# January 21, 2011 – The Sell-off and a Word on Spreads

The Sell-off and a Word on Spreads

I was planning an article on position limits, but market activity takes precedence. I'll cover more in the weekly review, so I'll try to make this brief. Silver got smashed, falling more than $2 in a 24-hour period. As is often the case, it was the weakest commodity on the sell-off compared to other commodities, including gold and other precious metals. Some would say that is only normal and fitting, as silver went up more than most commodities. I don't agree with that.

Yes, an 11%+ sell-off for a commodity that rose more than 80% in a year and more than 170% in two years wouldn't seem out of place. I understand that. I just don't agree with it. That's because I'm not much for price projections, particularly of the short term variety, even though that's what everyone desires. I'm more interested in the reasons behind what moves the price of silver. That's a prime purpose of this service Â? to understand and explain what the silver price is doing at any particular time.

The sole reason for this latest swoon in the price of silver is coordinated and collusive manipulation upon the part of the big commercial interests, including JPMorgan, on the CME Group's COMEX market. I realize that I make this statement repeatedly whenever there is a significant sell-off in silver. I don't set out to be repetitive, nor do I have my mind made up in advance; it's just that commercial manipulative behavior always stands out as the sole cause of every silver sell-off. Certainly, one would think if it weren't so clear that the commercials were engaged in collusive illegal behavior on what I call a criminal enterprise of a market (the CME), one of them would object to my characterization of them as crooks. I'll let you know when and if that occurs.

Collusion is a strong word. I don't use it loosely. It's easy for me to label the large COMEX commercial trading entities as operating collusively on this sell-off, because they have operated collusively on every silver sell-off over the past 25 years. The proof is simple and clear and contained in CFTC data, both the COT and Bank Participation Reports. This sell-off and every sell-off have always been met with uniform commercial net buying. There has never been an exception to this pattern. How is it possible that the big commercials can always find themselves to be net buyers on every sell-off? Easy Â? they are acting collusively. In fact, considering their easily documented history, it is not possible for them not to be acting collusively. How otherwise could one cohesive group always end up buying big on every decline? Are they just the luckiest sons of guns in the world or is there a more plausible explanation?

That there exists a federal regulator, expressly created and funded by taxpayers, to prevent such collusive behavior and the collusion still persists is more than disheartening. We are all collectively diminished with the collusive criminal behavior and the regulators' sanctioning of it. The mechanics of the crime are also simple Â? gun the markets through critical levels where known technical selling will occur, collectively pull bids, operate when trading conditions are thin, raise margins when the longs are most vulnerable. We're witnessing all these dirty tricks and then some currently.

When will it end? When the last leveraged long is liquidated. That we are now decisively below the key 50-day moving average, the last of the speculative capitulation is fast approaching. What price will it end at? I don't know and I don't think anyone else does either. I thought we had seen the worst more than a dollar higher.  I am convinced that when this forced collusive sell-off is complete, the price of silver will rocket, as physical fundamental conditions for silver have never been better. What should you do? Hold and buy more if you can, but only on a cash basis, no margin. Cash buyers don't get margin calls and can't be forced to sell.

As aggravating and scary as these engineered sell-offs can be, it is important to recognize that it makes for a stronger market structure. Not just because the price is lower and a better value, but because the crooked commercials will soon run out of the reason to rig prices lower, namely, to force leveraged speculators to sell. We'll only know in hindsight what the actual bottom will be, but all the data tell us we are much closer as a result of this smash than we were before. It's no fun experiencing these crooked sell-offs, but I would submit it would be a lot worse in not knowing what was really going on. Knowledge gives us power.

On Wednesday, the COMEX experienced an epic event in the silver spread market. Let me state this clearly Â? the spread differences between the various trading months in COMEX silver futures experienced the largest price changes in history. The price direction of the spreads was to relative price strength in the nearby months and weakness in the more deferred months; a dramatic Â?tightening Â? of the spreads that may be a precursor to backwardation, or a premium developing on the nearby months. Let me be frank Â? I'm not sure what this monumental spread price move may mean at this point. There is no news from knowledgeable and trusted observers, just that the market changed.

Spreads can be an esoteric issue, so let me try to describe them in understandable terms. For some background, I did specialize in spread trading when I was a commodities broker, some 25 to 30 years ago. I haven't traded spreads in almost as many years, but I do study them in silver. The only silver spread trading I ever engaged in was for tax purposes, but that disappeared with changes in the tax code decades ago.

