August 24, 2016 – Still Unresolved

Still Unresolved

We've been in an extreme market structure, considered bearish on a historical basis, for most of this year; having started out the year the most bullish the structure had ever been in COMEX gold and silver. By March, the structure got bearish, as gold was up $200 and the commercial net short position grew by 200,000 contracts (20 million oz). In silver, by March the price was up by $3 and the headline COT number grew by 40,000 contracts (200 million oz).

At that point, it was reasonable to expect some correction in price, based upon historical parameters. Not only was there no correction (until May), but prices ran $100 higher in gold, as more than 100,000 additional commercial contracts were sold and another $3 higher in silver on 35,000 additional contracts of commercial selling (and technical fund buying). In the process of establishing the largest positions in history, the managed money technical fund longs held the largest unrealized open profits ever, while the commercial shorts held the largest open losses, exceeding $3.8 billion at the price highs.

Given the historical extreme market structures, it's been a case of waiting for a resolution that would relieve the positioning and financial pressure. Would the commercials lose for the first time and rush to cover to the upside or would they manage to induce technical fund selling to the downside at some point with little financial damage? Unfortunately, COT resolutions are not time constrained, sometimes occurring at times almost between COT reports and other times stretching to many months. This forces everyone to wait and watch.

As I start this article today, silver has traded below its 50 day moving average for the past three days and gold has just penetrated its 50 day moving average for the first time since late June or earlier. I'll come back to current pricing later, so let me comment on a few things related to how the coming resolution might develop. Before I do that, I'd like to point out a development in keeping with last week's article about a user buying panic to come in silver. It concerns an article in the Wall Street Journal about Volkswagen's automobile production being impacted by a potential parts shortage.

http://www.wsj.com/articles/vw-supply-dispute-affects-27-000-1471880832

Summarizing the article, a contract dispute with two parts suppliers was resulting in production cuts affecting tens of thousands of workers. So potentially significant were the production cuts that it had attracted the attention of the German government, which urged both sides to resolve the issue. Modern manufacturing processes are so specialized and reliant on just-in-time inventory shipments that the lack of a single component throws a real monkey wrench into the works, threatening workers and the assembly line. In Volkswagen's case, the parts shortage was the result of a contract dispute, which by definition was unique to Volkswagen and no other automobile manufacturers were involved.

Now consider a shortage, not of a manufactured component specific to one company, but the shortage of a material common and necessary to many other companies and not just other automobile manufacturers. Rather than voluntarily putting themselves out of business and sending employees home, a good percentage of companies dependent upon silver would move heaven and earth to secure supplies and keep their assembly lines open. That's what caused palladium prices to jump tenfold and rhodium prices to jump twenty fold on two separate occasions absent investor demand. With investment demand, why couldn't silver jump ten or twenty times or more in price?

Back to things related to the extreme COMEX market structure and how it might be resolved. In essence, I'm looking for signs that suggest whether the commercials are in control or hanging on by their fingernails, about to be run over to the upside. The strongest component of the commercials getting overrun premise is the large open losses they have held on their massive gold and silver short positions, as chronicled on these pages. That, plus the fact that one of the big 5 thru 8 gold traders did bite the dust, confirmed that the large unrealized losses were no minor matter.

The strongest argument that the commercials are in control is the fact that they haven't been fully overrun yet (despite the one commercial failure). With the mathematical certainty that over time, the moving averages must and have moved higher, sooner or later the technical funds will demonstrate what they will do as the key moving averages get penetrated to the downside. Back in May, nearly 80,000 contracts of commercial shorts were covered on the $100 drop in the gold price and nearly 20,000 commercial contracts were bought back in silver on the $2 drop from the highs. Then, we were off to the price races again.

The key question is how many managed money technical fund contracts will be sold as the moving averages are violated Â? the same, less or more than in May? I don't think there is a way of knowing that in advance, so the best I can do is lay out the probabilities and price alternatives. If the commercials can only buy back the same or a lesser number of contracts they bought on the decline in May and we then make new price highs, the commercials will be in real trouble. An overrun would seem likely.

If the commercials end up getting much more managed money selling on this go around, then the price decline should be greater than seen in May and the commercials will likely emerge financially intact. I admit to not knowing which it will be, but I still cling to the premise that a sharpish selloff is likely to be the last such selloff.

One of the signs pointing to the commercial still being in control is the very wide price differentials between the various trading months in COMEX gold and silver futures contracts. I cited Paul Mylchreest for bringing this issue up some weeks back and for reminding me of something I forgot. Currently, we are in the midst of an important rollover period in COMEX silver from the expiring September contract to the December contract. Since this week is the most active rollover period, what the spread differentials are now is what matters most. And, in a word or two, the spread differential between Sep and Dec silver is crazy wide Â? wider than I would have ever imagined.

