June 22, 2016 – The Money Game

The Money Game

It's follow-the-money time again, so let's look at what has transpired over the past few days in gold and silver. Along the way, I'll discuss some factors that are a given to me, but are perhaps things I don't empathize enough.

Following the money is just another way of saying one is looking for the root cause for what moves financial markets. I suppose there are different money games in all markets, but as you know, I'm primarily concerned with what drives gold and silver prices. Seeing as there are many potential price influences, it is paramount that one identify and highlight the most important influence from the start. What kind of analysis would result if someone overlooked the most dominant influence on price?

In gold and silver, it's essential to conclude that the primary price drivers in the short to intermediate term are positioning changes in COMEX futures contracts, as indicated in the COT report. That's why more follow the report than ever before. Once someone grasps the report's significance, moreover, there's no going back. I've yet to see anyone who has seriously followed the COT report and grasped its relevance ever stop following it and embrace a completely different approach. (How are you going to keep down on the farm after they've seen Paris?)

Once the flame of COT understanding descends on someone, it's not too long before that knowledge quickly focusses on the main feature of the report, namely, that this is a money game between two very specific groups of traders Â? the commercials and the managed money technical funds. Take away these two groups of traders and the COMEX would not exist as we know it. The fact that these two groups account for upwards of 90% of all net positioning changes in COMEX gold and silver and are very small in total number (no more than 50 to 100 on either side), points to the absurdity of how prices are set. Absurdity notwithstanding, these two lightly-populated narrow trading groups determine gold and silver prices. Not to focus on this would miss the point completely. And while it may not last forever, in the here and now, it is the money game that determines price.

The managed money traders are classified (by the CFTC) as operating purely as speculators, while the commercials are assumed to be operating on a hedging or market making basis. Since there is very little legitimate hedging being transacted in COMEX silver or gold related to actual metal production or consumption, it quickly becomes clear that Â?market makingÂ? is just a thinly disguised form of speculation. When the commercials take the other side of whatever the managed money traders wish to buy or sell, as has always been the case, they are doing so to make a profit, not out of some imagined higher calling of public service to provide liquidity and price stability.

I make this point because it helps support and clarify the money game being conducted. The reason so many are pulled to the COT report is because there is an undeniable connection between extreme market structures and gold and silver price movement. There have been very few instances (I can't think of any) when the commercials are light on the short side and the managed money traders are heavy on the short side that prices don't eventually rise, until that market structure is changed. When the commercials are heavily short and the managed money traders are heavily long (like currently) it is very likely that prices will eventually fall, until that market structure is changed.

Therefore, I have always viewed the contest between the commercials and the managed money traders on the COMEX in terms of which side is making or losing money. It doesn't take long to establish that over the years the commercials have mopped the floor with the managed money traders, to the point that the question is invariably asked as to why do the managed money traders persist in a game in which they usually lose. It's a good question that also has good answers, but for the sake of brevity, let me just say that persistent commercial profits and managed money losses are undeniable. (Write to me if you need to know why the managed money technical funds persist in a game stacked against them).

The fact that the commercials have so rarely ever lost to the managed money traders on a collective basis lies at the heart of why gold and silver prices are considered rigged on the COMEX. One would think, even if the commercials were operating as high-principled market makers, that they still might lose from time to time. After all, how is it possible that the commercials have never lost in COMEX gold and silver? Can they see the future with complete accuracy or is there something else that accounts for their remarkably consistent success? Previous I reported that the 4 biggest commercial shorts in silver (and gold) had never suffered a loss on a single contract after adding to short positions.

The simple point is that no one can always know how the future will evolve and the commercials have proven that in other lines of their business (think London Whale). The commercials have always won so consistently in COMEX gold and silver because they control the money game, not because they can see the future better than anyone. The commercials do know how the technical funds will react and how to jigger prices to get the desired reaction from the managed money traders and that adds up to control and manipulation

I claim that the money game between the commercials and the managed money traders in COMEX gold and silver is the primary driving force for price movement and, further, the ongoing money game is reasonably quantifiable. Once you can Â?countÂ? the contract change, it's just a matter of superimposing the price change accompanying the contract change to derive the money results. Collectively, the commercials have made many billions of dollars over the years from the managed money technical funds in COMEX gold and silver and I have chronicled the running financial balance from the beginning of this year.

On Saturday, I calculated the running financial results for the commercials in gold to be close to even for the year to date. On Friday's close, I estimated the commercials had booked and realized profits of close to $1.2 billion for the year to date in COMEX gold and silver and were sitting with nearly a billion dollars in unrealized losses with gold at $1300. That was based upon an extrapolated short position in gold of more than 330,000 contracts (33 million oz) at an average price of $1270.

