

## September 2, 2015 – Lessons from Crude Oil

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The price of the world's most important commodity, crude oil, has been gyrating wildly over the past week, with daily percentage moves of 5% to 8% and more. The unprecedented price volatility extends back nearly a year, to when Saudi Arabia announced it would not cut and instead increased its crude oil production in the face of a glut. At the extreme lows, oil prices were down more than 60%.

More recently, after declining 35% from the end of June (\$60/bbl. to \$38), crude oil prices shot up 29% in three days (\$38 to \$49), before falling back yesterday (again by 8%). It's no exaggeration to say that these are the among the largest percentage price moves in the history of the oil market. As remarkable as this price volatility may be, what makes it absolutely astounding is the size of the oil market and the kind of numbers one gets when converting into dollars (or any currency).

The world produces 96 million barrels of oil each day, worth more than \$4.5 billion, even at prices half what they averaged for years. The dollar amounts are truly staggering and it's not much of a stretch to suggest that the annual production of crude oil is equal to the value of most, if not all other commodities combined. For example, the total value of crude oil production is 15 times greater than gold or copper world production and more than 135 times greater than the value of world silver mine production.

Further, most of the world's seven billion inhabitants, except the extreme poor, consume crude oil in some form and those engaged in oil production, processing and distribution number in the many millions. By every possible measure, the crude oil market is massive in size. What makes the recent price volatility so astounding is that one would think the more consumers and producers and the greater the size of a market, the less volatile prices would be. Most amazing of all is there have been no compelling changes in the production and consumption of crude oil to account for the incredible price volatility over the past week.

For sure, in a market as important as crude oil, the price volatility is not going unnoticed or unreported on. The trouble is that because there have been no discernable changes in oil supply or demand, the many explanations published mostly miss the mark. So what the heck is going on? What is the real reason crude oil prices have been careening all over the place?

Regular readers probably know how I'm going to answer the question of positioning changes by the managed money traders on the NYMEX futures market. It would be arrogant to suggest no other factors had any bearing on the remarkable price volatility in crude oil, but the evidence pointing to managed money technical fund type traders being the prime cause is compelling. And as it turns out, I'm going to be quite specific in targeting only these funds' excessive short positions this year.

Before I present that evidence, let me point out that these price momentum type futures traders had never established short positions in NYMEX crude oil futures to the extent they did on two occasions so far in 2015. So, for the first time ever we are witnessing extreme price volatility accompanied by record managed money short positions in crude oil; a connection impossible to deny. On both occasions this year, the managed money traders didn't build up record short positions until crude oil prices broke below \$60. In other words, based on COT data, the managed money traders didn't add to short positions on the move in oil from \$100 to \$60, but only established record short positions of more than 150,000 contracts on two occasions after prices fell below \$60.

The first time that managed money traders established excessive short positions in NYMEX crude oil futures was when they added 100,000 new short contracts from the end of December to the end of March as prices fell from \$60 to near \$40. They then bought back those shorted contracts over the next two months, driving prices back to \$60. I would contend that the sale of 100 million barrels of crude oil futures on the NYMEX drove prices \$20 lower to the end of March and the subsequent buying back of those same 100 million barrels drove prices \$20 higher into June. This may sound over simplistic, but I would remind you that there were no notable supply demand developments over this time and that is true through today. Something caused the \$20 roundtrip in crude oil prices from \$60 in December to \$40 at the end of March and the subsequent move back up to \$60 in June. Now prices moved back below \$40 before bouncing up by \$10 by Monday and the only common denominator was that prices moved in lockstep with managed money shorting and short covering

In the Commitments of Traders (COT) Report for June 16, with the price of oil at \$60, forty-two managed money traders held less than 59,000 crude oil contracts short. By the August 18 COT report and with oil prices approaching \$40, fifty-nine managed money traders held just over 159,000 NYMEX crude oil contracts short, an increase of 100,000 contracts, the equivalent of 100 million barrels of crude oil, or more than a full day of world production. This was the largest positioning change by any trader category in the NYMEX crude oil market, the largest such market in the world. (In addition, managed money trader sold out more than 55,000 long contracts, bring the total net selling by managed money traders to more than 155,000 contracts on the move to below \$40).

I would contend that the sale of 155,000 net contracts by the managed money traders from June 16 to August 18, was the prime driver to the collapse in oil prices of nearly \$20. Apparently full up on the short side, there should be little doubt that the managed money traders had turned aggressively to the buy side on the spike in prices to \$49 thru Monday, although we'll have to wait for future COT reports to see how many short contracts were bought back.

