Compressing the Springboard

I was planning on discussing the dismal price action this week anyway, but I was further encouraged to do so with the receipt of a subscriber email asking me to explain the price drop in light of what I concluded was the spectacularly bullish COT market structure in both COMEX gold and silver. Thomas didn't say it, but he would be entitled to if he so chose what good is being bullishly configured (in a spectacular manner no less), if prices continued to be sliced lower?

This is not only a fair question, but goes to the heart of how I analyze the silver and gold market, namely, that futures positioning on the COMEX determines price movement virtually to the exclusion of any other factor, including the supply and demand for the actual metals. The fair (and only) answer is that the price weakness over the past few days was caused, exclusively, by COMEX futures contract positioning.

Sure, we'll have to wait until Friday to see the changes in positioning for the reporting week that ended yesterday, but it remains the weekly COT reports

that have been issued over the many years and their undeniable influence on price movement that explains this week's decline. Both by process of elimination and basic observation, there are no other plausible or reasonable explanations for price movement. I follow these markets very closely (for a living in fact) and see the fabricated explanations offered daily on the Internet and in the main stream media to explain the daily price changes, but only a fool wouldn't recognize the explanations were created for whatever that day's price change happened to be. Invariably, price declines beget negative stories, while price gains bring out positive or bullish stories.

While it is true that COT market structure change also occurs after the fact (or more correctly as prices are changing), there is such compelling logic and a clear historical pattern in the dealings between, essentially, the managed money traders and the commercials on the COMEX; so compelling that it is hard for me to conceive of a better explanation for what makes gold and silver move up and down in price. I can assure you that I continuously try to monitor every possible explanation for what makes prices move and if there was anything even in second place (behind COMEX positioning) to account for movement, I would comment openly. But I don't think developments involving China, Russia, India, Greece, the dollar, the stock or bond markets, inflation/deflation, or the weather have much to do with gold or silver prices the COT market structure is everything. That's why more seem to be following changes in the market

structure.

Back to Thomas' question what good is it to be structured spectacularly bullish if prices go lower still? I'll answer, but the question needs to be put in a slightly different context. If I ever had stated or inferred that is was impossible for prices to go lower when there was a strongly bullish market structure, either currently or in the past, then there would be no good if prices went lower. However, if I always stated clearly that it was always possible for prices to move lower and if they did move lower that would actually improve on the spectacularly bullish market structure, then I would say there would be a lot of good. What good?

For one thing, this week's move lower was almost assuredly caused by new short selling by the technical funds in the managed money category of the COT report. Regardless of what the new report indicates, it has been massive and continuous short selling by managed money traders over the past month that has brought the price of silver, gold, platinum, palladium and copper lower. In fact, all four precious metals are at or near record large managed money short positions and copper isn't off by much. It's not a coincidence that there has been pronounced price weakness in these commodities; the record managed money short positions are the cause of the price weakness. What's good about

that?

What's good is that the technical fund traders in the managed money category are the weakest short sellers of all because they can't possibly deliver actual metal to close out their short positions and, therefore, must buy back at some point. Besides, history shows these traders always cover in unison as soon as the moving averages are penetrated to the upside and simply mathematics dictate the moving averages must be penetrated at some point. This guarantees (there are not many guarantees in life) that all these metals will rally in price when the managed money shorts buy back their short positions.

I can't guarantee you how much of a price rally will result and fully admit recent rallies have been disappointing; but that's due to the aggressive selling by the commercials when the managed money shorts have bought back recently. The technical funds in the managed money category always buy back with maximum aggression, that's part of their DNA □ what determines the extent of the price rally is the commensurate aggressiveness of the commercial selling.

Therefore, while it doesn't seem like there's much good in lower prices to

investors in a general sense, when it comes to improving an already spectacularly bullish market structure, there is great additional good. Let these technical funds add all the short contracts they wish, because they will soon be buying back every short contract they added recently. Again, that's guaranteed by history and how these funds operate.

One thing I haven't mentioned in a while is the complete control the commercials hold over the technical funds in the managed money category. Not only do the commercials control price movement through HFT activities and spoofing and can make the technical funds chase price like a puppy chases his own tail; the technical funds hold their trading accounts with the big commercials, like JPMorgan, as their prime brokers. This gives the commercials complete and intimate control over the technical funds as the commercials not only know what the technical funds are likely to do next and then execute the funds' trades, they know the technical funds financial position better than even the funds themselves. I can't begin to describe how incestuous is this relationship and this further explains the control the commercials exert over the technical funds.

On Monday, gold got slammed for more than $20, amid very heavy selling, while silver actually finished a bit higher in price on low real volume (after

subtracting roll-over switch trading). While it is rare to see gold down that much with silver not lower at all (and one can't help feel that something may be afoot), at this point it looks like the price action was strictly due to COMEX positioning. In my opinion, there may have been 15,000 net contracts of gold sold by managed money traders on Monday, while I detected little change in silver.

You'll remember that last Thursday, gold rallied through its 20 and 50 day moving averages on heavy volume and this caused me to conclude on Saturday that net managed money buying and commercial selling may have amounted to more than 30,000 contracts. In contrast, there may have been little net change in silver last week, or so I hoped, because the rally in silver wasn't near as pronounced as the rally in gold.

