May 25, 2016 – Probabilities

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I'm guided by a few maxims in what I write. Not to hurt anyone is on top, as well as not writing anything so wrong as to be personally embarrassing. I suppose that necessitates avoiding precise investment advice of the Â?buy or sell at this priceÂ? variety, particularly on short term time parameters. That's not to say that I am not confident that silver will ultimately soar in price, because I am more convinced of that than ever. And it's easy for me to explain why I am more bullish than ever long term on silver. In addition to the many bullish points I've made about silver over the past two decades, I have added the most bullish factor of all Â? JPMorgan now owns more silver than any private entity in history.

Where I get wishy washy about short term price prospects is when the COMEX market structure gets lopsided with too many technical fund longs and commercial shorts; which is where we have been recently. Having learned the lessons of the Commitments of Traders (COT) Report the hard way – first hand and over three decades – the market structure premise looms large in my thinking. I have always admitted that the COTs will stop working one day; just that I don't know which day that will be. Certainly, a physical silver shortage would likely make the COT approach invalid and we came close to that in the early part of 2011.

But absent a physical shortage or a black swan event of unimaginable proportions, the history and mechanical logic of COMEX futures positioning is impossible for me to ignore. I'm convinced this positioning is the main driver for gold and silver prices and believing I understand the nature and workings of the two principle trading entities involved – the managed money technical funds and the commercials – explains my reliance on this approach. However, given my fear of hurting anyone or embarrassing myself, the minute I feel this approach is be no longer operative, I'll drop it like it's hot.

The COT market structure approach is based upon probabilities, that is, what is most likely to occur given history and how the two principle trading entities operate. The managed money technical funds have been steadfast in buying as prices rise and selling as prices fall Â? that's what they do. The commercials have been just as steadfast in taking the opposite side of any trade the technical funds care to make. This has been true for more than 40 years in my personal experience and has grown to incredibly large levels in all markets, although my main interest is silver (and gold).

The technical funds have bested the commercials in COMEX positioning in gold and silver on some very rare occasions, but never to the extent that would constitute a complete victory. I would define a complete technical fund victory as the technical funds closing out the bulk of their open positions at big realized profits and the commercials taking big realized losses. By definition, the commercials do experience many occasions where they hold significant open losses, as they establish positions opposite to the technical funds which, while adding positions, hold those positions with large open profits. But it always seems to end with the commercials closing out their positions with profits or, at the very least, with no big losses. Because the commercials always seem to come out ahead (or not behind) in the end, is one reason pointing to manipulation or price rigging. How could one side always win in game not rigged?

Certainly, the action since the start of this year points to the typical result of the commercials besting the technical funds. At the start of the year, the managed money technical funds were extremely short COMEX gold and silver and the sharp $200 gold rally into mid-February resulted in realized managed money losses and commercial profits of approximately $750 million in gold and silver. Then gold and silver prices remained firm or rallied into the end of April as the technical funds established record long positions in COMEX gold and silver and the commercials established counterparty record short positions.

At the beginning of May, the commercials had a net short position in COMEX gold of 295,000 contracts (29.5 million oz) and a net short position in silver of more than 90,000 contracts (450 million oz); with the counterparty technical funds holding proportional record net long positions. I have calculated the average price of the commercial net short position in gold as $1252 and in silver at $16.50. At a gold price of $1292 and a silver price of $17.82 at the end of April, the commercials had open losses and the technical funds open profits of roughly $1.5 billion, among the largest such open losses and profits I can recall.

Since the end of April, prices of gold and silver have declined and the open loss of the commercials and open profit of the technical funds have completely disappeared and then some. As I write this, the price of gold today is around $1220 and silver around $16.35. At these price levels, the commercials open net loss of $1.5 billion is now an open profit of close to $1.5 billion Â? nearly a $3 billion turnaround in the past few weeks.

Needless to say, this is among the largest such financial turnarounds in history and the prime reason for the reversal is more the size of the position, rather than the price per ounce change in gold and silver. Certainly, we've had price drops of more than $70 in gold or $1.50 in silver over the course of three or four weeks. It's just that the math is simple Â? a $70 decline in gold on close to 30 million ounces is $2.1 billion and a $1.50 drop in silver on 450 million oz is $675 million.

Of course, now that gold has decisively penetrated its 50 day and shorter moving averages and silver less decisively so, the technical funds have reacted like the usually do, by selling. Therefore, it is no longer strictly a calculation of changes in open profits and losses because as the technical funds sell out open long positions and the commercials buy back open short positions, unrealized profits and losses become realized to some extent. The calculations don't change drastically, except to the extent the open positions no longer exist. As technical fund long positions and commercial short positions are closed out, they get switched over to the realized category and only remaining open positions can be measured.

For example, if somewhere around 50,000 gold contracts and 10,000 silver contracts have been sold by the technical funds and bought back by the commercial shorts at prices prevailing during the reporting week ended yesterday, the open profits and losses on those contracts must be switched over to the realized category and deducted from the open category. In this case, I would estimate the gold contracts were closed out at an average price of around $1245 and silver at around $16.60.

