September 14, 2011 – Opposing Forces/Best of the Lot

Opposing Forces

There are some great forces currently in play in the silver market. Because these are opposing forces, their clashing accounts for the current price volatility. Because the forces are diametrically opposed, only one can ultimately prevail. That resolution will determine the future level of price.

One great force in silver is the sum total of all the ingredients that comprise physical supply and demand. Total production and existing inventory compared to total demand (all fabrication plus investment demand). Because silver is unique in that it is an industrial material as well as a widely-held precious metal investment, that hybrid quality takes on particular importance in the process of analysis. Basically, this great force of supply and demand is the only thing that should be considered when evaluating a commodity. It comes down to how much stuff is there and how much demand is there for what's available and at what price. This is the great force that drove silver from $4 ten years ago to a ten-fold gain.

Normally, most observers would assume that the great force of physical supply and demand is the only force at play in determining the price of a commodity. And most times, that would be largely correct. But in the case of silver, real supply and demand is not the only force influencing price. There exists another powerful force Â? a paper trading mechanism, which at times is more powerful than the force of real supply and demand. While there are paper trading mechanisms present in other commodities, which greatly impact the price of commodities from grains to energies, the paper mechanism in silver stands alone in many regards.

I'll define the paper trading mechanism force in silver as mostly centered at the COMEX, but also including OTC (over the counter) trading. I would also include the short selling of shares in the big silver ETF, SLV, in this category. All paper trading is a derivative transaction (based or derived from an underlying host asset) which is different from trading in the actual commodity. Paper trading is different than trading in the actual commodity and instead of trading actual silver metal, what's traded are contracts to deliver the silver. In a contract there must be two parties Â? a long and a short. One party, the buyer or long, looks to accept delivery and the other party, the seller or short, agrees to deliver at some point in the future. In reality, very little actual delivery takes place in silver or other paper markets and most of the paper trading is a speculative bet on whether prices will rise or fall (although paper trading exists to allow legitimate hedging).

In theory and according to US commodity law, paper trading is not supposed to set the price of a commodity, but should follow or Â?discoverÂ? the price based upon developments in the real world of actual supply and demand. But, as is often the case, what actually occurs can be very different from what should occur or as intended by law. This is precisely the case in silver. The silver paper trading mechanism has come to overpower the force of supply and demand at times. Obviously, the force of paper trading hasn't totally overpowered the force of supply and demand in determining the price of silver otherwise the price wouldn't have risen ten-fold over the past decade. But it would be mistake to fail to recognize the pricing power of silver paper trading.

Let me stop here and explain why I am making (yet again) the distinction between the opposing forces of real supply and demand and paper trading. As investors, we are generally ecstatic about the long term performance of silver and should be excited by its prospects in the future. But we can grow concerned with the sudden price plunges which seem to be inherent to this market. Not only are these conflicting emotions, the conflict is based entirely on the opposing forces at play in the silver market, namely, the clash between supply and demand and paper trading. The clash between supply and demand and the paper trading mechanism explains any emotional conflict we face as silver investors. What I am trying to do is to explain why silver has gone up so much and will continue to go up in the long run (because of the real fundamentals), but is also subject to such sharp sell-offs (because of crooked paper trading). I firmly believe that grasping this will make things easier for silver investors.

Don't look for or expect legitimate supply/demand explanations for any silver sell-off. I can't say that there will never be a legitimate supply/demand explanation in the future, but I can tell you I have never found one yet in 30 years of close observation. The price has gone up in the broad sweep because of the force of supply and demand, but has only declined on crooked games in the paper markets. I realize that's an extreme view, but it is one on which I am convinced to my core. I further believe that if you come to accept this as a core belief as well, you will be doing yourself a favor. What it means is that you should come to expect, simultaneously, that silver has done and will do as well as it has in the past because of the real fundamentals, but that the crooks running the paper game will engineer sell-offs at will to shake (leveraged) paper silver holders out of their positions. If you think you can out smart them by short-term trading, you have my best wishes for success, but little in the way of my expectations. Faced with the reality of the opposing forces, my solution is holding on a fully paid for basis (with an occasional options fling). If anyone has a better approach, I'm all ears.

The most salient feature to the silver paper trading mechanism is that the short side of the derivatives equation is extremely concentrated, while the long side exhibits very little indication of concentration. In other words, the silver longs are diverse and unrelated to one another. This is the hall mark of a free market. The short position is dominated by large financial institutions, led by JPMorgan, that are few in number but hold very large positions; the very definition of concentration. This is as far from a free market as it gets. Further, the shorts appear to act collusively, generally buying and selling in unison. Even the exchange mechanism, run by the CME Group, is closely related in mutual interests to the large shorts who dominate. Criminal enterprise is a measured description of this arrangement.

I think it's normal to feel outrage that such a circumstance could exist in the presence of federal regulators who have been more than adequately informed of the silver crime in progress. I also think it is healthy to never let up in pressing the CFTC to man up and end the increasingly obvious silver manipulation. But the main take away I would leave you with today is to understand that the two opposing forces cannot mutually exist indefinitely; one force must overcome the other at some point. The good news is that there is no question the force of supply and demand will prevail over the crooked paper trading mechanism force run by JPMorgan and the CME.

