

## February 27, 2013 – Odds and Ends/Switching

### Odds and Ends

I'd like to address a couple of things before the main thought of the day. I've read a variety of commentaries (many sent by readers) that concern the current very high total open interest in COMEX silver. Total open interest is the total number of all long and short contracts in a market and can be an important metric. Until last night, the total open interest in COMEX silver futures was recently above 150,000 contracts, the highest level in years. Since each COMEX silver contract is for 5000 troy ounces, that means that 750 million ounces of silver are held long (betting on the upside) and short (betting on the downside).

750 million oz is also the equivalent of annual world silver mine production. I don't know of any other regulated futures market where total open interest equals annual world production, certainly not in any metals contracts like gold, copper, platinum or palladium or in any other commodity of finite supply (remember that term from the "old days" of position limits?). And this says nothing of an additional large and separate open interest in COMEX silver options. The disproportionately large open interest in COMEX silver versus real world production, consumption and inventories compared to all other commodities is what originally alerted me to the manipulation in silver 27 years ago.

But I'm going to stop right here and say that the current very high level of total open interest in COMEX silver is not particularly instructive at this time. That's because there is an unusually large number of spread transactions embedded in the total open interest numbers. Spreads are transactions involving the purchase of one contract month of a commodity and the simultaneous sale of a different contract month of the same commodity (not always, but mostly). Since there is an offsetting long and short position, spread transactions are said to be non-price directional. In other words, spread transactions are generally not affected if the commodity goes up or down, nor do spreads impact the price of a commodity. Spreads are bets on how the months involved move relative to one another and not on the overall price of the commodity.

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For some reason (which I can't figure out), there are an unusually large number of spreads in COMEX silver currently and this is why total open interest levels are so high. For instance, in the latest Commitment of Traders Report (COT) that most accurately delineates spreads, the total number of spreads as of Feb 19 was 52,631 contracts, or a full third of total open interest on that date of 155,353 contracts. [http://www.cftc.gov/dea/futures/other\\_lf.htm](http://www.cftc.gov/dea/futures/other_lf.htm) Once you remove the spreads, the total open interest in COMEX silver drops down to close to the 100,000 contract open interest usually prevailing. Again, since spreads are not price directional bets, they should be removed before anyone dissects total open interest in the silver market.

Even though I am unsure of why there have been so many spreads in COMEX silver lately (some 20,000 more than "normal"), I know for sure what effect it has on concentration ratios. Concentration ratios are also given in the above link and for every other commodity market weekly in the COT. The CFTC provides a figure for the percentage of the market held on a gross and net basis by the four and eight largest traders on the long and short side for every commodity. The agency's reason for doing so is to monitor concentration ratios to guard against market manipulation, which is caused by large concentrated holdings. The most important figure is always the net concentrated position of the big 4 on the short side of COMEX silver, in my opinion. The way you determine this figure in the report of Feb 19 is to multiply the total open interest listed of 155,353 contracts by the percentage given for the big 4 net short position (30%) to get the position expressed in number of contracts held net short by the big 4, or 46,606 contracts.

What bugs me is that if the short position of the big 4 (60% held by JPMorgan) is 46,606 contracts (it is), then once you remove spreads, the actual percentage holding of the big 4 jumps to more than 45%. A thirty percent market share is too high, but 45% is flashing concentration levels off the charts for 4 traders. I guess my gripe is that the CFTC is publishing data that verges on being intentionally misleading. I mean, I can figure it out, but why doesn't the agency make it more transparent and easier by providing true net percentages of the market by removing spreads from the total open interest? There is a big difference between a 30% net market share and a true 45% net market share. Let me end this wonkish discussion and get into a more general discussion of the COT.

