February 14, 2015 – Weekly Review/Remarkable Proposition

Weekly Review

Friday's sharp rally in silver accounted for nearly all of the price gains for the week, as the metal finished 60 cents (3.6%) higher. Gold's rally on Friday wasn't as pronounced as silver's and the yellow metal finished $5 (0.4%) lower for the week. As a result of silver's relative outperformance on the week, the silver/gold price ratio tightened in by a fairly significant 3 full points to 71 to 1, but still reflects an extreme undervaluation of silver to gold historically.

While I'm convinced that silver will outperform gold on a longer term basis, I'm hesitant to interpret this week's price action as the start of a steady march from here to greater relative valuation for silver compared to gold. Perhaps it is, but it's hard to read much meaning into Friday's sharp silver rally based upon the data available. For one thing, the rally had all appearances of being an exclusive COMEX HFT computer production, as the lion's share of the gains occurred within minutes after the traditional day session opened around 8:30 am EST.

Sometimes, when sharp price moves occur in the wee hours, I understand how someone would doubt my assertion that it was still a COMEX arranged affair, but few would doubt that Friday's price spike was 100% COMEX-orchestrated. As to who was doing the selling in silver Friday (who was buying is less important unless it was you know who), we'll have to wait until next week's COT report. Certainly, the data in this week's report (released yesterday) wouldn't seem to explain why silver was so strong yesterday. I'll return to the new report in a moment and to high frequency trading later, when I comment on an important new paper on the subject.

The jury is still out as to whether there has been real change in the turnover pattern of the physical movement of metal into and out from the COMEX-approved silver warehouses. After a very slow movement of 1.4 million oz in the previous week, this week saw nearly 3.5 million oz of silver enter and leave the COMEX warehouses, with total inventories falling 1.6 million oz to 176.3 million oz. This is the highest weekly turnover in four weeks, but still below last year's weekly average of nearly 5 million oz. I have no way of predicting what future physical silver turnover will be and am still amazed how unique and unprecedented the COMEX silver movement has been, whether it continues or ends.

A reader asked me this week for clarification concerning physical and paper silver. In very simple terms, on the COMEX all futures trading (like is reported in the COT report) is paper silver, or more correctly, electronic derivatives contract trading Â? of which there must be a long and short for every contract. In contrast, the turnover I report on for the movement in and out of the COMEX silver warehouses is strictly physical metal and should not be confused with futures trading. There is no long or short in the movement of physical silver in and out of the warehouses Â? just metal owned by someone being manually transported either in or out of specific warehouses, not owned, but licensed by the COMEX.

That the unusually frantic pace of physical inventory movement has been unique to COMEX silver of all commodities, it warrants attention and analysis (speculation). Or at least, that's what I contend. But another thought occurred to me as a result of the subscriber's question that strikes a familiar theme of mine. As you know, I contend (as do many others) that paper (futures) COMEX silver trading artificially and illegally dictates prices to the world of physical silver, particularly the concentrated short position by the eight largest COMEX traders. Quite unintended, Jack's question helps make that point as well.

The weekly movement of physical silver into and out from the COMEX has had no discernable effect on price and is quantified at an average weekly turnover of 5 million oz (less recently). While this level of physical movement is very large when compared to other commodities and past silver movement, it is miniscule when compared to COMEX weekly futures trading volume (around 750 million oz equivalent) or typical changes in the weekly COT report on open positions (25 million oz equivalent). I realize that futures trading volume exceeds physical movement in all commodities, but not to the extent seen in silver. Certainly, in terms of relative world production, no commodity has a larger concentrated short position. My point is simple Â? because COMEX futures trading volume and concentrated positioning is so much larger than the quantities of silver in the physical world, it shouldn't be hard to see which is setting the price.

Another example of physical metal are the holdings in the two big hard metal precious metals ETFs, SLV for silver and GLD for gold. Recently, there has been little change in the holdings of SLV, not that unusual considering the relatively low volume and subdued price action (excepting Friday). Before that, of course, deposits and withdrawals in SLV were most counterintuitive, falling when there should have been increases and vice versa. On the other hand, the metal holdings in GLD have been much more active and seem to conform to normal expectations, namely, increasing on gold price strength and decreasing on gold price weakness. Why the pattern of holdings is different in SLV than GLD seems centered on the silver side, which is usually the case.

Sales of Silver Eagles from the US Mint are still very strong relative to sales of Gold Eagles or Buffaloes, but may be abating a bit. Sales of Silver Eagles on a daily basis have dropped below 110,000 coins on a calendar day basis this month, suggesting the Mint has caught up with pent up demand and no longer has to ration coins. It's too soon to know if we are entering a period of softer relative demand for Silver Eagles, but it has been months since the Mint has not been forced to sell at maximum production/blank supply capacity. More pronounced is the sharp drop off this month in gold coin sales compared to January.