At yesterday's close (the cutoff date for the COT report), gold ended around $1270, down $30 from Friday's close; so the commercials' collective net loss was eliminated and the commercials are better off, in terms of open losses, to the tune of a billion dollars. If gold rises $30 in price from here, the commercials will go back to an open loss of $1 billion (minus any realized profits from closed out short positions on the drop over the past two days). If gold prices fall another $30 from here, the commercials will be better off by another billion dollars in unrealized profits. This is the essence of the money game.

I'm talking mostly about gold because up until now, silver hasn't moved as much, in money game terms, as gold. The commercials' short position in gold has accounted for most of the money game calculations this year. That is not to say that should silver prices start to move in larger increments, there would not be a more significant contribution to money game results. The calculations are dependent upon price movement and contract positioning change. There have been much bigger positioning changes in gold this year, so it is natural for gold to make up the bulk of the financial results.

The positioning changes have been so large this year, particularly in gold, that it's hard to imagine how such changes could grow significantly larger in the future or be sustained at recent levels. The whole point of the money game premise is that it is so large and quantifiable that nothing is more pertinent to gold and silver price movement. The position changes on the COMEX are much larger and occur with greater coordination with price movement so as to eliminate price changes from other influences Â? like ETF flows or actual production and consumption.

Gold rallied from yearend by $260 as the technical funds bought and the commercials sold nearly 300,000 net contracts (30 million oz) of COMEX gold futures into the end of April. In May, gold fell nearly $90 as the commercial bought and the technical funds sold roughly 80,000 contracts (8 million oz). In little more than two weeks, gold rallied more than $90 as the technical funds bought and the commercials sold more than 115,000 contracts (11.5 million oz). If more verifiable gold or gold equivalents have been transacted in other venues away from the COMEX, I am unaware of such transactions. COMEX positioning drives prices and the money game drives COMEX positioning.

Despite the obvious dominant influence that COMEX positioning has on gold and silver prices and the undeniable successful track record of the commercials over the managed money technical funds, I am still unsure how the current extreme market structure gets resolved. That's because the extremely bearish commercial short position is at odds with almost everything else in the real world of gold and silver to an extent never seen. I confess to leaning towards expecting the commercials to prevail once again, but let me lay out the case as objectively as possible.

In the commercials' favor is that they are currently positioned better than I can ever recall. They hold their largest net short position in COMEX gold (close in silver) both at an average price that is above the important 50 day moving average and with no current unrealized loss, a configuration never seen to my knowledge. Usually, the average price of an extreme commercial position (long or short) is much further away from the 50 day moving average and held with a much larger unrealized loss. (Granted, the unrealized loss was $1 billion a few days ago and can quickly reappear and that is why I am more unsure than ever of the eventual outcome).

At this point, if the commercials are in complete control (as I suspect), they could really put it to the managed money technical funds. By that I mean the commercials may attempt to pull the rug out from under the technical funds by rigging and allowing gold prices to nose dive by $100 or more. Remember, a $100 price move in gold comes to $3 billion in the money game between the commercials and the managed money traders. And while the COT market structure approach is not correlated well to timing price moves, it is hard to see why the commercials would refrain from pulling the rug out sooner, rather than later, if they are in control. I don't mention short term outside events, like the Brexit vote because such events don't have much to do with the real reasons investors should buy gold or silver or not. But such events could cause short term price gyrations apart from COMEX positioning that either set the commercials back a bit or that the commercials can use to their advantage.

The central question is still if the commercials are in control or are hanging on by their fingernails. That equation includes, of course, any double cross by JPMorgan. The not in control version is dependent upon JPMorgan, but also on whether the commercials have bitten off more than they can chew in amassing their current extreme short position. Because this short position is so large, the possibility exists it becomes too expensive to maintain – margin call wise Â? for all the commercials on a sharp surge in price.

Not only will the commercials have a collective unrealized loss of $3 billion on a $100 move in gold, each and every commercial short will have to deposit the full extent of individual unrealized losses with the exchange in margin calls Â? no exceptions. Where any new unrealized losses and margin calls would amount to hundreds of millions of dollars to each of the 8 largest gold shorts, individual margin calls in the tens of millions of dollars would apply to smaller commercials.

In such an event, it is not inconceivable for a smaller commercial to throw in the towel and move to buy back short positions. Also in such an event, if the larger commercials didn't step in to not only sell short into any technical fund buying but also to replace any smaller commercial short covering Â? well, that's the blueprint for a price melt up. Therefore, any possible smaller commercial short covering would likely result in either a price melt up or a noticeable increase in the concentrated short position of the 4 and 8 largest gold shorts.

