Milestones

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It's only natural to reflect on life's passages at certain times. Having just experienced one in my son's marriage, I've done my fair share of reflection these past few days. Of course, mine are silver-tinged, as you might suspect. I'm a pretty private person, not given to public attention, so I tend to stick to my knitting when it comes to silver analysis and try to leave the personal stuff out. But I do so on rare occasions and a couple came to mind recently that concern me writing about my son (and silver) in the past.

One instance that came to mind was an article seven years ago, in which I addressed a question he asked me about dialing 911 and having no one respond.
http://www.investmentrarities.com/ted_butler_comentary/06-19-06.html
Remember, this was years before the CFTC embarked on the never-ending 4.5 year investigation dealing with the same issue as covered in the above article. But my main reflection had to do with the prospective shortage of silver which has been a core belief of mine for decades.

In this article from eleven years ago, I described the coming silver industrial user buying panic after a trip to the mall with my son, then 23 years old.

http://www.investmentrarities.com/ted_butler_comentary/03-05-02.html Long time readers should know that I've held the belief that there will be a shortage in silver for decades, as that outcome must result if silver had been manipulated downward in price as I have long contended. In other articles over the years I referred to what occurs in terms of human behavior in times of shortage brought about by hurricanes and gasoline shortages.

My basic premise was that due to the structural silver deficit (consuming more than was being produced) at some point we would run out of silver unless the price soared. This shortage would cause a panic among the industrial silver users who would rush to build inventories, causing a blow-off in prices. Prices did rise substantially and that brought into balance silver production and consumption around 2008, for the first time in 60 years. That might have ended the run in silver prices had it not been for the emergence, after an absence of many decades, of silver investment demand. Silver is a very unique commodity, both a vital strategic metal and a primary investment asset. No commodity comes close to silver's dual role and it seemed to me early on that the investment role would carry silver prices higher, despite the closing of the consumption deficit.
http://www.investmentrarities.com/ted_butler_comentary/01-22-08.html

This all has been a prelude to where I feel we sit currently with silver. After more than a half-century of depleting world silver bullion inventories from 10 billion ounces to 1 billion oz, we are now adding around 100 million oz to bullion inventories annually. Some might call this a surplus, but that's not the appropriate description, considering how much inventories had been previously depleted. And more than ever, I believe the silver shortage and industrial user buying panic still lies ahead for a very obvious reason — the silver that has been flowing into bullion inventories (mostly in the form of ETFs) has been purchased by independent investors throughout the world and not by industrial users.

What has always set the stage for a silver industrial user buying panic was that the users operate on a just-in-time inventory and manufacturing process. This is not just for silver, but for everything that is used in the manufacturing process. For more than 30 years, the world has moved to produce goods while carrying the lowest level of inventories possible; this is how modern goods are manufactured. And over the years, there have been pronounced temporary, but serious shortages in a variety of vital commodities, including palladium, nickel and other industrial metals.

What sets silver apart is that it has been developing into a widely-held investment asset over the past six or seven years. This has resulted in the vast bulk of the world's one billion oz of silver bullion now being owned by investors, principally through the world's ETFs (exchange traded funds). Previously, this metal was held by dealers and bullion banks which used it in a variety of ways, including leasing. That's no longer the case. My point is that while this silver exists, it is not necessarily available near current prices. That's because every ounce is owned and only the owners will decide at what price it is available. It may be available to industrial users in a pinch, but that depends on what price is offered in a pinch. In fact, it is highly probable that should a silver wholesale shortage appear, that shortage was precipitated first by strong investment buying.

Eleven years ago, very few were talking about a silver shortage; to most, that was an impossibility that had never occurred in history. Then, starting in 2008 (thanks to Izzy, in my opinion), the US Mint started experiencing difficulty in keeping up with demand for Silver Eagles. This has continued periodically and now the Mint has been struggling to keep up with Silver Eagle demand for months. Yes, I know that the shortage of Silver Eagles and other forms of retail silver are not the same as a wholesale silver shortage (although I continuously point to signs of wholesale tightness in inventory movements). But what most overlook is that we never had any shortage of silver, retail or wholesale, prior to 2008. The fact that we have experienced and are now experiencing such a retail silver shortage where there was none before, suggest the same might occur on a wholesale basis for 1000 oz bars.

Additionally, the US Mint serves as a good model for a potential widespread wholesale silver shortage. Due to record demand for Silver Eagles over the past few years, the Mint has become the largest silver user in the world (I believe).

