March 9, 2022 – A Margin Call Tornado

What we have witnessed recently in commodity markets is nothing less than a margin call tornado. At least with hurricanes and wildfires, there is usually enough early warning to batten down the hatches or evacuate; but with a tornado the advanced warnings are limited because a tornado is on top of you in a flash. Therefore, I find it appropriate to call what has occurred in many commodity markets as a tornado of margin calls so severe so as to raise questions of concern to the financial system itself.

We would all mostly agree that the precipitating agent for the recent spate of extreme commodity price gyrations has been the shock of Russia invading Ukraine and the resulting sanctions, but there is something underlying the current dislocations that also needs to be examined. First, some basic background on commodities trading.

Generally speaking, prices for world commodities don't change much on a daily basis; after all, we are talking about commodities produced and consumed daily throughout the world and the actual supply and demand changes are glacial-like in nature, up or down a few percentage points annually. As a result of the long stretches of relative commodity price stability, there has evolved in our modern derivatives trading, which dominates the price discovery process, the practice of extreme leverage, where the margin requirements to buy or sell a typical futures contract runs on the order of 5% or 10%.

This means a trader, going long or short a commodity futures contract, only needs to put up $10,000 or less to control $100,000 worth of a commodity. Of course, should prices move adversely to one's position (lower for someone long or higher for someone short), then the broker carrying the trade will demand near-immediate additional deposits to maintain adequate margin levels or, alternatively, the liquidation of the position. Those are the rules and every trader has to sign a variety of legal documents agreeing to the rules – no exceptions. Of course, should one decide to take delivery of a contract, then the full value of the contract must be deposited or, conversely, the actual commodity must be made available in the case of a trader delivering against a short contract. All basic stuff.

Oh, and one last thing – because we are talking about derivatives contracts, we know there has to be a long for every short and vice versa, meaning whatever side wins, the other side must lose, dollar for dollar. This a zero-sum structure and changes daily. The problem that has emerged of late is that because the price moves have been so extreme in so many markets and mostly higher, particularly in crude oil, the granddaddy of all commodities, that a literal avalanche of margin calls have been generated – almost exclusively to those holding short positions.

Undoubtedly, not all the shorts have been able (or willing) to come up with the massive amounts of additional margin money suddenly demanded by the brokers carrying their positions – resulting in the forced buyback of short positions, which adds additional buying pressure for still-higher prices. As Daniel Drew famously said – "He who sells what isn't his'n, must buy it back or go to pris'n".

Once again, the London nickel market has become the poster child for shorts gone wild and unable to meet margin calls to the point of blowing prices sky-high on Monday, to the extent that the exchange, the London Metal Exchange, had to rescind and bust trades – about the biggest no-no in trading and also take other measures Like closing the market) to protect the short sellers at the expense of those holding long positions. Remarkably, this has become a regular feature for the LME, as I wrote about 16 years ago –

http://news.silverseek.com/TedButler/1156198042.php

I would imagine the LME will succeed, once again, in screwing the longs in nickel, as is its custom and the matter would be quickly forgotten, largely because there is so little public participation in this market – except for one thing, namely, the tornado of margin calls occurring in other markets, particularly, in crude oil (but with a decided gold and silver connection). Perhaps the biggest question swirling around the flood of margin calls being issued daily to the shorts is who exactly are the shorts under pressure?

Due to regulatory protocols, the names of individual traders are kept confidential by the regulators (unless public charges are filed) and brokers are not likely to reveal the identity of customers issued margin calls. But that doesn't mean there is no information trail. Thanks to existing public reporting data available from the CFTC, in the form of the weekly Commitments of Traders (COT) and monthly Bank Participation reports, we are at least able to isolate certain groups of traders which might be heavily long or short. Again, the longs, generally, aren't facing any margin call difficulties – this is strictly a problem for the shorts at this time.

A quick perusal of the current COT and BPR data for last Tuesday, March 1, 2022, indicates that US and non-US banks are generally not heavily short in most markets – except for crude oil and other energy markets and in precious metals, specifically, gold, silver and platinum. I raise the issue of what commodities the banks, particularly US banks, might be short because of my longstanding allegations that a small number of banks are manipulating the price of silver (and gold). My more recent allegations regarding Bank of America being massively short silver and gold in the Over-the-Counter market is a separate issue and wouldn't be included in COT and Bank Participation report data.

