May 18, 2016 – The Key Consideration

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With new commentaries daily highlighting the extreme market structures in gold and silver, there now appears to be sufficient attention being devoted to the main price driver Â? COMEX futures contract positioning. Certainly, I've tried to cover the issue on these pages. Before updating developments in market structures growing more extreme, I thought I'd briefly review what has transpired year to date and focus on the key consideration not yet widely discussed.

Gold ended 2015 at $1060 and silver at $13.84, the lowest levels in five years, with collective investment sentiment the most negative in my memory. Almost perversely, the COMEX market structure was extremely bullish, with commercial shorts at historic lows and managed money longs at historic highs. Over the first six weeks of the New Year, gold rallied $200 as just over 100,000 net COMEX gold contracts were bought by the managed money technical funds (mostly short covering). To mid-February, silver had proportionately more managed money buying and commercial selling of 40,000 net contracts (200 million oz), but silver's price lagged on a relative basis to gold and climbed a little more than $2, compared to the $200 surge in gold.

From mid-February through today, gold traded between $1200 and $1300, mostly around the $1250 mark, as close to 200,000 additional contracts were bought by the managed money technical funds and sold by the commercials. Silver's pattern was a bit different; after sinking to under $15 in early April (on managed money selling of 10,000 contracts), it surged to $18 by that month's end, on managed money buying and commercial selling of 30,000 net contracts.

All told, from year end through today, close to 300,000 net gold contracts (30 million oz) and more than 60,000 COMEX silver contracts (300 million oz) were bought by the managed money traders and sold by the commercials on the gold and silver price rally to date. Not only was this the largest amount of managed money buying and commercial selling in the shortest period of time (four and a half months) in history, the quantity of metal equivalent transacted far exceeded any amount of real metal bought or sold in any other venue (ETFs, warehouse stocks, etc.), justifying assertions that COMEX futures positioning was the main driver of price. Considering the truly astounding quantities of metal equivalent positioned on the COMEX this year, it's a wonder gold and silver prices didn't rally more than they did. (And I believe the main reason gold and particularly silver mining stocks did surge as much as they did was because they weren't subjected to heavy short selling).

As a result of the fairly tight trading range in gold since mid-February and the extraordinarily large number of managed money contracts bought and commercial contracts sold since then, it would appear that the record managed money long and commercial short positions are currently held at an average price of around $1252 or so in gold (coincidently the same level of the 50 day moving average). I would peg the average price of the record silver position at close to $16.50.

Needless to say, with a total commercial net short position near a record 300,000 gold contracts (30 million oz) and 92,000 net contracts in silver (460 million oz), the stakes have never been higher for the commercials or the managed money traders on the long side. Every $10 change in gold is worth $300 million in equity change to the commercials as a whole, with every dollar change in silver equal to $460 million. A $100 move in gold would result in a $3 billion change in open profit/loss to the commercials collectively.

This is all pretty straight forward and based upon reliable data from the CFTC in the Commitments of Traders (COT) Report. I am encouraged that more seem to be commenting on the large financial stakes represented by the record current market structure extremes. But up until now, perhaps the most important feature of the record commercial net short positions in COMEX gold and silver has largely remained absent from most commentary. Of course, I'm referring to how incredibly concentrated the commercial short positions in COMEX gold and silver are. This is the most important consideration of all.

As important as it is that there is such a large record short position in COMEX gold and silver; it is significantly more important that the record position is held by just a handful of traders and not by hundreds or thousands of different traders. According to the same COT reports which spell out, to the contract, the level of the record commercial net short positions in COMEX gold and silver, the CFTC provides clear data on what the 4 and 8 largest traders hold. The current readings are simply astounding. In gold, 84% of the record commercial short position is held by 8 traders and in silver 8 traders hold 100% of the total short position and then some. It also appears likely the 8 traders are largely the same in both gold and silver. Why is this so important (and dangerous)?

Free markets are characterized by open competition between as many different participants as possible. The greater the number of participants, the freer a market is considered. However, the converse is also true Â? the fewer the number of participants, the less free a market becomes. The key consideration in gold and, especially, in silver is that so few traders dominate the short side. Not only are there many more long holders in COMEX gold and silver than there are short holders: in terms of concentration in silver, the 8 largest traders on the short side hold a position 45% larger than the position of the 8 largest longs.

