August 20, 2014 – The Coming Silver Bubble

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I thought I would take a break from discussing the ongoing manipulation of the price of silver to present a longer tem perspective Â? my conviction that silver will likely develop into an asset bubble; perhaps the greatest asset bubble in history. Actually, I've written of this before, some five and six years ago, in a number of articles dealing with asset bubbles.
http://news.silverseek.com/TedButler/1212510161.php
http://www.investmentrarities.com/market_update_09-2009early.shtml

Between mid-2008 and mid-2009, the price of silver ranged from $16 an ounce to as low as $9 and subsequently climbed as high as $49 two years after the last article in September 2009. Now that most of those previous gains have evaporated, I feel it's a good time to review the bubble thesis. One important point to make upfront is that silver was not remotely close to having been in a bubble at the time of the price highs of April 2011. The bubble still lies ahead.

Asset bubbles have become a regular feature in the recent financial landscape. Less than 15 years ago, an asset bubble had developed and burst in Internet stocks, to be followed shortly thereafter by a bubble and collapse in residential real estate in the US to name just two bubbles. Some would claim we are presently engulfed in asset bubbles in stocks, bonds and high end real estate as a result of an over accommodation of monetary stimulus by the Federal Reserve and other world central banks. Time will tell, but it seems undeniable that we have recently experienced our fair share of asset bubbles; phenomena generally rare in historical terms.

What is an asset bubble? An asset bubble occurs when a large number of buyers, normally not usually prone to speculate in an asset, bid the price of that asset much higher than underlying valuations would support, most often fueled by leverage or borrowed money. Typically, towards the terminal phase of the bubble the most compelling reason for continuing to buy the asset is due to the rising price itself, as all caution is thrown to the wind amid the collective belief that prices can only move higher still. Then, when the last possible speculator has purchased the asset, the inevitable occurs and the price of the asset collapses as previous buyers turn into sellers and attempt to get out.

Since the formation of the bubble and its inevitable collapse are driven by the collective emotions of greed and fear, it is generally impossible to predict how long an asset bubble will persist and how high the price can climb, as well as the timing and extent of the subsequent collapse. Since asset bubbles are rare and involve tremendous percentage increases and subsequent spectacular busts, it can be stated that more money can be made and lost in bubbles than in any other investment phenomenon. I guess the key to profiting from a bubble is to both buy and sell before the bubble bursts.

How do asset bubbles develop? Most often, an asset bubble develops when an undervalued asset which has a compelling investment story and there exists an overall financial environment of sufficient buying power, catches the collective interest of the crowd. For example, by the mid-2000's and after years of steady appreciation, residential real estate developed into an asset bubble amid the self-fulfilling cycle of continued gains and the availability of easy credit.

Owning a home had been a good deal, typically becoming the largest asset for most people and in retrospect it is easy to understand why it became overdone, as many leveraged their homes to move up or buy additional houses to take advantage of the growing collective belief that real estate only went up. More than anything, real estate had a great story in both providing shelter and capital appreciation, complimented by a favorable tax angle. But the subsequent bidding up process and overinvestment created an overvaluation which couldn't support the never ending appreciation. Because residential prices rose too high, the basic real estate story became distorted and eventually collapsed. That's the basic theme with bubbles; an undervalued asset with a great story becomes too popular and is bid up to the point of overvaluation.

As far as great stories go, silver has the best potential story to develop into a bubble. First, there is little argument that it is among the most, if not the most undervalued asset of all by objective relative historical price comparison. In addition, it is at or below its primary cost of production, as evidenced in recent quarterly earnings reports. Remember, most bubbles start out with an asset that is undervalued Â? on this score silver more than qualifies as being undervalued.

Aside from extreme undervaluation, the silver story is multi-faceted. Silver is both an industrial metal and a primary investment asset, the net effect being that very little newly-produced silver is available for investment, perhaps only 10% of the one billion oz produced yearly (mine plus recycling), or 100 million oz annually. In dollar terms, at current prices that comes to less than $2 billion per year. There are two ways to look at that; the observation that there are countless individuals and investment funds capable of ponying up that entire amount on their own and the fact that $2 billion amounts to less than 30 cents on a per capita basis for the world's 7 billion inhabitants. Simply put, there is no other asset class which would require less buying to develop into a bubble than silver.

Apart from newly-produced silver available for investment, the amount of previously produced metal available for investment, or world inventories, is also shockingly low. As a result of a 65 year deficit consumption pattern that ended in 2005, world silver inventories have been depleted by 90% from the levels existing at the start of World War II. Today, only a little over one billion oz of metal in accepted bullion industrial form exists with perhaps another billion oz existing in coins and bars. In dollar terms, that comes to $20 to $40 billion, where most other asset classes (stocks, bonds, real estate and even gold) are measured in the many trillions of dollars. And please, never confuse what exists with what's available for purchase Â? only the owners of the small amount of silver that exists will determine at what price it is available.

The conclusion is simple Â? the asset requiring the least amount of buying to create a bubble is, automatically, the best candidate for developing into the biggest bubble. The fuel for any bubble is total (world) buying power versus the actual amount of an asset available for purchase. Previous, as well as prospective, bubbles in stocks, bonds and real estate grew to many trillions of dollars of total valuation. At $200 an ounce, all the silver in the world (bullion plus coins) would Â?onlyÂ? amount to $400 billion, not even a rounding error to the total valuation of stocks, bonds, real estate and, even, gold. In other words, due to silver's current undervaluation and its shockingly small amount in existence, it has more room to the upside than any other asset class.