Over the past few years and months, there has been an explosion in market commentaries utilizing the COT report. I think that's for good reason, namely, that the data contained in the report is important to the past and likely future direction of price. As I think you must know, I find the report invaluable in my market analysis. I even remember a few years back (ten?) when the CFTC solicited public comments on proposed changes in the report. It seems that the way the CFTC solicitation was written it gave the impression that discontinuing the report was also being considered. Alarmed that the CFTC might discontinue the COT report, the public outpouring was remarkable, in the thousands, including some of the top institutional names around.

Needless to say, the COT reports have continued and the changes and improvements to the report by the CFTC are highly commendable. I think the reports are terrific; my complaint is that the agency ignores acting on the data it publishes, as that data prove manipulation on the short side of silver.

Along with the explosion of commentaries and analytical interest in the COT report, naturally come some counter arguments that the COT should be ignored. This isn't necessarily a bad thing, as the world would be pretty boring if everyone agreed on everything. The best thing about disagreement is that it allows you to examine the reasons someone might disagree. For instance, I've read where it is alleged that the data in the COT were inaccurate and that the big banks fibbed on their positions. I think the commercials, particularly JPMorgan, are crooks when it comes to silver, as well as fibbers, but it is important to understand what it is that's being lied about. As far as I can tell, JPMorgan is not lying about its positions on the COMEX; it is lying about what it holds in markets away from the COMEX. In other words, the real fib is the excuse behind its COMEX positions. And make no mistake; JPMorgan does need to lie about its concentrated short position in COMEX silver because there is little doubt that it is manipulative to the price of silver.

One of the reasons I think the data in the COT are accurate is that every contract has a long and short side. Therefore, to lie in the large trader reporting system that underlies the compilation of the COT, would require two lies; one by the big commercial lying and another by the counterparty holding the opposite side of the contract. I can see JPMorgan wanting to lie on its COMEX holdings, but I can't see why a counterparty tech fund or speculator would assist in that lie. Please remember that lying on a large trader report is illegal and will be prosecuted by the CFTC (one of the few things they do well).

The main reason I believe the data in the COT are accurate is that they indicate a concentration on the short side of COMEX silver that proves manipulation. This is the data that have caused the CFTC to investigate silver so many times in the past few years. Without this data, the CFTC never would have investigated silver at all. As I've indicated previously, if the data in the COT didn't show the unusual concentration on the short side of COMEX silver, none of my allegations would have ever been investigated. Without this massive concentration, there would be no basis for alleging a silver manipulation and you would not hear a peep from me. It is precisely because the COT report is accurate that manipulation comes into view.

I appreciate that it takes some effort and time to grasp the meaning of the COT report. It's not like studying nuclear physics, but it doesn't jump out at you in understandable ways when first encountered. At least, it didn't for me when I started studying the report 30 years ago. In those days it came by snail mail and only once a month; so getting it weekly on the Internet (for free) with only a three day delay is like comparing a Kia to a Ferrari. The report is so much better today that it's not funny. It's easier to dismiss something not quite fully understood and I think that's behind much of the recent negativity towards the COT as an analytical tool.

Finally, in introducing the main theme today, I'd like to touch on something I don't think I've ever mentioned. For anyone who writes articles on the Internet, criticism must be expected and should be welcomed if that criticism has merit. But one bit of criticism directed towards me always struck me as being particularly untrue and unfair. That was the criticism that I was just writing what people wanted to read and hear. Hello? The stuff I've written about on the Internet for more than 15 years concerned metal leasing, manipulation, concentration, position limits and market regulation and is as far away from what folks wanted to hear as is possible, in my opinion. In any event, I don't set out to write what folks want to hear, but I do admit to writing for the purpose of influencing others. I have always intended to get folks to understand the issues I write about and not in pandering to them. Therefore I don't think I'll make many friends with the following, but I sincerely believe those that make the suggested switch will be highly rewarded. Certainly, regular readers won't be taken back by it.

