February 15, 2017 – Delicate Balance

Delicate Balance

The pricing of silver and gold seems to be joined, at least in my mind, in a broader sense with other current developments, both in the financial and the political worlds. I'm not sure of the exact words to describe the connection, but it includes a sense of artificiality or surrealism. I'm observing things more extreme and unprecedented and contradictory than in my adult memory bank of half a century and, at the same time, other things point to normalcy and not much going on. While I guess we're all getting used to strange developments, I can't shake the feeling that many things are artificial and, therefore, subject to change that could prove violent.

Sticking to financial matters, the pricing process of silver and gold falls into the artificial category, as I hope I have conveyed all along. In this case, as and when the artificial pricing is resolved, much higher prices will result, particularly in silver. Since the data, mostly from the CFTC, that point to the pricing artificiality are being grasped by more observers, it is only a matter of time before the artificiality is broken. It has basically evolved into a waiting game. While waiting for the resolution is inescapable, it also permits time to contemplate how we came to be in the artificial pricing state in the first place.

Certainly, artificial pricing is not unique to silver or gold and has become the norm in most markets. I would define artificial pricing as resulting from machine based trading and not related to long term investment. I believe this machine based trading has overtaken all the markets. Despite that belief, I was somewhat shocked to read some of the particulars in a recent article about the subject, with emphasis in this case on stock trading and the investment firm Goldman Sachs. I have not independently verified the information in the article (I'm not sure I could even if I tried), but it seems credible to me.

https://www.technologyreview.com/s/603431/as-goldman-embraces-automation-even-the-masters-of-the-universe-are-threatened/

The highlights include how 600 professional stock traders in 2000 have come to be replaced by just two traders (aided by computers) today. Most shocking was the revelation that computer engineers now make up a third of Goldman Sachs' total workforce. The whole thing is nothing short of mind boggling to me. But as shocking as it seems, it also helps explain things. The process is not unique to Goldman Sachs or the stock market and the same type of transition has occurred throughout the market world over the past two decades. And we can see it with our own eyes in daily price change in just about every market, certainly including gold and silver.

By definition, all this computer based trading involves speed and beyond split second timing that no human can compete with. As such, it is the epitome of short term trading and the opposite of long term investment. And therein lies the dilemma Â? the price process and, subsequently the price, is set in the extreme short term, while everything else about the item in question is long term in nature, including the actual fundamentals. For a commodity like silver, the price is all short term, while everything else important is long term Â? like actual production, consumption and investment and where the price may be headed long term.

The price of silver and gold and many other commodities are being set in the ultra-short term, by the fastest machines created, with no actual supply or demand or long term investment input. We all accept it, as we are given little choice (except to buy, sell or hold on our own timetable); but that doesn't mean we can't recognize the process for what it is Â? namely, artificial. All the computer machines are focused on the shortest time frames possible and, by definition, not the long term. This is what creates the current artificial price level in silver.

Because the price is set in the extreme short term by machines there is created an ever increasing imbalance between short and long term forces Â? many refer to the process as paper versus physical. So sharp is the imbalance that it has a delicate nature to it. I don't know what the trigger event will be to upset the price applecart, but the status quo could easily be disrupted by some type of machine accident, ala a flash crash type event. In the case of silver, there is a lot more room for a computer-trading accident to the upside in price than the downside. Moreover, any downside machine trading accident wouldn't result in massive dumping of physical silver by investors and the proof of that is no such dumping occurred over the past six years and 70% plunge in price.

On the other hand, a surge in price, due to a machine trading accident would be likely to set off a rush of physical investment silver buying that could lead to an industrial user physical inventory buying panic as well. The machine trading can malfunction in either direction, but clearly a price explosion would be vastly more disproportionate in actual numbers than a downside malfunction. The triggering event need not be a trading machine malfunction, but like every other circumstance in silver, any price move is disproportionately structured to be much higher than lower.

