

August 10, 2016 – Another Voice

Another Voice

Last week, I highlighted three separate articles, one that explained the wide differences between the various trading months in COMEX gold (and silver) and two others that claimed the big short sellers on the COMEX were mining companies and not banks. In agreeing with the first and disagreeing with the other two, I was grateful for the opportunity to debate the issues.

I commented that we stand much more likely to learn from those with opinions different from our own, provided those opinions was backed with fact and argued reasonably. That may have been an understatement on my part, because now that I think of it, finding factual and logical disagreement with my strongest held opinions concerning silver is a seemingly elusive task that is too rarely achieved. In other words, I mostly look in vain for legitimate counterarguments to my long held findings about silver.

Please don't think I'm looking for a fight with anyone, because that's not it at all. What I am looking for is a basic, fact-filled alternative presentation to the continuing narrative that I report on in silver. The last thing I seek is to miss something so basic as to render my analysis damaged and uncorrected. If I'm wrong about something important, I want to know that more than anyone else. In fact, it's kind of a sickness – I'm always on the hunt for disagreement and mostly unhappy that there is usually little such disagreement available.

So, in that sick sense, today I'm a happy camper because I did run across a detailed disagreement with perhaps my most basic finding about silver, namely, how it is not only undervalued on an absolute price basis, it is vastly undervalued relative to gold. Until now, I've never uncovered a convincing case that argued silver was overvalued relative to gold. I believe I can shoot more holes in this particular disagreement than in a block of Swiss cheese, but that determination, of course, is up to you.

You should know that I'm a fan of Otto Rock, the Internet name of the author of the article and proprietor of the web site IKN (Inca Kola News), which mostly deals in mining issues in Latin America. Otto is witty and professional. While he is no doubt genuine and sincere in his panning of silver, he is mistaken. I would ask you to take the time to read his case against silver relative to gold.

<http://incakolanews.blogspot.com/2016/08/keith-neumeyer-is-plain-wrong-about.html>

IKN lists four different reasons for why the silver/gold price ratio is unlikely to tighten (as I have long suggested) that I will deal with point by point. But I will admit that I happen to agree with the finding in the lead up to the four main reasons, namely, that silver's 9 to 1 production ratio to gold in physical ounces is not a particularly compelling argument in favor of the silver/gold price ratio tightening. Please know that I may have referenced the actual 9 to 1 silver/gold production ratio in the past (many years ago) as it does sound meaningful, but I haven't done so recently in making the case for silver over gold.

There are plenty of solid reasons silver should vastly outperform gold, but the actual production ratio of each isn't among those reasons for me. The example I would use is that gold's annual 100 million ounce world mine production is more than 15 times larger than the annual mine production of platinum or palladium and instead of each selling for 15 times the price of gold, each trade at big discounts.

When it comes to production ratios in silver versus gold, I am absolutely convinced there is a much more important factor — actual availability of total production in each for investment. Simply put, most or all the gold mined annually is available for investment, all \$130 billion, including jewelry bought in the East for investment purposes. It's different in silver because, as an industrial commodity (which gold is not), one must first remove total industrial and other fabrication demand from total silver production to properly assess investment availability. When you do this in silver, of the near one billion oz annual silver production (mine plus recycling), the —left-over— amount of new metal available for investment is only 100 million oz, or roughly \$2 billion in dollar terms versus the \$130 billion of new gold each year. It seems obvious to me that with so little new silver available for investment compared to gold, the impact on price would be much greater in silver.

The first reason given for why silver is not undervalued relative to gold is because humans prefer gold over silver. In some instances that may be true, but in many ways it comes down to color preferences. I suppose yellow is better when talking about hair (blonde versus white), but not when it comes to teeth or skin (jaundice). No doubt gold is more valuable than silver in terms of price, but the very debate is if that is valid.

I imagine many people prefer gold over silver for jewelry, but owning not a bit of each as jewelry makes me unqualified as a judge. I do know my wife has each and would never rely on me for what she should wear in any event. Certainly, as a commodity analyst, I could care less about color than just about any other factor. Also, I don't accept that gold has a richer history than silver because each dates back thousands of years, even predating the ancient Egyptians. Jesus Christ was betrayed for thirty pieces of silver, not gold. I can't argue that greater wealth is represented by gold than silver in terms of weight and if one were looking to bribe a border guard, then gold coins would be better. Then again, I don't face any border guards when travelling between Maine and Florida.

I don't deny that more people own or want to own gold than silver, but on its face, that has little to do with future changes in the silver/gold price ratio. Not only do more people own gold than silver, most governments do as well. In fact, the lack of silver ownership by any government or central bank precludes it from being sold or called upon in the event of a physical shortage or investment boom. Therefore, I have to dismiss IKN's first reason as not grounded in fact and as rooted in personal preference.

The next reason given by IKN for silver not to vastly outperform gold is the "rarity premium," implying that gold is more rare than silver. Huh? The only problem is that IKN fails to provide any substance behind gold being rarer than silver other than the price of gold is much higher than silver's. In fact, this is the key issue and is easy to substantiate in favor of silver.

