

August 3, 2011 – Volatility and Still Intact

Volatility

One of the themes of the most recent weekly review was that we should expect great volatility in the price of gold and silver, based upon the market structure on the COMEX, as depicted in the COT report. It didn't take long for those expectations to be realized, as there haven't been many days more volatile than yesterday's \$40 increase in gold and \$1.50 in silver. If history is any guide, volatility tends to beget more volatility until it burns out. Please adjust your expectations accordingly.

I've received a larger number of very thoughtful reader comments on what to do next in connection with the regulators' lack of action or response to the increasingly obvious manipulation in silver (and gold). Let me think about it more. I plan to share some of those thoughts from readers here. One reader did ask something that I had temporarily overlooked, namely, the beating the shorts took on yesterday's price jump in gold and silver. In brief, that beating was severe, particularly for the largest gold and silver shorts.

It's no secret that I focus on the concentrated short position in silver more than I do in gold. That's because on every reasonable measure, the short position in silver makes a more compelling case for manipulation on a relative basis. But since silver is a much smaller market than gold, its short position is smaller than gold's on an absolute dollar basis. In other words, the dollar exposure risk is larger for the big gold shorts (until silver makes a truly extraordinary move higher).

Using data from the latest COT, the 8 largest shorts in COMEX gold futures hold a net short position of nearly 25 million ounces. The 8 largest COMEX silver shorts held 230 million ounces net short. Based upon yesterday's \$40 move in gold and \$1.50 move up in silver, the big gold shorts lost \$1 billion (25 million oz x \$40) yesterday, with the big silver shorts out an additional \$345 million. This is a very large combined daily loss to the big 8, the largest I remember. Of course, we can't know if the same 8 big shorts in gold are the same as in silver, but I wouldn't be shocked if they are the same, or at least if there is some overlap. We do know that all COMEX positions are marked-to-market daily, meaning the losses must be deposited or made good with the clearinghouse daily. The large daily change in the equity of the big 8 short holders in gold and silver puts them further in the hole on their collective trade. Therefore, the danger to the market has increased.

The danger to the market was the main theme in my last report. What is the danger exactly? One danger is for a large sell-off in the event the big 8 short traders can engineer (in collusion with the raptors) a deliberate weakening of prices sufficient to trick and scare the technical longs into selling. This version is the usual outcome. The flipside is a danger that the largest 8 shorts can't pull off a manipulative selloff and they panic and rush to buy back short positions, driving the price sharply higher. While that wouldn't seem to be a particular worry to silver investors, it may raise concerns about disorderly market conditions and even potential systemic risk.

Certainly, the public would have been better off had the large concentrated short positions in gold and silver never been allowed to exist in the first place. This is where the CME Group and the CFTC have been most negligent; they both looked the other way as this concentration developed. But they can't turn back the clock and undo the dangerous short concentration. Neither can we. All of us are forced to deal with the reality of a dangerous concentrated short position. What the regulators should do (aside from never letting another concentrated short position form again) is attempt a remedy that doesn't look to benefit the collusive commercial shorts. The CFTC should be pressuring the big shorts to close out their uneconomic short positions and not permit them to rig an artificial large sell-off. That would teach the commercial short crooks a lesson they wouldn't soon forget.

To be clear, any suggestion that the big commercial shorts are simply hedging is nonsense. Mining companies, the natural hedgers in metals, are currently not interested in hedging production and hold their lowest collective hedge position in decades. Let's call it as it is: the big commercial shorts in COMEX gold and silver just take, on a collusive basis, the opposite side of what the long speculators take. The commercials are not hedging, they are speculating on the short side, just as much as the long speculators are to the long side. The commercials know that the tech funds on the long side have been tricked continuously and might be tricked into selling at lower prices again. At least, that's how it usually turns out. But this is not a guaranteed outcome. The commercial shorts can miscalculate, as has been seen in many banking debacles.

Since this process has been so repetitive, it has also become obvious to many that this is manipulation, pure and simple. Obvious to many, perhaps, but apparently not to the CFTC. That is why it is important to press the agency to end this crime in progress. I wish I could tell you which way it will play out in the short term, but I simply don't know. Long term, silver still looks higher, so you shouldn't abandon core positions. As promised, here's a piece on the long term.

