Sep 13, 2009 – A Danger to All

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The most recent Commitment of Traders Report (COT) for positions held as of Sep 8, indicated extreme readings in COMEX gold and silver futures contracts. The market structure, while fully expected, still elicits a Â?Holy CowÂ? reaction, particularly in gold, where records were set in technical fund and speculative long/commercial short position levels. Never has the net speculative long and dealer short position been larger. And this was as of the Tuesday cut-off; surely it is much larger through Friday. It would appear the Razor's Edge has been sharpened, meaning a quiet price resolution is hard to imagine from the current set-up. The only question is which side blinks first.

Let me conclude here that silver investors must be prepared for either eventuality, namely, a sell-off if the commercials succeed in rigging the market sharply lower, but still meaningfully positioned in the event the shorts lose control and we explode in price. How does one do that? The most effective way of doing that is by holding only long-term and non-margined positions in silver metal, stocks or ETFs. Alternatively, more active trader types should have some dry powder (generated from selective profit-taking on the recent rise). Do not hold margined positions that might be lost if prices do sell-off. This is just basic and prudent advice.

Everyone has to determine what the right levels of holdings may be for them. When silver (or anything) is going up, you never hold enough, but when it goes down whatever you are holding is too much. The trick is to balance that based upon your own temperament. As always, this COT discussion is short term in nature. It has little to do with the long term, which will be determined by forces in the production, consumption and investment in real metal. By definition, the COTs are all about paper positions. But even if you are a long-term silver investor (as you should be), it's important to understand the dynamics that push prices around by dollars an ounce on a short-term basis. Now is one of those times.

The current COMEX market structure in gold and silver is extreme and a danger to all. We are witnessing something that is not allowed under commodity law. That something is that prices are being set for gold and silver by COMEX trading, instead of by the real world of production and consumption and real investment. Trading in commodity futures is supposed to follow and be dictated by developments in the real world supply/demand fundamentals. The term for this is price Â?discovery.Â? Commodity regulation dictates that futures trading discover prices, not set prices. Commodity futures are derivatives. Their existence is based upon, and derived from, the underlying real market. Having prices set for the real world market by trading in the derivatives market is like having the tail wag the dog. It's completely upside down. Yet I think I can prove to you that it has been trading on the COMEX, in gold and silver futures, that has set the price of each recently. Further, I won't stop at proving this; I will also offer a constructive solution to the CFTC to remedy this violation of commodity law.

From the lows of mid-July, the price of gold has rallied an impressive $100 per ounce, or more than 10%. Silver has rallied a spectacular $4.50 over the same period, or around 35%. (Performance, incidentally, that was largely in conformity with my articles and interviews at that time). What drove the rallies was speculative and technical fund buying on the COMEX.
From the COT of July 14, and extrapolating from the cut-off of the most recent COT, more than 100,000 net gold contracts were bought by long speculators, or the equivalent of 10 million ounces. In silver, more than 25,000 net contracts were bought by speculators, or the equivalent of 125 million silver ounces.

Of course, the commercials sold an equivalent and reciprocal amount of futures contracts aggressively and collusively, preventing prices from climbing even higher. However, the biggest short, JPMorgan, is still not increasing its short position according to my analysis. Despite the sharp increase in both the silver total commercial short position and the record total commercial gold short position, the concentrated short position that I complain about so much has actually shrunk. Relative to the total commercial short position, the concentrated short position in gold and silver is at the lowest levels in a year. I am not surprised that this is occurring, for many reasons, and fully expect that it will continue to shrink. In fact, I think the strong price rally since mid-July has occurred precisely because JPMorgan has ceased selling more, and forcing other commercials to step in at higher prices. I believe this validates my allegation that JPMorgan was and is a big part of the manipulation.

But let me return to the buyers of COMEX gold and silver futures contracts from mid-July. Please bear with me, as I'm not trying to confuse you. I am trying to make a new point. Yes, I think many of the commercial shorts in silver and gold are crooks and manipulators. But it takes two to tango, and I believe many of the speculative and technical fund buyers play an important role in the silver and gold manipulation. At the very least, these buyers are enabling the commercial shorts in the manipulation. If these technical long traders were prevented from buying on the COMEX, long term silver investors would be much better off. Yes, you are reading that correctly; in my opinion, long term silver investors would be better off if the technical funds and other momentum traders who buy futures contracts on the COMEX were greatly restricted. Please let me explain why.