In fact, the force of the paper trading mechanism is inherently self-destructive because nothing can overcome the force of supply and demand forever. It was uneconomic short selling on the COMEX that created the unsustainable price of silver of $4, ten years ago (among other factors). If it weren't for excessive short selling back then, silver never would have gotten as low as that. So the manipulators did all silver investors a favor (although that was not their intent) by creating such a low price. Today, even with the price up ten-fold, the concentration on the short side is much more pronounced than it was back then. Certainly, the issue is more widely debated and understood today than it ever was before. This augers well for the future.

Let me leave you with a short article along this same theme that I just prepared for Investment Rarities.

The Best of the Lot

Being in a reflective mood over what occurred ten years ago, I'd like to expound a bit about investment conditions in ten year increments Â? both past and future. Obviously, it's easier to recount than it is to predict, but it is also said that we need to look back in order to see ahead. As much as things have changed over the past ten years and will change in the next decade, there are some things that haven't changed much. One thing that hasn't changed is the attractiveness of silver as an investment compared to other investment choices.

In essence, the quest in investing is to be positioned in those assets which will perform the best compared to other assets. We all strive to have the best eggs in our investment basket as possible. It's all a matter of relativity; there are many choices in what to invest and it's our job to pick the best. That's how we measure investment success. Over the past 10 years, the best investment asset class has been silver because silver has performed better than anything else. In fact, silver is up ten-fold over the last decade, while some very big asset classes, like the stock market and real estate are largely unchanged. That's about as much outperformance as is possible.

Silver has even outperformed gold, although many people assume gold has done better because gold has made new all-time price highs while silver hasn't. But new price highs in gold aren't the real measure; what matters most is relative percentage performance per dollar invested. In simple terms, a dollar invested in silver 10 years ago would have made you more money than a dollar invested in gold or in any other asset class.

Of course, past performance is no guarantee of future results. Just because silver rose the most over the past ten years, doesn't mean it will rise the most over the next ten. If successful investment was simply a matter of always investing in what had done the best in the past, then there would be a lot more millionaires in the world. Case in point – if one were to have picked silver to be the best investment ten years ago, it certainly wouldn't have been because silver had done so well in the ten years before that. In fact, ten years ago silver had been one of the world's worst investments up until that point and those looking at past performance alone wouldn't have touched silver with a ten-foot pole. But neither does silver's great performance over the last ten years mean it will do poorly going forward.

So if past results do not dictate what the future holds, what does? The answer is the specific circumstances in place in silver and in all other investment choices. In trying to judge what future relative returns will be, we are forced to study the current factors in place and anticipate what future forces will impact different investments. As someone who did pick silver to be the best performing investment ten years ago, I can assure you I did not rely upon silver's performance up until that point. Silver looked great to me back then due to reasons unrelated to past performance. The remarkable thing is that there are compelling reasons, some new and some old that convince me that silver will again be the investment star of the next decade.

One of the main reasons why I expected silver to outperform back then and still do now is because of its rarity. Not only is there less silver bullion in the world than there is gold, that fact is still unknown to the vast majority of the world's potential investors. Even though silver has outperformed everything for the past ten years, considering how little of it exists, its relative valuation is still miniscule by any standard. Ten years ago, there was about one billion ounces of silver bullion in the world, compared to three billion ounces of gold bullion. Today, there are still roughly one billion ounces of silver bullion, but maybe ten percent more ounces of gold bullion. That means there is only $40 billion worth of silver bullion in existence, but almost $6 trillion ($6,000 billion) of gold bullion. In other words, there is 150 times more gold bullion in the world in dollar terms than there is silver. Silver is set to outperform this coming decade as it has over the past decade, as people grasp the fact of its rarity.

Ten years ago, very few people predicted silver would be the investment star of the decade. There are a few more people attracted to silver as a result of its outstanding performance, but in reality the numbers are still small relative to those attracted to other asset classes. That's good, as it means the silver trade is not crowded. Given the realities of silver's rarity and supply and demand fundamentals, more will become attracted to silver as the next decade unfolds. That will be reflected in the price moving higher.

What's different in silver today from what existed 10 years ago? Several things. For one, thanks to the introduction of silver Exchange Traded Funds throughout the world, the little silver that does exist is now held in incredibly diverse hands. That diversity translates into silver being held in stronger hands than it was held ten years ago. Also different today is that more people are aware of my allegations of manipulation coming from the COMEX and the regulators seem to be moving (albeit slowly) to deal with the increasingly obvious attempts to depress the price. Ten years ago, very few were aware of the manipulation; today, the tables have been turned and those denying a manipulation exists look silly.

But there is one factor different today that towers above everything else. We are now much closer to the inevitable physical shortage in silver than we ever were before. Because silver is an industrially consumed material, in addition to being a precious metal investment asset, and because both roles appear destined to grow, it is just a matter of time before a physical supply crunch arrives. When, not if, that occurs, the doors will be blown off the price. Exactly when that moment will occur no one can predict; that it will occur is a certainty. It's hard to predict the day to day price movements, but it is imperative that you be positioned before the supply crunch hits.

Ten years ago, not many recognized that silver was poised to outperform all other assets. Those who included silver in their investment portfolios were greatly rewarded. All the important factors suggest we will look back ten years hence to recognize that history did repeat itself.

Ted Butler

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Silver – $40.50

Gold – $1820

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