Here's what a quick perusal of the current Bank Participation report will reveal – that the banks, particularly the US banks, are short up the wazoo, not only in silver and gold, but in crude oil and related energy markets. While I, obviously, knew the banks were heavily short COMEX silver and gold, I must say I was quite surprised to discover them heavily short in crude oil and other energy markets.

https://www.cftc.gov/MarketReports/BankParticipation/deamar22f

Let me quickly summarize the situation in the big NYMEX crude oil contract. We know that crude oil prices have surged (notwithstanding today's sharp correction) – up by $50 a barrel since the start of the year (a bit over two months), with $30 of the gain coming I the last 7 trading days. We also know that 4 US and 14 non-US banks hold and have held at least 400,000 short contracts of the total open interest of 2 million contracts and with the 4 or less US banks holding roughly 250,000 contracts, or 60% of the total bank short position. Since the NYMEX crude oil contract is for 1000 barrels of oil, we know the total bank short position is the equivalent of 400 million barrels, with each dollar move worth $400 million.

Knowing this, it is easy to calculate at any particular price and time, how much the US and non-US banks short crude oil are fairing financially and how much additional margin they had to deposit as oil prices hit their recent peak. At yesterday's price peak, the banks had to have deposited at least $20 billion in variation addition margin since the beginning of the year, with roughly $12 billion coming from 4 or fewer US banks. Today's sharp price fall means that the banks can remove much of that additional margin deposited and I would suggest that the sharp price retreat in oil was ”motivated” by banks and other shorts seeking to relieve margin call stress.

The amounts of additional margin required to be deposited by banks and other shorts in crude oil was the most in the shortest time ever and because these banks are at the top of the food chain, the question of systemic financial risk comes into play. Let me explain why with some other commodity trading basics.

In normal cases, whenever any of us enter into a contractual agreement, say by buying or selling or leasing a house, car or apartment, the contract is between specific individuals or entities – the buyer and seller, or lessor and lessee. But when anyone buys or sells a commodity derivatives (futures) contract, the contractual agreements are not between specific individuals or entities – no one buying or selling a futures contract ever learns the identity of the counterparty on the other side of the contract.

Instead, all contracts are guaranteed by an overarching entity – the clearinghouse of the particular exchange on which the commodity is traded. In the case of NYMEX crude oil (and COMEX gold and silver), the guaranteeing clearinghouse is owned and operated by the CME Group. Make no mistake, the beauty and genius of our commodity futures trading system is made possible by the clearinghouse structure – which enables the instantaneous contractual agreement between unknown market participants. The miracle is that instead of the drawn out and complicated process of closing a contract on a house sale, with can take weeks and months, standardized commodity futures contracts involving many millions of dollars can be transacted in fractions of a second – truly a modern financial miracle.

What is a clearinghouse? The best example I can give you is to equate it to something that has been in the news a lot lately – NATO or the North Atlantic Treaty Organization, in which a group of nations pledge to stick together to protect each other against any aggressors. The biggest difference, of course, is that NATO involves guaranteed military solidarity and assistance, whereas the clearinghouse function of the CME Group or other clearinghouses is for mutual financial guarantees.

The performance guarantee behind each futures contract is based upon the promise of the 50 or 60 clearing members in the NYMEX and COMEX clearinghouses to guarantee the performance of every contract no matter what. What that means is if a clearing member goes bankrupt (rare but possible – think Bear Stearns or Lehman Bros.), all the other clearing members promise to step up and guarantee the performance of contracts held by customers of a failed member. The clearing members are mostly large banks and financial institutions, mostly with household name recognition – JPM, BofA, Goldman Sachs, Morgan Stanley, etc., plus an assortment of investment firms and commodity trading houses.

