November 16, 2016 – The Current Setup

The Current Setup

I know there should be other factors driving gold and silver prices, like actual supply and demand; but the prime price force continues to be the supply and demand of paper derivative contracts, not metal. I also know I've promised to stop talking about COMEX paper trading when it stops dictating price, but the paper influence has only grown stronger. So let's look back over past year or so in the hopes of understanding the future price prospects for silver and gold in terms of the COMEX market structure.

Last November we were in the middle of the most classic case of Â?salami slicingÂ? I ever recall, as gold and silver prices were sliced lower and managed money traders sold longs and added shorts to levels never seen as gold prices fell to $1050 and silver to under $14. The low prices and extremely bullish COT setup lasted into January and then prices surged higher, with gold leading silver. The price rise had everything to do with managed money buying and the market structure turned bearish by the end of February, with gold up $200 and silver by only $2.

From around April and with some gyrations in price and structure, managed money traders continued to buy, and into the summer price surged again, this time with silver adding on as much as $5 (to near $21) and gold by another $100 (to $1370). Managed money long positions exploded, as did commercial short positions to the highest levels ever and the COMEX market structure remained extremely bearish through the summer. At the highest prices in August, the commercial shorts were under water by nearly $4 billion, the most ever and one large gold short covered a short position at great loss, also for the first time ever.

Back in the summer, it appeared touch and go as to whether we were witnessing a commercial failure in which gold and silver prices soared further as the possibility loomed that the commercials might panic and buy back shorts on higher prices for the first time ever. I remember characterizing the summer setup as going one way or the other, but leaning towards the commercials succeeding in driving prices lower eventually, based upon the historical record and the rules of the game favoring the commercials. That is not to say that I knew what would occur because I didn't purport to know Â? it was a matter of probabilities.

The recent price decline has taken us down by $150 in gold and by $4 in silver from the summer highs. In the process, the commercials' $4 billion open loss on the COMEX has turned into a $3 billion profit (some realized) as managed money traders have sold and the commercials have bought back a good number of their short contracts in both gold and silver. Regardless of what occurs from here, it must be said that the commercials successfully pulled their chestnuts from the fire to this point.

However, since I don't believe the commercials allowed themselves to get so deeply into the financial hole on purpose, I'm still of the mind that they won't be so quick to repeat that experience Â? meaning the commercials won't be as aggressive in selling to the managed money traders on the next upturn in price, when that turn up commences. If true, the next rally should be bigger than most (and maybe even the big one in silver).

In essence, the question from summer of will the commercials fail has now turned into how much managed money selling can the commercials arrange on the current price takedown?
As most always, the measurement is a question of the contract count and not the price, although lower prices are needed to generate managed money selling.

Yesterday marked the end of a COT reporting week that encompassed sharp price declines in gold and silver, as well as the highest weekly trading volumes in history. The important 50 and 200 day moving averages (and all other averages in between) were violated first to the upside and then decisively to the downside. As such, it would be reasonable to expect record or near-record changes in Friday's report. For numbers, I'd guess a reduction in the total commercial net short position of around 75,000 contracts in COMEX gold futures and 25,000 contracts in silver. As always, bigger reductions would be preferable to smaller reductions and I'll be sensitive to the reductions in the concentrated short positions of the four largest traders in silver and gold.

If the numbers come in as expected, that would translate into a total commercial net short headline number of around 170,000 contracts in gold and around 55,000 contracts in silver. On a longer term historical basis, these are not particularly bullish market structure extremes; but on the other hand, these would be the most bullish readings since February. Interestingly, should my expectations prevail, they would represent 50% reductions in the commercial total net short positions from the summer peaks.

Therefore, the question has definitely shifted from will the commercials get overrun to how much more managed money selling can the commercials arrange? I didn't pretend to know the answer then and don't pretend to know now. But I do think I know that those are the right questions. And I also think there are some more definitive things that I can say about the difference between the summer and now.

For one thing, silver (and gold) is a much better buy now than it was then, not only because of sharp reduction in price, but more because of the big improvement in market structure. Is it possible that there is much more managed money selling in store, particularly of the new short selling variety? Yes, that is absolutely possible. To that end, I'm starting to think the managed money traders are called that because it's so easy for the commercials to manage them.