Still Intact

There are two great forces in the silver market; one has a short-term influence on price and the other a longer term influence. The short-term force is largely centered on what takes place in COMEX trading of futures contracts on a day to day and week by week basis. The long-term force is based upon what happens to physical metal supply and demand over months and years. Both forces are still intact.

Human nature dictates that we are always more focused on the short term. It's just natural to dwell on the here and now. Life is meant to be lived and savored one day at a time. It is intellectually challenging and satisfying to stay up with daily developments in things in which we are interested. But we also live life over a long term and must strive to keep things in perspective and look ahead intelligently. This longer term focus is particularly relevant when dealing with investments. By process of elimination, the vast majority of investors must look to the long term as most of us can't hope to prosper by trading daily. The only fighting chance we have is to invest for the long term.

The right approach for investing in silver has been to approach it on a long term basis. Those who have done so have profited mightily. Few investments have offered a better return than silver over the past five or ten years, as silver is up ten-fold from the price lows of the past decade. These returns have been achieved in silver despite numerous dramatic price sell-offs along the way and amid endless commentary that the price of silver was too high. I believe this pattern will continue over the next five and ten years, namely, silver will continue to climb sharply in price accompanied by commentary that it won't.

Undoubtedly, there will be continuing price volatility in the short term, as the increasingly obvious COMEX price manipulation plays out. That means silver prices will jump and fall in the short term, as they have over the past ten years. But what will determine the future level of prices will be developments in the supply and demand for actual metal, including investment demand. The price of anything is ultimately determined by the law of supply and demand. It will be no different in silver.

What caused the price of silver to rise ten-fold over the past decade was the supply and demand for actual metal. Interestingly, silver supply from mine production grew significantly over the past ten years, by roughly 25%. It would not surprise me to see silver mine production grow over the next decade, at least the first half of the decade. Obviously, to see the price of a commodity rise sharply in the face of increased supply only means demand had to grow even more than supply. That was certainly the case for silver. Not only were new technological and industrial applications developed that required silver, but world population and standards of living increased as well which resulted in increased silver demand. It's hard not to imagine those trends continuing far into the future.

But for all the increased demand for silver required by new applications and world economic and population growth, the demand category which had the greatest impact on the price of silver was investment demand. This can be verified by observing the price performance of silver in the first five years of the last decade when there was no real net investment demand for silver, with the price performance of silver from 2006 onward where all the big gains occurred. What is most remarkable is that there was no true world net investment demand for silver for the 50 years before 2006. Up until that time, silver was shunned by the world's investors, save for coin collectors and some outside the mainstream investors. In fact, there was cumulative investment dishoarding in silver for the 50 years prior to 2006. Until 2006, net investment demand was not a price influence for silver.

There were several factors that turned the world's investors into net buyers of silver starting in 2006. One was the introduction of a series of investment vehicles called exchange traded funds (ETFs) which made it easy for investors to buy silver as they would a common stock. Perhaps of more influence was the growing awareness of what an attractive investment opportunity existed in silver given its relative scarcity and rarity, especially when compared to gold. In any event, a confluence of reasons caused the world to become a net investor in 2006 and that pattern has persisted and grown to this day. The key question for the next decade is whether this silver investment demand will persist?

Considering all the facts surrounding silver and the technological advances in information dissemination throughout the world, it's hard to conceive how the real silver story won't become more widespread. As the real silver story is spread, more of the world's investors will be driven to buy silver and increase investment demand. What's the "real" silver story? It's a theme that holds how little silver bullion actually exists in the world (less than in gold) and how little world production is left over and available for investment after industrial and other fabrication demand is subtracted. It is also a story that includes how the manipulative short-term influence of paper trading on the COMEX has created a better buying opportunity than would have existed otherwise. Superimpose this theme on a world increasingly wary of assets that are dependent on someone else's liability to make good and you have a picture of increasing investment demand for silver.

Sometimes it's hard to think and invest on a long-term basis in a world with a short-term attention span. For most of us, however, the long term is our only real chance for success. Fortunately, the long-term prospects for silver are still intact. What's also intact is the necessity for investors to take the time to objectively study the real facts in silver. The investors who did so in the past and purchased silver have been richly rewarded. There is no reason for me to believe those who come to grasp the real silver story and invest accordingly won't be richly rewarded as well.

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Silver – \$41.70

Gold – \$1664

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