August 31, 2011 – The Death of Liquidity

The Death of Liquidity

I know I have been on a one-track mission recently about the extraordinary development of the COMEX gold commercials miscalculating in establishing their giant short position. I know I have been virtually alone in depicting the resultant commercial short covering as being the prime price driver behind gold's $300 run from $1600 in early August. But government data still suggest that the unprecedented commercial blunder is very much at the core for explaining the volatile price action we are witnessing. Today, I would like to explore what this means for the future, even though I am on record as warning that the correct explanation for something that has occurred can be different from accurately predicting what may happen next.

Restating what I feel is the obvious; the dramatic gold rally was caused by aggressive buying by the group of speculative traders which are classified as commercials by the CFTC. Many make the mistake of assuming that just because these traders are classified as commercials that means their trading is purely for legitimate hedging purposes. Nothing could be further from the truth, as the bulk of their trading is speculative in nature. Therefore, while it would be technically correct to say that the gold rally has been caused by speculative buying, most would assume that meant new buying of long positions by easily-identified speculators such as hedge funds and momentum traders. That is definitely not what has transpired in gold recently, as the Â?normalÂ? hedge fund and technical fund speculators have been selling COMEX gold contracts, not buying them. Instead, the big COMEX gold speculative buyers have been the commercials who were previously heavily short. Correctly identifying the true speculators driving a market is a distinction that makes all the difference in the world. That so few see it is amazing to me.

There is little doubt that the commercial gold shorts have taken a horrific beating in buying back their short contracts. My guess is that the collective loss on the covered gold contracts so far is on the order of $1.5 billion. Such a loss, even when spread among the roughly 40 traders classified as COMEX commercial gold shorts, amounts to a hefty per entity average loss of $37.5 million each. And I'm speaking of closed out losses only; there is still a large number of open gold shorts that the commercials are holding whose resolution remains to be seen. Those Â?openÂ? losses run to an additional $8 billion at current gold prices. It is imperative to recognize the unprecedented magnitude of these closed out and open gold losses. It's not enough to say that these commercials lost big-time; having never lost before on such a scale, the turnabout for these commercials must be shocking to them. As such, I'd like to explore what this may portend in the future.

The commercial COMEX gold shorts are banks and trading companies, not individuals. Every commercial trading corporation maintains some financial controls and is overseen by corporate treasurers and financial risk officers. The amount of loss generated in this recent gold short debacle dwarfs the gains recorded in prior years. (Same as with silver earlier in the year). Because of the suddenness and extent of the commercial gold short losses, it is not plausible that the corporate risk controls have not kicked in. For sure, the chief financial officers and corporate risk officials have restricted the traders responsible for the gold losses. Unlimited margin money is not being extended; quite the contrary Â? traders are undoubtedly being ordered to reduce risk and close out positions. Anything else would be irresponsible.

If my analysis as to what has just transpired in gold is close to the mark, what does this portend in the future for gold and, especially, for silver? The one result that looks almost certain to me is a severe loss of liquidity or true market depth. In fact, it looks like the death of true liquidity for COMEX gold and silver, the signs of which are increasingly evident. I can assure you that I am very much aware of the recent high volume statistics recorded on the COMEX and despite what may appear to be high volume and great liquidity; the real level of actual market depth may be near death. Please allow me to explain.

The big reporting COMEX commercials' modus operandi has always been to serve as counterparties to almost all other market participants, particularly the technical funds which buy and sell based upon price signals. In this role, the commercials served as market makers, providing liquidity to the market. The tech funds buy and the commercials sell to them and vice versa. This is the rhythm of the market that I try to analyze in the COT reports. Since commodity markets are supposed to be open auction type operations and not a market dominated by specialists, I always thought this market making function of the commercials was bogus. It is also no secret that I have found the uniform dealings of the commercials to be collusive and manipulative. My personal feelings aside, there is no question that the big commercials have functioned as market makers on the COMEX.

Therein lies the problem for liquidity; the dominant commercial market makers on the COMEX just got creamed in the gold price rally and are sharply restricting their activities. This is what is behind the great price volatility in gold. The former big sellers of last resort are sellers no more. Concurrent with the withdrawal of the coordinated selling of the commercials is the rise of computerized High Frequency Trading. The mindless HFT activity does wildly increase daily trading volume, but the nature of this super-charged day trading only adds to price volatility while providing no true depth to the market. Legitimate hedging, the economic justification behind futures trading, is ill-served by HFT. In other words, there has been an immense increase in mindless second -to-second trading which adds little real benefit to prospective hedgers and a sharp drop off in the actual market making on which hedgers depend. This is the very worst of both worlds. And this development was made possible due to the activities of the CME Group, owner of the COMEX, which is hell-bent on expanding HFT. Thanks a lot, guys.