But it is also possible that the bulk of the managed money selling is behind us, given the large amount of selling so far. In that case, the bulk of the price decline may be behind us. Yes, I'm equivocating, but my point is that the equation has shifted from a commercial failure to whether this is now a safe place to buy. It's certainly a safer point to buy, but included in that statement is the proviso that if we do move lower from here on aggressive further managed money selling, silver becomes an even more compelling buy. Same as always.

Complicating the question of whether we've seen sufficient managed money selling and commercial buying to suggest a price bottom is the manner of managed money selling to date. Last November, we reached extreme bullish readings in market structure on thin but persistent price slices to the downside; this time the price hunks and trading volume have been large and condensed in time. To be frank, normally I wouldn't think that the market structure could be resolved so quickly. But the manner in which the market structure changes is secondary to the actual changes in contract count. Maybe the sharp expected improvement in market structure over the reporting week ended yesterday suggests more to come in the way of lower prices. But maybe it suggests a near completion in managed money selling in which case prices needn't fall sharply from here.

Where the probabilities favored sharply lower prices and very large potential managed money selling at the summer price highs, those probabilities have been reduced by the amount of price decline and actual selling to date. And where the probabilities argued against a further sharp price rally in the summer due to massive new managed money buying; the probabilities have been strengthened now for a rally due to the selling to date.

Additionally, other factors are more supportive of a gold and silver price rally than they have been recently, including the switch from overbought to oversold technical indicators on this recent price smash. Plus, I've had the strong impression that JPMorgan has upped the pace of its physical silver accumulation, based upon trading volume in SLV and even appeared to return to buying Silver Eagles yesterday. JPM has been laying back from taking delivery on COMEX silver futures contracts of late (after being the largest stopper of all for a year and a half), so perhaps the upcoming December delivery period, always a big delivery month, may feature JPM's return. Superimposed on everything, of course, is the number of short silver (and gold) contracts bought back in the new reporting week.

Am I pounding on the table, declaring silver to be at rock bottom prices and maximum managed money selling? No. Am I ruling out the start of big rally? No. If we did go lower amid massive new managed money shorting, would I then pound the table and get over-invested in silver? You bet. The COT market structure also changes over time in terms of actual levels of extremity. Where 170,000 commercial gold short contracts and 55,000 silver contracts were once considered extremely bearish, those levels would be among the most bullish this year.

So while it may be premature to call the selloff largely over, it is important to be mindful of the extent of managed money selling and commercial buying that has occurred to date. This is not that complicated Â? the lower price goes on additional managed money selling, the more bullish the market structure becomes. Certainly, there should be no doubt as to what is behind the price decline or, for that matter, what has been behind just about every significant price move in silver and gold over the years. COMEX positioning may be difficult to predict and time; but it has been the only legitimate explanation for why prices have moved.

If, as and when the commercials continue to succeed in inducing additional managed money selling, the sole potential negative price factor gets removed. I'm enclosing an article that I just wrote for Investment Rarities on this subject. I admit it's somewhat repetitive with what I just wrote, but I thought subscribers would appreciate it nonetheless. Besides, is it that bad to repeat what is, essentially, the most important factor in silver and gold pricing?

Removing Silver's Only Negative

After being the best performing investment asset for a few years as silver surged to nearly $50 in early 2011, it then reversed downward to under $14 by the end of 2015. From the start of this year into the summer, silver jumped by 50% to nearly $21, making it among the best performing assets once again. Silver has a documented track record of superior investment performance when it is bought at the right price.

The right time to buy silver is after it has fallen sharply in price. That's true with many investments, but buying silver at the right price can make you more money than just about anything else. The good news is that silver has fallen sharply from its summer price highs; making it a better buy now than it has been in many months. But the best news about silver is not just the opportunity to buy it after it has fallen in price.

Most observers believe silver's price moves up and down are rooted in changes in supply and demand or in changes in investor sentiment. That's true if you properly define supply and demand and investor sentiment. After more than 30 years of intense study, I am more convinced than ever that the only supply and demand and sentiment that matters for the price of silver today is what occurs on the COMEX, the largest silver futures exchange in the world.

The reason is simple Â? more paper silver changes hands on the COMEX daily than actual metal could ever be produced or consumed or accumulated on any day. Yes, I know it is against US commodity law that a paper derivatives market dictate price to the real world of commodities Â? just like the tail wagging the dog Â? but that's the way it is. And this paper trading control on price is not limited to silver, just about every commodity, from gold to copper to crude oil and foodstuffs, is similarly controlled by paper derivatives trading. But silver is in a class by itself when it comes to paper trading price control.