Try to imagine a circumstance where there was no concentrated short position in COMEX silver (admittedly a difficult thing to do since silver is always head and shoulders above every other commodity in terms of a short side concentration). In other words, if 8 big shorts didn't hold the entire total commercial net short position and instead the short position was spread out among many different traders (as is the case in just about every other commodity), what would be the likely impact on price?

If the 8 largest shorts were somehow removed from COMEX silver and needed to be replaced by many other traders Â? what price would those traders be willing to sell short at? Clearly, the answer would be that new traders would demand some much higher price, otherwise they would be willing to sell at current prices and offer competition to the current 8 big shorts. The fact is that there are no such traders willing to take the place of the 8 big concentrated shorts because the price is not high enough. The only traders willing to sell and hold silver short at current prices are the 8 concentrated shorts and the only reason they will continue to hold and sell short is because they must Â? because if they attempted to buy back at current or higher prices, silver would truly explode in price.

Therefore, it should be clear that the 8 big concentrated silver (and gold) shorts are isolated and are the de facto short sellers of last resort, because without their short position, the price would be much higher. One problem is that there is no economic justification for the concentrated short position in that it only exists to meet managed money buying. Few, if any silver producers or owners of real silver (ex-JPM) are involved in the concentrated short position Â? it's all a paper betting game with no connection to the real world of silver, except that it dictates prices to the real world. That's what makes it manipulative.

What makes it dangerous are several things. For one, most the traders holding the concentrated short positions in COMEX gold and silver are domestic and foreign banks (according to the Bank Participation Report). Back in 2008, the worst financial crises in most of our lifetimes revolved around leveraged bets gone bad at Lehman Bros, AIG and Bear Stearns, with the bets gone bad at Bear being its large concentrated short positions in COMEX gold and silver. Have we learned nothing in the interim?

Silver exploding in price should matter little to most of the world, but the fact that the concentrated short position in gold and silver is mostly held by banks changes that. There was very little transparency for what Bear Stearns, Lehman Bros or AIG held before their derivatives bets went bad; but the concentrated short position in COMEX gold and silver couldn't be more transparent, as it is published weekly. How the CFTC and CME Group can publish data so unquestionably manipulative and dangerous without lifting a finger to diffuse the concentrated short position is beyond reason.

Aside from the risk to the financial system should banks heavily short gold and silver find themselves in trouble, the concentrated short position is the main risk of the COMEX being dissolved. Should gold and silver prices move significantly higher under current short concentration levels, the regulators may have little choice but to bail out the banks and close the COMEX to save them. Gold and, particularly, silver prices would likely explode under such a development but the cost would be great. Both the CFTC and CME should be ashamed to have let the concentration grow so extreme. Why publish the data if you are going to ignore the ramifications when manipulation and danger are clearly indicated?

Because the stakes are so high and the danger so great to the big shorts should gold and silver prices move sharply higher from here, the probabilities still suggest that the concentrated shorts should succeed in rigging prices lower first to induce managed money technical fund selling. I'm not necessarily rooting for that outcome, just trying to use history and the high stakes involved to handicap the likely result. I also think that all of this must be known to the banks involved, as well as the regulators and believe that none would let it go to the extremes currently in place if they did not have a firm handle on the situation. Then again, history is replete with instances to the contrary, ala 2008.

With yesterday being the cutoff for Friday's COT report, it appears to me that based upon total open interest data, the technical funds bought and the commercials sold the early rally on Monday. Accordingly, I'd peg Friday's report to indicate a 15,000 contract increase in the total gold commercial net short position to a round 300,000 contracts; with the headline number in silver up perhaps a modest 1000 to 2000 contracts.

Almost daily, I've been torn between the apparent inability of gold and silver prices to either genuinely break out to fresh price highs or break down below the moving averages. This has resulted in feelings alternating between the big shorts being strongly in control, to them hanging on by their fingernails. I'm still confident of much higher prices to come in silver, but just not sure of the short term roadmap of how we get there. But it also seems certain that whatever happens, it will be directly related to extreme market structure.

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Silver – $17.01 (50 day moving average – $16.27)

Gold – $1264 (50 day moving average – $1252)

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