

September 1, 2010 – The Critical Factors, Part 3

(Thanks to all who forwarded me the news stories about JPMorgan shutting down their propriety commodities trading desk. This does appear to be significant. I'll have a comment in the next day or so.)

The Critical Factors, Part 3

This is the conclusion of my series on the three unique factors that make silver a particularly compelling investment. Each of these three factors, taken alone, provides a powerful force for sharply higher silver prices. Put them together, and the resultant projected price impact on silver seems almost incomprehensible. At least, I have trouble picking a specific ultimate price target, which is why I rarely list such a number. I think it's more important that you understand the factors that may determine the future price, rather than fixating on a certain number. I'm sure if you focus on these factors, whatever price projection you come up with will convince you that silver is the best investment possible.

As way of review, the first critical factor was the large and concentrated silver short futures position on the COMEX. This unique and massive short position explains the artificially low price, both compared to silver's supply demand fundamentals and relative to other commodities, especially gold. The short position creates both a low price entry level and a powerful force to the upside when this short position is covered. Public awareness and regulatory scrutiny of the concentrated short position are growing daily, with no legitimate explanation forthcoming. The new comprehensive financial regulatory reform law also threatens the concentrated short position's continued existence. The end to the concentrated short position would mark the end of the silver manipulation, since they are one and the same. That termination would cause the price of silver to explode.

The second critical factor was the mismatch between how much potential investment money could flow into silver versus how much silver was available to be bought. The amount of world investment buying power is measured in the trillions of dollars. The artificial depressed price of silver and the stunningly low amount of remaining world silver inventories means that all the silver bullion in the world is worth less than the smallest fraction of a percent of the investment funds available. This is a price formula unique to silver, guaranteed to multiply the price once the first big investor does his homework and decides to buy silver. In a world hungry for new investment ideas, it is only a matter of time before enough eyes glance in the direction of the real silver story. Once that awareness is realized, increasing quantities of silver will be demanded, driving the price higher. It's not as if the real facts about silver need to change for the better; it's just a matter of time before enough recognize just how good the real silver facts are today. Ask yourself what you did when you first learned of the real silver story? Ask yourself if you know of anyone who took the time to objectively study silver who didn't buy?

On top of the first two critical factors, let me add the third. Even though this critical factor has yet to occur in silver, I am certain that it must occur, for no other reason than it is tied to basic human nature. Critical factor number three is the coming industrial silver user buying panic. Based upon simple observations of how people behave in certain circumstances, it is not possible for the world's industrial consumers and processors of silver not to rush to buy silver in a panic at some point. When, not if, that silver user buying panic starts, it will force other users into the buying frenzy. At that point, the whole buying panic must burn itself out at some sufficiently astronomical price. There will be no other way to put out the panic, once it commences.

What is it that will start the silver user buying panic? The answer is a delay in silver shipments to a sufficient number of users. What is it that guarantees that there will be growing delays of silver shipments to users? The answer is that the artificial low price that creates demand from users and investors alike. Sooner or later, an artificial price level causes imbalances in the physical market that must be rectified. If the artificial price is too high, it is only a matter of time before great surpluses are created which eventually crush the price. If the price is manipulated too low, as is the case in silver, it is only a matter of time before a physical shortage hits the market causing prices to explode. This is the basic message of the law of supply and demand.

Why hasn't the artificial low price resulted in delays to silver users yet? Up until now, any delays of physical shipments have been confined to silver investors, not users. The big commercial COMEX shorts, which also happen to be deeply involved in the wholesale distribution of silver, have made sure that any delays in silver shipments have been restricted to silver ETFs and investment programs, like the Central Fund of Canada. These commercials know that these institutional investors are much less likely to react strongly or panic, as would a silver industrial user. It's no big deal for institutional investors to have to wait for actual silver deliveries. These investors have financial contract assurance that they will eventually get the silver, so it matters little to them if there is a delay. In contrast, an industrial user of silver needs the timely delivery of actual metal to keep his operations running, not a financial guarantee. It's a very big deal for users to be delayed.

Up until this point, the big COMEX commercial shorts have done a masterful job of supplying the users on a timely basis, making the institutional investors wait for silver whenever necessary. This is a juggling act, or like borrowing from Peter to pay Paul. But the cumulative effect of the prolonged silver price manipulation dictates that delays must hit the users at some point as well. It's like the commercial shorts trying to hold back the tides of a shortage. Sooner or later it will overwhelm you. Then, the commercials will start to discriminate between users, delaying those less likely to scream or panic. As the number grows of silver users experiencing delays in the deliveries of the physical silver necessary to run their operations and assembly lines, some will seek to avoid future delays by laying in an extra supply of physical silver in inventory. It's the only logical reaction.

As some silver users panic early and build extra physical inventory to protect themselves from operational interruptions, this process only exacerbates the overall shortage. The extra silver bought by early inventory-building users removes more silver from the market, in turn creating more delays to other users, prompting those users to panic and attempt to build inventory. Once started, it truly becomes a self-reinforcing phenomenon that will only end when prices go high enough to exhaust the panic buying. I don't know how to build a logical model for how high silver prices may climb in such an emotional panic buying frenzy by users. That's why I rarely throw out specific price targets for silver.

