

November 20, 2013 – Volcker Rule/Demographics

The Volcker Rule

Named after the former Federal Reserve chairman, the Volcker Rule was included in the Dodd-Frank Act to eliminate proprietary trading by financial institutions which were also the beneficiaries of government guarantees, like deposit insurance. The purpose of the Volcker Rule was to eliminate speculative trading by systemically important financial institutions to eliminate the possibility of ruinous losses that then would require taxpayer bail-out assistance, like occurred with AIG during the financial crisis.

To me, the Volcker Rule was always like motherhood, apple pie and the American flag in that who could possibly oppose it? As it turned out, the opponents are the same large banks, led by JPMorgan, to which the rule was intended. The Volcker Rule was one of two proposals (the other being position limits) which if enacted and enforced would terminate the silver and gold manipulations. Position limits promised to restrict how many contracts any one trading entity could hold and the Volcker Rule would rule out banks holding any speculative positions.

Either proposal, if enacted and enforced in the spirit of the law, would knock JPMorgan out of the market corner game in silver and gold. That's a big "if," of course, but in truth I always thought the two rules were a bit of overkill when it came to the silver manipulation because preventing market concentration by JPMorgan would result if either were enforced. How many times does one need to be hit by Joe Louis to be knocked out?

Of course, the passage of either the Volcker Rule or position limits was not undertaken with silver or gold in mind. This despite the fact that the violation of the spirit of legitimate position limits and the Volcker Rule was more apparent in COMEX gold and silver than in any other market. These were proposals intended to apply to long side speculation in food and energy markets; not excessive speculation on the short side of silver and gold (and recently on the long side of gold) by JPMorgan and other large banks. I didn't fully appreciate this when the CFTC first undertook the adoption of position limits several years ago, after denying to me that position limits were needed for the 20 years prior to that. Same thing with the Volcker Rule – I had questioned the legitimacy (and sanity) of large banks speculating with concentrated short positions in COMEX silver for years before the Volcker Rule was proposed.

Just like was the case with position limits, there has been a push by the regulators to enact the Volker Rule before the end of the year, apparently led by the US Treasury Secretary, Jacob Lew. I ask you to take the few minutes necessary to read the following article on the Volker Rule with one specific filter. <http://dealbook.nytimes.com/2013/11/17/pressure-builds-to-finish-volcker-rule-on-wall-st-oversight/>

In the section (about two-thirds thru) which discusses how CFTC Chairman Gary Gensler wants to tighten the definition of market making by the big banks as a thin disguise for proprietary trading, please substitute COMEX gold or silver futures contracts for shares of Apple stock. (I'm not sure why the article used a stock example and not futures contracts, as Gensler is not primarily a stock regulator). A couple of paragraphs later, the topic of hedging comes up, also in regard to it being used to camouflage speculative proprietary trading by big banks.

These two issues, market making and hedging, are more central to the Volker Rule than any other issues. These are the same two issues I harp on repeatedly in regard to position limits. In Saturday's review, I pointed out that there is no legitimate excuse for a market corner, certainly not phony hedging and market making excuses. I'm taking the time to point out how similar is the substance between the NY Times article and what I have been writing for several reasons. I hope this comes out in the manner I intend.

The first point is that these matters are clearly the most important to those at the tippy-top of the financial food chain. These matters are what the Treasury Sec, CFTC chair, heads of other government agencies, CEOs and directors of major banks (including JPM) and exchange leaders are most concerned with and, by definition, that makes them the most important issues.

These are also about the only issues that I have written about over the years. In fact, I have been thinking and writing about these issues long before the current high level official discussions got underway. Ego aside, because of this timing sequence, it's not possible that my thoughts originated from the current official discussions; although the reverse may be true.

One thing is for sure – I see little similar serious debate about position limits and exemptions for hedging and market making discussed anywhere else in the general media or in the gold and silver blogosphere – just on these pages and, according to news reports, at the highest levels of government and commerce. Instead, I see endless debate about the level of COMEX gold warehouse inventories and deliveries and the latest GOFO rates (still goofy) and whether all the statistics from the COMEX are invalid because of a disclaimer. This baffles me. What baffles me the most is that most Internet commentators fully accept that COMEX gold and silver prices are manipulated; it's just that they all seem to want to come up with their own version for why gold and silver prices are manipulated and what the signs will be for when it ends.

