November 2, 2011 – MF Global

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Undoubtedly, you are aware of the ongoing drama/debacle which has unfolded at MF Global, the large commodity derivatives brokerage that filed for bankruptcy protection on Monday, Oct 31. This is no small matter, as it has been reported that the bankruptcy is the eighth largest in US history. I believe the event has specific relevance to silver (and gold) and associated regulatory matters frequently discussed here. Although I had planned to write about broader issues related to silver away from COMEX-related trading, this is too important an issue to ignore. Just when you try to step away, they pull you back in.

Given the large amount of media attention currently devoted to MF Global, I'm going to restrict my discussion, but let me encapsulate the story as I see it. MF Global got caught in a liquidity squeeze brought about by a big in-house bet on European short-term government debt. Ironically, it wasn't so much that the bonds declined in value, but that creditors demanded more margin as the position became known. Unable to continue to meet calls for more collateral, the firm imploded rapidly. Because MF Global was such a large brokerage and clearing member, its implosion left many other trading firms and individual customers of the firm suddenly unable to transact futures and options trades, in effect, freezing their accounts and funds. Worse, reports of possible commingling of customer funds with the firm's own capital raised allegations of missing customer money. This is an all-around black eye on the futures industry and (big surprise) to the regulators, the CME Group and the CFTC. Appearances aside, I promise you that I don't spend my time trying to invent negative things to write about the CME and the CFTC.

The first point about MF Global that I would like to make is that I believe the event was primarily responsible for the sudden take down in the price of silver and other commodities yesterday and Monday. Here's my reasoning. MF Global was one of the largest clearing (guaranteeing) firms of all, including being the largest on the NYMEX/COMEX (according to MFG's web site). Since we know that JPMorgan and other large commercial clearing firms on the COMEX are the big shorts in silver and therefore wouldn't rely on MF Global for clearing purposes since they clear their own trades, it is most probable that MFG held a net long position for its customers in COMEX silver. Since the immediate fall-out of the race to bankruptcy was customer account freezing and then an order for liquidation only, it stands to reason that long silver contracts would be among the first to be liquidated, especially if prices started off lower just prior to the freeze (which they did). The resultant fall in the silver price fueled more silver long contract liquidation by MFG customers. As is the case in times of emergency and panic, more attention is given to those leveraged positions which continue to generate loss. Any short contracts held in liquidation-only accounts would tend not to get liquidated withy urgency, since they weren't incurring losses on the downdraft in prices. This would explain why selling occurred even in commodities without a big speculative net long position, like copper.

If my analysis is correct and silver fell almost $3.50 in two days due to unusual liquidation from MF Global, it suggests some other thoughts. One is that this is a short term pricing event, as panic liquidation is always temporary. It also has nothing to do with silver supply/demand fundamentals. This was strictly another exclusive paper market price event. I don't suggest it was completely intentional, as were the two giant 30% silver takedowns in May and September, but it still highlights just how dominant paper derivatives' trading has become in determining the price of world commodities. Specifically, I don't think that JPMorgan had recently increased its concentrated short position in silver knowing that MF Global was about to implode and cause the liquidation of long silver contracts. But I do know that JPM is a master at exploiting circumstances to its own advantage and I believe it took full advantage of the forced liquidation in buying back short contracts. Whether this will be visible in the upcoming COT is unknown, as there was the opposite activity thru Friday following the Tuesday cut-off. I also have little doubt that had the overall COT structure not been as bullish as it was going into this event, the sell-off in silver and gold and other commodities would have been much more severe.

Let me stop here for a moment and address the issue of just how powerful JPMorgan is in the silver market. Because I am convinced of the critical role that this bank plays in the silver market, I write about it extensively. This, in turn, may lead to the thought that JPMorgan is all-powerful and will continue to price silver to their advantage and at will. After all, JPM is perhaps the largest, most powerful and connected bank of them all. Many believe JPMorgan is more powerful than the US Government itself, or is, in fact, the government in disguise. I don't think so. More to the point, while JPMorgan has been instrumental in manipulating the price of silver, certainly since its acquisition of Bear Stearns in 2008 and perhaps before, they are not more powerful than the physical fundamentals in silver. They are not alchemists who can produce metal from thin air. While they may seem to be above the law, they are not immune from growing allegations that they are violating the law. This is never a good thing for a large financial organization, particularly when there are increasing calls (the Volcker rule) to limit the speculative trading of big banks.

More than anything, however, what proves that JPMorgan is not all-powerful in silver is the performance of the market. Despite a concentrated short position that screams manipulation, JPMorgan has not been able to stem the tide of rising silver prices since the Bear Stearns acquisition. Nor have they been able to respond to the growing allegations of their involvement in the silver manipulation. Yes, JPMorgan's concentrated silver short position has enabled them and others to rig sell-offs monumental and unprecedented in nature, but not to prevent the overall rising tide of silver prices. As to why JPMorgan is short silver, the most plausible explanation is because they miscalculated and are now stuck and trying to work their way out of the jam by trading strategically, which means adding to the position at times. The trick is not to fall victim to the silver manipulation by dealing on a leveraged basis where you will lose positions in the deliberate takedowns. From a different perspective, JPMorgan is responsible for creating the wonderful long-term investment opportunity present in silver because silver is priced much lower than it should be because of JPM's concentrated short position. This is a good news/bad news circumstance. It's very bad that JPMorgan has been manipulating the silver market, but very good that the manipulation allows investors a special opportunity.