While sales of coins from the US Mint are followed and reported on widely, such sales don't appear to have any obvious impact on price. For instance, the last four years have seen absolutely phenomenal sales of Silver Eagles by any objective measure, by far the most in history, and yet those same four years were the worst in history for silver pricewise. I would contend that the only rational explanation lies in the manipulation premise, but whatever the reason, the disconnect between record sales of Silver Eagles and rotten price performance is plain to see.
http://www.usmint.gov/about_the_mint/index.cfm?action=PreciousMetals&type=bullion

The changes in this week's Commitments of Traders Report (COT) met my expectations in terms of there being reductions in the headline number of the total commercial net short position for both gold and silver, but my guess was under in gold and over in silver. Of course, the reporting week ended Tuesday Feb 10, featured lower prices, including a very sharp selloff in gold and silver on Friday, Feb 6, after the monthly employment report. Therefore, it wasn't hard to predict net speculative selling and commercial buying.

There was much more speculative selling/commercial buying in gold than in silver because gold had deeply penetrated its 200 day moving average to the downside on that Friday, while silver, never having penetrated its 200 day moving average to the upside, couldn't possible violate it to the downside. As a reminder, when prices are first penetrated to the downside, technical funds sell – that's the key to COT analysis.

In COMEX gold futures, the commercials reduced their total net short position by a hefty 32,700 contracts (my guess was for at least 20,000), to a total of 170,600 contracts. By commercial categories, the big 4 and big 5 thru 8 bought back around 5000 short contracts each, leaving the raptors as the prime gold futures buyers of more than 22,000 contracts. I have to confess to being concerned that of the 35,000 commercial short contracts bought back and covered over the past two reporting weeks, the four and eight largest commercial shorts have accounted for less than 2000 contracts of that covering and, accordingly, hold a much larger relative share of the total commercial position than they did before the gold rally began. All things being equal, price prospects are better when the big commercials aren't heavily short.

There was no surprise that the technical funds in the managed money category were the big sellers, accounted for nearly 29,000 net gold contracts sold, including the liquidation of 26,475 long contracts. These contracts were originally bought as various moving averages were violated to the upside since year end and it would be highly unusual if they weren't sold on moving average penetration to the downside.

As far as the prospective Â?countÂ? in gold, there was undoubtedly additional technical fund selling (long liquidation/new short selling) after the cutoff on Wednesday's downside violation of the 50 day moving average and the gold rally was weak enough on Thursday and Friday so as to suggest not much position change on those days. There are probably around 30,000 contracts of managed money long liquidation potential on lower gold prices from here. The big question (as is the case in silver) is how many technical fund short contracts can be added on lower prices. If there are only 10,000 to 20,000 contracts of technical fund short contracts to be added, it shouldn't take terribly long for the gold COT structure to bottom at. If, however, many more than that new short contracts are to be sold by the technical funds being lured onto the short side, gold prices should drop further and take longer to accommodate the new short selling.

In COMEX silver futures, the total commercial net short position declined by 2700 contracts (versus my guess of 5000 contracts), to a total of 53,500 contracts. Silver did violate slightly its 50 day moving average on the Feb 6 selloff, but didn't decisively close below that key technical fund level. That would appear to explain why more silver contracts weren't sold by the technical funds and bought by the commercials.

By commercial category, the raptors accounted for most of the 2700 commercial contracts purchased in buying 2500 new longs and adding to a net long position that now amounts to 12,200 contracts. The 4 largest shorts added more than 800 new short contracts while the big 5 thru 8 bought back around 600 contracts. I would peg JPMorgan's short position to be 21,000 contracts. Even though the total commercial net short position has declined by 8000 contracts over the past two reporting weeks, very little can be attributed to the 8 big shorts. At 65,745 contracts, this concentrated short position is the equivalent of almost 329 million oz.

That's still 40% of world annual silver mine production and a third of all the silver bullion (1000 oz bars) that exists in the world and is by head and shoulders the largest concentrated short position of all commodities, defying all legitimate explanations for why it exists. By comparison the concentrated short position of the 8 largest traders in COMEX gold of 17.5 million oz (admittedly high) is equal to 17.5% of world annual gold mine production and only the smallest fraction of one percent of total world gold bullion inventories.

It was no surprise that the technical funds did add 1600 new shorts (still only 10,660 contracts), but that they actually added 648 new longs to a long position just under 49,000 contracts was somewhat of a surprise. The numbers aren't large this week, but perhaps the non-technical fund longs, which I estimate at 40,000 contracts in the managed money category, added to long positions. As was the case in gold, the key question is how much technical fund selling can be triggered by lower prices. I only imagine 10,000 contracts or so in long liquidation (and maybe less). The wild card in the prospective Â?countÂ? in both gold and silver is the potential number of additional contracts that could be sold short by the technical funds.

This calculation is even trickier in silver than it is in gold as a result of the extraordinary short covering by the technical funds in November in which the funds bought back very profitably and out of character to the downside and a number of commercial raptor longs bit the dust. In thinking about that unusual turn of events (which I stated was impossible beforehand) ever since, the most plausible explanation for why the technical funds overrode their normal behavior for not buying until prices moved higher had to be that silver got to an unreasonably low price and undervaluation trumped the wait for technical confirmation. (If anyone has another suggestion, please don't be shy about passing it along).

