

## September 14, 2016 – Mr. Market Comes Unhinged

### Mr. Market Comes Unhinged

A couple of weeks back, I tried to explain how prices get set today. Instead of commodity prices being set by the collective physical interaction of the world's producers and consumers, as most assume, I contended that prices are dictated to the world's producers and consumers by a highly select group of derivatives traders on the leading futures exchanges, most notably the COMEX and NYMEX (owned and operated by the CME Group). In other words, in terms of how prices get set, the consensus understanding was far removed from how things are in actuality.

Whether in gold and silver or copper and crude oil, these days prices get set by a few large futures traders most of the time, while real producers and consumers are little more than passive observers. I realize my contention may sound outlandish, so I thought it might be constructive to explain how things got turned so upside down in the commodity price discovery process. In essence, it boils down to the difference between price takers and price makers. Virtually all the world's actual commodity producers and consumers have become price takers, when they are still thought to be price makers.

Mineral producers don't spend much, if any time in the pricing of what they produce. All their energy is spent on maximizing production at the lowest cost. They accept whatever the price is the moment they sell. Same with industrial consumers, which factor in the cost of raw materials in their utilization process, but must buy at prevailing prices in the end. Industrial buying agents look to get the best available price, but they too are price takers.

This has created a void or vacuum in the commodity price discovery process that certain large futures traders have stepped into. The problem is that few, if any of these large futures traders are actual producers or consumers and instead trade and set prices on technical and computer considerations in the case of the managed money traders. In the case of those who take the other side of the managed money traders, the commercials (mostly banks), their objective is to take money away from the managed money traders and are also completely separate from the interests of actual producers and consumers.

Futures trading by a handful of large entities on either side of derivatives contracts makes the price that actual world commodity producers and consumers take. And it's not just in silver and gold, but in copper, crude oil and other markets. Sure, Saudi Arabia or OPEC can slash production and impact oil prices greatly, for instance, but unless they do, oil prices will move up or down based upon managed money trading on the NYMEX. The record of this is evident in the evolving COT data, as is the case for gold and silver and other commodities.

Let me approach this from a different angle today. For months, I have been emphasizing the large and unprecedented unrealized losses held by the commercial shorts in COMEX gold and silver and the corresponding open profits held by the managed money longs. I'm still convinced the resolution of the extreme market structures in COMEX gold and silver will determine future price levels, so that hasn't changed.

Prior to this year, the most the commercials have collectively been underwater on combined gold and silver short positions has rarely exceeded \$1 billion. This year, the open loss hit nearly \$4 billion and as of last week still remained close to \$2 billion (I'll update the current figure later). After having focused on this large and unprecedented unrealized loss for months, clear evidence emerged that one of the 8 largest COMEX commercial gold shorts was forced to buy back short positions at great loss in what appeared to be an arranged transaction. This singular commercial failure reinforced my contention that the matter of the unrealized commercial loss on the COMEX was a serious issue and worthy of attention.

Now I'm going to turn around and argue that in a different perspective, the current \$2 billion open loss to the commercials and open profit to the managed money traders is not that large. Certainly, \$2 billion isn't much in a world awash in trillions of dollars of total debt and equity and other measures. More importantly, the few billions of dollars at stake on the COMEX is very small when measured against the dollar amounts received by actual producers and paid by actual consumers.

For illustration purposes, I'll use gold and silver as examples, but I could just as easily use copper or crude oil in their place. Using round numbers, the world mines 100 million new ounces of gold annually, which at current prices has a dollar value in excess of \$130 billion. Total world production of silver comes to under \$20 billion. Since I have been combining the unrealized loss/profit in COMEX dealings, it is only proper to combine the two in terms of actual world production value, which I'll round off to \$150 billion. In simple terms, all the world's mining companies sell their annual gold and silver output for \$150 billion and all the world's gold and silver buyers pay that same \$150 billion (minus the cut for distributors and middlemen).

The world produces and consumes \$150 billion worth of gold and silver annually, but not one penny of that amount matters in the setting of price because real producers and consumers are price takers. Only the traders in COMEX gold and silver futures contracts are price makers because, in the end, world gold and silver prices emanate from the COMEX. The COMEX is the wellspring from which all gold and silver prices flow. And while this year's money game on the COMEX is the largest on record, it should strike you as completely insane that a \$2 billion paper game is dictating prices for the \$150 billion worth of actual gold and silver produced and consumed each year.

Of course, none of this is allowed under US commodity law and, in fact, there exists a time-honored and simple solution for a handful of speculative traders setting the price of commodities — speculative position limits, whose purpose is to limit speculative control of price. But the CFTC has demonstrated no real interest in enacting legitimate position limits in gold, silver, copper or crude oil, mostly out of allegiance to its prime constituents, the large traders involved in excessive speculation.

But even without the regulators stepping up to the plate to remedy a deep malady that has Mr. Market completely unhinged, I don't think this situation can exist for long. And I know it can't continue forever because it's completely nuts that the world's producers and consumers of the commodities that drive the world will forever take prices made by a handful of speculative derivatives traders. Things that can't continue won't at some point, especially things that are nutty.