There is only one possible cause for a market manipulation – a market dominance brought about by a concentrated position or market share. Add in total trading control brought about by predatory computer trading and willing victims (the tech funds) and the manipulation picture is complete. JPMorgan has held a market corner on the short side of COMEX silver for going on six years and has managed to flip a short market corner in COMEX gold to a long market corner. The enforcement of legitimate position limits uncompromised by phony hedging or market making exemptions would make a market corner impossible. That's the promise behind the proposals for position limits and the Volker Rule.

Will that promise be realized? I don't know. I don't doubt that the current high level debate is well-intended to prevent and end manipulation in most markets; my concern is if the silver (and gold) manipulation is excluded. The fact is that market concentrations and market corners seem to be present only in COMEX silver and gold (and other COMEX/NYMEX metals) and do not currently exist in other markets. Since these metal markets are specifically included in the proposed formula for position limits and are not, to my knowledge, specifically excluded under the proposed Volker Rule, one would think that JPMorgan's reign of financial terror in gold and silver would be at an end.

Unfortunately, there are few signs of that. In fact, gold and silver are increasingly subject to artificial pricing almost to the exclusion of that behavior occurring in any other market. This brings me to the great disconnect of silver and gold being, effectively, excluded from the proposals for position limits and the Volker Rule. It's hard to avoid the conclusion that private agreements have occurred at the highest levels to include silver and gold (and other precious metals) in name only for the new proposals, but no actual effort would be made to ending the manipulations by JPMorgan.

Perhaps it has come to this due to the popular sentiment that the US Government is assisting in or directing the metals manipulation to protect the dollar and the system. I'm still of a mind that the motive is to spare the CFTC the embarrassment of having to admit to missing the silver manipulation for a quarter century and the damage that could accrue to JPMorgan and the financial system should the Fed bust these cons. I don't think the motive for permitting an injustice to continue matters much. What's more important is that high officials have turned a blind eye to market illegality and have dishonored themselves and all the citizens they swore to serve. No wonder so many appear to be beating it out of town.

Price action this week continues rotten, as the "slicing of the salami" by HFT operators keeps setting successive lower prices in gold and silver designed to induce technical fund selling. Based upon public data and anecdotal feedback, investor sentiment to silver and gold has rarely been more negative. This is not accidental and unintended; commercial buying cannot occur unless there are willing counterparty sellers. You don't get anyone to sell unless they become convinced of lower prices to come. Nothing does that convincing better than a steady drip lower in price.

It's always important to keep things in perspective; the lower the prices, the more tech fund and speculator selling and the more commercial buying. That's the game. We are advanced in this sell-off in price and time and relative to historical COT readings. We are also in the highly unusual circumstance of being below the cost of production for many miners. Although it may seem prices will go only one way (down), the stage has been set for a price rally of no small significance. More important than the almost daily price sell-offs is what JPMorgan will do on the next silver rally. If they don't add new shorts in silver, that rally could astound.

It's also important to remember that the negative investor psychology in force can and will change, often on a dime. As I hope to show in the following article, there is a mountain of money capable of overwhelming the investment side of silver. Admittedly, that mountain of money wants nothing to do with silver currently, but instead is devoted to stocks and other assets (including bitcoins). The history of investments guarantees that investor sentiment always changes. It appears to me that the negative investor sentiment caused by deliberately-set lower prices on the COMEX is the only remaining obstacle to a significant silver rally. Of all obstacles, that's the one that change the fastest.

I've been meaning to mention that in addition to the growing extremely bullish COT set up in COMEX silver and gold, there looks to have been a dramatic improvement in the COMEX copper structure on the recent price decline. When the commercials (I believe led also by JPMorgan) get done buying as many copper contracts as possible, don't be surprised by a sharp rally there as well.

Special Silver Demographics

Demographics are the quantifiable statistics of a given population. By studying the trends and changes of population, we hope to predict the future with greater clarity. Demographics are used in a wide variety of fields, from politics to economics. In the past, I have used world population trends to underscore likely growing industrial demand for silver, as a result of not only the growing numbers of humans, but of a noted increase in standards of living. More people, more demand for electronic goods, solar power, clean water, etc.; all things requiring silver.

Total industrial and other fabrication demand for silver remains intact as most population and economic trends suggest. This total fabricated demand remains the largest component of total demand; accounting for 90% of the total one billion ounces of silver produced each year (mining and recycling). Silver is such a versatile industrial material that demand has grown largely through new applications for the metal. It's pretty amazing that world silver demand has increased despite the near-demise of silver halide photography, formerly silver's single biggest application.