To this point, net commercial short covering has never occurred on higher prices. The next time will be the first time. Again, that is the prime price proof of the manipulation Â? the commercials have never bought back an extreme short position on higher prices. Once a commercial short position is extreme on an historical basis, it has never been reduced on higher prices. You can attribute that to skill and luck on the part of the commercials or you can surmise, as I do, that the game is rigged, but there it is Â? the commercials have never blinked or panicked as a whole and bought back short positions to the upside.

Please don't think I'm rooting for the commercials to succeed, because a commercial signal failure or full pants' down price explosion would validate everything I have held to be true for more than three decades and get the near lifelong manipulation monkey off my back. It seems it can only go two ways Â? the commercials rig prices lower and buy back as many of their collective short positions as possible or they lose control, for the first time, to the upside. If the commercials do succeed in rigging gold and silver prices lower, I still believe that will be the last such thrust to the downside, but that's dependent on a selloff first.

But I would be negligent in not pointing out that what I just described is nothing short of a massive regulatory failure that didn't have to be. The great shame is that an historical market structure extreme exists in the first place. As I've tried to establish over the years, the COMEX positioning I speak of involves a relative handful of traders in two distinct groups. There are few, if any real metal producers or consumers involved in COMEX futures contract positioning. Why would there be such a participation Â? how would short term trading be a great benefit to a real producer or consumer of metal? Mining companies don't depend or brag about trading on the COMEX; they focus on mining costs and production expansion.

COMEX positioning is strictly a matter of a game between a small group of commercials and a small group of managed money technical funds. The biggest regulatory failure has been in not addressing this clear fact. Where is the common good in allowing the world pricing mechanism for gold and silver to have become hijacked by two highly concentrated trading groups pursuing their own self-interest from the world's real metal producers, consumers and investors? The CFTC's failure has been in not restricting either the commercials or the managed money technical funds in the collective size of their positions. I have no doubt that the commercials are the crooks and collude among themselves and the CFTC has simply looked away. But that's separate from the regulators' failure to restrict the growing size and price influence of the managed money technical funds.

The reason the commercials' short position is so extreme is because the technical fund long position is so extreme. To debate this is like debating which came first Â? the chicken or the egg? Much more constructive would be to recognize that the unintended consequence of unrestricted positions on either side has come to set prices and that is unacceptable under commodity law. The problem is that the regulators refuse to admit that many traders acting as one have the same price impact as one single large trader wheeling around a massive position.

The technical funds aren't concentrated by common ownership, as are the commercials, but they are concentrated by being captive to the same exact trading strategy. It makes no practical difference to price whether one trader buys or sells 100,000 contracts or 50 different traders buy and sell 2000 contracts at the same time and in the same manner as the single large trader. The impact on price will be the same. Commodity law prohibits speculative trading from determining price. In COMEX gold and silver, concentrated speculative trading is the sole determinant of price.

The solution to the very real problem of growing technical fund and commercial extreme positions is legitimate speculative position limits, not only on an individual basis involving the commercials, but also on an aggregate basis concerning the managed money technical funds. If many traders are going to trade as one, following the same technical signals at the same time, such traders should be restricted by a collective position limit as well as an individual position limit. As constructive as my suggestion may be, the likelihood that it would ever be adopted is not much above zero. There's no way in this world that the CFTC or the CME would ever adopt any suggestion from me in any circumstance.

Instead, the sure bet would be the game continuing just as it has developed, with no regulatory interference, no matter how egregious the price influence of the money game gets between the commercials and the managed money traders. Trying to remain objective, I would think this favors a price resolution to the downside to the commercials' advantage. From a regulatory (CFTC and CME) perspective, a price explosion in which the commercials get clocked as a group seems something that would threaten to expose the regulators' ongoing failure more than a downside price resolution.

There has been some decent technical fund selling and commercial buying over the past few trading days on lower prices and any such positioning would soften the large increase in the commercial short position in gold I suggested on Saturday. I originally thought that through Friday's close the total commercial net short position in gold had increased by 30,000 to 40,000 contracts. I would trim the increase to around 20,000 contracts as a result of the price decline on Monday and Tuesday. I'm less sure on silver, but would stick to an increase in the total commercial net short position of a few thousand contracts.

Regardless of the actual numbers, the commercial net short position in gold (and silver) is still historically extreme and there's no real legitimate reason for it. The resolution of this extreme market structure will have a big effect on price, one way or another, and the biggest shame is that this never should have been allowed. The money game on the COMEX has supplanted real world metal fundamentals.

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Silver – $17.28 (50 day moving average – $16.92)

Gold – $1267 (50 day moving average – $1259)

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