply/demand changes in the crude oil market as a result of the price drop. In fact, that's my point - the futures market tail is wagging the actual market dog; not just in a tiny market like silver, but in the largest commodity market of all, crude oil.

What I have seen unfold over the past 40 years has been a steady progression of futures trading overwhelming actual supply and demand as the prime influence on price. I'm not suggesting that actual supply and demand don't matter to price, just that they have been pushed aside for extended periods by the influence of derivatives positioning. I discovered it in COMEX silver nearly three decades ago and have seen it creep into most markets currently. What I am saying is that in the "old days" (30 to 40 years ago) it was strictly supply and demand that determined price; but that we have evolved into a modern era of derivatives trading overwhelming actual supply and demand as the prime price influence.

For example, the largest oil producer and exporter in the world, Saudi Arabia, was very quick to fully match and set its prices lower in response to the derivatives-induced price drop in order to maintain its market share. However, almost everyone concluded that it was Saudi Arabia intending to lower prices all along. Some even concluded that this meant the end of OPEC and that crude oil prices would move lower permanently, even though OPEC holds the largest share of oil production and export and the US is still the second largest oil importer in the world, despite the dramatic increase in domestic oil production. Just like few hold a futures-oriented perspective, few remember the time when Saudi Arabia chose to maintain price and not market share, some thirty years ago.

In the 1980's, flush from the dramatic surge of the price of oil from near \$2 in the 1970's to over \$30, Saudi Arabia chose to become the swing producer and cut its oil exports in order to maintain what was too high of a price. It succeeded for years in maintaining the price at \$30, but only at the cost of seeing its production and exports decline from near 10 million barrels a day to the low 2 million barrel a day level. The kingdom then said no mas and unilaterally returned to full production and flooded the market with oil, driving the price to single digits.

Faced with the severe drop in the price of oil, all the other members of OPEC, eventually towed the line and curtailed production and eventually supply and demand restored the price to former levels, but it did take time. I'm not condoning the actions of an oil cartel like OPEC, but I am pointing out that back in the 1980's, the price of oil was determined by actual supply and demand and not derivatives trading.

One thing seems sure to me, namely, that Saudi Arabia learned the lesson back then about being the sole swing producer responsible for withholding production and experienced firsthand how it must end disastrously. Many of us have life lessons gone bad which we have learned the hard way and we will never repeat those mistakes. I suppose that is the essence of experience. I believe Saudi Arabia learned the lesson of being the sole swing producer in oil and will never repeat that mistake again. In fact, this seems clear in the kingdom's quick reaction of posting price cuts in response to the derivatives' induced drop in the price of oil. Saudi Arabia will not tolerate a loss of market share as it knows what will happen if it goes down the path again of trying to maintain price by unilaterally cutting production.

My main point here is that a few decades ago, it was all actual supply and demand that determined the price of commodities. But that has morphed into a modern world where derivatives trading is the prime catalyst for price change. That is not to say, however, that price changes brought about by derivatives trading do not impact actual supply and demand. For every action, there is a reaction, regardless of what caused the original action. Saudi Arabia's announced price cuts didn't cause prices to fall initially, those price cuts were caused by futures positioning and the Saudis reacted to that.

In the end, actual supply and demand will win out as the prime determinant of price; but the tragedy is that the world must accept the derivatives' influence in the interim. Worse, the control of derivatives trading has been assumed by mega financial institutions whose interests are not aligned with actual producers and consumers of commodities. On the one hand we have the big banks, typified by JPMorgan, which seem to be accused and admit to manipulation and control of everything they touch and, on the other side, massive but mindless computer oriented traders only interested in price change to establish and liquidate giant positions in a flash. Thus, my conclusion that oil and every other commodity had caught the silver disease where the price had nothing to do with actual supply and demand.

