February 15, 2012 – Bubble Ahead/Fair is Fair

The Bubble Ahead

I thought I'd step back from the shorter term influences on the price of silver which tend to dominate our thinking and focus instead longer term. It's very easy to get caught up in the latest economic and trading developments and sometimes it's important to look at things in different perspectives. One aspect about silver that I'd like to explore is its potential to return extraordinary profits if a bubble were to develop. The two key words here are potential and extraordinary.

Financial bubbles are very rare and that makes them extremely difficult to predict. In fact, I don't know of anyone who predicted the recently burst real estate bubble in advance of that bubble or the Internet stock bubble before that. I also doubt whether anyone predicted the Holland tulip bubble of the 1600's before it developed and subsequently burst. Certainly, many did predict the bursting of these bubbles after they had formed. Therefore, it would be presumptuous for me or anyone to speak of a bubble developing in silver in terms of certainty. However, we do have some knowledge of the elements that make up bubbles and those elements appear to be in place for a bubble developing in silver.

Importantly, the gains that can be made in a bubble are so great that should one develop in silver how an investor handles it could make all the difference in the world. Given the rarity of financial bubbles in the first place, recognizing the development of a silver bubble and handling it correctly could, quite literally, represent the investment opportunity of a lifetime. The one thing we know for certain in an investment asset bubble is that the final price of the asset in question goes beyond any level ever imagined. Getting into an asset before a potential bubble develops and not getting out too soon is the investment equivalent of winning the lottery.

What are the elements required for a financial asset bubble to develop? The first element is that there must be a sound investment story, the sexier the better. Later, the sound original fundamentals come to be so over-embraced that the resultant price rise completely overvalues the asset. In the recent residential real estate and Internet stock bubbles, initial sound fundamentals and exciting technologies resulted in prices that overwhelmed reason. In a bubble, the initial good investment story comes to be over-believed and then bid to extreme over-valuation.

The silver story is phenomenal. It starts with an investment asset known since the dawn of civilization that morphed into an important industrial material starting about 50 to 100 years ago. As a result of this new industrial consumption, due to chemical and mechanical properties unique to silver, the world's 10 billion ounces of bullion was depleted by 90% because production could not keep up with demand for much of the last 70 years. The depletion of world silver bullion inventories was so severe that it has resulted in the almost impossible circumstance that there is now more gold bullion in the world (3 billion+ oz) than there is silver bullion (one billion+ oz). Despite this imbalance in inventories, gold trades at more than 50 times the price of silver.

Most amazing of all about silver's phenomenal story is that it remains largely unknown. Most non-silver investors would stare at you blankly if you told them that there was three times the amount of gold bullion in the world than silver bullion. This is probably the most bullish thing you could say about any asset thought to have the potential of forming into a bubble. Since a bubble is only fully formed and overvalued when the story becomes over-embraced; little awareness of the real story means there is much room to go for the story to be recognized. But the depleted state of the world's silver inventories is only a part of a story that is phenomenal.

Additional unique aspects to the silver investment story are that net investment buying has only commenced in the last six years or so, while industrial demand has continued to grow. Most of the new silver produced each year is already spoken for in industrial fabrication and is unavailable for purchase by investors. Because there is relatively little remaining new silver available for purchase, in bubble terms, it would take a much smaller number of investors to drive prices to overvaluation than were involved in the real estate and Internet stock market bubbles. Throw in allegations of a downside price manipulation and the possible regulatory resolve of a long term silver investigation and there exists a separate silver story which could develop into a full blown bubble if taken to excess.

Since we are discussing the potential for a bubble to develop in silver, let's consider the impact such a bubble would have both on silver investors and everyone else in the world not invested in silver. Because silver is used in most industrial applications in very small quantities relative to the total cost of the finished product and because substitution of other materials is impractical in short periods of time, a sudden price spike due to a bubble forming would not likely be met with a dramatic drop-off in industrial consumption. In fact, any bubble-like investment demand would likely cause industrial silver users to rush to buy to build inventory levels to assure continued functioning of assembly lines. Yes, there would undoubtedly be an interest in increasing silver mine production in response to a price spike, but opening silver mines takes a lot longer than it does for a bubble to form and burst.