There are different trading months in all commodity futures markets. In silver, the trading months range from the January 2011 contract to the December 2015 contract. Most of the spread trading volume and open interest is confined to the nearest months, as trading volume and open interest trails off the further you go out on the time spectrum. Each trading month has a price and spread traders hope to profit by simultaneously buying one month and selling a different month. Because a spread position involves being long one month and short another month, changes in the actual price of silver don't exclusively impact spreads much. In other words, a one dollar rise or fall in the price of silver doesn't impact a spread trader as it would someone long or short a single contract, as both months of a spread position would generally rise by a dollar, creating a gain on the month long and the same loss on the month held short. Where the spread trader profits or loses is in the relative change between the months of the contracts he holds.

Because there is less risk in a single spread position consisting of both a long and short position than an outright long or short position, the margin requirements for spread positions are a small fraction of the margin requirements required on outright positions. Currently, the minimum margin requirement for speculators is a bit over $11,000 for an outright long or short COMEX silver contract, but for a spread position (one long and short combined) the margin can be as low as $200, depending on how far out one goes on the trading spectrum. Because of the low margin requirements and lower perceived risk, spreads traders usually deal in many spreads in order to make it financially meaningful. It's not unusual for a spread trader to carry 50 or 100 contracts where a non-spread trader would carry one outright contract long or short.

A one-penny move on a COMEX contract is equal to $50. For someone holding an outright long or short position, a $50 move on an $11,000 margin deposit is less than one half of 1%, no big deal. But the same one penny or $50 move on a spread position with only a $200 margin deposit represents a 25% gain or loss and is meaningful. What influences spread changes between the different months is similar, but not identical to what moves the price of silver (away from the manipulation). The influences on spreads include the price of silver, interest rates, storage charges and things like that.

Because of the low margin requirements on spreads and for other reasons I can't fathom, there has grown to be a great number of spreads on the COMEX. In last week's COT report (disaggregated futures), of the 136,331 total contract open interest, roughly 42,000 are spreads, or more than 30% of the entire market. I just don't understand the economic rationale or justification of so many spreads. But this has been the case for a while and the silver spread market has functioned fairly routinely

One thing that would greatly impact the movement of silver spreads would be a physical shortage. In a true physical shortage, it would be reasonable to expect the nearby months to actually invert and trade at a large premium to more deferred months. This pricing structure, referred to as backwardation, occurs regularly in other commodities, including base metals, such as copper, or nickel or lead, whenever pronounced tightness in physical supplies is evident in the market. This is a condition that has never occurred in silver as the world has yet to witness an actual shortage of the metal. But if a silver shortage develops, as I expect, there is no reason to expect that silver won't go into backwardation. That would have a pronounced and significant impact on silver spreads, especially considering how many currently exist on the COMEX.

In the event of a true silver shortage and pronounced backwardation, we could easily see the nearby months trading 10% to 15% or more higher than more differed months, as has been experienced in base metals in the past. In that case, we could easily see premiums of $1000 or $10,000 or more develop between certain trading months in COMEX silver. That's a far cry from the $50 move highlighted above. If that were to occur, it would cause a financial disaster for some spread holders and severe stress to the clearing structure. (In the interest of full disclosure, I had privately warned senior officials of the CFTC of this exact possibility more than two months back. If it turns out that my worst fears come to be realized, I'm sure I'll publicly release that warning in due course)

Was the sharp and dramatic tightening in COMEX silver spreads on Wednesday, a precursor to a move to true backwardation? I don't know. The spread tightening was unusual in that it didn't appear driven by delivery considerations. Generally, spread pricing is more gradual and trending, than the sharp out of nowhere event that occurred on Wednesday. It appeared to be driven by spread traders for financial reasons. The tightening was completely at odds with the dramatic fall in the price of silver these past few days as such spread tightening would normally be thought to result in sharply rising silver prices. Instead, the opposite occurred. I don't know how this is connected to the manipulation, but I have been conditioned to believe that there can be no coincidences in a market as crooked as silver. I don't mean to leave you with more questions than answers regarding the spread event, but I don't want to make things up. I'm sure we'll know more as time rolls on.

Ted Butler

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Silver – $ 27.20

Gold – $1342

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