Switch Gold to Silver If You Can

If there has been one consistent theme that I have maintained from whatever can be described as the very beginning for me, it is that silver would prove to be a far better investment than gold in the long term. Accordingly, it has been natural for me to suggest a switch; selling gold and using the proceeds to purchase silver. I know that many gold investors are repelled by any suggestion to sell gold under any circumstance, so I would not annoy them by making such a suggestion lightly. Knowing that built-in resistance, I would not ask that anyone simply take my word for it, but instead merely ask that you consider my reasoning for such a switch.

Please know that I am not negative about gold's immediate price prospects; in fact, the extreme market structure on the COMEX, the principal price-setter for gold, looks to be set for a price rally according to what I see. Therefore, I expect gold to rally in price. Then why in the world would I suggest the sale of gold if I expect the price to rise? That's because I am not suggesting only the sale of gold, I am suggesting the sale of gold AND the purchase of silver at the same time. And the simple reason for making that suggestion is because the facts indicate that silver will outperform gold by a wide margin in the future. In other words, making such a switch from gold to silver will result in much more profit than by sitting pat and holding gold and not switching. Best of all, I think there is a stronger case for a switch now than at any time over the past decade.

Since I have long felt more positive about silver than gold, it's fair to ask how that suggestion has turned out over time. Actually, pretty good, as silver has kept up with and exceeded gold's performance over most reasonable time frames going back 5, 10 or 12 years ago when I first started writing for Investment Rarities, Inc. Certainly silver is more volatile than gold and if you bought silver and sold gold at the peak of silver price spikes the pay-off hasn't come yet. The only real lesson from that is not to buy silver after it has spiked up in price. Currently silver has been in a price slump for a while, making it easy to avoid buying on a price spike. The bottom line is that silver has kept pace with gold over the past decade and most that made the switch from gold to silver are better off for having done so. But that's not the reason for why I would suggest a switch be made at this time.

Fortunately there are many good reasons, but if I had to pick only one reason why you should switch gold into silver at this time it would concern investment money flows. This is a concept I have been thinking about a lot lately. For better or worse, it is internally driven and very little has been written about it as far as I can tell. It has to do with looking at gold and silver, not in terms of ounces or tons, but in terms of what those ounces represent in dollars. In other words, first convert gold and silver ounces into what they are worth and then do the relative comparisons. This is not a difficult exercise and I think it reveals a lot.

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I started doing the conversion to dollars from ounces in comparing existing world inventories for gold and silver. At current prices, the 5 billion+ gold ounces in the world are worth some \$8.5 trillion. Because gold is basically not an industrial material driven by industrial users, I feel it fair to include all the gold said to exist in the world. Because silver is an industrial material and the price will eventually be determined by investors and industrial users competing with each other, I only include the one billion+ oz of silver in the 1000 oz bar form bought by users and silver ETFs. At current prices, the value of these 1 billion silver ozs is less than \$30 billion. In other words, the entire world's gold (\$8.5 trillion) is worth almost 300 times more than what all the silver bullion in industrial form is worth. That's a lopsided equation that seems certain to end with silver gaining in price much more than gold.

Twelve years ago, all the world's gold was worth around one trillion dollars. Twelve years later, at \$8.5 trillion, no large asset class, including stocks, bonds and real estate, has climbed anywhere near as fast as gold's total market capitalization. The value of all the world's silver industry-grade bullion inventory has grown as fast as gold's on a price percentage basis, but at \$30 billion in total worth, silver is a pittance in relation to gold, stocks, bonds and real estate. My point here is simple – as world asset classes grow into the many trillions of dollars of worth, they usually reach a point where that size begins to limit additional large percentage price gains. Bubbles aside, the bigger asset classes get, the more “drag” is exerted on additional price gains. In simple terms, it's harder to lift an \$8.5 trillion asset class (gold) than to lift a much smaller asset class (silver).

As time marches on, from a size perspective, more drag must be exerted on gold than on silver. It should be easy to see that if an equal percentage of existing gold or silver were to be sold, that would result in wildly different dollar amounts of metal potentially coming to market. If 1% of the world's gold were offered for sale, some \$85 billion of gold would be offered. If 1% of the world's silver bullion were offered, that would amount to \$300 million. Which should influence prices more to the downside – \$85 billion or \$300 million?

