September 25, 2010 – Weekly Review

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Continuing an impressive month-long rally, gold and silver hit historic new price highs. Gold finished at an all-time high of $1298, up $22 for the week, after penetrating the $1300 level earlier. Silver finished up almost 70 cents, to a 30 year high of $21.47. One thing to be said about these prices is that very few, if any, buyers of gold can be holding at a loss, and very few silver buyers over the past 30 years are holding at a loss. All the buyers are in the green. There are not many investments one can make that statement about.

Away from the price action, trading and physical metal signposts provided additional clues for how things may unfold in the future. COMEX silver inventory totals remained near unchanged, but with the continued brisk movement and turnover highly suggestive of tight wholesale conditions. As expected, there was a heavy inflow of some 7 million ounces deposited into the big silver ETF, SLV this week. That brings the monthly total silver deposited into SLV to 13 million ounces, after a real lull in metal inflows the prior six months. Based upon my analysis of SLV trading volumes, I calculate that more than 5 million additional silver ounces are now Â?owedÂ? to the trust.

A quick word about these actual and anticipated metal flows into SLV. I'm very encouraged by the relative brief time delays of metal coming into the trust recently based upon when they were due. This is pure speculation on my part, but I sense that the new sponsor of the SLV, BlackRock (who purchased Barclays Global Investors' ETF business a while back), is sensitive to shares being shorted in SLV that have no silver backing and is insisting the metal be deposited quicker than had been the case in the past. A couple of years ago, I detected as much as 50 million ounces of silver being owed to the trust when Barclays ran it. That's crazy and borders on fraud. Such large share shorting in SLV also raises the issue of price manipulation, especially when executed by large existing COMEX silver shorts. If I'm correct and BlackRock doesn't want that to occur again, it bodes well for the price of silver. As I said, this is my speculation, but I sense BlackRock is looking to run a clean operation.

This week's Commitment of Traders Report (COT) didn't reveal significant changes, which I interpret as good news. I had been expecting more deterioration or an increase in the commercial net short position in both gold and silver. Instead, the commercial net short position was virtually unchanged, with the big 4 shorts increasing their short position by a bit over 1000 contracts in silver and reducing their net short position by almost 2000 contracts in gold futures. Still, the COT structure in both gold and silver is near commercial shorting extremes. If we do get a sharp sell-off, commercial short seller rigging will be the only cause.

Will we get that sell-off? I don't have a clue. I don't think that's knowable. Historically, we've gotten big sell-offs when the COT is this negative. I suspect it may be different this time, especially in silver, based upon a variety of inputs. The important thing is not the near-term price action, which we can't predict or control, but how we handle it. We can't control the market, only our reaction to it. It is important that we hold silver positions that we won't have to sell in the event of an engineered price decline, and position us to be fully-exposed in the event of a silver price melt-up. How do we do that? By not holding positions on margin. Save some cash for a possible sell-off, hold call options if you have the investor profile, but most importantly Â? hold as full a silver position as possible. The one thing we must all avoid is holding too light a position if silver prices explode. Let's face it Â? silver should explode. Heck, it should have exploded long ago.

What are those factors that could overcome the negative COT structure? The list is long and familiar to regular readers, like physical tightness/shortage, investment flows, short covering, user panic and the potential for real regulatory reform. But, it seems to me, these familiar factors have an added sense of urgency about them. For instance, the continued turnover of COMEX silver inventories and the sudden inflows into the SLV, coupled with JPMorgan's very notable taking of delivery on the September contract bolster the physical tightness argument. And please remember, the physical silver shortage is more powerful than any single factor. No entity can stop a worldwide silver shortage once it starts in earnest, only a high enough price. It just feels that silver tightness is more critical than ever.

The two-year anniversary of the formal CFTC silver investigation, coupled with statements of an expected announcement of some type soon could be a surprise factor. Certainly, I think few (away from you) understand the significance of the coming position limit mandate and how quickly it must unfold. In the very near future (months, if not weeks), we will start the open discussion on position limits and the majority should be jolted with its significance and/or price impact on silver.

We could be very close to a short-covering event. The big concentrated silver short position is a two-edged sword to the commercial shorts. Being able to short in unlimited quantities brings price manipulation power, especially when the technical funds have been historically so compliant. However, the recent price rally has caused the 8 big commercial shorts financial damage, with the potential for a lot more pain. Just like any cohesive group, the big commercial short chain is only as strong as its weakest link. As of the latest COT, the eight largest COMEX silver shorts hold over 343 million ounces net short. Every dollar rise from here brings the group $343 more in margin calls, on top of the $1 billion they are out over the past month (silver alone; add $2 billion including gold). Even the smallest of the big 8 is out tens of millions of dollars with open potential exposure of much more. Who can say when such a distressed player might throw in the towel? That would immediately pressure the remaining commercial shorts, perhaps to the point of group disintegration. Such a process, should it occur, would be rapid, resulting in a silver price explosion. If and when smaller commercial shorts throw in the towel, the only way to prevent a price melt-up would be if the larger commercial shorts take on significant additional shorts. But the position is so concentrated now, as to argue against a further dramatic increase in the concentrated silver short position. Is JPMorgan going to end up with 100% of the commercial short position?

Something I don't often mention is the non-commercial shorts. In addition to the big 8 commercials holding 343 million silver ounces net short, there is a sizable short position held by large reporting non-commercials and the non-reporting traders. I don't normally mention this additional net short position because it isn't concentrated and, therefore, is not a part of the manipulation. But that doesn't mean it is not a powerful potential price force. This additional combined net short position amounts to some 135 million ounces (27,000 contracts).
While not manipulative, this additional short position is also under stress due to the price rally. At $135 million for each dollar move in silver, this short position can be expected to add great buying pressure if prices rally further. The total net short position in COMEX futures is 478 million ounces. A $10 move would put these shorts $4.78 billion in the hole, if they didn't cover. I know we're all nervous being long silver because of a possible temporary sell-off. Try to imagine how nervous you would be if you were short silver? Talk about needing a drink.

Gold's move to all-time highs has garnered significant attention, as should be the case. However, it is important to put things in proper perspective. Over the past month, as gold has surged to a series of new historic price highs, silver has actually out-performed gold by three times, with silver up almost 20% since August 23, versus gold's 6.4% rise. I'm not one to over-analyze short-term price performance, but given all the factors, I think this is a harbinger of things to come. While many have started talking of silver doing better than gold, very few suggest you sell gold and buy silver. It's almost blasphemy to suggest a sale of gold in any way, but unless you do so to buy silver, it matters little if silver outperforms. And please remember, I'm talking of a physical sale of gold to buy silver, not some margined COMEX spread trade.

While there has also been a recent notable increase in public commentary about the investment merits of silver, due to its price action, I am flabbergasted by the lack of substance in that commentary. Just yesterday, on CNBC, I watched a featured interview in which the reporter asked a stock market trader/analyst what we used silver for. Was it solely used for jewelry or did it have any other uses? The trader response was honest in that he said he didn't know, it looked like a buy based upon the price action. That's an extreme example, but I have yet to hear any silver commentary in the popular media that refers to the real silver issues, such as, the big concentrated short position, the silver investigation and coming position limit resolution, the pending physical shortage or the real supply/demand situation. The coming price explosion will cause many to become aware of the real factors. As that awareness grows, more will be compelled to buy silver, as they realize there is substance behind the silver price rise. The short term may be up or down, but on a long-term basis, the big move will be up. Keep the long-term perspective.

Ted Butler

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Silver – $21.47

Gold – $1298

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