Compared to previous bubbles, the impact on the world at large to a silver bubble would be minor. If oil were to go into a bubble, everyone on the planet would feel the effect immediately. With silver, most would not even know that silver was in a bubble until well after it burst. Most everyone, of course, except for those that invested in silver. And what impact a bubble would have on investors would depend on when they bought and sold. If buying an asset before a bubble formed and selling before it burst is nirvana, then buying after a bubble has formed and selling after it bursts is investment hell. That's why, if you place any credence in the potential for a silver bubble forming, you best invest before the formation and not afterwards. Please remember that the possibility of a bubble forming should not be the only reason for buying silver, as the list of good reasons is long.

But if a bubble does develop in silver then it is important to have some general awareness of what that may mean for the price. In a bubble, all normal valuation yardsticks get thrown out because reason itself is discarded, replaced by the raw collective emotion of the crowd. The price rising and rising at an ever-increasing pace becomes all that matters in a bubble. Who has time to objectively weigh supply/demand considerations and long term investment goals when there is quick money to be made by buying indiscriminately?

Let me confess one of my greatest fears about a potential future bubble in silver. If a silver bubble does develop, by definition large numbers of uninformed investors will join in the fray, eager to capture sure profits. The concerns for risk will be cast aside, as they are in any bubble. Undoubtedly, many of my former bullish arguments for buying silver will be trotted out as current reasons for buying even as price and risk grow. I doubt very much that I will be pounding the table to buy in a silver bubble and instead will probably be way too early in suggesting its sale. Yet new uniformed buyers will mistakenly view my past pronouncements as reasons to buy after a bubble is formed. The thought that I will inadvertently be responsible for damage to the latecomers is troubling.

Of course, the risk to latecomers only grows deep into the bubble, should it form. The risk of a silver bubble bursting now is remote because it hasn't formed yet. Yes, there is always the risk of short term sell-offs for reasons related to manipulative activities on the COMEX, but those sell-offs should be viewed as buying opportunities as has been the case for the life of the silver bull market to date. In terms of a bubble-like collapse in silver prices, that risk will not exist until a bubble first forms.

In the meantime, since a bubble has not yet formed in silver, what are the possible effects on the price should a silver bubble form? Certainly, I have not been particularly surprised by the 8 to 10 fold increase in price over the past 5 to 10 years. If anything, the price performance to date in silver, given all the facts, has been somewhat muted. Leaving out a possible bubble forming, it would not surprise me to see eventual long term silver prices at $100 or even $200. That's without a bubble. If a silver bubble does form, it is hard for me not to imagine some multiple of those prices.

Please remember, I'm talking about a potential bubble forming in silver, something that may or may not occur. Certainly, there are conditions present in silver very conducive to a bubble forming at some point and if one does form, it will carry prices much further than if no bubble formed. There was no bubble or investment mania in silver in 1980, when it ran up to $50 largely as a result of concentrated buying by the Hunt Brothers. There was no bubble in silver last year as it approached $50 again, according to a clear reading of all the data. Logic and common sense would dictate that should a bubble form in silver, the price would run much higher than the previous peaks. When it comes to bubbles, the historical lesson is to get in early and leave the party when the latecomers arrive.

Special note – I'm including the following article because I intend to make it public and didn't want to shortchange subscribers. I tend to make public only articles in which I invite readers to contact the regulators or other officials in the hopes of effecting change (that will in turn benefit subscribers). Unfortunately, it may seem at times like I ask readers to write in (in these public articles), but I don't usually follow up to report publicly on the results of them writing in. That's not fair, so I think the recent dramatic reduction in the short position of SLV should be more fully disclosed. If it turns out this reduction proves only temporary, I'll report on that as well.

