

February 11, 2011 - Timely Questions

Timely Questions<?xml:namespace prefix = o
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I received a couple of good questions from subscribers that I would like to answer publicly. Before I do so, I'd like to direct your attention to a print and video interview in today's New York Times featuring Gary Gensler, chairman of the CFTC. Regular readers know of my high opinion of Gensler and his role on position limits, which I'll have more to say about in the near future. While it remains to be seen how the matter will be resolved, I am still convinced that the public interest has been greatly advanced with Gensler at the helm of the CFTC. I don't know if you have to register (free) to retrieve this, but please do so if you have to.

<http://dealbook.nytimes.com/2011/02/10/at-center-of-debate-over-derivatives-a-gung-ho-regulator/>

Dear Ted,

Thank you so much for all you've done for our family. I have been following your work for several years and it has helped enormously.

One particular area has been in planning for college costs - rather than work only through the very restrictive investment options allowed in a "529 plan", our family put some funds into silver eagles with a ~10 year or so horizon. Now this is looking very smart for the tuition bills that are looming though still several years out. The smarts were yours, not ours. For that we thank you!

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Question:

You write often about the silver manipulation and I find all of the technical points about how it is done very interesting.

I also find it very interesting how it is beginning to unwind and how you can see this in the bank and cot reports and in various aspects of the physical metal market.

My question and I do not think I've seen you write anything about this, is ***how did this short position get started and why is it limited to the silver market?***

Were there some unusual market circumstances that somehow encouraged it or facilitated it?

Many thanks and best wishes,

Bill

The situation we've evolved to in the silver market came from circumstances that are similar in most commodity futures markets. Some of the biggest players in all these markets are the technical trading funds and their counterparties, the commercials who operate like market makers. The tech funds are motivated by price action, buying as prices go up and selling as prices go down, hoping to latch on to a big trend. The commercials take the other side of whatever position the tech funds take. I think that the commercials, because they generally know in advance what the tech funds are likely to do at certain price points, game the system at times. I suppose that's only natural.

What developed in silver is unique in that the commercials miscalculated and made the mistake of getting too big of a position for the overall size of the market, especially in terms of real world production and inventory. The commercials became too complacent, after 20 years of tricking the technical funds in and out of the silver market, and wound up with too big of a short position. Now, they are trapped and trying to buy back this silver short position

with minimal impact to the price on the upside. In addition, not only did the short position become too big for the silver market, it became super-concentrated. Because it became increasingly obvious that silver was undervalued, fewer commercials or other market participants were interested in selling it short. This resulted in the bulk of short position being held by a very small number of traders, led by JPMorgan.

I know many people assume there are other reasons for the origin of the big silver short position, such as the US Government being involved to protect the dollar or something like that, but I have found that if you are given a choice of something being caused due to a miscalculation or due to a vast conspiracy, the safe bet is on miscalculation.

Hi Ted- I just read your comment this morning on Paulson and it reminded me to ask you about something that Jeff Christian recently said on the financialsense news hour. Christian was on with Morgan and Nick Barisheff and they were talking about how tight the silver market is, as well as about the COMEX. Christian admitted that there is likely less than 45 million ounces for delivery at the Comex, but that the reason no billionaire even tries to get it is that "you don't want to be the person who messes up the silver market" or something to that effect. If you hadn't heard this, I wanted to know your response. To play devil's advocate, isn't the silver market just too small for a large, billionaire investor to get in? They would by definition move the price up considerably and possibly look stupid if no one else follows them in? Sort of the paradox of an asset that- by definition of its being so small- is therefore irrelevant to most people as a vehicle of savings?

Thanks as always!

Ryan

I think this is an example of rationalization. By that, I mean people are looking for an explanation for why nobody big has tried to buy silver, given its great merits and price performance. I appreciate the confusion caused by this dilemma, namely, if silver is so good, why hasn't anyone big bought it yet? All we can do is objectively analyze the various explanations and choose the most plausible.

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The small relative size of the silver market would preclude a significant number of large investors all buying at favorable prices simultaneously. But the small size could have certainly allowed one or a few from buying gradually. These big hedge funds hold a wide variety of positions in many small securities and are skilled at building positions in thinly traded assets quietly. If one or a few hedge funds wanted to buy silver and silver related securities over the past few years, they could have done so. But they didn't. Why not? It's certainly not because they aren't smart, as these guys are as sharp as they come. My best guess is because they haven't looked at silver seriously. No matter how smart you may be, if you don't look, you can't see. That, to me, is the most plausible explanation for why nobody big has come into the silver market yet. It hasn't been on their radar screens. But what can bring it onto their radar screens is continued price outperformance. My friend and mentor, Izzy Friedman, suggests these big guys will only buy once we cross the \$100 mark. Izzy isn't always right, but he's not often wrong. The main point, however, still remains that the big hedge funds not having bought silver yet is incredibly bullish.

Ted Butler

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