Yesterday, the Sep/Dec spread differential settled at a 14.3 cent premium to the December (it's slightly tighter today). Annualized (x 4), this is a 57.2 cent premium, or the equivalent of 3% in a zero interest rate world. As Mylchreest indicated, the only reason the spread is so wide is because it is very beneficial to those who are short (the commercials) and very costly to those long (the technical funds). That's because a short holder rolling over gets to reset his short contract at a higher price and longs must pay up to maintain a long position. How beneficial (or costly) are the current silver spreads? (By the way, the same situation exists in gold). Should the spreads be maintained for a full year, it would benefit the silver shorts and punish the longs to the collective tune of $285 million annually (57.2 cents x the 500 million oz net short position).

Instead of trading at 14.3 cents, the Sep/Dec spread could just as easily trade at one or two cents and no one would even notice. The only reason the spread is so wide is because it benefits the big silver shorts and those big commercial shorts set the spreads wherever they desire. You can be sure that if the commercials were long and the technical funds were short (as was the case at year end), the spreads would be tight or even with the nearby at a premium, because tight spreads hurt the shorts at rollover time (as Mylchreest indicated).

Two points here. One, this is further clear proof of price manipulation on the part of the commercials (think JPMorgan), with the spread manipulation separate from but related to the overall price manipulation. In fact, it can't be anything else. Two, the wide spread differentials indicate that the commercials, being in control of the rollover process, may be in control overall on the COMEX and not hanging on by their fingernails.

Another sign the commercials may be in overall control in gold and silver is that they seem to be in control in other markets, like COMEX copper and NYMEX platinum, palladium and crude oil. There is a remarkably similar price profile and market structure in the futures-traded precious metals that can't be explained by supply/demand fundamentals or news Â? only CME positioning comes close to explaining this phenomenon. Unfortunately, price declines in the precious metals would benefit the commercials most.

I would consider the deciding factor to near term price direction to be JPMorgan. The fact that Silver Eagle sales have fallen off the cliff seems directly related to JPM stepping aside as the big buyer. Already, those not familiar with JPMorgan's involvement are calling the sales decline as evidence of weak demand and being bearish in nature. I would concede that to be more than coincidental in that by stopping Silver Eagle purchases, JPMorgan may be trying to influence prices to move lower .

The key is trying to decide what is best for JPMorgan. Particularly in silver, the bank owns enough actual silver that a price explosion at any time couldn't possibly hurt it. On the other hand, since JPMorgan appears currently to hold elevated short positions in COMEX gold and silver, a price decline in which it could buy back at least its recently added COMEX short positions would appear to be right up its alley. More and more, analysis in gold and silver revolves around what's best for JPMorgan, as sick as that is.

Based upon the public data (the COT and Bank Participation Reports), what might be best for JPMorgan would be for the bank to buy back the 10,000 to 13,000 silver and 35,000 gold contracts it added since early June. Not only that, it would appear easier for JPM to buy back these shorted contracts than the equivalent 50 or 60 million silver ounces or 3.5 million gold ounces in physical metal. Of course, JPMorgan won't achieve the paper short covering unless the technical funds sell in force.

Even with Monday's 50 day moving average penetration in silver and today's penetration in gold and platinum, how this is going to play out is anyone's guess. If it unfolds as it always has prior to this year, more technical fund selling is on the way in the salami-slicing mode of the past. The only thing that would prevent that is a true black swan event away from COMEX positioning. To be objective, by virtue of the lowest prices in silver, gold, copper, platinum and palladium in one to two months, it must be said that the commercials have been in control, at least for this time period. If they stay in control, still lower prices will be seen.

And if we move lower in price, it becomes a matter of Â?The CountÂ? in which we try to measure the number of technical fund and commercial contracts sold and bought. Through yesterday's close of the reporting week, I would anticipate a sharper relative improvement in silver compared to gold in Friday's new COT report. Given the penetration of the 50 day moving average, a reduction of 5,000 to 10,000 contracts in the commercial total short position in silver would not be surprising. Regardless of the actual number, the market structure will remain extreme.

Today's (and this week's) price decline does reduce the unrealized dollar loss to the commercial shorts in gold and silver. At today's closing prices, the commercials reduced their open and unrealized combined losses in gold and silver by $800 million this week, from Friday's $2.5 billion level, to $1.7 billion. Since the commercials were out a combined $3.8 billion at the price peaks, the recovery of more than $2 billion is no small matter. Still, $1.7 billion is the most the commercials have ever been out prior to this year, so these market crooks may not yet be out of danger.

I continue to believe gold and silver price movements and levels are best explained by COMEX positioning. If there is a better framework for analyzing gold and silver than this COMEX positioning, I don't what that framework is.

Ted Butler

August 24, 2016

Silver – $18.55   (50 day moving average – $19.37)

Gold – $1323   (50 day moving average – $1328)

Date Created
2016/08/24