The coming silver users buying panic has been a long time in the making and the set up has been formed by easily recognizable developments. The first is the widespread business practice of just-in-time production and inventory management. Adopted from Japan around 1980, just-in-time methodologies relied on computer systems to match orders to manufacturing schedules. The net result was an abandonment of maintaining inventories of raw materials and component parts. Due to the high interest rate environment at that time, the slashing of inventory levels resulted in a giant boost to the corporate bottom line. This development was certainly not limited to silver, and lean inventories of everything have become a business fact of life.

As long as the distribution and supply lines are running smoothly, nothing is more efficient than just-in-time. The problems arise when there is a break or interruption in supply. With no in-house inventory to fall back on, manufacturing operations are quickly threatened in the event of a supply disruption. Therefore, the just-in-time method is a two-edged sword; great when all is well, horrid in a supply disruption.

In most industrial applications, the amount of silver used is very small relative to the total cost of the final product. In these applications, even a large increase in the price of silver has little impact on the total cost of the finished product. This means that silver is price-inelastic in these applications, as any increase in the silver price is unlikely to result in less demand. If a manufacturer is using ten cents worth of silver in a product with a final total cost of \$20 or more, even if silver doubles or triples in price (or more), that manufacturer will find it easy to continue to use silver and absorb or pass along the cost increase. Of much more concern to such a manufacturer is the availability of silver, not the price. In fact, the small amount of silver used per application makes the coming user buying panic likely to be all the more intense.

The fact that silver makes up such a small fraction of the total cost of a typical finished product means that in a silver shortage users will be more motivated to build silver inventories. No one would allow a production line to come to a halt for lack of a low-cost component. Faced with such a work stoppage, users will buy from the open market (COMEX) if normal suppliers can't provide silver. Today, corporations are flush with cash and interest rates are at record lows, unlike the environment that begat the just-in-time process in the first place. Silver is easy to store and lends itself towards inventory accumulation. In a shortage, users will attempt to build silver inventories. How can I be so sure?

The coming silver user buying panic is inevitable because of human nature. I've been through too many hurricane warnings and actual hurricanes to think otherwise. If you are in the path of either, certain commodities, like bottled water, certain foodstuffs, ice and gasoline will quickly become unavailable. People will rush to buy these items and supply will disappear in a flash. I've never seen it not happen. Faced with a threat of supplies being disrupted by any cause, people will rush to protect themselves and their families. The buyers for the silver users are also people. When faced with delays and the unavailability of silver in a shortage, the buyers for the silver users will do what people do in the event of an approaching hurricane; they will secure as much inventory as possible. The silver users will have just as urgent a mission as those preparing for a hurricane; maybe even more. Whereas hurricane preparations are made to get through a week or two of interrupted power, a prolonged silver shortage could prove fatal to a company whose operations are indefinitely disrupted. If buying silver is the prevention to a shut down, no effort will be spared in securing that silver. And please keep in mind that I am referring to a user buying panic of real silver, not paper silver. In a shortage, a manufacturer will be interested in holding actual silver in its own possession, not a paper promise of delivery that could be delayed or subject to force majeure.

The coming user buying panic has been seen in other commodities, most notably in palladium into 2001, when prices hit \$1100, up ten-fold from a few years earlier. This was due to automobile manufacturers, principally the Ford Motor Co., buying palladium in a panic mode on the cash market. Ford was worried that a shortage of palladium used in catalytic converters would cause vehicle assembly lines to shut down. They needed to prevent that and bid the price of palladium skyward. That is a realistic precedent for what will happen in silver. Only there are additional critical factors in silver that wasn't present in palladium. Palladium didn't have a giant concentrated short position and there were no allegations that palladium prices were artificially depressed before the price explosion. Nor was there great investment demand lurking in the weeds, as there is in silver.

What is so unusual about the coming silver users buying panic is that it is only one of three critical factors in silver. In its own right, it may be the most explosive of all. And while it may not be entirely unique to silver, it is not present in gold. Because there is little industrial consumption in gold, it is not possible large numbers of gold users would rush to build gold inventories. This is an important reason why I favor silver over gold. That's not to say gold won't get good investment buying, just that it won't get that panicky "keep the assembly lines running at any cost" type buying coming to silver.

However, it is very unique that silver has three critical factors about to be set off; a user buying panic, an investment buying panic, and a short covering buying panic. I certainly can't imagine this set up in any other commodity. If the facts weren't so clear, it would be easy to think the set up didn't exist in silver, either. But the facts are clear and they are easy enough for you to confirm and consider. The most phenomenal circumstance is that any one of the three critical factors going off will set the others off as well.

Ted Butler

September 1, 2010

Silver – \$19.47

Gold – \$1254

Date Created

2010/09/01