What Now?

Now that price volatility has returned to gold and silver, a sharper focus is naturally placed on the day to day price movements, even though such a focus is almost universally acknowledged as folly. Still, there's no denying that volatility creates attention and awareness and that's certainly true for me. In my case, it gets narrowed down to the specific question of how likely is it for the current price action to lead directly into the big silver move up. The answer is still unknowable before the event, but that doesn't mean we can't outline some possibilities.

Last Wednesday I tried to convey the thought that almost anything was possible and gold and silver prices could go up or down. Since then, prices did both, moving first sharply higher, before declining almost as sharply (and ending not far from where they were a week ago). My goal today is to flesh out the short term price possibilities, while knowing full-well how hard it is to predict the short term.

The long term for me is much more certain and based upon an inevitable

physical shortage in silver. It is impossible for the price of any commodity not to soar in a genuine physical shortage. When the silver shortage becomes evident, it will become the main price driver; but until then, COMEX futures contract positioning will continue to dominate price movements. I know there is a swirl of news surrounding the precious metals, including stories of new exchanges and imbalances between COMEX physical inventories and existing open interest, but up until this point, price movements have been still best explained by changes in the COMEX market structure.

We entered into 2016 in a strongly bullish COMEX market structure in gold and silver. In the first six weeks of the New Year, gold prices rallied as much as $200 and silver by $2 due to technical fund buying of roughly 100,000 gold contracts (10 million oz.) and 30,000 silver contracts (150 million oz), which the commercials sold into. There can be little question that this COMEX positioning was the main price driver, not only because it was so widely predicted (thanks to the growing attention to the COTs), but also because it involved the largest verifiable amounts of gold and silver transacted over this time. Yes, there is a difference between real metal and paper derivatives in many ways, but when it comes to the impact on price up until now, there is little difference.

Keeping it simple, the rally was mostly due to technical fund buying on the

COMEX. Since the managed money technical fund buying included that of the short covering variety (as compared to the buying of new long contracts), for those short contracts bought back at prices well above the average price originally shorted, it is also simple to conclude those short contracts were bought back at a loss. I remember calculating that the technical fund average price on the short position before this year's rally occurred was around $1085 for gold and $14.30 for silver.

Without putting too fine of a dollar amount on the closed out loss, the technical funds lost and the commercials made many hundreds of millions of dollars yet again on the rally to date. I know all sorts of reasons are given to explain both gold and silver price movement and the manipulation, but the lure of profits measured in the many hundreds of millions of dollars into the many billions seems most persuasive to me.

Because the gold rally seemed so much stronger than in silver and considering the backdrop of stock market weakness and a budding flight to safety over this time, gold experienced more ETF buying than silver, further amplifying the gold move. I continue to believe that silver's price was kept more in check by aggressive COMEX commercial selling for the purpose of heading off stronger buying in SLV, which would have resulted in critical physical silver demand.

That's the condensed version of what transpired over the year to date; what's next in terms of possibilities?

The first possibility is more of the same, namely, rising prices caused by continued technical fund buying and commercial selling until the market structure gets into extremely bearish readings and an eventual price takedown in which newly-minted technical fund longs are forced to sell at much lower prices (along with whatever new technical fund short selling can be induced). There is no definitive time or price parameter restriction under this possibility – prices move higher, establishing new highs, until they get sold down below whatever the key moving averages are at the time. Under this possibility, investors may decide to trim some positions along the way.

The second possibility is that continued technical fund buying on the COMEX sets off enough ETF and other physical types of buying in both gold and silver that the force of that physical buying finally overcomes the price manipulation and prices then melt up. Based upon how much relative buying of physical it would take to overcome the COMEX price manipulation, it still seems that silver is more prone to melt up in an actual shortage than gold. In any event, even if gold ran first that would only underscore and make more certain an actual shortage in silver, given the potential inventory panic buying by industrial silver

users. Under this possibility, investors sit back and enjoy the price ride.

A further possibility is that future COT reports surprise and prices rise without demonstrable additional technical fund buying. In this case, the technical funds turn out to be the big winners as something else (the physical markets) powers prices higher. We saw this on the big run up in silver prices into the highs of early 2011 and this is a version of the melt up scenario.