The Mint has acknowledged that the reason it has been unable to keep up with demand is not due to its stamping capacity, but because its supply of blanks has been insufficient to produce enough coins as demanded. I even offered the constructive suggestion that to avoid this in the future; the Mint should lay in a supply of blanks for 10 million ounces or more. But if you step back, you may see the similarity between what's happening now to what may happen in the future.

Even though it's a law that the US Mint must produced enough Silver Eagles to meet demand, the Mint is still a government agency and not much will happen to that agency as a result of its failure to keep up with demand. I doubt anyone will get fired or reprimanded and the Mint's future existence is not in question as a result of not producing enough Silver Eagles. But the vast majorities of the world's silver industrial users are not government organizations, but are for-profit entities. For-profit companies are different than government agencies.

For the US Mint to not have enough blanks to meet demand for Silver Eagles is not that big of a deal for the agency, aside from maybe having to answer questions from a few congressmen. So the public can't buy enough Silver Eagles; big deal and what's for lunch? For a company needing silver in its manufacturing process, not having enough silver when needed is a very big deal when it means shutting down the whole assembly process. The US Mint may not panic and rush to build silver inventories, but a for-profit industrial user most certainly will panic and do whatever is necessary to ensure continued production. That means paying any price possible to secure supplies.

My point is that if the US Mint were a for-profit entity, it would have already made sure it had enough silver on hand to produce Silver Eagles to whatever was demanded. The big takeaway here is that the world's largest silver user clearly can't get enough silver blanks currently. Instead of dismissing it as a one-off for a certain form of silver, it may be a harbinger of other forms of silver, including 1000 oz bars, being temporarily unavailable to others. Remember, the manufacturing world has never experienced a silver supply interruption before and it's unknown how users will react. If they act like everyone else in a shortage, they will panic and try to buy. This adds to any shortage.

I believe we came very close to a widespread wholesale silver shortage at the price peaks of April 2011. Then the deliberate and vicious price smack down starting May 1 that year resulted in selling in the big silver ETF, SLV, cooling things off and averting a user buying panic. But the silver supply tightness didn't completely go away, it was just put on slow boil; capable of erupting at any time. And one last point while I still believe that a silver shortage is inevitable, I don't believe that will be the case in gold, simply because so little gold is used in industrial applications. Now on to other matters, including the rotten price action today.

There has been present a market condition that I should have empathized more that is at the heart of today's price decline and the overall price declines recently. That condition is illiquidity; there is no true market liquidity present in gold and silver trading on the COMEX. It's not so much evident in daily trading volume statistics, as the number of contracts traded doesn't have much to do with what I'm talking about. It's more the type of trading that has settled into gold and silver (and other markets). It seems to be all this rotten High Frequency Trading and computer algorithms and not the real trading by traditional hedgers and speculators normally associated with futures trading. I've mentioned this previously, but the markets, certainly gold and silver, have been conquered by the machines.

It has become a regular occurrence for prices to move sharply (and usually lower) for no good fundamental reason, other than the computer algos kicking in. That's the short answer for why we suddenly declined today or, for that matter, why we declined 15% in gold and 20% in silver in two days a little while back. In the long run, the law of supply and demand will win out in silver, but on any given day, like today, the answer to why we are down so much is always the same, namely, these damn crooked computer programs. Please allow me to vent about this for a moment before explaining why it must be ignored by long term investors.

My main complaint is with the regulators, mainly the CFTC's Chairman Gensler and Commissioner Chilton. I'm singling these two out because Gensler should know better than to allow the market distortions and Chilton is parading in front the press, but missing the main point. Last week, there was a high jacked Twitter feed that caused a very temporary 100 point sell-off in the Dow Jones average, or a decline of 0.7%. This brought out Commissioner Chilton to say something must be done about high speed computer trading. I don't disagree with him, but how about the Commissioner put things in proper perspective?

Chilton is moaning about the very temporary 0.7% decline in the stock market in front of every TV camera and newspaper available, but has chosen to remain publicly silent and ignore the two-day decline of 15% in gold and 20% in silver. That's such a lopsided double standard and so different from the way Chilton talked a few years ago, that it's hard not to conclude that Chilton has been compromised as a regulator; Gensler too. What the heck happened to the main promise of Dodd-Frank and the Volcker Rule, which included position limits and getting the banks out of proprietary trading? Chilton doesn't answer much email these days, mainly because few accept his version that the Commission is looking at silver and gold, but it is embarrassing to see him lose his way. Back to the lack of true market liquidity.