Why this matters at this time is that, as described above, the recent margin calls have been coming fast and furious, not only for customers of the clearing members, but for margin calls for some of the members themselves, such as the banks short in crude oil and gold and silver. These have been, without a doubt, the largest margin calls on the shortest time in history and necessarily puts great financial strain on the clearinghouse structure like never before. Perhaps most of the short positions under duress are true hedges, with an offsetting long position of some type, but even that is no assurance against a liquidity mismatch as has occurred with Peabody Coal or the big China short in LME nickel. And it’s no secret that banks do speculate on the short side – with no offsetting long hedges.

Therefore, when many billions of dollars are suddenly required for margin deposit beyond what is normally the case, the question of systemic risk to the financial system becomes front and center. Most unfortunately, the possibility of a world-ending nuclear Holocaust now exists as result of Russia's invasion of Ukraine, whereas the fear was largely non-existent or somnolent prior to the invasion. In a similar vein, should the clearinghouse system fail, due to margin call stress, the many millions of existing futures contracts will no longer exist because the guarantee of performance would disappear and that would be the financial equivalent of a world-ending nuclear Holocaust.

Turning to gold and silver, today's sharp price decline has ended, at least temporarily, the margin pressure on the shorts, but given world conditions and physical tightness, particularly in silver, it wouldn't appear the shorts are completely out of danger. And there is no doubt in my mind that the sharp decline is in no small measure a direct result of the big gold and silver shorts working to relieve margin call pressure, as price selloffs are the surest way to prevent additional margin calls. As always, higher prices hurt the shorts, while lower prices are of benefit.

Trying to be objective, no one can blame the CFTC or the CME Group for the explosion in commodity prices and resultant margin call tornado given the circumstances of Russia's invasion of Ukraine. And it is to the collective benefit that despite the extreme stress on the clearinghouse structure, the system has held. But what's going on in COMEX gold and, particularly in silver, is nothing less than a massive and continuing regulatory failure. I say this because in the face of sudden and obvious stress to the short sellers of most commodities, only in COMEX silver has there been a multi-decade drumbeat of warnings to the regulators (the CFTC and the CME Group) about the excessively large and concentrated short position held by a handful of banks. To my knowledge, there have been no warnings of potential trouble to short sellers in any other commodity, aside from COMEX silver. I say this with the certain knowledge of personally complaining about the concentrated short position in COMEX silver.

With no notable concentration on the short side of most commodities, the prices of many commodities have exploded, exposing the short sellers to great loss. Silver has yet to explode, precisely because the big shorts have held ranks, but the continued physical tightness will not go away unless prices climb much higher. It's a true dilemma – silver prices can't rise in the manner they should, because the 4 big shorts have refused to ever buyback short positions on higher prices – an unprecedented and freakish saga in short selling history. As long as the big shorts refuse to buy back silver short positions on higher prices, the manipulation continues and the inevitable date with the destiny of higher prices is postponed – as long as the big shorts on the COMEX and now on the OTC market in the form of Bank of America hold firm – despite mounting losses.

A major new factor in the prevention of long-overdue exploding silver prices is the recent role of JPMorgan in providing enough physical metal to meet increasing delivery demands on the COMEX and, most likely, in providing sufficient metal (to come) for SLV and other silver ETFs. This has always been a key unanswered question for me, namely, what would JPMorgan do as physical conditions in gold and, particularly in silver, tighten and when demands for physical metal outpace supply from other sources – as is currently the case.

As a result of JPMorgan's aggressive physical accumulation of massive quantities of silver (1.2 billion oz) and 30 million oz of gold over a decade starting in 2011, it is the only entity in position to satisfy increased physical demand. So, it is no big surprise JPM has been stepping up to the plate and averting a full-fledged shortage and the out-of-control prices that would dictate.

Some might question why JPMorgan, having so thoroughly double-crossed the other commercials on the COMEX and now Bank of America in the OTC market, would not simply stand aside and refrain from providing any physical metal and let prices explode (as they surely sould)? It seems obvious to me that a true melt up in prices, from JPM's perspective, would not be its most-desired outcome because such a melt up would threaten to expose and drag JPM back into the spotlight it is trying hard to avoid.

In a very real sense, JPMorgan has achieved such a stunningly successful criminal achievement in amassing such massively-large physical silver and gold accumulations and removing itself from the short side, that it has no interest in bringing attention to its achievement by the glare of intense scrutiny that a true melt up in price would bring. On Saturday, I outlined how JPM was in the black by more than $40 billion from being dead even two years ago. It's not as if JPM doesn't make money on just about everything it touches and would be perfectly content to let things progress in silver and gold on a timetable that excludes close scrutiny of its past illegal deeds.

