

## October 15, 2010 – Up Against the Wall?

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The price of gold and silver continued the march to historic new highs. Gold finished \$20 higher to a new all-time weekly closing high, with silver up around one dollar to a new 30-year record. Given widespread expectations of a correction, sentiment indicators remain subdued, while technical price indicators are basically overbought. Silver has continued to outperform gold, with the gold/silver ratio closing below 56.5. Although this is a multi-year ratio reading favoring silver, my sense is that silver will surprise many with its continued out-performance over gold as time unfolds. When all is said and done, in the end silver will prove to be a superior investment compared to gold.

In the physical market, there were inflows of some 4.5 million ounces into the big silver ETF, SLV, lifting the holdings to a new record of over 328 million ounces. Based upon volume and price action this week, millions more ounces are owed to the Trust, perhaps another 5 million ounces or more. In somewhat of a change, there was a large one-day inflow into the big gold ETF, GLD, reversing a string of withdrawals over the past two months. Still, over that time, the SLV's holdings have grown more than 10%, while its counterpart, GLD, was basically flat. In looking for explanations for why the price of gold rose so much over the past two months, one can eliminate strong investor demand in GLD or other gold ETFs, by virtue of no metal coming in.

The latest COT came in basically unchanged in the total net commercial short position in both gold and silver. In silver, the big four traders (read JPMorgan) reduced their short position by 1500 contracts. The chief take-away on the impressive gold and silver price rally that began on August 24 is that there was no real increase in the commercial net short position, either on a total or on a concentrated basis. This is very rare and raises the question that many have asked me about, namely, is the COT signaling something different ahead? I still can't be sure which way it will play out in the very short term, but I'd like to point out some facts and then speculate as to their meaning.

The first fact is that over the past 7 weeks, gold has climbed by \$140 and silver is up by \$6.30. The commercials didn't increase their short positions materially on those rallies. Nor did they reduce them. Looking at COMEX futures contracts only, one contract of gold is up \$14,000 over the past 7 weeks. In silver, the move up has resulted in a \$31,500 per contract change in value. It is important to understand how the futures market operates. Every day, all long and short position holders have their holdings marked to market. If a position moves in one's favor, the mark to market amount is credited to each account. If a position is adversely impacted by the daily mark to market, each account is debited by the appropriate amount. Additional funds covering the adverse move are required to be immediately deposited to make up for the market to market paper loss. This is a margin call. If you don't cover margin calls immediately by depositing additional funds, the brokerage house will close out a sufficient portion of your position to cover the margin deficiency. If you hold long positions, they will sell you out. If you hold short positions, they will buy back your short position.

The COT reports tell us that there are about 120,000 total net contracts of silver futures held on the COMEX. You get that amount by subtracting all spread positions from total open interest. That means that there are 120,000 contracts of silver held long and 120,000 contracts held short, as there must be a long for every short and vice versa. (One long plus one short equals one contract). Therefore, on the \$31,500 per contract move in silver since August 24, \$3.78 billion has been credited to all the silver longs and \$3.78 billion has been debited against all the silver shorts. The total margin call to the silver shorts has been \$3.78 billion.

In COMEX gold, the total net futures position is about 500,000 contracts, once spreads are subtracted. In gold, the \$14,000 per contract move on the 500,000 true net open interest has resulted in \$7 billion being credit to all the gold longs and \$7 billion being debited to the shorts' accounts. The COMEX gold shorts have faced a \$7 billion collective margin call. Since I believe that many of the gold shorts also hold silver shorts, it is reasonable to look at the silver and gold total margin calls on a combined basis of almost \$11 billion. Because the big 8 commercial silver and gold shorts hold a concentrated short position of more than 50% of the true net total open interest, these 8 trading entities have been hit with \$6 billion in margin calls alone. Further, JPMorgan is out almost a billion dollars on silver alone.

