Jan. 6, 2010 – The Cotton Caper

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Yesterday, the CFTC published its findings on an almost two year investigation by the Division of Enforcement on allegations of a manipulation in the price of cotton during the week of March 3, 2008. This concludes one of the three major investigations into manipulation that the CFTC has been conducting; the other two being crude oil and silver. The bottom-line conclusion of the investigation into the sharp run up in cotton prices was that there was no manipulation.

Perhaps some may find it odd, but I generally agree with the CFTC's findings. In fact, the investigation contained no surprises for me at all, as I felt from the beginning that the conclusion was obvious. But there are some very important lessons in the cotton report for what lies ahead in the silver market. The complete report can be found here – http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/cottonfuturesmarketreport0110

First, allow me to provide some background into what led to the investigation of a cotton price manipulation. In late February to early March 2008, the price of cotton futures and options ran up from roughly 81 cents a pound to $1.09 and then collapsed back to 81 cents, all in the course of about a week. This price action caused great damage to the commercial shorts, mainly cotton merchants and producers. These commercial cotton shorts were very vocal about their losses and they are politically well-connected. They were instrumental in getting the CFTC to hold a one day agricultural Â?complaint-festÂ? in Washington, DC, to air their gripes. I watched the entire episode at the time and remember the cotton shorts as the biggest complainers. The event is still available on the Internet – http://www.cftc.gov/newsroom/cftcevents/2008/oeaevent042208.html

It struck me as odd at the time that producers and owners of inventory would complain about high prices, until it became obvious that they all were heavily short cotton and grains. These shorts were all blaming the long position holders for the high prices. As the CFTC's report makes abundantly clear, it was the short position holders who were responsible for the run up in prices. The longs didn't buy or sell much at that time. The shorts panicked when their positions moved against them and they received margin calls they couldn't meet and were forced to buy back their short positions all at once. This short covering panic drove prices sharply higher and when this buying subsided, prices then collapsed. This is pretty basic stuff and the CFTC report confirms this.

I'm simplifying things to a great extent as this is an issue that I have written about frequently in the past. I am also convinced that the big run ups in wheat and crude oil in 2008 were as a result of short covering panics by commercial shorts caught off guard. I believe there is a direct connection in this cotton report to the silver market. In 2008, I wrote that the big short commercials in wheat, cotton and crude oil were the real speculators, not the longs. This was the concluding paragraph of an article titled, Â?The Real SpeculatorsÂ?
http://www.investmentrarities.com/ted_butler_comentary/06-10-08.html

Â?In the meantime, we must try to decipher and understand and learn from the events of the day as they occur. I think oil prices recently shot up, just like wheat and cotton did not so long ago, because a number of shorts, at the margin, decided to buy back short positions in a hurry. I know that the short position in silver is held by very few participants, so when they cover, it will not be an event measured at the margin. It will be an event characterized by a change at the core of the market. The short covering in oil, wheat and cotton are just a hint of what's to come when the shorts cover in silver.Â?

Of course, there are plenty of differences between what occurred in cotton, wheat and oil, and the circumstances in silver. For one thing, the short covering in cotton, wheat and crude oil has already occurred; the short covering in silver is ahead of us. It's too late to position yourself for the short covering rallies of 2008; there's still time for the short covering to come in silver. Another important difference is that there were no obvious physical shortages in cotton, wheat or crude oil in those short covering rallies. With silver, it's hard to imagine the coming short covering rally not being accompanied by physical shortage. The only question is whether the physical shortage will kick off the short covering, or the short covering will kick off the shortage (as industrial users panic). The point is that as dramatic as were the short covering rallies in cotton, wheat and crude oil, they will not compare to a short covering rally in silver accentuated by a physical silver shortage.

Most importantly, the CFTC investigations into possible cotton and crude oil manipulation were for events that had already transpired. Any market crime, if one did exist, was already over. In silver, any manipulation would be a crime in progress. This makes all the difference in the world. A crime in progress demands immediate regulatory attention. That the CFTC has taken almost two years to reach the obvious conclusion in cotton and probably the same in oil at some point is not that critical, time-wise. They should take their time and get it right. But for them to drag their heels on allegations of a manipulative crime in progress in silver is shameful. This delay is going to haunt them in the future.

A quick closing comment on the great price action of the past few days. While gratifying and in accordance with recent suggestions to deploy any dry powder on price weakness, it's still too soon to conclude whether the big move has started. I guess I don't want to jinx it, but hopefully everyone is fully invested. I will comment more as the evidence rolls in.

Ted Butler

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