When silver is said to be an industrial commodity (IKN's point three), that means, just like all other industrial commodities, it is consumed industrially. Gold is not considered an industrial commodity because only around 10% of its demand comes from industrial consumption. After more than a century of industrial silver consumption, guess what? Most of the world's total silver bullion inventory has been used up. At the start of World War II, the world had ten billion ounces of silver in total inventories, with the US Government holding nearly 5 billion oz of the world total. Today, the USG holds zero silver and documented world inventories are somewhere between 1 to 1.5 billion oz.

Seventy five years ago, there were 1.5 billion oz of gold in the world in all forms. Today, because so little gold has been industrially consumed over the years, the total amount of gold aboveground is 5.5 billion oz or more than 3.5 times the amount in 1940. The amount of silver in the form of 1000 oz bars went from 10 billion oz to little more than one billion oz, a drop of 90%, while the total amount of gold increased by 350%. Why would gold and not silver have a rarity premium?

The fairest measure of rarity, of course, is in a straight up money comparison. Which is rarest in dollars and cents? Gold's 5.5 billion ounces are currently worth more than \$7 trillion (\$7000 billion). The 1.5 billion silver oz thought to exist in the form of 1000 oz bars, is worth around \$30 billion. In terms of dollars and cents, gold is 230 times more plentiful than silver. Yes, I'm comparing all gold with only silver in the form of 1000 oz bars, because this is the form of silver that sets the price. It is the form of silver the industrial users will seek to buy in the event of a physical silver shortage.

Not that it matters much, but in this section, IKN misstates the actions of Warren Buffett in purchasing silver as a "quick trade" he sold in 2007 because the carrying costs were so large. As regular readers know, Buffett held the silver for ten years and lost it because he was so heavily involved in trading against the technical funds on the COMEX, and got caught heavily short and was forced to deliver his physical silver holdings. Buffett made a fortune trading against the technical funds for ten years and the 0.5% annual cost to carry silver was no factor at all. To this day, I don't understand how anyone could accuse an investor considered by many to be the best in the world who bought silver but disdains gold as being a dummy. If you read the real reasons Buffett bought silver and not gold (in his own words) and fail to agree with him, please reread those reasons. Just saying.

Reason number three for IKN's pan of silver is because it's an industrial commodity and gold is not, as I just covered. Here, IKN misses the obvious in calling silver a "quasi-commodity." I think what Otto meant was that silver is a rare dual-use commodity "a vital industrial commodity and also a prime investment asset. That's not bad for silver, but instead adds a high price potential kicker. Being an industrial commodity with potential investment demand is the main reason to hold silver.

As I quoted Steve Saville in last week's piece, any commodity that is industrially consumed is capable of going into a physical shortage. Silver is an industrially consumed commodity and gold is not, as IKN agrees. Therefore, it would be hard, if not impossible for gold to develop into a physical shortage, since little of it is consumed industrially, which means there is more gold in the world every single day since the dawn of man (excepting the occasional sinking of a treasure ship). That's not to say gold can't go up in price and perhaps up sharply; just not because of physical shortage. Neither Saville nor IKN argues otherwise. The most bullish factor is should (when) a silver shortage develop, the buyers will include both investors and industrial users in intense competition.

IKN's reason number four for silver to underperform gold is that it is much cheaper than gold to produce. I accept that silver is cheaper to produce than gold, but so what? Or more specifically, the only way production costs would matter is if the price of the commodity in question was so low as to suggest a curtailment in production. We were at such levels recently in both gold and silver, but not so much now, so it seems production costs are not so relevant currently. Certainly, should investment demand surge for gold or silver, production costs will take a further back seat in the pricing equation.

Much is made by IKN of silver's by-production profile, meaning that close to 70% of world silver mine production comes as a result of being a by-product of lead, zinc, copper and gold production. This by-production profile is neither bearish nor bullish on its face and is more a statement of the price inelasticity of silver's by-production profile. Yes, if silver declines in price below its primary mine cost of production, but the price of other commodities stays high enough, there should be little silver lost in by-product production. Then again, should silver soar in price, there would be little increase in by-product silver output. Silver's by-production profile is likely to be felt more on the upside than the downside in price, but in any event isn't always bullish or bearish.

One issue where I do strongly disagree with IKN's take is the amount of time necessary to increase silver mine production in response to higher prices. Another is the thought that gold miners will perform better than silver miners. That hasn't been the case this year and I do note that IKN seems to place a lot of emphasis on what prices have done recently. Otto does mention the topic of manipulation, but quickly dismisses it as occurring in all markets. Of course, that leaves unexplained factors highly unique to silver, such as an impossible to explain concentration on the short side of COMEX silver futures.

