January 18, 2017 – Paper/Physical Connection

The Paper/Physical Connection

More observers than ever have become convinced that futures market trading has come to set prices for the physical markets that futures trading is derived from. The way it is Â?supposedÂ? to work is that changes in actual supply and demand in world commodities (the law of supply and demand), cause price to rise and fall and governments allow futures (derivatives) trading so that actual producers and consumers can hedge or lay off price risk. Of course, there would be no hedging possible if a sufficient number of speculators didn't exist to provide liquidity to the hedgers. However, things don't always operate as intended.

Principally as a result of the institutionalization of financial markets (not evil in and of itself), a remarkable shift has occurred in the profile and composition of futures market traders over the past few decades. In many markets, like gold and silver, both traditional hedgers and small speculators have been driven out of futures markets to the point of near extinction and replaced by mega speculators and other large traders pretending to be hedgers. While not the central theme of this article, let me at least provide proof of what I just stated.

Government data, in the form of the weekly COT report, clearly demonstrate that the two largest categories for position changes are the managed money traders and the commercials. Believe it or not, there was a time when the small (non-reporting) traders were the category to follow; now, such traders are hardly an afterthought (I can't recall the last time I mentioned the non-reporting traders). And it's not just me, practically every article I read focuses on the twin headline positions of the commercials and managed money traders. In terms of position changes and price impact, the small traders, effectively, no longer exist, having been replaced by the much fewer in number but massively larger managed money traders.

As far as the disappearance of legitimate hedgers in futures trading, many are confused because the two commercial categories listed in the disaggregated COT report are titled Â?Producer/Merchant/Processor/UserÂ? and Â?Swap DealerÂ?, thus strongly implying that the traders in these categories are, indeed, legitimate hedgers. But category titles can be deceiving and in the case of gold and silver, at least, a bit of common sense is required to determine that. The real producers of gold and silver, the miners, are mostly publicly-traded companies and as such are required to disclose any hedging they engage in.

Of the many hundreds of publicly-traded gold and silver mining companies, I'm hard pressed to come up with any that disclose any type of hedging, particularly on the COMEX. Some gold and silver mining companies do hedge by-product base metal production, but hardly any hedge in gold or silver. I don't study mining companies deeply, so if you know of any actively engaged in hedging gold or silver, please let me know. I did follow hedging by mining companies years ago, when leasing/forward selling was prevalent and exerted a great influence on gold and silver prices, but that type of hedging no longer exists.

My point is that the actual producers of gold and silver, the mining companies, aren't hedging on the COMEX, regardless of what the COT category titles may be. We also know, from other CFTC data that the commercials in COMEX gold and silver futures are mostly domestic and foreign banks. Probably because the titles – commercials and producers/merchants and swap dealers – are used to describe the banks trading in COMEX futures (opposite to the managed money traders), many assume the banks must be hedging, otherwise they wouldn't be included in commercial categories. That assumption is flat out wrong. Every bit as much as the managed money traders are speculating, so are the banks and other traders in the commercial category.

This is old stuff to regular readers and serves only as a background for today's intended theme. The growing recognition that futures trading has grown so large relative to actual commodity production and consumption so as to control prices and that the principle futures traders are nothing more than massive institutional speculators on either side of the market, has led to a number of memes. One particular meme that has grown in popularity is that there is a growing disconnect between the paper futures market and the physical market for gold and silver that is destined to blow up and result in the destruction of the COMEX amid soaring prices. In fairness, I suppose I may be responsible for some of this thinking, considering how I harp on the fact that it is wrong for speculative paper market positioning to set and dictate prices to the host physical markets and how that can't last forever.

Therefore, I think it would be appropriate to comment on how this paper/physical COMEX connection might play out. Not that I have a lock on what may transpire in the future, as no one has such prescience; but, as always, I'll give you my reasoning and leave it up to you to decide for yourself. First, it is important to acknowledge that COMEX paper positioning has never been a stronger price influence than it is currently. If COMEX paper positioning is about to end as the prime price driver for gold and silver, it has not been slowly shrinking in influence, considering the record large bearish and bullish market structures over the past year. By extension, that means any break between paper and physical is likely to be dramatic (which I would agree with).

Second, I think a distinction must be made between gold and silver. I see constant references to gold soaring by thousands of dollars when the physical market overwhelms the COMEX paper market. I have trouble with that because the COMEX futures market in gold, while it is the price driver, is not all that large when compared to the physical world of gold. The latest COT report put the total commercial net short position at 126,000 contracts or 12.6 million oz. That's a lot when converted to dollars ($15 billion), but not so large when compared to annual world production (100 million oz) or total world inventories (5.5 billion oz).

It's different in silver, where the commercial net short position on the COMEX is around 80,000 contracts or 400 million oz, or close to 50% of world mine production and more than 25% of the 1.5 billion oz thought to exist in bullion form (1000 oz bars). Clearly, any type of COMEX blow up would impact silver much more than gold, given the large and disproportionate percentage of paper positions relative to real world amounts in silver compared to gold. And if I'm wrong (as I hope I'm allowed to be) and some type of breakdown in COMEX paper dealings impacts the price of gold more than I suspect, I still feel if that occurs the net result would be a much larger impact in silver.