The last possibility (as I see it), is that gold and silver prices get sold off in the near term without much of a further rally, as the commercials seek to harvest those technical funds which have gone long on the rally and lure new technical fund shorts back onto the short side. Because the rally over the past six weeks has been sharp, particularly in gold, the key moving averages are quite some distance below current prices.

Gold's 50 day moving average ($1105) is about $100 below the current price, meaning if the commercials decided to rig prices lower in the very near future, the pain to investors caught up in the prop wash would not be minor. In silver, the 50 day moving average ($14.30) also translates into fairly high potential

short term pain for long term silver investors. For those trying to gauge how much gold and silver prices might drop under the take-them-down-now scenario, I would guess somewhere under the 50 day moving averages and close to the old lows (kind of one and the same).

Paradoxidly, the possibility of a sharp selloff in the near term might be the most bullish development on a longer term basis in that it would greatly reduce the lone negative element in play the move away from the bullish COMEX market structure that existed at year end. As I outlined last Wednesday, the one potential problem for higher prices is always the COMEX positioning after the technical funds have been aggressive buyers.

I suppose it is possible for the COMEX commercials to get overrun to the upside after the technical funds have purchased gold and silver futures contracts, as nothing is impossible. But, as I think I may have previously reported, any commercial short overrun is not likely to come from a contract delivery default. For one thing, the biggest buyers (the technical funds) aren't interested in taking physical delivery on futures contracts – it's not part of their usual operation.

Further, should an "outsider," technical fund or other speculator, take a large futures position with the intent of demanding physical delivery (perhaps intending to "goose" prices), unless a COMEX insider was the big buyer/instigator, there would be an immediate and aggressive backlash from the exchange and the CFTC. Not only has a deliberate delivery short squeeze by an outsider never succeeded (to my knowledge), this is also an issue in which I've had personal experience (orange juice 30 year ago). I don't believe a speculator would be allowed to bust the COMEX via delivery default. And from an objective perspective of how markets are supposed to function, I don't think a speculator should be allowed to roil the markets in such a manner.

Where I can see the commercial shorts getting overrun is if a physical shortage develops away from COMEX derivatives trading and creates a rush by new buyers (not technical funds) for futures contracts not to trade, but for the express purpose of securing physical metal. The regulators could and would block such buyers if the buyers' intent was strictly for speculative gain. But I can see little justification or practicality in the regulators blocking legitimate industrial consumers from buying futures contracts in order to secure needed physical supply. If such buyers were blocked from taking physical delivery on COMEX futures contracts, in an instant the world would know the extent of the physical shortage.

Of course, that is at the core of why I own and advocate owning silver, namely, because of its highly unique dual demand profile investment and industrial demand which virtually guarantees a pronounces physical shortage at some point. This, coupled with the shockingly small amount of physical silver in the world, points to an eventual peak price that makes any near term risk almost inconsequential. Even if one assigns a one or two dollar risk in silver should the commercials prevail in snookering the technical funds yet again, what's that compared to peak prices of $100 or more?

That said, another selloff can't be considered a fun prospect. But it would be wise to remember that silver is still dirt cheap and all the stars and planets are aligned for sharply higher prices except the one having to do with COMEX positioning. Almost regardless of what happens pricewise, in time the COMEX positioning aspect will be resolved in some manner. Long term investors are advised to do just that focus on the long term.

The only problem is for those investors who tend to go all-in like me. The only way such investors can take advantage of any selloff is to raise some cash by selling a portion of holdings before a potential selloff. One takes the risk of missing the big rally on any portion of holdings sold. It's a nerve-wracking business that doesn't always play out as intended and, as such, one that you

would be well-advised to avoid. The best approach is to stay fully invested and use fresh funds to buy silver should it decline.

As for what this week's COT report is likely to reveal, the big up day last Thursday undoubtedly featured continued heavy technical fund buying and commercial selling, but Monday's and Tuesday's holiday trade featured very heavy volume on the selloff that has me scratching my head about who may have been buying and selling. I'm prepared for further deterioration (commercial selling) in Friday's report, but not enough to reliably estimate. Expect the unexpected.

Ted Butler

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Silver – $15.30 (50 day moving average – $14.30)

Gold – $1210 (50 day moving average – $1105)