

October 5, 2016 – Still Two Markets

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More than ever, there are still two forces driving silver, gold and a whole host of other commodity prices. One is the short term force of futures contract positioning on the COMEX and other exchanges; the other the long term force of actual supply/demand fundamentals. I suppose I tend to talk more about the short term forces than I used to, but it's hard not to – mainly because people want to understand price movement in the here and now and the explanation is readily available. On the other hand, it's most practical for investors to focus longer term, because the odds of success in short term trading are generally not good.

So today I'll try to cover both, the short term first and then conclude with an article on the long term prospects for silver. The biggest difference between the short term and the long term is that the short term is dominated by derivatives (paper) trading, while prices in the long term are determined by physical metal developments. Since there was a very sharp price decline yesterday, in which gold fell more than \$40 and silver by a dollar, let me start here.

Yesterday's plunge in price capped off a Commitments of Traders reporting week in which gold fell to fresh price lows every day, a classic example of "salami slicing", the term first used in daily conversations with my silver mentor, Israel Friedman, a very long time ago. As a reminder, this is the term used to describe the trading pattern of the managed money technical funds which are programmed to sell and continue to sell as new price lows are hit and buy as successive new price highs are established. We can argue until the cows come home as to whether this trading pattern makes sense, but not as to its existence.

In fact, given the massive new investment inflows into the managed money traders over the past few years, the positions they take are also larger than ever, which makes "salami slicing" more pronounced than ever. All of this is documented in official government market data, which more seem to be following. That's why I am – well, puzzled – to read accounts not understanding what caused prices to plunge yesterday. While yesterday's price plunge in gold and silver was dramatic, the explanation for it should be easy to see – massive managed money selling on the COMEX (mostly long liquidation, but new short selling as well). I'm not suggesting anyone should have been able to predict beforehand that gold and silver prices would plunge yesterday, but that's way different from understanding after the fact why it occurred.

Managed money traders sold massively yesterday in COMEX gold and silver futures (with the commercials buying) and that was the sole reason prices plunged. The proof of that should be seen in this week's COT report, where I would expect a record or near record reduction in the total commercial net short position in gold and a similar reduction in managed money net longs.

I'm always concerned that all the data might not be reported in a timely basis when price and volume changes are dramatic on the cutoff day, but I would expect the total commercial net short position in COMEX gold to have declined by a massive 75,000 contracts or so. Silver looks a little trickier, based upon last Friday's "dipsy-doodle" in price, but could be in the 5,000 to 10,000 contract range and possibly more considering what likely occurred in gold.

Regardless of what the actual numbers turn out to be, the relevant question is if the managed money selling and commercial buying was sufficient enough to sound the "all clear" - a full resolution of the bearish market structure? I don't think so. That doesn't mean we can't see sharp price rallies, as was seen after the price decline into the end of May when a similarly-sized number of gold contracts were sold by the managed money traders and bought by the commercials. That contract repositioning led to a gold rally of \$150 and in silver of \$4+ into early July.

But in hindsight, it is now obvious that the commercials just dug in their heels (minus the one big 8 gold short no longer among us) and sold into the technical fund buying that drove prices higher into July. Yesterday, we closed at the lowest price levels since late June, meaning every new managed money long position established in gold and silver over the past four months is a loser, whether closed out or still open. This is reflected in my running money scoreboard calculations.

On Saturday, I calculated that the collective and combined commercial short position in COMEX gold and silver stood at \$1.4 billion in unrealized losses (since the price bottom at the end of May). Based on yesterday's close, the commercial sons of guns are now ahead by \$600 million, having picked up \$2 billion on the price smash. Seeing how the commercials were underwater by nearly \$4 billion in early July, at this point it's hard to argue that they are not in complete control, a proposition very much under question back then.

Having clearly succeeded to this point in terms of rigging prices lower, it is now incumbent on the commercials to rid themselves of still-massive open short positions. The only way that can occur, of course, is if the commercials can induce the managed money technical funds to sell many more gold and silver contracts than have been sold to date. There should be no question that this sharp plunge in price is directly related to the record concentrated short positions recorded in the most recent COT report in silver and gold.

For months, I have been repetitive in noting that the sole potential bearish factor for a significant selloff in gold and silver has been the extremely bearish market structure on the COMEX. I was also repetitive in stating that I did not know how the lopsided market structure would get resolved, only that it must be resolved in time. It would get resolved with the commercials getting overrun to the upside for the very first time or it would end as it always has in the past, namely, with the managed money traders finally selling and allowing the commercials to buy sufficient numbers of contracts to get the commercials "off the hook."