Just like commercial short covering was the prime driver of the gold price rally, it is also behind the increase in volatility. As these commercials withdrew from the market, not only did it drive gold prices higher, it also created a void in true liquidity. If the commercials don't sell on higher prices, who will? Someone must take their place, as there must be a seller for every buyer, but it is increasingly obvious that the sellers replacing the commercials have not sold with the same force and power that the commercials formerly sold. To date, the noted sellers have been the technical funds and other long speculators who have cashed in on enormous profits. As a result, the gold price is subject to sudden spurts in price both up and down, as I have suggested previously.

On the one hand, the lack of additional commercial shorting has provided a lift to gold prices. On the other, the lack of technical fund buying allows for sharp downdrafts in the price as well. The withdrawal of the commercials and the cessation of buying for now by the technical funds (as we're so much above all technical fund buy signals) have created a market devoid of real liquidity. Hence, we get great price swings on not much real overnight buying and selling. Yes, we get high volumes from HFT, but that's garbage volume to everyone except the HFT web-bots themselves and the greedy pigs at the CME who collect on every contract traded, garbage or otherwise.

What does this all mean to regular investors? It means get used to the volatility, because it isn't going away. Surprisingly, I think it means a lot more to silver investors than it does to gold investors, even though I have been talking more about gold than I have silver. There's a reason for that. What I've described is a process that has already occurred in gold and to a much greater extent than in silver. There may be more commercial short covering to come in gold and if there is, that will exert continued upward price pressure. But the process is fairly well advanced and having already launched the gold price upward, it's hard for me to predict what happens next, other than almost nothing would surprise me price-wise for gold. I see something very different for silver.

I believe we have also lost true liquidity in silver, as we have in gold. This can be seen in the volatility of the silver price, same as in gold. Back in April, the commercials panicked in silver and bought back shorts, causing prices to explode into the end of that month. Then, a giant manipulative takedown occurred, starting May 1. Recently, the commercial shorts in silver haven't panicked as they have in gold. In fact, JPMorgan, who I believe to be the largest COMEX silver short, added to short positions in the last COT, as I reported on Saturday. Considering what has occurred in gold, I believe it is only a matter of time before the big commercial shorts also panic in silver. But the panic in silver will be much more profound in silver than it has been in gold.

The prime driver in the gold rally was commercial short covering on the COMEX. In silver, if the commercial shorts panic, it will trip off other powerful forces as well. That's due to the basic difference between gold and silver, namely, that silver is an industrial material in addition to being a precious metal investment. Gold and silver can go sky-high in price, due to commercial short covering or investment buying. But since gold in not an industrial material, it is most unlikely that it could experience a shortage or a rush to buy by industrial users. How can industrial users panic if there are no gold industrial users?

In silver, there are great numbers of industrial users throughout the world, who are like a vast herd of wildebeests grazing on an African plain. The wildebeests will panic at the first scent of lions. The scent that will cause the silver industrial users to panic will be sharply higher price along with delays in receiving silver deliveries. A commercial short covering on the COMEX will certainly increase prices, just as it has in gold and previously in silver. But given the consistently tight signals emanating from the wholesale physical silver market, it will take little to set off a scramble for physical material which will cause delays to industrial users. As the first few silver industrial users panic and buy physical inventory to insure continued production, this will further tighten supply lines and exacerbate delays in deliveries, thereby inflaming additional user buying. It's impossible to say when such a process will start in silver, but we surely are closer to that than ever before. This is more a case of inevitability than it is of timing. It will come when it is least expected, but it will come.

It is lamentable that real liquidity seems to be dying on the COMEX, but that is of secondary importance to long term silver investors. Of more importance is that the death of liquidity will likely also signal the death of the ongoing silver manipulation. That's because liquidity and manipulation are rooted in the big commercial shorts on the COMEX. If there is one thing that could put the price of silver to the stars, it would be the end of the silver manipulation. The message from gold is that the commercials are capable of miscalculating on a massive scale, causing prices and volatility to soar. The message from silver will be not just that, but also that the inevitable physical shortage will cause prices and volatility to soar far higher than any of us can comprehend.

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Silver – $41.70

Gold – $1833

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