I don't want to make this too complicated, but how much of a realized loss the technical funds suffered and a realized profit the commercials booked on closed out positions this reporting week depends on which accounting method (first in first out or last in first out) one deploys. But the bottom line is that the commercials, at this point and at current prices, have made back all their open losses and have begun to book profits and are in the process of closing out their open short positions. I'm going to hold off in gauging realized profits and losses until the process has further advanced.

Most importantly, we are now at the point where we have begun Â?the countÂ? Â? trying to calculate how many more technical fund contracts need to be sold and commercial contracts need to be bought before we can declare a bottom in price.

Needless to say, this isn't easy and is an ongoing process. And here's where the possibilities are almost endless. It's possible that the commercials can now Â?toyÂ? with the technical funds, rigging sharp price rallies designed to lure the technical funds back onto the long side to replace contracts just closed out. Or it's possible that the commercials, still being extremely net short, could rig prices sharply lower and rip the technical funds' faces off. Or the commercials could slice the price salami lower in an orderly fashion and get the technical funds to continue to liquidate on slight new price lows. Of course, it's also always possible for this whole crooked COMEX rig job to blow up amid exploding prices. Ultimately, silver prices are going much higher, it's just a question of what they do in the near term. As always, you pay your money and you take your chances.

Here's where the probabilities come in. There was some question, at $1300 gold and $18 silver, that the commercials may have bitten off more than they could chew in establishing such large short positions in COMEX gold and silver. But now that the commercials have seemed to turn the price tide, the immediate danger of a commercial overrun appears to have passed. In other words, there was an open question of whether the commercials were always firmly in control or whether they were hanging on by their fingernails. Nothing would make me happier than to see these COMEX commercial crooks panic in an orgy of short covering, but recent price action just doesn't point to that.

Then again, one doesn't want to be penny-wise and dollar foolish. Silver is still cheap as dirt and worrying about a dollar or so to the downside will probably seem a waste in time when we look back to this period from the future. But having seen this movie countless times over the decades, I, for one, can't brush off my worries easily. I don't like being wishy washy about near term prices, but at least in my defense, being worried about the COMEX structure near term and being wildly bullish long term makes a heck of a lot more sense that the opposite or just being bullish no matter what to this point. Again, if the COT market structure premise stops making sense, I'll stop focusing on it.

A number of subscribers have asked, and for good reason, about the spectacular performance of the mining shares, particularly the silver mining shares. Compared to the price advance in the metal, the mining shares have far outperformed, to put it mildly. I'm not a mining company analyst and don't purport to be, although it's hard not to be positive about the equities in the long run given my conviction as to where I believe the price of silver is headed. I will say that the metal looks cheap to the shares at this point.

I did pass along the thought that earlier in the year that it looked like someone big (JPMorgan) had taken big positions (but less than 5%) in the shares. That thought came from Jim Cook at Investment Rarities. Here's another thought to make of what you wish. It doesn't appear that the recent big buying in silver mining equities is coming from those considered to be typical resource company investors. Silver is not up so much from levels in the last quarter to bring enormous profits to those companies mining it. Instead, I sense the buying has come from those typically considered to be momentum type investors. Momentum traders don't pay much attention to actual company fundamentals and pay more attention to the price action in the shares. They are not the same, but similar to the technical funds on the COMEX, in that both buy and keep buying as prices rise and eventually sell as and when prices fall. If it is momentum type traders buying the mining shares, I have no idea of the price parameters they employ and am offering no opinion on the shares, other than silver seems cheap on almost every measure, including compared to the companies which mine it. The only potential negative for silver, as always, is the COMEX market structure.

As I indicated above, I'm guessing that a significant chunk of technical fund selling and commercial buying took place in the reporting week ended yesterday and to be reported this Friday. After all, the past few days saw the first decisive downward penetration of the 50 day moving average in gold this year and going back to last November. In contrast, silver's downward penetration of its 50 day moving average has been much less decisive and there was a more decisive penetration in early April (which led to sufficient technical fund selling to clear the way for a $3 rally into the end of that month).

I'm guessing we may see around a 50,000 contract reduction in gold's total commercial net short position and a 5,000 to 10,000 contract reduction in silver. Of course, the bigger the reduction, the better. Regardless of what the numbers turnout to be, the biggest question is how many technical fund contracts need to be sold and commercial contracts need to be bought before the COT market structure can be considered bullish? Please know that there is absolutely no scientific precision in my guess, but it seems to me that before a COT bottom can be even timidly pronounced, we would need to see a total of 100,000 to 150,000 contracts of commercial short reduction from the top in gold and at least 30,000 contracts in silver (again from the top of early May). And there is no way to even guess how long, time-wise, this could take.

It goes without saying that futures contract positioning on the COMEX is not how gold and silver prices should be set and that the entire process is artificial and manipulative. But if there is a better explanation for the behavior of gold and silver prices, I am unaware of that explanation. I am also still convinced that if the current structure plays out as it has in the past, the next COT bottom should be the last.

Ted Butler

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Silver – $16.35 (50 day moving average – $16.38)

Gold – $1225 (50 day moving average – $1251)

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