Despite the sharp selloff, I must admit that the actual manner of resolution is still unknown, although it has clearly tipped in the commercials' favor. This keeps alive my long-held personal premise of one final selloff in the price of silver in which the big commercial shorts, principally JPMorgan, buy back as many COMEX paper short contracts as possible and once that occurs for the bank to stand aside and refrain from adding new shorts when the next rally develops. By itself, should this occur it would create an explosion in price. Should my hopes be dashed (yet again) and JPMorgan does add aggressively to short positions, there will be ample advanced warning of that. Please remember JPMorgan is still better positioned for a silver price explosion than anyone else, by virtue of its 500 million oz physical position.

But let me not get too far ahead of myself in thinking about what JPMorgan will do once the market structure turns bullish. What would it take, in terms of numbers of contracts, to consider the COMEX market structure no longer to be bearish, but bullish instead? From the very end of last year to the recent price top, the managed money traders bought (and the commercials sold) 300,000 net contracts in COMEX gold and more than 80,000 contracts in silver. If my estimates for this week's report is close, that means that around 100,000 contracts of gold and 20,000 net contracts of silver have been unwound as of yesterday from recent extremes. This still leaves significant liquidation potential.

I don't think we're going back to the super bullish market structure of year end and shudder to think what that would mean in price terms should that occur. That was an extraordinarily bullish structure and the circumstances that led to it are not in synch with conditions today. But we could see a further repositioning of 50,000 to 100,000 net contracts in gold and 30,000 net contracts in silver to get to a somewhat bullish market structure. Yes, for that to occur, prices would have to move lower.

What I will be focusing on the most will be the concentrated short position in gold and particularly in silver. I'm allowed to change my mind as the data evolve, but I'd imagine that JPMorgan would need to reduce its concentrated short position in silver to less than 20,000 contracts to sound the all clear signal. This is very subjective on my part and not to be relied upon except as an indication of what I'm thinking. Sometimes things unfold as I imagine, other times not so much.

But it's always important to keep things in proper perspective. The price of silver is low enough now to be considered attractive for long term investment. That is, even if we do go lower in the short term, in the longer term, silver bought and held at current prices should prove highly profitable. The short term resolution of the extremely bearish market structure appears to be under way and if completed should result in a truly outstanding buy point. But the price jigs and jags will likely continue to be unsettling.

Here's that longer term piece I mentioned at the outset Â?

Silver's Past, Present and Future

While I have some concerns about the very short term direction of price based upon paper trading shenanigans in COMEX silver, a review of the past, current and future actual supply and demand for the metal points to much higher prices to come. Unless you are a bona fide short term trading crackerjack, your best bet for investment success is on a long term approach, based upon value and facts easily confirmed. The most important long term facts in silver are those that relate to its actual supply and demand fundamentals. So what are the fundamentals in silver?

Silver's past is quite long, but easy to summarize. After being a highly sought-after precious metal used as money and adornment for thousands of years, over little more than a century ago, it was discovered that silver had important and unique industrial applications in a wide variety of uses considered vital today. Silver was well-known and highly valued by everyone long before its most important uses were even dreamed about. For example, who could have known that silver was the best conductor of electricity before electricity was first discovered?

In being the best electrical conductor, the best reflector of light and a whole host of other special chemical applications, including photography and medicine, silver came to be widely consumed. Starting around 1940, the world began to industrially consume more silver than it mined and that continued until 2006, resulting in a massive depletion of world silver inventories to the lowest levels in hundreds of years. Summing up silver's past by 2006, modern industrial consumption used up 90% of what world silver inventories were at the start of WW II, or from more than 10 billion ounces then to just over 1 billion ounces today.

What about present day supply/demand fundamentals for silver? The deficit consumption pattern in silver, in which the world consumed more metal than it produced, necessitating the drawdown in world inventories, ended in 2006 due to a combination of higher prices and little available inventories remaining. But the ending of the structural consumption deficit hasn't resulted in a true surplus circumstance either, more of a standoff in world silver inventories. As such, world silver inventories have grown only marginally since 2006, perhaps by a few hundred million ounces compared to the many billions of ounces previously depleted. I'm further convinced that JPMorgan holds most, if not all the silver that may have been added to inventories over the past five years. The bottom line is that world silver inventories are still critically low on any historical measurement.