Perhaps the most compelling comparison of the dollar amounts of gold and silver comes when you compare the new amount of world annual investment of each is required to maintain the price. First, I'll do the ounce comparison and then convert it to dollars. With an annual total gold mine and recycling production of more than 100 million ounces, some 60 million oz of gold must be bought by the world's investors in order to absorb the new flow of gold in order to maintain or drive the price. Sixty million oz of gold is worth close to \$100 billion at current prices. Therefore, the world must spend \$100 billion each year to buy the new supply of investment gold coming to market.

Since silver is largely an industrial material, the vast majority of its total world production of one billion oz is consumed in many various industrial and other fabrication demands. The amount of silver "left over" for investment annually after all other demand is somewhere around 100 million oz. At current prices, that comes to around \$3 billion. In simple terms, gold needs \$100 billion annually in new investment buying to absorb the new investment supply and maintain the price; silver needs around \$3 billion annually to sop up new investment supply. It seems clear to me that coming up with \$100 billion a year should be harder than coming up with \$3 billion. Because so little money is needed to drive silver prices higher, it would appear obvious that investment flows must work in silver's favor compared to gold.

Compounding this example is the fact that the gold story is much more advanced than the silver story and some very big and well-known names among the hedge fund community have come to embrace gold over the past few years. So widespread has been hedge fund investment in gold that the cycle has advanced to the point where some big names are now selling gold as well. Compare that to silver where few big hedge funds have taken a silver position. Certainly it will be very hard for hedge funds to sell physical silver since they haven't bought it in the first place. The implications for potential investment flows into silver by hedge funds are staggering in that they are just learning the real silver story.

One thing that hasn't changed is the potential of an industrial user inventory buying panic in silver where that doesn't seem possible in gold, since there are so few gold industrial users. A coming clash and buying competition between silver industrial users and investors over 1000 oz bars seems inevitable to me and is accentuated by the tiny amount of money (\$3 billion annually) actually available in metal to be fought over.

Obviously, this article is targeted on gold investors who should own more silver. One of the reasons I persist in preaching the switch from gold to silver gospel is because those who have held gold for the long term are sitting pretty and are in a position to take advantage of the outstanding investment potential of silver. Because silver has largely moved in lockstep with gold over the past decade, gold investors have the buying power with which to purchase silver. I don't know of many investments that have kept up with silver over the past 10 to 12 years and because gold has it has created an unusual opportunity for those gold investors to now switch into silver. For an investor who bought gold at \$300 or \$400 an ounce, converting to silver is like buying silver at \$5 an ounce.

Finally, this is a logical switch as no two investment assets are more similar than gold and silver. It's not like switching to a completely different asset class, like into raw land or the biotech industry; I'm talking about two precious metals that have existed side by side for thousands of years. For those investors reluctant to part with gold for any reason, perhaps you might consider this as a way to increase your gold holdings. By selling gold and buying silver now, you can later sell silver into my expected price spike and buy more gold ounces with the proceeds than the ounces of gold sold originally.

It almost doesn't matter to me which direction the gold price moves, up or down. Because of the small amount of money needed to support silver, a decline in the price of gold doesn't automatically mean silver must fall from current depressed price levels. Conversely, a rise in the price of gold should easily allow for silver to climb faster. As I said, I expect gold to rise in price, just that I expect silver to rise much more considering the large dollar headwinds present in gold. If gold prices do rise (as is suggested by the current market structure on the COMEX), those headwinds will become stronger, not weaker. I believe any gold investor that checks the math as I've presented it will become convinced of silver's better investment prospects. The whole idea about investments is to hold the best investment possible; the one that gives you the best bang for the buck. From my dollar flow comparison, the best investment is silver, whether you have gold to sell or money to invest.

Ted Butler

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Silver – \$28.95

Gold – \$1596

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