It has to do with the expression, Â?if you live by the sword, you die by the sword.Â? The technical traders on the COMEX who I think should be restricted buy on price signals and sell on price signals. In simple terms, they buy as prices are rising and sell when prices are falling, in classic technical fashion. I don't have any problem with their market approach, even though I am not a practitioner of that methodology. These technical traders are not evil or corrupt. The problem is that there are too many of them. So many, in fact, that they are also manipulating prices, just like the commercial shorts. The big difference is in intent. The technical funds are inadvertently influencing prices. So many contracts are bought and sold by the technical funds collectively, that prices are artificially impacted, first up when they buy, then down when they sell. The commercials know this and take advantage. But the market is still unnecessarily and illegally impacted.

A case in point; in the big price rally from mid-July, where 10 million ounces of paper gold and 125 million ounces of paper silver were bought on the COMEX, there was no evidence of anything close to that being bought in the real market. The big gold and silver ETFs had basically flat holdings and no big documented buying took place in any other market, just on the COMEX. $10 billion of paper gold and $2 billion of paper silver were transacted on the COMEX and nowhere near that amount anywhere else. Thus, it is easy to conclude that the COMEX paper buying was responsible for the price rise in gold and silver. That's not discovering prices, that's price setting. It's not just that commodity law is being violated; it's more that the market is not functioning as a free market. The market is being dictated by buyers who are influencing the market by their collective behavior and sellers collusively preying on that collective buying behavior. The bets on both sides have become so large as to threaten innocent participants and the market itself.

The solution is remarkably simple. In fact, it was raised during the recent public hearings on position limits by Michael Masters, a hedge fund manager. In addition to legitimate position limits for individual traders (including a reduction in silver position limits), a further limit should be placed upon overall categories of types of traders. In the context of the hearings, the additional category limits were suggested for some of the big ETFs and swap dealers who aggregate and deal in futures contracts. That's reasonable. Many observers have trouble understanding that it is wrong, under commodity law, for many investors to buy an ETF that in turn buys futures contracts, when the resultant futures position becomes too large and concentrated. Fortunately, the new chairman of the CFTC, Gary Gensler, does seem to understand that concept. I believe that was behind the recent yanking of the Â?no actionÂ? letters allowing exemptions to position limits. But I would extend that concept to include large technical traders as a category. Let me point out that any trading limits would only apply to large reporting traders, not to smaller non-reporting traders. There is no suggestion by anyone that small traders be limited in any way.

The point is that many large technical funds are following the exact same trading signals (mostly moving averages), even though they are separately-owned and unrelated trading entities. By their identical mechanical approach to buying and selling, they are, in effect, operating as one single trader. They all do the same thing at the same time. Their intent may not be to manipulate the market (unlike the commercial shorts), but the collective buying and selling has the same effect. Of the 100,000 net gold contracts bought since July 14, the large reporting technical traders accounted for roughly 65,000 contracts bought. In silver, of the 25,000 net contracts bought, roughly 22,000 were bought by large technical funds. That is super-concentrated buying that is almost every bit as wrong as concentrated short selling. But I did say almost. Just to keep things in proper perspective, all the net selling in gold and silver since July 14, was by large reporting commercials, by definition. With no apparent legitimate reason to sell (other than to trick the tech funds eventually), the large commercials sold 10 million ounces of paper gold and 125 million ounces of paper silver on the COMEX. Because there was no legitimate hedging purpose behind this selling, the CFTC is derelict in allowing these commercials to be classified as commercials, and not in the non-commercial category. Such a proper category change would make it easier to subject them to legitimate position limits.

I know many are reluctant to criticize the paper COMEX technical traders who buy for purely price momentum reasons. (Although there is some criticism when they sell and depress the price). There is a natural tendency to overlook flaws in those who agree with us or who take action that appear to be in our interest. I think that is wrong at times. What's good for the goose should be good for the gander. Just because paper short sellers have been manipulating prices, doesn't excuse the actions of buyers who may be artificially influencing prices as well. Two wrongs don't make a right. Remarkably, the solution is the same in each case Â? legitimate position limits and an end to phony exemptions to those limits. Throw in category limits and manipulation becomes impossible, if the regulators enforce the right rules.

In my opinion, no individual trader should be allowed to have more than a 1% to 2% share of the total open interest of any futures market. No category of trader, involved in identical trading strategies should be allowed to hold more than a 20% share of total open interest. That goes for technical funds and the commercial shorts that prey on them.

Long-term silver investors don't need gimmicks and tricks to see silver at the price it should be at. In fact, we need to eliminate all the trading tricks and gimmicks that have depressed the price for so long. They are mostly on the short side, but if we are honest, also on the long side. Besides, these technical fund traders don't give a hoot about silver or gold or anything that they trade. They are not interested in the long term merits of anything. They buy and sell based only upon price movement. They are not our allies, just fair weather friends. I know we would be better off without them. The CFTC should let them trade, but not let them influence prices as much as they do. That's not just my opinion, that's the law.

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