The whole purpose of this article is not to dwell on the COT details in NYMEX crude oil futures, aside from establishing that this is what accounts for the recent unprecedented price volatility. My purpose is to point out the obvious, which includes that there is a defective price discovery process currently in force in the world's most important commodity and this is what is causing the crazy price volatility in crude oil. The collective short selling and subsequent short covering of many tens of thousands of futures contracts by no more than 60 money managers is responsible for most of the price movement and price volatility in crude oil this year — at least the move from \$60 to \$40 , back to \$60 again and the subsequent collapse to under \$40 again. Where we go from here remains open.

What I just described is actually quite crazy, in addition to being true. That the market regulators and exchange officials would allow this to exist is crazier still. But that's not where I'm going with this today. Where I'm going is to point out if this distorted price setting mechanism can come to dictate prices of the world's largest and most important commodity, crude oil, and so few can see it — it would seem a cinch to dictate prices of a much smaller commodity, like silver.

So first I am making the connection between what is happening in crude oil to what is happening in gold, silver and copper (and other commodities); the connection being excessive speculation by managed money traders and their speculative counterparties in CME Group futures markets. The net effect is price distortion by excessive futures speculation.

But there are some obvious differences between the price actions in crude oil and silver. While both are depressed in price (for different reasons), the price volatility in crude oil, which should be low considering its size and number of consumers and producers, is shockingly high; while the price volatility in silver, which is historically the most volatile commodity of all, is rather subdued recently. Where a near 30% price rally erupted in oil over 3 days, such a rally in silver would amount to more than \$4, something not seen in silver in years. So why is price volatility busting out all over in crude oil, but not in silver (and to a lesser extent not in gold)?

It's been more than four and a half years that silver (and gold) have headed relentlessly lower in price, with historical price volatility being squeezed out along the way. In retrospect, it's now clear that there had to be great forces responsible for the price action. In crude oil, it was fundamental oversupply by increased production in the US, coupled with Saudi Arabia's decision to increase its production, responsible for the halving in the price of oil. In the interim, positioning on the NYMEX by managed money traders has accounted for the recent volatility as explained above.

But in silver there has been no fracking production revolution or documented oversupply of metal. In fact, all the major statistical services in silver point to a general close balance in actual supply and demand with some reporting deficits or small surpluses, depending on how investment buying is defined. Certainly, there has been no reported build in visible silver inventories over the past few years (nor has there been any big decline). Where oil inventories are bulging, in silver that's not the case.

Additionally, the past four and a half years of declining silver prices have included recurring bouts of shortage in retail forms of silver, such as the one we're currently involved in, all led by the US Mint's recurring sellouts of Silver Eagle coins. Since it's impossible for the public to be net sellers and buyers simultaneously, it's easy to conclude there has been no net selling of silver in retail forms of silver over this time.

On the wholesale front, the front that matters the most, all signs (except the price) point to tightness in 1000 oz. bars, the form of silver that sets the overall price. The prime clue pointing to wholesale tightness remains the incredibly large and consistent turnover or physical movement of 1000 oz bars in and out of the COMEX silver warehouses. Nobody moves 200 million oz of physical metal annually through the COMEX silver warehouses, as has occurred for the past 4.5 years, for no good reason. The only plausible explanation is that the silver bars are moving because they must be moved. And the only explanation for why they must be moved, at least to me, is because of physical demand. If there was a surplus of metal, inventories would climb without interruption (as has occurred in crude oil) and not churn continuously as has occurred in the COMEX silver warehouses.

This year, signs of tightness on the wholesale side of silver have appeared in COMEX futures deliveries. Starting in March, JPMorgan, for the first time in years, began to "stop" or take delivery on COMEX futures contracts and then move the silver into its own COMEX warehouse. The total amount of silver taken by JPMorgan this year in COMEX deliveries is still relatively small (under 20 million oz) compared to what I think the bank has amassed over the past 4.5 years (400 million oz), but COMEX deliveries are highly transparent, particularly when done in a clearing member's own house or proprietary trading account.

Thus there is a large disconnect between the price of silver and the clear signs of tightness in the wholesale market, which sets the price. We know that shortages in retail forms of silver impact the premiums and availability of metal in those forms, but not the wholesale price of silver. Now there are increasing signs of tightness in wholesale silver (1000 oz bars), but those signs have not yet affected the price of silver.