Where to from here, now that the derivatives monster has come to dominate just about every traded market? The first step is to recognize the realities of our new trading world and the pitfalls and opportunities those realities have created. Since price is most often set by derivatives trading games and not by actual supply and demand, it is important to recognize that there will be times that price bears no relationship to the real supply/demand fundamentals.

Do not think for a second that I am preaching and suggesting that I foresaw the extent of the price drop in silver over the past few years and, particularly, of late. I did know the game was rigged (by JPMorgan and the CME Group), but despite that awareness I did not expect the price rigging to reach the extremes it has. These price extremes were achieved by manipulative intent and have occurred, moreover, at a time when it seems that every day brings new charges and admissions by the big banks to have manipulated every market they touch — except, of course, silver.

There is a reason why the regulators seem to be finding that the big banks have manipulated every market except silver (and gold). In all the new findings and admissions of wrongdoing by the banks, there was no prior strong record of allegations that the banks were up to no good. Because of this, the regulators haven't been accused of overlooking and missing crimes that they should have caught long ago, even though the crimes couldn't have just started recently.

I know firsthand that the regulators (including the CFTC and CME Group) have been made aware of the silver manipulation for decades and have investigated at least three times on a formal basis, primarily because I instigated each investigation. How the heck does the CFTC or CME admit something is amiss in silver now after openly certifying it looked and found nothing wrong on several previous occasions? They can't do that without admitting they failed at their most important mission — preventing manipulation.

Another key difference to why the regulatory charges of manipulation in Libor and foreign exchange can't be made in COMEX silver and gold is that damage to outsiders is too easy to prove in the case of the precious metals. This means the flood of private lawsuits that would emerge should the CFTC find what most everyone knows already (that silver and gold are manipulated) would swamp the banks and the CME. Can't have that.

Since there won't be a regulatory resolution to the silver manipulation, there can only be a market resolution. After all, actual supply and demand will win out in the end as the final price determinant, despite long periods of derivatives based mispricing. Here, the recent shockingly low price of silver is the best catalyst for change. The extreme silver price drop, brought about by excessive speculative selling on the COMEX, is the action that must result in a reaction. It would be one thing if the COMEX existed in a vacuum and the big banks and technical speculators activities didn't matter to the outside world; but in reality the COMEX sets the price of silver to all the world's silver producers, consumers and investors. It is the reaction by those involved in real silver to the actions of the COMEX paper traders that will come next.

The signs of reaction by those involved in the production, consumption and investment of real silver are already visible. The earnings of the primary silver miners are coming in lower than previous expectations for the third quarter and silver prices are now dramatically lower (by as much as \$4) than prices that prevailed in the quarter. This means, unless silver prices rise sharply and soon, earnings (losses) for the fourth quarter will be much worse.

All things considered, I don't recall a time when the prospects for the primary silver miners were worse than they are currently. In time and at current silver prices, most primary silver miners must cut production or go out of business (or both). The only thing that could possibly turn those prospects around is a sharp rally in the price of the metal (which I clearly expect). At 250 million oz or 30% of world annual silver mine production, a significant loss of primary mine production is almost incomprehensible in supply and demand terms; yet that prospect is unavoidable at current silver prices.

There does seem to be a budding reaction building among the leaders of the primary silver miners to the COMEX action of depressing silver prices, namely a recognition that the continued existence of their enterprises is threatened. This has long been recognized by the shareholders of mining stocks and is reflected in the prices of the shares. An intelligent reaction by the primary silver miners to the artificial price-setting on the COMEX could have a profound influence in hastening the coming resolution and in ending the continuing silver price suppression. But what's the most intelligent reaction by the primary silver miners at this time?

While understandable, withholding production alone is not the best way of fighting back, simply because the extremely low price of silver is not caused by overproduction, but by COMEX dealings. And forget about any illegal cartel of silver miners. As I've suggested previously, the best thing for the primary silver miners to do, either individually or collectively, is to openly petition the regulators to address the price manipulation on the COMEX. But wait a minute Â? didn't I just say that there would never be a regulatory resolution? Yes, I most certainly did and I still believe that to be true. Please hear me out.

