March 26, 2014 – How Markets Work

How Markets Work

I'd like to expand on something I mentioned in Saturday's review, namely, how the recent 10% drop in the price of copper was caused by the sudden selling of 20,000 COMEX contracts by the technical funds. I postulated that such an amount represented a full 15% of the net open interest of the entire COMEX copper market and how it was mandatory that such a large and sudden change in ownership must have an outsized impact on price. To be clear, I'm not particularly focused on copper other than to learn how it relates to silver and gold. On that basis, I believe there is plenty to learn.

Most holders of investment assets are long term in nature and not short term traders. In any given asset class, the turnover or amount that changes ownership over the course of a year is quite low, say less than 5% to 10% for real estate or bonds and maybe more than that for stocks, considering the ease of ownership transfer and given the presence of High Frequency Trading (of which most is day trading and as such doesn't result in a change in ownership). I don't think more than 5% or 10% of the 1.3 billion oz of silver bullion in the world changes ownership annually and less than that for silver held in coin or small bar form. Most investors buy and hold for the long term.

With 5.5 billion ounces of total gold in existence, I doubt if even 5% changes ownership each year, as that amounts to 275 million ounces of gold worth more than $350 billion; a level of actual ownership change not compatible with observable data. And that excludes the 100 million oz from new gold mining that must be absorbed by the market annually.

My first point is that ownership change in most asset classes are on the order of less than 5% or 10% annually. Depending on who was more aggressive and anxious to initiate the ownership change, the buyers or sellers, is what determines the price direction. If the buyers collectively were more aggressive prices should rise, with prices falling if the sellers were more aggressive. Think of the turnover in residential real estate; out of every 100 homes, no more than 5 or 10 change hands in a year.

What I am attempting to do today is to present data that explains past and future price movements in a way different than in terms of ounces or tons or percent of world production or consumption. Instead, I will focus on the actual change in ownership of entire markets, in this case, the COMEX.

That's why I'm making a big deal out of what just happened in COMEX copper where there was a 15% ownership change in less than a week Â? not in a year, but in a less than a week. And, as I've written recently, there was technical fund buying of 60,000 COMEX copper contracts from November 19 to December 1 which caused prices to rise from $3.10 to $3.40. Then the tech funds started selling (guided and assisted by the commercials) and have now sold 55,000 contracts net as of last week as copper prices tumbled to under $2.90. This highlights the matter even more.

55,000 contracts equals 40% of the total net open interest in COMEX copper futures (minus spreads). So, since December 31, forty percent of the ownership of the entire COMEX copper market changed hands. Is it any wonder that copper prices moved lower by 50 cents, or 15%? All the technical fund sales were transacted at progressively lower prices, as the technical funds only sell as prices decline (and buy on rising prices). Ask yourself this Â? what if 40% of the homes in your neighborhood were sold in three months, or if 40% of the total shares outstanding for any stock were sold in three months, what effect would that have on prices, especially considering that the sales were made on progressively lower prices and initiated by the sellers? It's a wonder copper prices didn't fall more.

What I just described in COMEX copper is the same thing that happens over and over in COMEX gold and silver and in a wide variety of futures markets operated by the CME Group, including corn and wheat on the Chicago Board of Trade. The same thing means that many important commodity prices are being determined by the flow of buying and selling of futures contracts by technical funds. Even if someone rejects my further conclusion that the commercial traders are orchestrating and rigging the technical fund buying and selling, there should be no disagreement that when the technical funds buy aggressively, the price rises and vice versa on the sell side. Quite simply, this is how many markets work.

Whether that's how markets are supposed to work is a matter for another day and I'll spare you my repetitive rant on manipulation and the exclusion of real commodity producers and consumers in the COMEX price discovery process. Today, I'll stick to the mechanics of what sets prices. I try to avoid short term price predictions, but at the same time something is causing large short term price moves and it would be unproductive to ignore what's causing them.

While the 40% change in ownership of the entire COMEX copper futures market in less than three months is an extreme example of the force that the technical funds can exert on a market, it is not an aberration. In the first two and a half months of this year on the $200 rise in price, the technical funds bought a net 120,000 contracts of COMEX gold futures, or 37.5% of the net total open interest of that market. In COMEX silver, some 25,000 contracts were bought by the technical funds in just one month (Feb 4 to March 4), or 23% of the entire market, on a $2.50 rally. Similar technical fund movements and resultant price changes can be verified in other markets.

The key point here is that it is undeniable that collective technical fund buying and selling causes prices to rise and fall. It is not possible that a sudden 25% to 40% change in the ownership of a total market wouldn't be the price driver, almost to the exclusion of any other factor. In the short term, technical fund buying or selling is the only supply and demand equation that matters. It's why I've studied the Commitments of Traders Report for 30 years.

I think it is absolutely crazy that we have allowed our markets to evolve into such a state where a small (less than 100) group of specialized trading entities (mostly not trading their own money) are determining prices for the rest of the world. Some will be quick to say that the COMEX or CBOT are not the only markets in the world, but that's naÃ¯ve. These markets set the price of metals and grains, period. Everything is based off these exchanges. This creates problems, since the traders setting the price (the technical funds) are completely distinct and separate from the real producers and consumers of commodities.