The backdrop of recurring shortages of retail silver and the increasing signs of wholesale tightness, coupled with the extremely depressed price, strongly suggest we are fast approaching the physical tipping point of a wholesale physical shortage. I would have thought it would have arrived by now (since it did first appear in April 2011), but notwithstanding the unexpected delay, it still appears set to occur.

One point I may not have stressed enough recently is that when a physical shortage hits the wholesale silver market, there will be an immediate effect on the price of silver. Just like there is no way to hide a retail silver shortage, there will be no way to cover up a wholesale shortage once it occurs. With retail forms of silver, the shortage is seen in rapidly escalating premiums and delivery delays, not in the wholesale price of silver, but in retail forms. The growing retail premiums are premiums to the price of 1000 bars; in an actual wholesale shortage it won't be a question of premiums, but of the price and availability of 1000 oz bars. As and when investors and users of 1000 oz bars experience what retail investors are experiencing in most forms of retail silver, the jig is up as that can't be hidden.

We're not there yet, but appear to be close; at least that's what the growing signs of tightness in wholesale silver point to. And just like the recurring retail shortages in silver, when the wholesale shortage hits, it will come like a thief in the night, suddenly and without much warning (unless you are studying the clues beforehand). That's because the same backdrop that allowed the retail shortage to develop is the same in 1000 oz bars, namely, a remarkably small amount of available silver set against what could appear to be plenty of silver.

As an example ^ the US Mint has been pumping out prodigious amounts of Silver Eagles over the course of the past 29 years, over 350 million, including more than 200 million over the past 5 years. There has to be more Silver Eagles in existence (depending on how many JPMorgan may have melted) than any other silver form of retail silver produced over the past 5 years. Yet, this is the first form that goes into shortage and whose premiums seem to lead the way. If there are so many Silver Eagles in existence, why doesn't that prevent a shortage from developing in this form of retail silver?

Just like there seems to be plenty of Silver Eagles in existence, there appears to be plenty of 1000 oz bars around, some 1.3 billion oz in total (1.3 million bars in all). The catch is that just because it exists, doesn't mean it's available for sale at current prices. Because not enough of the 350 million Silver Eagles were available for sale, a shortage erupted. Likewise, when not enough 1000 oz bars are available for sale, a wholesale shortage will erupt. And the same reason not enough Silver Eagles were available will apply to there not being enough 1000 oz bars available at some point ^ the price was too low. In the case of Silver Eagles, prices are adjusted higher in the form of premium increases. In the case of 1000 oz bars, it must be the price of silver itself to adjust upward, as this is the core form of silver upon which premiums of everything else are derived.

The main lesson from the explosion in price volatility in crude oil and not in silver, it seems to me, is that there is some great and unique price force at play in silver over these past 4.5 years. Remarkably, everything I look at, including the discussion above on the signs of developing wholesale tightness, revolves around my core belief that JPMorgan has amassed a massive amount of physical silver. This is the one thing that ties everything else together. The reason silver has been down in price for the last 4.5 years is because that is in synch with JPMorgan buying silver at the cheapest price possible.

From the record purchases of Silver Eagles (and Canadian Maple Leafs) over the past 4.5 years which have led to recurring retail shortages, to the start of continuous frantic physical turnover in the COMEX silver warehouses over that same time, to the counterintuitive metal flows in the big silver ETF, SLV, particularly when compared to GLD, to the recent evidence of JPM's involvement in taking delivery on the COMEX and the very recent signs of tightness in COMEX futures, all roads lead to JPMorgan accumulating physical silver.

I can't imagine any other single factor explaining everything important in silver as does JPMorgan's accumulation of physical silver. My whole purpose is to identify what is most important to the silver price equation. Everything I look at points to JPMorgan being at the heart of what's important in silver. I'm convinced that just as it explains why prices have been so rotten for so many years, JPMorgan's involvement now points to sharply higher silver prices, not for any reason more complicated than because the higher silver prices move eventually, the better it will be for JPMorgan.

I did an interview with Geoffrey Rutherford from Sprott Money, in which viewer questions were asked beforehand. Among the questions were topics directly related to the mechanics of manipulation and what JPMorgan intended to do with the silver I claim the bank has amassed. It's in both written and audio form.

<http://www.sprottmoney.com/blog/ted-butler-coming-end-of-august-2015.html>

As far as this Friday's COT report, I have no firm expectations in gold or silver, but will be quite surprised if we don't see significant managed money buying in crude oil, particularly in the form of short covering.

Ted Butler

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Silver – \$14.65 (50 day moving average – \$15.05)

Gold – \$1134 (50 day moving average – \$1130)

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