

Nov. 4, 2009 – Prophetic Words

Prophetic Words

Last week, I commented on the gold analysis in Paul Tudor Jones' Oct. 15th letter to investors in his hedge fund. One of the key points in that letter was his observation of how large were the foreign currency reserves of most developing world central banks compared to how small were their holdings of gold. The purchase of 200 tons of gold from the IMF, by the central bank of India, immediately underscored Jones' analysis. According to Bloomberg, The \$6.7 billion purchase accounted for less than 2.5% of the total foreign reserves held by the bank. In terms of ounces, the 6.4 million ounce transaction amounted to 8% of annual global mine production.

The announcement of the transaction coincided with a dramatic jump in the price of gold to all-time highs. The announcement clarified Jones' point about how much money is out there in central banks and investment pools that could find its way into gold. The mismatch between the relative mountain of money and the molehill of gold available for purchase sets the image of very big upside and contained downside if enough buyers decide to own gold. Further, I have the thought that very big potential buyers are confined to purchases when initiated by large sellers of gold, which appear limited. It's hard today to imagine central banks which do own large quantities of gold, selling metal to raise money, when money creation is easy and rampant. All this argues in gold's favor.

The point I tried to make in my article on Jones was how bullish his gold analysis was for silver. Not only did the same buying power exist for silver as well as gold, because there was less silver bullion available for purchase and the price of silver so low, it wasn't even possible that big official silver sellers would emerge. We will not see an IMF sale of silver, as they have no silver to sell. But if there was silver to sell, the IMF-India \$6.7 billion deal, were it to involve silver instead of gold, would have amounted to 400 million ounces of silver, or 60% of annual world production, not 8%, as was the case in gold. Further, 400 million ounces of silver is the total amount (100%) of visible metal deposited and purchased in every silver ETF and investment vehicle over the past three and a half years, since the introduction of the big silver ETF, SLV. The 6.4 million ounces of gold bought by the Indian central bank amounts to 15% of the 43 million ounces of visible gold added to similar gold ETFs and investment vehicles over the same time. Lastly, the 6.4 million ounces of gold represent 0.3% of the 2 billion ounces of gold that exist in bullion form. Were it possible to buy 400 million ounces of silver, such an amount would account for 40% of the one billion ounces of silver bullion thought to exist.

I make these comparisons with gold, as I always do, not as a knock on gold, but to show how it relates favorably to silver. Many silver investors own gold as well, and it would serve no purpose for me to slam gold. Besides, gold rising in price is good for silver, as makes the silver undervaluation story more compelling. I am highlighting Tudor Jones' case that there is a mountain of money compared to a molehill of gold. But if there is a molehill of gold, there is an anthill of silver. If gold is a flea compared to the elephant of money available to purchase it, then silver is a microscopic mite on that flea. If gold is going to the moon as a result of big investment buying, then silver is going far beyond the solar system. In fact, I want to clarify something I wrote in the first Tudor Jones article. I said that it was unlikely that any central bank would ever buy silver, but impossible for them to be big silver sellers.

After thinking about it, and reflecting on what my friend and mentor Izzy has said recently and in the past, it wouldn't surprise me if there were central bank buying of silver in the future. Izzy's reasoning goes like this "if central banks have so much currency to invest billions into gold for monetary purposes only (no utilitarian purpose), then when the silver shortage comes, who's to say that a central bank, flush with cash, would not look to buy silver for assured supplies for industries vital to the local economy? I realize that central banks and governments don't always do the logical thing, but if just one government entity made the move to secure adequate silver inventories, it would profoundly impact the price. I remember, years ago, making precisely this case to the Department of Defense and the Chairman of the Joint Chiefs of Staff about silver, for patriotic purposes. All I got in response were complimentary letters on some very impressive stationery, but at least I tried. When the silver shortage hits in earnest, I won't have to try to convince them.

So does the burst in gold to new highs signify the lift-off to much higher levels, with no looking back, in both gold and silver prices? The short answer is I still don't know. Certainly, I don't see clear evidence of a resolution in the extreme COT structure, although such a resolution may soon be apparent. Such a resolution must come at some point. Notwithstanding the bullish potential of the IMF-India announcement, there was something about the price reaction that gave me pause. It's important not to become too bullish at what may be temporary tops, just like it is important not to become too bearish at temporary bottoms. What gives me pause is the nature of this price rally. It has the appearance of being a paper COMEX rally. Yes, India did buy \$6.7 billion worth of gold, but it didn't buy it Tuesday. It was purchased a week or so ago. Yes, the dollar has been weak, but it wasn't weak Tuesday. Undoubtedly, if more central banks and other big investors rush to buy gold (or silver) now, the price will soar. But who was buying yesterday?

It appeared to be a COMEX-centric affair. I say that because the price of gold and silver spiked up around 10:30 EST, many hours after the India announcement and hours after the traditional COMEX opening. The most obvious cause of the price spike was a move above the old price highs on gold, which set off massive technical fund type buying. That buying appears to have been met with new commercial short selling, at least in gold. Open interest increases and heavy volume statistics indicate this in gold, where the two-day combined increase in gold open interest was near 24,000 contracts. Silver's open interest didn't decline which would have indicated short covering, but neither did it advance proportionally with gold, with a combined two-day increase of less than 2000 contracts. This week's COT and Bank Participation Reports will clarify the position, even though big moves on Tuesdays can mess up the reporting. Bottom line Â? if there is an explosion, silver will not be left out.

What should a silver investor do? If you are a long-term buy and hold investor (the preferred variety), you continue to sit and hold metal and shares, as silver must still be considered cheap on a long-term basis. You must still be prepared emotionally for a sell-off. If you are willing to hold a portion of your position in cash to take advantage of a temporary sell-off, you must still wait. You shouldn't be buying anything if you will sell, or be forced to sell, at lower prices. Does that raise the possibility that silver may take off without you owning a full long position? Yes. If there was a way to hold cash and a full long position simultaneously, I would tell you. (Other than call option protection).

This is still a high-risk/high-reward circumstance. Value buyers prefer low-risk/high-return circumstances, although you can't always get what you want. As I indicated in this week's interview on King World News, there is only one potential negative presently, the extreme COT position. Other than that, on a supply/demand basis, silver has never looked better. If the dealers can rig a sell-off that will be the only explanation for why we may go down. But no one knows if they will succeed or they will get overrun with the Â?full pants down.Â?

If you have recently sent me a question, the reason I have not responded is that I'm planning on answering publicly. Just so I don't miss publishing some excellent questions, send them again to be on the safe side.

Ted Butler

November 4, 2009

Date Created
2009/11/04