The primary silver miners (the byproduct producers aren't necessarily excluded either) have to go the regulators, even if the regulators will do nothing, because it's the right thing to do. In fact it's the only practical approach the miners can take. Petitioning the regulators is the only legitimate action the miners can take (although I am always open to other suggestions). Forget low-cost, my approach is no cost to the miners. Further, shareholders would applaud any mining leader who took this approach.

Most importantly, the miners have a responsibility to adopt such an approach for the simple reason that they have the most legitimate reason for complaining about the COMEX price setting. It is this legitimacy that makes the silver miners the perfect candidates to petition the regulators. Miners are not speculators or market analysts desirous of higher prices; they have a legal right to expect the level playing field of a non-manipulated price. Producers of every product hold important protections against dumping and artificial price restraints.

But why should the miners petition the regulators if the regulators will do nothing? Because of the message that will send to the rest of the world. Try to imagine the potential reaction in the investment world to news that a silver miner or group of miners asked the regulators to investigate evidence of manipulation? It is one thing for an Internet analyst (me) to make such allegations, but quite another for a legitimate producer to do the same. It's all about legitimacy. It is well-known that in establishment media circles the allegations of a silver (and gold) manipulation is populated by conspiracy types and that's a big reason the scam has lasted so long. But if a silver miner or miners the allegation, it just might prompt some of the establishment types to actually look at the evidence, something none have done to this point.

The only thing a silver miner must be careful about in adopting an approach of openly petitioning the regulators to address the goings on in COMEX dealings is to stick to the facts and don't say anything wrong. Unfortunately, there are an incredible amount of misstatements of fact regarding the COMEX's role in setting silver prices that a miner repeating them will reduce any petition to a fool's errand. Ego aside, I don't think I've ever made an error when petitioning the regulators and it is this careful approach that has made me immune from a counter reaction in calling JPMorgan and the CME market criminals. Of course, I would assist any miner desiring to petition the regulators.

The silver industrial consumers are on the right side of the artificially manipulated low prices for now (by accident) and are enjoying the cost savings the low price brings. But silver industrial demand can only rise at times of low prices as there is no reason not to use more metal. The big risk to the silver users is when prices rally, as they must. The users will be unprepared for the surge and will be more, not less, likely to panic when metal is not immediately available. Please remember how thin and fragile are the supply lines in silver in normal times, to say nothing of what's to come when current low prices cause the supply lines to tighten further.

The third major category of actual metal participants are the world's silver investors, from retail buyers around the world to investors in ETFs and metal in other 1000 oz bar form. So far, on the price decline over the past three and a half years, these investors have shown a remarkable tendency to buy and hold silver, particularly relative to gold investment. It would appear that the recent price drop has only enhanced the tendency of these investors to flock to silver as measured by reports from the US Mint and the holdings in the silver ETFs. The manipulative actions on the COMEX are already resulting in strong buying reactions in the investment world of silver. I can't see how this won't continue. I can't help but mention that if the silver miners openly complained that COMEX was impacting the price of silver that would likely draw the attention of large investors throughout the world to investigate the facts. Then it's easy; once they investigate the facts, they will buy silver. Didn't you?

I prepared the above comments on the road and with little input from developments over the past few days. There doesn't appear to have been any major structural changes and that means the clock is still ticking towards the inevitable resolution of the lopsided COT structure. The technical funds are still sitting on massive paper profits with open short silver and gold positions and the moving averages are drifting down and suggesting the technical funds will book large realized gains on these open short positions and thoroughly trounce the commercials. That flies in the face of past experience and my expectations, as it is hard for me visualize the technical funds besting the commercials. The passage of time matters little in structural terms, so it doesn't matter how long it may take in the COMEX game. But time matters a lot when you are a silver miner losing money by the day.

Ted Butler

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Silver – \$15.65

Gold – \$1159

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