The purpose of this piece is not the demographics of industrial demand for silver, but rather how the trends of population change might impact the remaining 10% of total silver demand — investment demand. While new investment demand only accounts for 10% of total silver production, history has shown that it is investment demand that largely determines the price. Strong net silver investment demand moves the price higher; soft investment demand equates to stagnant prices.

The simplest way to think about it is that total industrial and fabrication demand are mostly price-insensitive, meaning whether the price is \$20 or \$30 or \$40, close to the same amount of silver will be industrially consumed each year. Yes, sharply higher than those prices may impact industrial demand, but let's get to those sharply higher prices first and then we'll discuss it. And remember, there were many that predicted silver industrial demand would collapse when silver first hit \$10, \$15 and every other price up to \$50 and that never happened.

I believe that the current demographics suggest a coming boom in new silver investment. This is not a new issue for me as I wrote an article with that very title back in 2008.

<http://news.silverseek.com/TedButler/1201020133.php> Most of the reasons I cited (for what in hindsight came to be accurate beyond my expectations) for the coming investment boom are still in place; including an easy way for large institutional investors to buy silver for the first time (silver ETFs). But there are some new demographics that have emerged which appear to make a new investment rush into silver highly probable.

While unquestionably negative for society as a whole, the real and growing financial inequality developing in the US and throughout much of the world is the key demographic pointing to a new leg up in silver investment demand. Please allow me to proclaim that I am saddened by financial plight of too many of the world's citizens and were it in my power I would banish such suffering. But as an analyst, I can't help but contemplate the practical consequences of the trillions of dollars flowing to an increasingly smaller percentage of the world's population.

The simple fact is that a mountain of money has flowed to the wealthier segments of society in the form of asset appreciation and income gains over the past few years as a result of Fed pumping and stock and real estate gains. It doesn't matter how you characterize the wealthier segments, whether the top 10%, 1% or one-tenth of one percent of society, they all have something in common. The upper levels of the financial hierarchy can be considered the investor class. People unemployed and on food stamps are not likely to invest in silver or any other asset. My heart goes out to them, but it would be impractical to put them into the potential investor profile.

The same cannot be said of those getting wealthier, as any increase in wealth likely came from prior investments and is likely to be directed to new investments. The common denominator among the wealthy at any level is that they are the investor class. There has been an historic increase in the total value of stocks, bonds, real estate, art and collectibles measuring in the many trillions of dollars worldwide. Granted, most of the appreciation has remained within the assets responsible for the growth; but it is undeniable that the overall financial pie, while more concentrated, has grown to historic levels. This creates the potential fuel or buying power for every other asset.

While the world financial asset pie is has grown immensely, nothing about it is particular or unique to silver on the surface. To grasp why this growing pie will be important to silver, you must consider the facts on silver as discussed earlier. Because only 10% of total world silver production (mine plus recycling) is available for new investment, the smallest percentage of the rapidly growing financial pie would overwhelm new silver investment supply of 100 million oz annually. At current prices, the 100 million oz of new silver available for world investment yearly is worth around \$2 billion.

Two billion dollars may seem like a lot, but measured against the world financial asset pie, it is a pittance. World stock market valuation is more than \$50 trillion, with most world stock markets up more than 10% this year. One-tenth of one percent of just the gain in stocks (\$5 trillion) is \$50 billion. One one-hundredth of one percent of \$5 trillion is \$5 billion. I'm not suggesting that any set percentage of the world financial pie will flow into silver because there isn't enough silver available from new production to make the smallest fraction sound credible. And that's the point — there is so much buying power and so little material available for sale that a price crack-up must occur in silver at some point.

To further highlight the incredibly tiny amount of silver available for investment (\$2 billion) from new production, on the same basis, the dollar amount of gold available for investment from newly produced metal annually is \$120 billion, or 60 times the dollar amount available in silver. What makes the demographics of the growing financial inequality so special for silver is the extreme mismatch between what's already in the pie and new silver available for sale.

I must also point out that silver is considered by most investors to be different enough from stocks, bonds and real estate as to constitute a hedge of some type against those assets. By that I mean if investors someday become worried about their holdings in these markets (as they always have in the past), silver offers one of the few true diversifications to run to. In the meantime, the growing total values of the stock, bond and real estate markets should be viewed as growing potential buying power in silver.

We witnessed silver running from \$4 and \$5 to nearly \$50 on strong investment demand in the past. That investment demand occurred when the total financial pie was much smaller than it is presently. The demographics of growing concentrated wealth in the world suggest that investment flows into silver will be stronger the next time and that will be reflected in the price.

Ted Butler

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Silver – \$19.90

Gold – \$1245

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