I know most people's eyes glaze over when talk turns to derivatives trading on the COMEX and for very good reason – it's complicated and difficult to grasp at first. And the complexity explains in large measure how something that shouldn't be occurring has been allowed to continue. But sometimes one has to wade into the weeds of complexity to find the answer to difficult questions, such as why has silver gone up and down as it has and where is the price of silver going next? I believe the answers to these questions can be found in COMEX trading.

COMEX silver trading has evolved into a massive, but private betting game between two main groups of large traders who dominate upwards of 90% of all trading on the exchange. One group consists of traders called the managed money traders, which follow technical price signals Â? always buying as prices rise and selling as prices fall. The other group of traders are called the commercials and in silver these traders are largely domestic and foreign banks, the largest of which is JPMorgan.

Don't let the term Â?commercialsÂ? throw you off, because in this case there are few if any silver miners trading on the COMEX and little to no legitimate hedging taking place. The managed money traders are speculating, pure and simple and so are the banks in taking the other side of the managed money traders bets. The simplest way to understand what transpires in COMEX silver trading is to visualize the managed money traders as big betters and the banks as bookies taking the bets. If the managed money traders buy, this pushes prices higher and the banks sell to them and if the money traders sell, pushing prices lower, the banks will buy from them. This is the tidal force that causes silver prices to rise and fall and not actual silver production, consumption or investment.

It may not seem right that a few large paper traders in either group (no more than 50 or so and in reality closer to 8 or less) would control silver prices, but that's just the way it is. But because these two groups of large COMEX paper traders have such a dominant and controlling influence on price and because changes in their respective positions are required to be reported to and by the federal commodities regulator, the CFTC, a clear public record exists as to what big changes in positions mean for the price of silver.

When the managed money traders have bought heavily and hold very large long positions, silver prices are likely to fall. After the managed money traders have sold aggressively and hold small long positions and even large short positions, the price of silver is very likely to rise. I study and consider every possible factor that might matter to the price of silver and, simply put, the positioning of the managed money traders and the banks on the COMEX is the most important factor by far.

On the price surge in silver into the summer, the managed money traders bought heavily, established record long positions and the commercials (the banks) established record short positions. Record managed money buying was the main, if not only reason silver went higher. The problem is that once record managed money long positions are established that automatically becomes the single most negative factor for prospective silver prices.

In fact, since quite early in the year, the large managed money long position has been the only potential negative factor for the price of silver against a plethora of bullish factors. However, on the recent drop in the price of silver (and gold) there are strong signs that the managed money traders have begun to sell aggressively, eliminating their large long positions and adding to short positions. I can't overemphasize what an important sea change this portends. For the price of silver in the future, this is like the sun coming out after months of nothing but stormy weather.

Of course, it is impossible to predict exactly when the last managed money paper silver contract will be sold, but when that occurs the price of silver will have hit bottom and is likely turn up very sharply. However, we are well into that process and oftentimes it can end quickly, although I can't know exactly when at this point. I do know that once managed money selling has climaxed that is the perfect time to buy silver and a long term investor shouldn't quibble about price at that point.

Going hand in hand with managed money selling is the buying of paper contracts by the commercials, particularly JPMorgan. It has been my firm opinion for years that JPMorgan, more than any other entity, controls the price of silver. From everything I look at, this bank is ideally positioned to profit immensely on its physical silver ownership of 550 million ounces whenever prices turn upward. Most importantly, it is also my conviction that JPMorgan has whittled down its massive COMEX paper short position on the very recent decline in price making an imminent turn up in silver prices even more likely.

Finally, I have held that whenever silver prices turn upward this time around, for a variety of reasons, the move up is very likely to be the move that will matter most Â? the big one. I may not know what the exact bottom will be or when it will occur, but that is far less important than being positioned for the move up. When the last managed money COMEX paper contract is sold, there will be no negative factors remaining and no reason for not being fully positioned in silver.

Due to a number of requests to include both the 200 day and 50 day moving averages and because they have grown so close to each other, I'll do so. Particularly in gold, it's hard to see how the 200 day moving average could be penetrated to the upside, without the 50 day moving average also being penetrated.

Ted Butler

November 16, 2016

Silver – $16.93 (200 day ma – $17.60, 50 day ma – $18.36)

Gold – $1225 (200 day ma – $1281, 50 day ma – $1289)

Date Created
2016/11/16