Never in modern times have the concentrated commercial shorts in gold and silver been so adversely pressed than by the 7 week up move just witnessed. (The COT data from 1980 are not complete). Away from the big concentrated commercial shorts, all other gold and silver short holders are also stressed financially. The initial minimum margin requirement for one contract of COMEX silver is \$6,750. That means you must deposit at least \$6,750 for each contract of COMEX silver whether you initiate a long or short. Since August 24, all long holders have been credited \$31,500 for each contract they hold, assuming they didn't sell. All short holders have had to deposit an additional \$31,500 per contract. A short holder of 10 contracts (not a particularly large number in COMEX trading circles) would have had to come up with \$315,000 in additional funds because of marked to market, if he didn't buy back and cover the short position.

These are very big dollar amounts, both on an individual and collective basis. Some individual gold and silver short holders have covered, of course, but the COT data clearly indicate that there has been no great reduction in the total net short position, despite such an adverse result to date. What does all this mean? At a minimum, there has had to have been some number of financial casualties among the gold and silver COMEX shorts. Some short traders have already been wiped out, but are not yet visible. As in a gangland war, we know there are casualties, but the bodies haven't floated to the surface yet. While fortunes can change quickly in markets, especially manipulated markets, any damage in the gold and silver market has been to the shorts, not the longs on this rally.

On a broader perspective, the financial set-back to the shorts has created a dangerous situation for the market itself. The big shorts, which are out the lion's share of the total \$11 billion mark to market loss, have become more desperate than ever to rig a sell-off. That's a real danger. But so is the chance that they are so weakened by the margin calls of the past two months that they may not be able to pull off a rig job to the downside. Certainly, if we do sell-off sharply it will be because the commercial crooks manipulated prices lower and the CFTC continued to look the other way.

However, the possibility does exist that the CFTC, under Chairman Gensler will not look away. Perhaps the reason the big shorts didn't increase their concentrated short position over the past 7 weeks is because they were informed by the regulators not to do so. I know that I may be naïve to assume that a US regulator might actually do the right thing and enforce the law, but this new Dodd-Frank reform law represents a big change. Who could categorically deny that the rally to date might have been touched off by the regulators taking seriously their oath to uphold the law?

As has been my theme since Gary Gensler was sworn into office, we are on a collision course of resolution. Resolution of the silver position limit issue is within sight. I can't tell you what the Commission will do, but I can tell you what they should do — set limits at 1400 to 1500 contracts in silver and throw out the phony hedge exemptions held by JPMorgan and others. We are also coming close to resolving the two-year old silver investigation, which started before Gensler became chairman. If the Enforcement Division tries to sugar coat an obvious crime in progress, as did the Market Oversight Division several times, I think the public reaction will be swift and decisive.

It's possible that the pressure on the shorts will expand to a critical point beyond their control. Certainly, potential short covering remains one of my critical factors. It's amazing to think we ran \$140 in gold and over \$6 in silver with little change in the overall short position. I know I say this all the time, but if you told me we would be over \$24 in silver with no resolution of the short position, I wouldn't have believed you. Silver has climbed six-fold from the \$4 price low and the short covering rocket fuel has been untouched. What will determine the movement of silver prices won't be the charts, interest rates, the dollar, the stock market or the weather; it will be how this dangerous and manipulative concentrated short position is resolved.

What should a silver investor do? Sit tight with fully-paid-for positions. If you absolutely, positively must speculate, confine the speculation to call options using a very small percent of total capital. Avoid margin. Any call options purchased before the rally started should be profitable and you should have taken money out by rolling up and out. Maintain option positions, but you should be operating on house money at this point to some extent. Most assuredly, there will be greater volatility to come. I can't tell you the very short term price direction, as that is unknowable. But the longer term looks clear — the coming resolution of a confluence of factors points to sharply higher silver prices. With that type of set up, you must not lose long-term silver positions in the coming volatile times.

Ted Butler

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Silver – \$24.30

Gold – \$1369

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