Gold and silver prices were relatively contained throughout the COT reporting week that ended yesterday, although both metals hit multi-month price highs intraweek. Total open interest remained mostly unchanged in each, suggesting no great positioning changes in Friday's report, the opposite of the big changes in total open interest in recent weeks. The market structure in gold still appears to be much more bullish than the structure in silver, but so far that is not evident in daily price changes. Just to be clear, positioning changes between the managed money traders and the commercials is related to, but different from the daily computer high-speed day trading that constitutes 95%+ of trading volume. I have no guesses for what the report may indicate this week.

A key question remains unanswered Â? what the managed money traders will do in gold? Through last week's COT report and since the price lows of December 20, these traders have been missing from action on the COMEX gold front, although many more have gone long in silver on a relative basis. While I can't know for sure, I'm still inclined to think that the technical funds haven't permanently abandoned the gold market, but are awaiting the decisive upside penetration of the 200 day moving average ($1266) before buying in force. Even though silver has been seriously flirting with its 200 day moving average ($17.95) for the past several days, it also has yet to decisively penetrate its 200 day moving average, at least on a closing basis.

Because the managed money technical funds have yet to buy gold futures to this point (either by adding longs or by covering greater numbers of shorts to date), the matter is unresolved. As such, the COMEX gold market structure is extremely bullish, with silver less so. This also means that there would appear to be less reason for the commercials to rig gold prices lower since declines would not likely prompt aggressive selling by the managed money traders. That said, both gold and silver very much remain manipulated and artificial markets, so price jabs to the downside can't be ruled out. Same as it ever was.

Just to clarify matters, I am expecting the managed money traders to buy gold in earnest on eventual higher prices. This is to be differentiated from the lack of managed money shorting in silver a few months back. In silver, after noticing the lack of short selling early on, I didn't expect managed money shorting to develop on even lower prices (apart from the lone managed money short which did eventually sell short). Once again, I do expect eventual strong managed money buying in gold.

I've been meaning to comment on the extreme COT readings in two other markets Â? COMEX copper and NYMEX crude oil, both owned by the CME Group and both having risen sharply in price accompanied by record large managed money buying. Copper has rallied by more than 70 cents a pound since mid-October, while crude oil has jumped by more than $10 a barrel amid record managed money buying in both markets. Please don't take any of this as market advice because it is not intended that way.

On a strict COT basis, both copper and crude oil have to be considered to now be structured extremely bearish and at risk for technical fund selling should key moving averages be penetrated to the downside (the opposite market structure that exists in gold). Sooner or later, it should be expected that the managed money technical funds will sell off much of their record long positions in copper and crude oil on declining prices, but it is also impossible to know if those lower prices will come from current levels or from much higher prices. But there are some interesting variables that complicate the matter currently.

While the managed money traders have been the biggest buyers by far in copper and crude oil futures, unlike the case in gold and silver, the banks are not on the short side of COMEX copper and, in fact, also hold a notable net long position Â?same as the technical funds. I guess I've become somewhat jaded by bank activities in gold and silver, but the banks being long, not short in COMEX copper stands out. Then again, the banks haven't been short big in copper for some time and that hasn't affected copper prices moving lower on managed money selling over the years.

In crude oil, the banks do hold a sizable net short position and would not be apparently opposed to a decline in price, but here I am concerned with actions taken by OPEC in cutting actual production. Having followed the actions or lack thereof by OPEC in curtailing or expanding actual oil production for decades, I'm not inclined to dismiss the price impact of such actions. So here is a unique opportunity to witness which it will be in copper and crude oil as to what role the managed money traders will play in each. I'll report on this as it evolves.

All of this is in keeping with the delicate balance that I believe exists in many markets, although none quite as extreme as in silver and gold. Prices can and will do just about anything in the short run and it's more important to focus on the longer term. Based upon the current market structure in gold, the major path of least resistance is still greatly configured to the upside. While silver's COMEX market structure is not currently configured as bullishly as gold's, silver has so many other things going for it (starting with JPMorgan's massive physical position), it does not appear to be worth the risk not to be fully invested. And, yes, it's still possible for this to be the big one.

Ted Butler

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Silver – $17.95 (200 day ma – $17.95, 50 day ma – $16.90)

Gold – $1233 (200 day ma – $1266, 50 day ma – $1184)

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