Fair is Fair

In December, I made public an article discussing the short position in the big silver ETF, SLV. At that time, the short position in SLV shares was in excess of 25 million shares and would run up to 26.6 million shares by mid-January. I hold that the shorting of shares in SLV is both fraudulent to shareholders of SLV and is manipulative to the price of silver. That's because shorted shares of SLV do not result in physical silver being deposited into the Trust and leave the Trust, effectively, with shares not back by metal to the extent of the short interest. (There is supposed to be one ounce of silver deposited for every share issued according to the prospectus and short selling circumvents that requirement.) Because physical silver is not bought and deposited on shorted SLV shares, the normal price impact of more demand on the physical silver market is also circumvented. That constitutes price manipulation.
http://www.silverseek.com/commentary/slv-short-position-update

As a result of many of you writing to the sponsor of SLV, BlackRock, there were a number of consequences. For one, as previously mentioned to subscribers, within days of the publication of the article, lawyers representing BlackRock demanded, in no uncertain terms, that I cease what they claimed was defamation of their client and my publication of email addresses of top officers. More importantly, another consequence may have revealed itself late last week with the release of short interest data as of Jan 31. The new report indicated that the short position in SLV plunged by more than 35%, or by more than 9.4 million shares, from 26.6 million to under 17.2 million. This is the lowest level of shares held short in SLV in almost a year. The number of shorted shares in SLV is still too high, at over 5.3% of all outstanding shares issued, but at its peak last spring, the shorted shares represented more than 12% of total shares outstanding.
http://www.shortsqueeze.com/?symbol=slv&submit=Short+Quote%99

The timeline on all this suggests that the most plausible explanation, at this point, is that BlackRock or someone in position to influence the SLV shorts to reduce their short position, did exert such influence. The sudden reduction in the short position came as prices were rising strongly, something not witnessed previously and also suggestive of an outside influence. Certainly, big future increases in the SLV short position will negate the explanation that BlackRock saw the merits of the allegations against the shorting of SLV and moved to curtail it. For now, however, it looks like the short covering in shares of SLV is as it appears, namely, as a result of the matter being brought to BlackRock's attention and them acting on it. Thanks to all who took the time to write in.

Potentially, this could be a big deal in silver. Unlimited shorting in hard metal ETFs can have a very negative influence on the price of silver. At two previous significant tops in the silver price, in 2008 and 2011, the short position in SLV was at record high levels. I believe these record short positions in SLV were a strong influence in the price of silver breaking badly on both occasions. Eliminating and then preventing excessive short positions in SLV in the future will eliminate the incentive of large short sellers to rig prices lower and insure that SLV shares are issued in accordance with the terms of the prospectus and have real metal backing.

This is not my first initiative in attempting to influence how the SLV is run. As a silver analyst, the Trust is an important factor in the silver market since it is the world's leading silver investment vehicle and the largest single stockpile of silver on the planet. Not to focus on it would be a mistake. Back at the end of 2007, after the SLV had been trading for a year and a half, I asked you to write to Barclays (then the sponsor of the Trust) and ask them to publish the list of serial numbers, weights and hallmarks for the bars that were held in the Trust. Up until that time, I had made a big deal about holding silver in professional storage only if you had the serial numbers and weights of every 1000 oz bar held for you. It seemed only fair that the SLV be held to the same standard. http://www.investmentrarities.com/ted_butler_comentary/10-29-07.html

Within a couple of months, much to their credit, Barclays agreed that the full bar list would be published and updated regularly. I believe to this day that only because so many of you wrote to them and because it was a simple and constructive suggestion that aided Barclays and SLV shareholders that Barclays quickly agreed to the listing the bars.
http://www.investmentrarities.com/ted_butler_comentary/01-07-08.html

Just like was the case with Barclays, it's only fair for a tip of the hat in BlackRock's direction for any possible involvement by them in the reduction in the SLV short position. Let's hope it lasts. Let's also hope that the CFTC follows through and finishes their silver investigation soon. In the meantime, it's important to recognize that sometimes we succeed in trying to bring about change and that bodes well for the future.

Ted Butler

February 15, 2012

Silver – $33.75

Gold – $1735

Date Created
2012/02/15