The most popular theme about the coming COMEX paper/physical disconnect is a delivery default; a failure to deliver physical metal when required to a futures long contract holder. Once again, this is a subject I have contemplated from the beginning, decades ago, although I haven't written much about it over the past several years. There's a reason for that Â? I don't think we will wake up any day soon where long futures contract holders on the COMEX are suddenly demanding inordinately large quantities of gold or silver be delivered.

For one thing, the biggest futures contract long holders are the managed money traders and it appears highly unlikely they would suddenly change their stripes and demand physical. Even if they did, the exchange would intervene to quash any unreasonable delivery demands that were intended to push prices higher. In fact, it is precisely because there has been virtually no demand for physical delivery in silver or gold from managed money traders or other speculators that JPMorgan has been able to take just about all the silver delivered on the COMEX for years. I do think there will someday be inordinate delivery demands for physical silver on the COMEX by industrial users and others, but that will come only after widespread shortages have developed.

Over time, I have become less concerned about the immediate prospects for a delivery default in COMEX silver for a different reason, namely, any such default would likely be the death knoll for the exchange and its parent, the CME Group. While I do insist that it is completely wrong and illegal that paper trading sets the price for physical metal, there has been no disconnect whatsoever in the ability to convert paper to physical via the COMEX delivery mechanism. (The same goes for the share/metal conversion mechanism in the big ETFs, SLV and GLD).

Until and unless the COMEX futures/physical delivery mechanism is vacated or interrupted in any way, there is no reason to expect the physical market to overwhelm the paper trading market. However, should the COMEX futures/physical delivery mechanism be disrupted or suspended for any reason, the physical market will immediately overwhelm the paper market. Everything rests upon the sanctity of the delivery mechanism. This is the glue that cements the legitimacy of the COMEX and the CME Group.

So important is the delivery mechanism that it's hard for me to see it ever suspended. Many speak of a coming switch to a Â?cash settlementÂ? of some type from the current physical delivery mechanism, but I don't see it. The managed money and other speculative traders which deal in COMEX silver futures may never have taken (or made) delivery of physical metal on futures contracts, but that's not the same as them continuing to deal in such contracts should delivery contract requirements be suspended. It's too easy to switch to dealing with allocated physical metal or instruments where the physical mechanism remains intact (like in SLV or GLD). If I know this, then the CME certainly does as well.

Because any suspension of the physical delivery mechanism in COMEX silver would bring every physical delivery contract trading on the CME into question and drive business elsewhere eventually resulting in its demise, I can't see it happening. At the same time, I can't see the current paper positioning price dominance continuing indefinitely either, because it has little to do with actual supply and demand. The solution, it seems to me, is much higher silver prices which will eventually dissuade those seeking physical delivery. Not at first, to be sure, but eventually.

In response to a subscriber question this week, I commented that the COMEX was like the Mafia, in that it was too well-established and proficient at making money that it would never do anything to undermine the continuity of the enterprise. It is for this reason that the COMEX wouldn't tamper with the physical delivery mechanism in silver or gold. Besides, now that the main silver price manipulator and former biggest paper short, JPMorgan, is positioned the best it has ever been for higher silver prices, there is less reason for the COMEX to mess with the physical delivery mechanism.

Yesterday, silver finally joined up with gold in the decisive upward penetration of its 50 day moving average in very heavy trading volume on the COMEX. Gold, of course, had previously penetrated its 50 day moving average every day of the holiday shortened reporting week that ended yesterday. There's no doubt that managed money traders were net buyers and the commercials were net sellers in the COT report to be released this Friday; the question is by how many contracts and which commercials sold?

Based on changes in total open interest, I'd guess we'll probably see the same overall deterioration that I originally predicted for the last report (which, fortunately, came in under), or a 30,000 to 40,000 contract increase in the total commercial net short position in gold and 5000 to 10,000 contracts in silver. Like last week, I'll also be happy to be wrong if my guess is too high. Even if I prove to be too low, the overall market structure can't be considered to be strongly bearish, because it's nearly impossible to flip from a strongly bullish market structure to extremely bearish in a week or so.

Seeing as we have climbed in price by $85 in gold and close to $1.50 in silver from recent lows, it's only natural that we would experience an increase in commercial selling and managed money buying. After all, this is the main price driver. While we are not in bearish territory in market structure terms, the managed money buying and commercial selling to date does increase the possibilities of sudden price selloffs of the scam within the scam variety I've written of previously. Be that as it may, there is greater room for price rallies as opposed to prolonged price declines.

The key is still what the market criminals at JPMorgan are up to. If they have added aggressively or do add aggressively to silver short positions, then the chance of this rally being the big one is diminished. Until then, the prospect remains alive. Unfortunately, I can't tell which it is until the cards are turned over in the form of the new (and later) COT reports. Then, it becomes a matter of read Â?em and weep or halleluiah.

I do know that the actions (or lack thereof) by JPMorgan are the key to silver, just as they have been for the past near nine years, or ever since the bank acquired Bear Stearns. I also know that JPMorgan will need sharply higher silver prices to monetize profits on its massive physical silver holdings and that it has never been in a better position than now for letting prices rip upward. Finally, I know that I will continue to identify JPMorgan as the big silver crook and manipulator until the facts suggest otherwise. What I don't know is how long a supposedly reputable financial institution can ignore direct and open allegations of wrongdoing; but I wouldn't be terribly surprised if I came to know that as well.

Ted Butler

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Silver – $17.15 (200 day ma – $17.85, 50 day ma – $16.82)

Gold – $1208 (200 day ma – $1269, 50 day ma – $1189)

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