Some have noticed the sharp decline in trading volume in silver and gold and other commodities due to the demise of MF Global. There is no doubt trading volume has declined and some question exists as to when or whether it will return to former levels. I don't know and I am inclined not to be concerned. That's because I doubt the accepted connection between daily trading volume and true market liquidity. I think a better measure of true liquidity lies in price volatility. I have written in the past that most (over 95%) of all the daily trading in COMEX silver and other similarly traded items is day-trading, in which contracts are rapidly bought and sold throughout the trading day but all the trades are closed out before the close of the trading day. Even though enormous quantities can be transacted during the trading day, this only gives the appearance or illusion of liquidity; much like a river may be thought to be deep because it is very wide. If few net overnight positions are established or liquidated (as evidenced by changes in open interest), massive amounts of day trading add little to true liquidity. Certainly, day trading provides little real benefit to legitimate hedging, the economic justification for futures trading. The clearest proof that day trading provides little true liquidity to the market is that price volatility has grown as day trading volume has grown. It should be that volatility should be tamped down if increased day trading was providing true liquidity. Long term silver investors are not beholding to day trading on the COMEX for future price performance. As I've also written in the past, if the COMEX didn't exist, silver prices would be much higher as a direct consequence. Bottom line is that a decline in COMEX trading volume because of MF Global matters little.

If daily trading volume does not provide true liquidity, why has it grown? The primary reason is because the CME Group has done everything in its power to encourage the growth of day trading for its own selfish purpose, especially pushing the price destabilizing version of day trading known as high Frequency Trading (HFT). More and more, I see people waking up to the market evil that HFT represents. The only supporters are the HFT cheaters themselves and the exchanges that reap the windfall of the increased trading fees that the artificial volume produces. In a remarkable juxtaposition, the matter of MF Global's demise arose during Monday's conference call for the CME's quarterly earnings report. At the same time the CME was showcasing their record earnings due to greatly increased trading volume, their CEO was forced to discuss the ugly matter that MF Global customers may end up losing money that the CME won't be responsible for. This goes to the heart of my complaint about the CME, namely, it is more concerned with increased profits and less in safeguarding customers of its member firms or the integrity of the markets. http://seekingalpha.com/article/304050-cme-group-s-ceo-discusses-q3-2011-results-earnings-call-transcript?source=yahoo

I suppose the case could be made that the CME Group, being very much a for-profit corporation, should be primarily concerned with returns to its shareholders. But if that is the case, then they should have little to do with true market regulation, due to conflicts such regulation may have on their profits. In other words, why is the CFTC allowing the CME any say in setting market regulation, especially including matters as vital as setting position limits and margin requirements, when the CME's quest is primarily for more day-trading at any cost? To add insult to injury, the CFTC (as I recently reported) completely disregarded the thousands of public comments asking for a 1500 contract position limit in silver and instead doted on every comment submitted by the CME, no doubt worried about the CME going to court if it didn't get its way. As this MF Global debacle has indicated, the CME is interested in profits for the CME and little else, just like any criminal enterprise.

In fact, this failure of MF Global is a regulatory failure for both the CME and the CFTC. It caught both unprepared and allowed for market damage and damage to MF Global customers. I understand that unforeseen events occur that can't always be prevented. But, clearly, MF Global could have been handled better by both the CME and the Commission, including proactive protection of customers, instead of waiting around for a sale of MF Global to occur. Even if you accept that MF Global provided scant warning of big trouble, even when the CME Group and the CFTC are given the luxury of ample time to deal with important regulatory matters, both regulators have neglected their responsibilities. Like JPMorgan, the CME Group has never responded to open allegations of an ongoing manipulation in silver due to JPM's concentrated short position, even though manipulation is the most serious market matter possible. Both may think this approach will make the matter disappear, but that hasn't been the case to date.

As far as the CFTC, the situation may be more critical. The Commission has reported an ongoing silver investigation by their Enforcement Division that is now the longest running investigation in agency history, at more than three years. Like the Commission's dismissal of the public comments on silver position limits, the unresolved investigation creates the impression, shared by many of you, that the agency is in the back pocket of the market gangsters. I believe the only way for the Commission to redress the low esteem in which many hold them is for the agency to be forthright with the public, not dismissive. Unlike the Madoff scandal, in which the SEC (at the Commission level) appeared to be unaware beforehand, the allegations of a silver manipulation have been made from the top down, starting at the commissioner level. There will be no Â?we didn't know.Â? This is not to say that the Commission has to agree that there is an ongoing silver manipulation, just that the matter is substantive enough to warrant answers about concentration on the short side of silver.

Where does all this leave silver investors? Actually, it leaves them in a pretty good place, all things considered. No doubt it becomes tiresome to experience the continuous dirty tricks of the manipulators and their never-ending efforts to rig prices to their advantage. But would it be better to remain unaware? If knowledge is power, then understanding the real silver story is surely an investor's most powerful advantage. No one is more upset about the continuous deliberate takedowns or more anxious to see this manipulation come to an end than me. That's shown in my continuous attacks on the manipulators and prodding to the regulators. But I learned long ago that you must pace yourself and keep the proper perspective. If the continuing stream of data and events (including price) didn't continue to confirm the premise that a manipulation exists that must end, I wouldn't continue to hold the premise. Given a comprehensive and convincing response from the regulators explaining why there was no manipulation, I may retract my allegations. Instead, the most common rejoinder is silence. Silver has a long way to run in price and time. That means not getting too caught up in the short run and maintaining a proper silver position immune from short term price fluctuations. The proper silver position is as much as you can hold through thick and thin. For most, that translates into paying cash for your silver investment and stop valuing it on a daily basis. I know that's easier said than done, especially for those that look at silver closely (myself included). Silver can erupt at anytime, except at the time you most expect. That's the drawback to short term trading. The key is to be in place when the eruption occurs. Based upon the market structure and most fundamental factors, it could be soon.

Ted Butler

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Silver – $34.25

Gold – $1733

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