But I'm not done. Silver's unique dual role as a vital industrial material and primary investment asset creates a setup for something happening that has never occurred in any previous bubble. As and when sufficient physical investment buying develops in silver to drive prices significantly higher, the industrial consumers of silver, in everything from electrical and solar applications to medical and chemical applications, will likely be subject to delays in the customary delivery timelines of the metal. As is almost always the case, whenever industrial consumers of a commodity are deprived of timely deliveries, they resort to stockpiling that commodity as a remedy, further exacerbating delivery delays to other users.

Thus, the stage is set for something the world has never experienced previously – an asset bubble accompanied with an industrial shortage. The two greatest upward price forces known to man, an asset bubble and a genuine commodity shortage, appear set to combine in silver. Either one, alone, would have a profound impact on the price, but the combination seems both inevitable and almost impossible to contemplate in terms of how high the price of silver could be driven. And it's hard to see how intense investment buying wouldn't trip off industrial user attempted inventory stockpiling or vice versa; it doesn't matter which comes first.

Tying everything together, there is one and only one explanation for why silver is so undervalued and the asset bubble/industrial shortage hasn't occurred yet Â? the ongoing price manipulation on the COMEX. Massive amounts of paper contracts traded between two groups of large speculators (technical funds and commercials), measuring in the hundreds of millions of ounces and completely unrelated to the supply/demand fundamentals have set the price of silver. This COMEX price control is both the curse and the promise in that it not only explains the undervaluation, it will explain why it seems inevitable for an asset bubble/user shortage to develop.

Think of it this way Â? the asset with the greatest potential for becoming the biggest bubble ever had better have the greatest story ever as well. And that is what the COMEX silver manipulation is Â? the key ingredient in the greatest investment potential score ever. If silver wasn't manipulated how good would the story be? Absent manipulation, I wouldn't buy or hold silver because that would mean that free market forces were setting the price all along. In other words, if silver wasn't manipulated there would be scant reason to buy it in my eyes. If I wasn't convinced silver was manipulated, I can't see how I would have ever written this or anything about it in the past or could have become interested in it in the first place.

As painful as recent prices have been to existing holders because of the manipulation, without it there would be little chance for a price explosion at some point. The easiest major potential change in the silver price equation is for the manipulation to end, one way or another. And if history and logic win out, the silver manipulation must end, not the least because of the coming clash between paper and physical silver. Some call it the disconnect between paper derivatives contract on the COMEX and actual physical silver, but in reality the story is that COMEX futures contracts are very much connected to each other via the delivery mechanism.

The connection between paper and physical has been forged because the main COMEX futures speculators are only interested in trading paper futures contracts and not in trading physical metal. Technical funds have no desire to buy and sell real metal for full cash payment when they can deal in paper contracts for only 10% cash down because they are trading, not investing. The problem is that the trading between the technical funds and the commercials has become so large that it dwarfs real world silver supply/demand fundamentals and ends up setting the price of silver in violation of commodity law. I know that this perversion of the price-discovery process has existed for a long time, but it would be wrong to confuse longevity with permanence.

The fact is that while the COMEX paper market dominance has lorded over the real supply and demand fundamentals, the stage has been set for a physical asset bubble/industrial user panic event. I've become convinced that any prospective bubble in silver won't be driven by the aggressive buying of COMEX futures contracts, but only by physical buying. For one thing, the crooked CME and CFTC would never allow any group of traders to drive silver prices sharply higher by buying unlimited amounts of COMEX futures contracts. If the technical funds do buy big amounts of COMEX silver futures contracts (as was the case from June to mid-July), you can almost be certain that the CME and CFTC knew that those funds would be soon forced to sell on lower prices (that's not to say the regulators and commercials couldn't turn out to be wrong).

As a result, any bubble in silver must and will develop from physical investment buying. Surely, any industrial user inventory buying panic must involve immediate physical delivery and not a paper futures contract in a time of delivery delays and uncertainty. In fact, it is hard to imagine, as a silver bubble begins to develop, a greater urgency for holding only physical metal to intensify, due to a growing recognition that the COMEX manipulation was responsible for the former low price.

Since I am speaking in terms of a potential historic asset bubble in silver, I am implying that the price of silver will far exceed its true value at some point before correcting sharply. It is before that collapse point, that God-willing, I intend to sell. I am not deluding myself that I will come close except hoping not to be terribly early or late. While I respect anyone's reasons for buying and holding silver, my mission has always been to help end the manipulation and be done with silver after that was accomplished and reflected in the price.

A few comments on developments this week. I'm scratching my head at Monday's 3 million oz deposit into the big silver ETF, SLV, following a 4 million oz deposit in the previous week. Trading volume in SLV has been light and price action rotten, not the ingredients for the 7 million oz deposits being due to plain vanilla investment buying. The only plausible alternative explanation is that then deposits are intended to reduce the short position in SLV, last reported at 17.37 million as of July 30, although only the first 4 million oz deposit occurred before the next report on August 26. At least the combined 7 million oz deposit is within the confines of reducing a 17 million oz total short position. If the deposits are not intended to reduce the short position, then I am at a loss to explain why they occurred.

This week's COT report should show hefty reductions in the total commercial net short positions and managed money net long positions in COMEX gold, silver and copper, as key moving averages were penetrated or new lows were made in all three metals. It looks like copper was the most advanced in the managed money selling (which perhaps explains the sharp bounce back today in copper prices), followed by silver.

On a relative basis, gold is the least advanced in the liquidation process since it has hung above its 200 day moving average so far. Accordingly, there is more relative potential selling ahead in gold since it is closer to its recent technical fund net long high point than is COMEX copper or silver. Unfortunately (unless you plan to buy), the short term probabilities still favor technical fund selling in silver and gold (and probably copper) on lower engineered prices by the commercials.

Ted Butler

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Silver – $19.47

Gold- $1292

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