Yesterday, gold continued lower and silver joined the selling in spades, hitting new price lows on heavier trading volumes. Thus, the market structure may have improved significantly in both markets yesterday, gold perhaps by another 10,000 contracts and silver by 5000 or so, meaning that amount more of net managed money selling and commercial buying. While I don't like to rely too much on the daily changes in total open interest (preferring to wait until the COT report's release), the increase in total open interest for yesterday's trading

on the COMEX of 11,000 contracts in gold and nearly 5000 contracts in silver would seem to support my estimates.

And while I prefer to gauge which traders are net short and long and to what extent than in judging total open interest, I can't help but note that total COMEX silver futures open interest breached the 200,000 contract mark in Tuesday's trading. That's the equivalent of one billion ounces, although it does include a large number of spread positions (37,000) which automatically reduces the true net open interest by that same amount. In other words, it's not so much the total open interest that matters, but the net open interest, particularly the net concentrated short position of the largest traders. By this measurement, silver is off the charts compared to every other commodity.

Today, on further new price salami slices to the downside in gold, accompanied with fairly heavy trading volume, I would guess an additional 5000 contracts or so of managed money short selling/commercial buying in gold. Silver's trading volume was low (net of roll-over switch trading) and prices were steady, leading me to conclude no net change in the silver market structure today.

Summing up the above, I'm guessing that this week's COT report will indicate a roughly unchanged headline number in gold, based upon last Thursday's commercial selling and this week's commercial buying. An increase in the commercial net short position in gold of as many as 10,000 contracts wouldn't be bad given the recent reductions, but unchanged or even a reduction would be much better. Likewise, a small increase in the silver short position wouldn't be the end of the world, but I'm expecting unchanged or, hopefully, a reduction in the commercial net short position and an increase in managed money shorting to a new record. Sorry to be all over the place but that's an occupational hazard when there are significant positioning changes intraweek.

I also try to avoid such detailed day to day analysis as I just engaged in, for the simple reason that it may make it appear like I (or anyone else for that matter) may be able to actually predict short term price changes. I don't believe that such price prediction is possible, although I do feel that it is possible to explain short term price movement, as or after it has occurred, in terms of the COT structure. It's important to recognize the difference between the two. More than anything this goes to Thomas' question.

These recent new price lows, while clearly not enjoyable, are in complete agreement with a strongly bullish market structure that is getting even more

bullish; not just in silver and gold, but in all the principle COMEX/NYMEX metals markets, including copper, platinum and palladium. And yes, further new price lows will augment the bullish structures. Of course, at some point, we must stop moving lower and rally and there is no question in my mind that moment is close at hand.

But the COT market structure is not about precise timing or price prediction; it is about the number of contracts that can be piled onto one side of the market before those contracts are un-piled. This is what determines price movement, up and down. Specifically, it is currently about how many managed money short positions (I hope you know managed money and technical funds are one and the same) can be put on in all the CME metal markets.

When the last managed money shorts are put on, that's the market bottom, pure and simple. And when the last managed money shorts are put on, it's only a matter of time before they are bought back, driving prices higher. It's a question of the number of contracts first and then time and price following that. Sometimes, perhaps most of the time, silver and other metal prices are in trading ranges and the COT market structure changes, but never hits historic extremes. Other times, like now, the market structure is at an extreme. I'd define extreme as a record or near record in managed money positioning.

When the COT market structure moves to an extreme, as is the case now in virtually all the CME metals, it is reasonable to expect an extreme price move in the direction opposite to however the managed money traders are positioned. In other words, whatever side of the market boat the technical funds may be overloaded on, expect a price move the other way. Now that these funds are overloaded on the short side, expect the biggest price move to be higher.

This core market premise always allows for additional overloading of managed money positions, such as we've seen this week, but in no way does it diminish the bullish setup. It may diminish and undermine our emotional opinion of the market, but it only enhances the prospects for higher prices. More importantly, the fact that we're at or near managed money shorting records in all the CME metals markets, strongly suggests a collective metal turn of the tide in positioning and, thereby prices, is close at hand. Certainly, if we weren't at or close to record positioning, I wouldn't insist that we were. That's the whole point of records they suggest maximum contract positioning. We can continue to see new records set, but by marginal amounts and not by a doubling or tripling of the record positions.

While I understand that the rotten price action over the past month, to say nothing of the horrid price action over the last four years, has taken its toll on collective investor sentiment that is a completely different circumstance than the COT market structure. We may feel negative about price prospects going forward because of the rotten price action, but that's a world away from what the market structure suggests. And if the commercials are successful in luring more managed money traders onto the short side, two things will occur most investors will feel even worse and the mechanical prospects for price appreciation will increase. I guess they go hand in hand. That's the dilemma I'm not rooting for lower silver prices, but I'm not going to be discouraged by further improvements in the market structure and neither should you. After all, more managed money shorting compresses the price coil to the upside.

Ted Butler

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Silver – $15.85

Gold – $1174