

May 21, 2011 – Weekly Review

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Still reverberating from the epic takedown of three weeks ago, silver finished about 30 cents lower for the week, while gold tacked on an impressive \$17 or so, finishing above \$1500. As a result of gold's outperformance, the gold/silver ratio widened out to a bit to just over 43 to 1. This ratio had been around 68 to 1 last August and given silver's outperformance, had tightened all the way in to 32 to 1 by the end of last month, setting a string of multi-decade records along the way. I don't think we've seen the end of those records yet. The sharp drop in the price of silver has caused a one-third retracement in the ratio. I think this creates an opportunity for gold-heavy investors to switch to silver.

This doesn't mean I am negative to the prospects for higher gold prices. As I hope to describe in a moment, I think there is a potentially powerful set up for a gold (and metals in general) price rally dead ahead. Nor am I suggesting that anyone engage in a leveraged long silver versus short gold spread trade, as that might require the use of margin, which I would avoid at all costs. But the long-term supply/demand factors in silver versus gold still strongly favor silver and if we do get the gold rally I expect, it would present a nice time to switch into silver for those who may have missed doing so earlier.

There were some extraordinary developments in the world of physical silver. In a conversation with my friend and mentor, Izzy Friedman, it occurred to us that there have been some noticeable changes on the COMEX compared to years past. The pattern of movement, or turnover, in silver warehouse stocks continues and that still suggests physical tightness and the general unavailability of the remaining 100 million ounces in COMEX stocks at current prices. But a more recent change has been the low level of deliveries and remaining open interest in the current delivery month of May, traditionally a big COMEX delivery month. The delivery month is more than half over and there have only been around 500 deliveries so far, with only a couple of hundred contracts still open. This has been the lowest delivery month total in memory.

Silver bears would point out that this indicates low delivery demand for silver and that could be a legitimate point. But old-timers like Izzy and me came to a different conclusion. In our conversation, I told Izzy how I remembered, back in the late 1980's to early 1990's, when there were close to 300 million ounces held at the COMEX, there was one first delivery day when close to 15,000 contracts (75 million ounces) were delivered. On one day. Now, only 500 were delivered for three full weeks.

Since those days, there developed a regular delivery pattern in COMEX silver where one or two big bullion banks would deliver thousands of contracts on the first notice day and some other bullion banks would take the deliveries. Then, a couple of months later, the banks would reverse positions and redeliver the same thousands of contracts back to each other and repeat this process seemingly without end. It really didn't have much to do with silver per se, but was all part of a cash and carry arbitrage where money market-like returns were generated. But the amount of these deliveries and redeliveries has diminished over the years until it dawned on us that it hardly exists anymore, judging by the experience in the current delivery month. We asked ourselves Â? what changed?

Our conclusion was spontaneous. We did, obviously, have an excess of silver that was forced to be held in hands that could generate a money market return. Without these arbitrage returns, these banks wouldn't be interested in holding the silver and it would have to be held by other entities at a lower price. That explained the constant game of Â?hot potatoÂ? where the silver was passed along only if it could generate some interest rate. Our spontaneous conclusion was that there was no more hot potato, or excess silver, that needed to be held to generate an interest rate return. We didn't set out to conclude something bullish about silver, but it seemed clear to each of us that there was no more excess silver floating on the COMEX.

The other big development in the physical world of silver is the liquidation of silver from the big silver ETF, SLV. At least 40 million ounces has been redeemed from the Trust over the past three weeks, as shareholders have sold in response to the crash in the price. Many commentators and media sources are arguing that this is bearish and indicative of a lack of demand and lower prices for silver. I couldn't disagree more.

I am intentionally not going to dwell on my outrage at the manipulative takedown in price that just occurred at this time. The purpose of this piece is to describe for subscribers the incredible set up that has been created as a result of the takedown. I intend to do what I can to expose just how criminal this affair has been in future articles. Today, the focus will be on what the future may hold.

The liquidation of the 40 million ounces from the SLV is incredibly bullish to me. There was nothing coincidental or unintentional about the sudden 30% drop in silver prices. As I have previously written, getting as much silver from the world's largest stockpile of silver was the reason behind the price plunge. This silver was forcibly taken from SLV shareholders, whether those shareholders were aware of it or not. It was taken by those who didn't mind violating market laws in order to get the metal. That should give you a sense of how serious was the intent to secure this silver. Many will say this shows that the silver wasn't in demand by the investors who sold it. I would say nothing could be further from the truth. Breaking laws to secure something indicates a motivation bordering on desperation. The bottom line is that these 40 million ounces are now held in incredibly strong hands.

But it wasn't just the silver in the SLV that was the prize behind the 30% price plunge; it also involved the other big venue for silver, the COMEX. This week's data from the Commitment of Traders Report (COT) are, once again, shockingly bullish. There were big declines in the total net commercial short positions in both gold and silver. For the first time, I'll also direct your attention to COT and related technical pattern set ups in copper, palladium and platinum. First, a general word about the COTs.

I'm not a pilot, although my son is, as well as some other close family members. One thing I've come to appreciate from being in an airline family is the training, preparation and discipline that go into flying a plane commercially. Procedures are rigid and exacting, as they should be where innocent lives depend on others for safety. Particularly in foul weather conditions and emergencies, airline professionals rely on instruments and check lists. It seems to me that the COTs provide guidance similar to the instruments and check lists of commercial aviation, namely, when you are flying in the soup, you better keep your eyes on the instrument panel. The turbulence witnessed in silver demands that we root ourselves in what has proved reliable in the past.