Let me use copper again as an example. On the recent price plunge, there has been universal agreement that the decline was due to Chinese economic weakness and copper collateral liquidation and that the decline in price signaled world economic trouble ahead. You know, Dr. Copper, the metal with the Ph.D. in economics. Not a word (except from me) has been given to the 40% change in ownership on the COMEX, even though the ownership change is documented in government data and Chinese collateral liquidation is hearsay. Again, I ask Â? if 40% of the homes in your neighborhood were sold in three months with no regard to price, how much would that drive prices down?

What makes technical funds technical is that they are only concerned with price change and not anything else; this is what separates them from the real producers and consumers who must contend with mining costs and profit margins. The technical funds only consider the price and not the underlying fundamentals. This is what makes the stories about pending economic weakness being signaled by lower copper prices ironic, because those who are creating the lower prices (the technical funds) don't consider economic activity at all.

The technical funds sold COMEX copper futures and kept selling for one reason Â? the price went down and kept going down, no doubt because of the technical fund selling (a self-fulfilling exercise). The technical funds pride themselves on not considering the real supply/demand fundamentals and focus only on price change. So if the technical funds are strictly selling because of declining prices and that selling is, in fact, causing even lower prices and more selling, it is absurd to then say that lower copper prices mean lower economic activity. Technical fund behavior has nothing to do with future economic activity and more to do with confusion about what caused copper prices to fall in the first place. When the technical funds exhaust their COMEX copper selling and begin to buy, prices will rise and that price rise will again have nothing to do with anything except technical fund buying.

The biggest problem of all is that technical fund activity is often at odds with real world supply and demand fundamentals. What difference does it make if silver's long term fundamentals are spectacularly bullish if the technical funds go on a selling binge? If the technical funds sell aggressively and collectively, the price of any market is going lower until that selling is exhausted. This is how these markets work. Knowing that, what's the long term investor to do? It seems to me that, at a minimum, the long term investor should be aware when the technical funds are in position to sell so as not to be blindsided emotionally. After that, if he or she want to time additional purchases, that seems reasonable as well.

The run up in gold and lesser run up in silver prices this year was entirely due to technical fund buying, as I hope I have reported all along. After such buying is concluded, the odds rise that the technical funds can or will be induced into selling by the commercials. It's hard to predict in advance when technical fund buying will be concluded and when the funds may be induced to sell, but that is much more likely after large ownership changes, like now.

It is reasonable to be concerned with big technical fund selling in COMEX gold and silver after considering how much the funds have bought this year. Of course, a reasonable expectation doesn't mean we are guaranteed to go lower from here, just that you shouldn't be surprised if that occurs. Silver is, after all, an extremely undervalued asset that away from the technical funds could and should move substantially higher in time. I'll repeat myself to say that the current technical fund and commercial position structure on the COMEX is the only negative factor for the price of silver. If we do go lower, this is the sole explanation in advance.

Many years ago, I even provided the solution to the growing unhealthy influence of the technical funds on commodity prices. Remarkably, this has little to do with removing the biggest crook, JPMorgan, from commodity dealings, which would certainly end the manipulation. There is no single large technical fund dominating and controlling prices like JPMorgan does on the other side of these ownership changes. Instead, there are many different technical funds all doing the same thing at the same time. That's because all the technical funds are solely keying off the price and price change for buy and sell decisions.

Since there many technical funds all acting collectively and no single giant technical fund holding a concentrated position, position limits in the traditional sense are ineffective. Position limits restrict only individual large traders, not groups of traders. A silver position limit of 5000 contracts is fine for JPMorgan or any other large trader, but is useless if 50 or 100 separate traders are all buying and selling at the same time. That's because the individual traders could be within the level of position limits separately, but not collectively.

The only solution is for there to be a position limit assigned to the technical funds collectively. As for what that limit should be in terms of contracts, something like 10,000 contracts collectively. Such a limit should prevent what we've just seen in terms of ownership change in COMEX copper, gold and silver. Any time there is a 25% to 40% change in ownership of entire markets, the price will be unnecessarily and uneconomically distorted in price. This is not as it should be and serves no useful purpose aside from expanding trading fees and enabling JPMorgan to prey on the technical funds.

While I'm not particularly encouraged by the current COT set up in COMEX gold and silver, I still believe it is better to look at markets with a correct view of what makes them work rather than to consider things that are marginal in importance (like 95% of what we are subjected to daily). Above all, the technical fund/commercial positioning dance is temporary in nature and guaranteed to change again. As and if the technical funds sell to the point of exhaustion ahead in COMEX gold and silver, that could present the last good buy point in silver.

I wish we didn't have to contend with all this technical fund/JPM/COMEX nonsense, but wishing it away isn't a practical application. My biggest concern is that it will cause some to abandon the long term investment opportunity in silver. Despite the pain of stagnant prices and time erosion, the long term never looked better for silver. In fact, the future looks so bright precisely because of the price distortions emanating from the COMEX in the short term. If it weren't for COMEX positioning, silver would have been well over $100 by now. In a world of growing overvaluations in many asset classes, silver's undervaluation is stark in contrast.

I don't know if the recent price weakness thru today signals the start of a bigger down leg, but my concerns are strictly short term. Considering the fundamentals, including that the price is already below the cost of production for many silver miners, I'm not particularly concerned long term. If anything, the things I have been focusing on recently, like the turnover in the COMEX silver warehouses and the pace of sales for Silver Eagles absolutely and relative to Gold Eagles, appear more bullish than ever. Still, that is separate from what the technical funds/JPM may do.
I mentioned a little while back to buckle up and that still seems advisable.

Ted Butler

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Silver – $19.80

Gold – $1304

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