In fact, the recent deliveries by JPMorgan in its house account in COMEX March gold and silver contracts may be looked at as the start of the cashing in process. I doubt JPM was planning on waiting until silver hit $100 or $200 and then attempting to unload its 1.2 billion oz at the market. A master market criminal like JPMorgan knows full-well it takes much time and great skill to first accumulate and then distribute a billion ounces of physical silver. After all, it took JPM the better part of a decade to accumulate its hoard of physical metal and it knows better than anyone that it will take time to unload that hoard in order to get the maximum proceeds. Please be certain that JPM has the skill and patience to pull this off.

What does this mean for the rest of us? One thing it means is to adjust to JPMorgan's strategy and think long-term, even though all this has already been going on for a very long term to this point. Prepare for much greater price volatility. There's no question in my mind that JPM is still expecting much higher prices, but not to the point that it risks exposure for past misdeeds. There's no reason to expect that silver prices have topped out, but neither is an immediate melt up likely as long as JPM provides enough physical material to prevent a default – either on the COMEX or in SLV.

Of course, the wild card of the fate of the 4 big COMEX shorts never covering short positions remains open, as does the ability of the 8 big COMEX gold and silver shorts to weather the financial losses that have been accruing. Then there's the matter of how much of a loss can Bank of America handle with its OTC short positions. In a strong sense, JPMorgan is attempting to thread a needle by keeping silver prices contained, with no guarantee it will succeed.

The cold reality is that the amount of silver that exists in the world in good-delivery bar form is extremely limited at 2 billion ounces, that is currently worth not much more than $50 billion. The 3 billion oz of gold bullion in the world is currently worth $6 trillion or 120 times the value of all the silver bullion. Should the price of silver run to $100, all the silver bullion in the world would be worth $200 billion, which is still a small fraction of what gold is or would be worth and in today's world, $200 billion in total financial terms for a world commodity is next to nothing. Sooner or later (and it most likely it has already commenced), enough world investors will take note of silver's incredibly tiny total market capitalization and try to take advantage of it.

For today, however, the forces of evil and manipulation have raised their head and managed to cap and contain commodity prices across the board, with particularly sharp declines in crude oil prices (which as an energy consumer I welcome). But neither does today mark the end of the unfolding silver saga, as there is little sign that macroeconomic or physical market conditions have changed. Silver is and has been positioned to move sharply higher, aligned against a very limited number of participants fighting desperately to prevent the inevitable higher prices. The few prevailed against the many and varied forces pointing to higher prices today.

As far as what to expect in Friday's COT report, it should be expected that there will be continued deterioration (managed money buying and commercial selling) as gold prices rose as much as $100 and silver prices by as much as $2, with both markets trading well-above all key moving averages. I'm going to once again refrain from specific contract predictions, but would expect close to complete exhaustion of the raptor long position in silver (which was 9700 contracts in last week's report). Of particular concern, as always, will be how many new short contracts may have been added by the big 4 in silver.

While today's sharp selloff in gold and silver must be considered disappointing (at least it wasn't as sharp as the selloff in energies), it would have been unrealistic to expect the big shorts to rollover and give up without a fight. As it was, the big shorts on the COMEX were seriously in the hole financially as a result of the gains Monday and Tuesday and that certainly goes for Bank of America in the OTC market.

Even with today's price smash, gold and silver prices are not down from Friday's close, meaning the losses to the 8 big shorts in COMEX gold and silver actually increased slightly, by $400 million or so, to $14.4 billion as this gets sent. Likewise, Bank of America's open loss on my claim it is short 30 million oz of gold and 800 million oz of silver is close to $11 billion. And JPM is still ahead more than $40 billion.

Ted Butler

March 9, 2022

Silver – $25.90 (200 day ma – $24.26, 50 day ma – $23.62, 100 day ma – $23.57)

Gold – $1990 (200 day ma – $1815, 50 day ma – $1851, 100 day ma – $1826)

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