Anyway, if the technical funds pulled the trigger and covered about 25,000 short contracts because they thought silver was priced too low back then, well with prices still in that range, what are the chances that the funds will now decide to add massive new numbers of shorts in silver at the same prices at which they previously bought back? While I can't know the answer, I believe that is the key question. The bottom line is that if the technical funds which previously bought back those 25,000 short contracts can be lured into selling those contracts short again, the pressure on price will be much greater than if they didn't sell. I can see as many as 15,000 to 20,000 contracts being sold by the technical funds (long liquidation and new short selling) on lower prices, but I am hopeful the potential for the extra 25,000 contracts of former shorts doesn't come into play.

One lesson of Friday's rally in silver is that COT analysis is not particularly useful in the very short term. Considering the data released in yesterday's COT report, the silver price rally looks even stranger, since this week's report was much more bullish for gold than silver. I'm always aware that someday the COTs won't matter much, particularly as actual silver fundamentals (a physical shortage) take hold. I also know that signs of physical shortage are likely to become visible only after that has been reflected in price. Therefore, any time silver acts Â?funnyÂ? to the upside pricewise, you can't be sure if something serious might be behind it. Or if the big commercials are just toying with the technical funds.

I am still confident that silver prices will advance sharply in the long term, but I am still less sure in the short term. The biggest negative factor is the current extremely large concentrated short position in silver (and gold), and while that doesn't guarantee prices must fall it points in that direction. I wouldn't be terribly upset if past COT patterns get broken and we move higher, but neither will I be surprised if new price lows lie ahead.

A Remarkable Proposition

A remarkable new paper by a Cornell law professor and CFTC staff counsel suggests that many aspects of high frequency computer trading (HFT) may be, in fact, illegal under various provisions of basic commodity law. Heretofore, it was generally assumed that HFT was legal, but disabused and impacted markets in disruptive manner on occasion. Many, like myself, never looked on HFT favorably, but few have tried to make the legal case against it. The author, Gregory Scopino, writes in his personal capacity and not on behalf of the CFTC. Not a short or easy read (at 90 pages), I feel Scopino makes a well-researched case and even offers answers to questions asked of me by readers, such as definitions for commodity terms and the like. Please take the time to scan the document. http://connecticutlawreview.org/files/2015/01/7-Scopino.pdf

If you would prefer a brief interpretation, try this http://www.marketwatch.com/story/study-by-cftc-official-questions-legality-of-high-frequency-trading-practice-2015-02-12

There are many points to draw from this paper and I'll offer my most salient takeaway. By looking at what is accepted by Â?everyoneÂ? as legally appropriate activity with a different perspective, the activity can instead look highly inappropriate and even illegal. Scopino looked at HFT not through the universal perspective of something that's here to stay and that we must get used to; to looking at it through an interpretation that it might violate existing law. His conclusion appears to be that much of HFT is not properly aligned with existing commodity law. Not being a lawyer, I can only agree with him by what I've observed firsthand about the disruptive and manipulative effect of HFT. Not explicitly stated in the paper is my suggestion that only the one percent of market participants actively engaged in HFT seem to be for it, while the 99% of market participants not engaged in HFT wish it didn't exist.

About the only difference I hold with Prof. Scopino is that he suggests that certain aspects of HFT may be manipulative on their face, where I consider HFT to be a manipulative price tool employed to extend the larger ongoing price manipulation in silver. He suggests HFT may be the manipulation; I claim the commercials first rig the price of silver (up or down) through HFT in order to force the technical funds and other price momentum speculators to buy or sell so that the commercials can take counterparty positions. I've alleged that the manipulation in silver existed long before HFT arrived on the scene some years ago, although I fully admit that HFT has made it easier for the silver commercial manipulators.

I was taken with something in the paper that is generally very hard to find Â? a good definition of the word Â?manipulation.Â? It's a word, as you know, that I tend to overuse. Here is the definition in question (page 655) Â?

Â?The phrase *price manipulation* . . . means the elimination of effective price competition in a market for cash commodities or futures contracts (or both) through the domination of either supply or demand and the exercise of that domination intentionally to produce artificially high or low prices. Price manipulation is kindred to the exercise of monopoly power to dictate prices that would be unachievable in a truly competitive environment. The existence of price manipulation is largely a factual question involving determinations whether the requisite domination or of monopoly exists, whether an artificial price is caused by the exercise of that power and whether the dominant party

specifically intended to bring about that artificial price.Â?

While Prof Scopino is referring to HFT only, I hope you recognize that Â?no competition, domination, monopoly and dictating pricesÂ? are words frequently used by me to describe the control of the 8 big short traders in COMEX silver. This definition clearly states that price manipulation first revolves around the factual question of whether the domination or monopoly exists, followed by the willful and successful exercise of that domination.