The general reasoning behind my take on the COTs is that most markets are dominated by certain key participants. Some participants are more powerful than others. The key participants in silver and other metal markets are the commercials, who are the largest players. These kingpins aren't infallible, but you always want to be aware of their influence. The COTs tell you when they hold extreme positions or when they radically change their positions. Quite simply, if they are selling with a reckless abandon, you want to be wary of a sell-off to come. Conversely, if the commercials are buying hand over fist, it's wise to conclude prices will soon rise. The COTs may not pinpoint the exact top or bottom, but if you read them correctly, they should keep you from crashing into the mountain.

The price plunge in silver this time did not come when the commercials held an extreme short position according to the COTs. It appears the biggest increase in short selling prior to the plunge was by players other than the biggest commercial shorts (Note to the CFTC's Surveillance and Enforcement staffs Â? please check for any backdoor connection between the big commercial shorts and these new players). But on the price plunge, the commercials were buying hand over fist. That's clearly visible in the latest COTs. So aggressive was the commercial buying that it is hard not to conclude an important price bottom is being, or has been put in.

This week's silver COT indicates that the total net short position of the commercials was reduced by 7300 contracts (36.5 million ounces) to 34,000 contracts. This is the lowest total commercial net short position since July of 2009, when silver traded around \$13. The raptors (the smaller commercials apart from the big 8) bought most (4700) of the 7300 contracts, but the big 4 (read JPMorgan) bought back 2000 of their net short position, reducing it to 35,200 contracts. This is the smallest net short position held by the big 4 since October 2006, when silver traded close to \$11. My guess is that JPMorgan's COMEX short position is near the 16,000 contract mark (80 million oz), the lowest, by far, since they assumed the position from Bear Stearns in early 2008. (A special thank you and shout out to Turner, a subscriber who provides some great data spread sheets).

In gold, the commercials reduced their total net short position by around 14,700 contracts to 207,000 contracts. This is the lowest commercial net short position since early February, when gold traded in the low \$1300 range. The gold raptors accounted for about half the 14,700 contracts purchased and now hold a net long position of 15,000 contracts. The big 4 and the 5 thru 8 divvied up the remaining gold contracts, covering shorts. The big 4 gold shorts now hold the smallest net short position since early September 2009, when gold traded below \$950. Interestingly, from that point, gold rallied about \$300 over the next three months.

What also makes gold interesting here is that the improvement in its COT market structure has occurred despite the price not violating the 50 day moving average to the downside, unlike silver, copper, platinum and palladium. In other words, the speculative longs bailed out of gold before the price declined below the key 50 day moving average. Of course, it is possible that gold will still decline below the 50 day moving average (currently around \$1471), but even if it does, there will be fewer speculative contracts to be sold there than normal, since so many have already been sold. My guess, however, is that gold goes higher without a penetration of the 50 day moving average.

In copper, the COTs show the lowest total commercial net short position since August 2010, when the price traded below \$3 a pound. Additionally, the commercials have bought back an enormous 30,000 short contracts over the past 5 weeks and now hold only 3000 contracts net short. In palladium, the commercial net short position is now the lowest it has been since July 2009, when the price was less than \$250 an oz. While platinum is not at multi-year low extremes, neither is its commercial net short position anywhere near high or bearish levels.

As I indicated above, silver, copper, palladium and platinum are all trading below their important 50 day moving averages. Somewhat perversely, I have learned to be most comfortable about the prospects for higher prices when an item has been trading solidly below its 50 day moving average. That's because the technical traders don't buy or hold long positions below this average. My reasoning is an item is most bullish before the technical traders come onto the buy side. Certainly, an item that has been trading below the 50 day has already seen much liquidation and therefore, has limited risk of further selling. That's exactly where we sit in all these commodities. Even though we are above the 50 day moving average in gold, historical COT data indicate much liquidation has already occurred. That's good for the risk/reward ratio.

My overall take is that this may be an unusually bullish set up in all the metals, based upon COT structures. In addition, overall market sentiment for all the metals is downright rotten. Since sentiment is absolutely a contrary indicator, that is extremely bullish. That all these metals appear to be structured bullishly is rare.

My primary interest, of course, is in silver. Here, the COT structure and sentiment readings appear to be the most extreme of all. Plus, we have just witnessed an intentional price smash of epic proportions. As a result of the deliberate takedown, 40 to 50 million ounces have been shaken from the SLV and maybe double that amount in equivalent COMEX ounces. This is an absolutely stunning amount of silver considering how tight the physical market has become. That it was forcibly taken from others is deplorable and shameful.

But this is silver that I believe now resides in the strongest of hands. It wasn't illegally taken from others to make a quick and small profit. If you stop and think about it for a moment, the high volume price smash is exactly the circumstance necessary for the biggest of players to get hold of a giant chunk of silver. There is no way a giant buyer could have bought the quantities involved by simply offering slightly higher prices. That's not how markets work. My common sense tells me that going to such lengths to secure this silver required an extraordinary motivation. I believe that motivation will soon become apparent in the future price of silver.

I'm not forgetting about the illegality and manipulation behind the price smash. But it would be a mistake not to recognize just what a powerfully bullish condition it created. When the commercials go to such extremes to buy, it shouldn't put you in a mind to sell.

Ted Butler

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Silver – \$35.03

Gold – \$1512

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