I may be glossing over other things, but I am tickled pink by the different take by IKN on the prospects of the silver/gold price ratio. Too often disagreements lead to personal insults and Otto avoids that. But by leaving out the most important factor of all, the probable and I would say inevitable physical shortage in which industrial users panic to build physical inventories as a way around delivery delays, IKN misses the boat. Otto is correct that industrial users would never complain about low silver prices, but when a physical shortage develops (as came close in early 2011) and needed deliveries are delayed, the users will be aggressively trying to stockpile physical silver inventories in lieu of shutting down production lines. That's the main reason to hold silver. All this has to do, of course, with silver outperforming gold in the long run, as the short term is anyone's guess.

On to developments since Saturday. The new report covering short positions in stocks, as of July 29, indicated reductions in the short positions of both SLV, the big silver ETF and in GLD, its gold counterpart. SLV's short position decreased by more than 2.8 million shares to 10.7 million shares (ounces) nearly erasing the big increase in the prior period. The short position in GLD fell by nearly 1.3 million shares to 13.9 million shares (1.3 million oz) after surging by 4.6 million shares in the previous reporting period.

<http://shortsqueeze.com/?symbol=slv&submit=Short+Quote%99>

Since price action in the two week period ending July 29 was first weak, then strong, I wasn't sure what to expect in the new short report. Overall, the short position in SLV looks low on an historic basis, particularly as a percent (under 3%) of total shares outstanding (370 million). I would still prefer no shorting in these securities at all, since such sales result in metal not backing some shares, but I've howled at the moon enough on this issue and will refrain from howling again unless the short position expand meaningfully.

There are still unusual and somewhat conflicting signals emanating from the COMEX August gold deliveries. A client (or clients) of JPMorgan has once again emerged as the largest stopper (acceptor) of gold deliveries this month at 3222 contracts (322,000 oz) and based upon recent daily delivery allocations looks set to take as many as 2000 more gold deliveries. Plus, JPM's client(s) appears back to adding new contracts in August, so the number of gold deliveries could grow even larger.

http://www.cmegroup.com/delivery_reports/MetalsIssuesAndStopsYTDReport.pdf

The COMEX delivery action this month continues to exhibit characteristics of physical gold tightness, the same as has been the case for months. Larger quantities of physical gold have been issued and stopped in the most recent COMEX delivery periods than at any time in memory. Make no mistake, these are very large quantities of physical gold changing ownership. Not much of the gold changing hands has been physically moved, except for the quantities that JPM took delivery of in its own name, but that is a separate issue. To be fair, the quantities look big from both sides, as to unusual buying demand and also the apparent easy availability of gold supplies. The big question, of course, is who the big client(s) of JPM may be, but I know of no way to uncover that at this time.

At the same time the August COMEX gold delivery reeks of continued physical tightness, someone appears to be backing out of pending physical gold demands in the September contract. The open interest in this very non-traditional delivery month has fallen nearly in half over the past week or so to around 5400 contracts. It is reasonable to assume a very large number of contracts were created in the September trading month for delivery purposes, as opposed to trading purposes (as why else trade in illiquid trading months?). Now it looks like someone changed their mind about taking delivery in the September COMEX gold contract, but it's impossible to know why. Strange things are happening.

One thing that appears reasonably certain is that the COMEX gold deliveries are mostly between the largest banks and/or their clients, as opposed to other parties transacting the bulk of COMEX futures contract positioning. In other words, there are two separate games playing out – the unusual COMEX physical gold deliveries between a very small number of banks and the futures contract positioning between the commercials (the banks) and the managed money technical funds. I don't see any signs that the managed money traders are involved in COMEX gold (or silver) deliveries.

I don't know how to reconcile the two separate COMEX games, although I am fairly certain there will be a final resolution involving both games – futures positioning and physical delivery developments. Therefore, both games must be followed. The data concerning the COMEX futures positioning money game are the easiest to follow. Last Friday's close indicated that the commercial shorts were in the hole by a combined \$2.5 billion in COMEX gold and silver, having recovered \$700 million on last week's price decline.

The sharp rally through today has erased much of last week's comeback by the commercials and puts them back in the hole by \$3 billion in unrealized losses, not the deepest they have been in the hole (\$3.8 billion), but not that far away either. The fact that one of the big 5 thru 8 gold shorts recently bit the dust would seem to support the notion of commercial financial stress and the high stakes involved. For this reason, a continued focus on the commercials' financial status seems imperative.

It is relatively straightforward calculating open profits and losses in COMEX gold and silver because the data and price changes are easy to measure and because all derivatives contracts are zero sum – what the longs lose the shorts make and vice versa. It's a wonder more don't do the calculations. But futures positioning is more transparent than in other markets. Earlier in the year I reported how Jim Cook opined that JPMorgan or others may have bought significant non-reporting quantities of mining stocks. If so, perhaps gains on mining stocks may have offset futures losses. I can measure collective futures market financial performance, but not in other markets.

There are those pounding the table about an imminent collapse in gold and silver prices because of the current market structure. There are others declaring we will g

Date Created

2016/08/10