According to the Silver Institute, industrial consumption, plus demand for jewelry and silverware consumes just about every ounce of newly mined silver currently produced. Let me repeat that, the Silver Institute indicates that silver consumed in these three categories is equal to total world mine production. Effectively, this means that the only silver available for investment demand comes from recycled metal, since all mine supply is spoken for in demands that must be considered rock solid. Of course, should silver prices soar to the levels I anticipate, perhaps future industrial, jewelry and silverware demand might suffer, but that's the whole point investors can sell and profit immensely at that time. Please take a moment and verify my findings for yourself.

<http://www.silverinstitute.org/site/supply-demand/>

Since total silver mine production is consumed industrially and for jewelry and silverware, the amount of metal available for investment must come, essentially, from recycled silver, said to be less than 150 million ounces a year. And this represents the total amount of silver for investment in all forms, including small bars and coins to holdings of metal in the form of 1000 oz bars. This is the form of silver favored by industrial users and institutional investors in silver ETFs. The only other potential source of supply is the selling of metal by existing investors. But considering the small amount of silver that exists compared to 75 years ago and how strongly that metal is held, it is completely unrealistic to expect widespread disgorgement at anything but outrageously high prices (over \$100 and more).

The closer you look at the data, the clearer it should become that no great production surplus exists in silver and even more obvious is how critically low world inventories have remained. Summing up the current supply/demand fundamentals in silver — total mine supply is spoken for by industrial and other fabrication demands, leaving investment demand to be satisfied by recycling and selling by existing investors. In other words, the present (2006 to today) fundamentals in silver indicate a continued delicate balance in actual supply/demand and little meaningful growth in world inventories. As an aside, the delicate balance in actual silver supply and demand is the perfect backdrop for a paper price manipulation. As and when the delicate balance gets upset by sufficient new physical investment demand, paper price manipulation will fall by the wayside.

What about future supply/demand fundamentals in silver? Obviously, one can speak in more definitive terms about the past and present than what the future holds. After all, I can document and explain past and present occurrences, while no one can document the future before it unfolds.

But it is also imperative to apply the lessons of the past and the present in predicting the future. In a very real sense, this is the basis for rational long term investment. And in silver, the future supply/demand fundamentals, in conjunction with what has and is occurring, points to shockingly higher prices.

Any objective vision of what will occur must be compatible with what's occurring today. Simply put, the modern world is becoming more electronic and electric as every day passes. Everything from electronic devices of all types, electric cars, new battery technology, to solar power involves electricity. (Previously, I referenced a fascinating vision of the future in this regard) —

<https://www.youtube.com/watch?v=Kxryv2XrnqM>

While the video never mentioned the word "silver" once, to me it was a seminar almost exclusively about silver. From the demise of Eastman Kodak due to silver halide film being displaced by digital photography, to the coming rise of electric vehicles and solar power generation, silver played or will play a key role in what's to come. As the world's best conductor of electricity, silver is destined to be demanded in greater quantities. While silver costs a lot more than copper, the next best conductor of electricity, in those applications where top performance is required, silver is indispensable. And in just about every new electronic and electrical technology, peak performance is critical and, therefore, will require silver. If the world was moving away from electrical and electronic advances, I suppose the future use of silver might be questioned, but nothing could be further from the truth.

It is this near certain increased future demand for silver that must be considered in analyzing past and present fundamentals. Insufficient actual supply in the face of industrial and investment demand is what led to silver rising to nearly \$50 in 2011, up ten times from a few years earlier. In the interim, industrial and fabrication demand have remained strong and supply has been sufficient to meet that demand because investors (except JPMorgan) have held back. But investors won't hold back forever and it's just a matter of time before the new electrical demands and renewed investment demand kick in. Almost guaranteed is that one will kick off the other, regardless of which occurs first.

The depletion of world silver inventories into 2006 set the stage for the surge in price to \$50 in 2011 and a delicate balance between actual supply/demand has continued to this day. World silver inventories are still depleted and along come indications of big increases in future industrial demand based upon present day observations, making it only a question of time before investment demand emerges. If silver could rise ten times in value over a fairly short time frame not too long ago, it's hard to see why it couldn't rise that much or more again "seeing as the facts look more compelling now than ever before."

Ted Butler

October 5, 2016

Silver – \$17.85 (50 day moving average – \$19.48)

Gold – \$1268 (50 day moving average – \$1332)

Date Created

2016/10/05