The biggest proof that COMEX gold and silver are illiquid is seen in the extreme price movements. It is the volatility that proves illiquidity. A case in point is the big two day price decline. Sure there was record posted volume, but 15% and 20% price declines in two days can only occur in illiquid markets, especially if there is no fundamental news to account for the declines. Particularly in gold, with more than $8 trillion in total worth, a fall of $1 trillion in two days proves illiquidity. Worse, there are clearly some traders gaming the illiquidity to their own advantage, as is indicated in the Commitment of Traders Report (COT). The only reason we are at such bullish extremes in the gold and silver COT is because some easily identified traders have caused such big price declines so as to force other (smaller) traders to sell. It's impossible to arrive at such extreme readings by accident. The bad news is that I don't see much to do to prod the regulators, given how inept they've been all along. Anyone waiting for the regulators to do their jobs when it comes to silver and gold will be waiting a long time. Also bad news is living with sudden computer sell-offs for no legitimate reason.

Fortunately, there is much good news, although it runs counter to the feelings one normally holds at times like these. Once you abandon hope for the CFTC riding in on white horses and accept the intentional sell-offs for the manipulative intent behind them, it may make it easier to think in the long term. The intentional sell-offs are all about shaking as many investors off silver as is possible before the price lifts off. Let's look at the facts.

First come developments in the physical market. There is no doubt that we are currently immersed in the most severe retail silver shortage in history, with premiums rising and delays stretching out like never before. It would be easy to recognize and get enthused about this with a strongly rising price; but the price falling gives one pause (as is intended). On the wholesale side, holdings in the big silver ETF, SLV, have risen in the price decline since year end, while 20% of the holdings in the big gold ETF, GLD, have been redeemed. One would think the price of silver should have performed much better than gold on this factor alone, but thanks to an illiquid and easily manipulated price on the COMEX, the opposite has occurred.

I would contend that the main thing out of place in a manipulated market is the price itself and that is exactly the case in silver. The only thing wrong with silver is its current price. The good news is that is also the easiest wrong that can be righted.

The second major development is the market structure as defined by the COT Report. For both gold and silver, the COT set up is great. I have been amazed at the many new commentaries attesting to this COT set up, but I am still dismayed by the lack of questioning as to how we got to the current bullish set up. There's no doubt, despite price weakness today or any day that we are set for higher prices due to COT considerations; but how does anyone think we got here? We just experienced the master-blaster of all sell-offs that has resulted in a spectacularly bullish set up; how can anyone feel that was accidental and not intentional?

Prior to the big two-day sell-off, the gold COT was bullish and suggestive to me of a $100 to $300 rally; after the sell-off one could add $100 or more to either previous guess. In addition to the gold COT improvement, I'm convinced that the commercials came to own the 10 million+ ounces that have been redeemed in the GLD since year end. This further suggests a gold price rally, although I'm still not in the many thousands of dollars gold price camp.

It is in silver that the price set up looks monumental. I know how crooked JPMorgan is and the extremes that this crooked bank will go to for their own selfish purpose; but I can't help but feel there is not much more selling to be had from other COMEX participants. With the non-reportable traders holding the lowest net long position in COMEX history, there can't be much more potential selling in that category. With the technical funds having bought back a good chunk of shorts at the recent price lows, it's hard to see them turn around and short more on new price lows.

The silver raptors hold their largest net long position in history and have always shown a rigid determination to sell longs only when profitable, no matter how much time that might take. The raptors have been holding a big (25,000+ contracts) net long position for almost two months and it would take a price in excess of $30 or more for them to sell their entire net long position profitably. The possibility exists that they might demand a much higher price than $30 to sell out completely and therein resides the chance of a real moon shot. Perhaps not coincidentally, all the important moving averages are above the raptors average profit point, promising even greater upside price volatility. Of course, there are no guarantees we will see that moon shot, but I would be remiss not to share how we might resolve the current set up.

This current set up seems to have my entire wish-list in place. A super-bullish COT structure, following an epic sell-off, amid indications that physical silver conditions, both retail and wholesale, are as tight as a drum and public sentiment on gold and silver in the gutter. I wish the crooks at JPMorgan were less short, but it's not a perfect world. As it stands, this is the best silver set up I think I've seen.

Ted Butler

May 1, 2013

Silver – $23.65

Gold – $1456