For one thing, while it has been many years in the making, more recently and particularly this year, the size of the futures positioning has soared and with it the demonstrable effect it has on price. Please don't take this as me being braggadocios in any way, but I do have a history of seeing things like this before others. Examples would include reliance on the COT data in market analysis and seeing the silver manipulation before anyone. After all, I did start complaining to the CFTC and the COMEX in 1986 about the silver manipulation and it wasn't from learning of it from others.

I suppose I could turn out to be wrong this time, but sooner or later, I'm convinced some big commodity producers or consumers will reject prices being set by excessive speculation on the COMEX or NYMEX and take steps to attack it. Picture a Saudi Arabia in oil or a Chile in copper when it realizes the impact managed money short selling has on price. And when that moment comes, it most likely will set off changes in other commodities afflicted with the same price setting malady, including silver and gold. I am certain that day is coming. And silver will then have a completely different price structure and level and it won't be lower.

In the interim, since prices are being made by a few large COMEX gold and silver futures traders, it would be foolish to not recognize that this is the prime short term influence on price. So I'll continue to do so while I await the day that is no longer the case.

There were a number of developments since Saturday's review. The new short report on securities was released and indicated a very slight rise in the short position in the big silver ETF, SLV, as of August 31. The total short interest in SLV rose by under 250,000 shares to just over 12.6 million shares (ounces). There was a similar slight rise in the short position in GLD, the big gold ETF.

<http://shortsqueeze.com/?symbol=slv&submit=Short+Quote%99>

While this is a hard report to predict (at least for me), I had expected a decrease in the short position given the large amount of metal (7 million oz) deposited into SLV during the reporting period. The most plausible explanation for the large deposits of metal was to close out short positions. Now that the report didn't feature a reduction in the short position, that explanation is water under the bridge, making the most plausible explanation for the large deposits net new investment buying.

Perhaps that should have been the most plausible explanation initially, because that's the way it is supposed to work in SLV and GLD – net new buying and the creation of new shares requires metal being deposited to back the newly created shares. Adjusting one's opinion as the facts change and all that.

The only twist in this case is that silver prices were lower (by \$1.50) during the short reporting period and it's not typical to witness net new investment buying on declining prices. Therefore – and please believe me when I tell you that I wasn't looking for another bullish factor in silver – the net new investment buying looked to be by a determined big buyer since it didn't at all appear to be broad retail demand. Additionally, the withdrawal of 1.6 million oz of metal from SLV on Monday looked to be a result of broader selling on Friday which had resulted in a big withdrawal in GLD that day. I've often noticed that changes, both deposits and withdrawals seem to occur quicker in GLD than in SLV, which is usually a day or two behind for some reason.

Yesterday, some 1.3 million oz were deposited into SLV, while withdrawals continued in GLD under price action that has to be described as flat and choppy so far this week. Therefore, yesterday's deposit into SLV can most plausibly be described as being due to net new buying. Since it didn't look at all like broad investment demand given the price action, most likely it was due to the determined buying by a large entity. Again, I'm not on some desperate prowl for new bullish factors in silver, but big buying by a determined investor appears to be the most plausible explanation and that isn't bearish. After all, we have plenty of bullish factors in silver and only one potentially bearish factor – the COMEX market structure.

I spend most of my time contemplating the resolution of the COMEX market structure in gold and silver. That's been the case for most of this year since the structures first turned bearish early on (Feb-March) and intensified over the past few months. This is a long time to wait for a decisive resolution, but hardly the longest time. And time matters little in COT market structure terms since that feature is controlled by the commercials.

The overriding question is if the commercials are still in control, seeing as they recently lost a gold short comrade in arms and have been in the financial hole deeper than ever before. To determine the answer involves an objective review of the facts as we know them to be.

Eight trading days ago, gold and silver staged a sharp high volume rally that took gold higher by as more than \$40 and silver by \$1.40 and which decisively penetrated the important 50 day moving averages to the upside. Since this is the sure trigger to induce heavy technical fund buying and commercial selling, predictions of such activity were confirmed and verified in Friday's COT report. That rally ended quickly into the cutoff date and prices for gold and silver have subsequently penetrated their 50 day moving averages to the downside. This most likely has resulted in managed money technical fund selling and commercial buying (short covering).

Gold and silver prices are largely unchanged for the week and that results in the unrealized collective commercial loss remaining roughly unchanged (at \$2 billion). However, a closer examination of the new positioning in the current COT report reveals that the commercial made and the managed money traders lost about \$100 million on new positions over the past eight days, many of which have been closed out. I'm basing this on the \$1+ move up and down in silver and the \$30+ move up and down in gold.

That the commercials can still ring the short term cash register for \$100 million, despite being \$2 billion in the hole on an unrealized basis, strikes me as a sign the commercials are still in control, but that's strictly subjective on my part. These crooks would likely scam until the very last moment even if they were about to fail completely. The safe answer would be to reserve judgement until the facts indicate otherwise.

However, failing or not, there should be little question that the \$100 million profit to the commercials on new positions over the past week or so was why prices first rose and then fell. \$100 million is hardly chump change, as is \$2 billion; but in the context of \$150 billion worth of new actual gold and silver being produced and sold annually throughout the world, it is ridiculous that such a small amount of money changing hands in COMEX paper trading could hold the world captive in the pricing department. Particularly when it's against the intent of commodity law.

Ted Butler

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Silver – \$19.10      (50 day moving average – \$19.68)

Gold – \$1324      (50 day moving average – \$1337)

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