

September 18, 2010 – Weekly Review

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It was a good week, price-wise, for both gold and silver, with gold up close to \$28 per ounce and silver up almost 85 cents. Gold closed at another new all-time high, with silver challenging its March 08 highs. On the surface, it would appear that statement would indicate gold's superior investment performance versus silver. However, a closer look would indicate that silver has largely outperformed gold over the past two years and has matched gold's performance over a ten year period. Admittedly, silver's almost \$3 run over the past 3-4 weeks has a lot to do with that relative performance.

Most of the week's gains, especially in gold, came on Tuesday. I can't help but feel that the announcement on that day that the big South African gold miner, AngloGold Ashanti, was closing out its remaining gold short hedges was behind the gold price gain. If I'm correct, this buying would be in the one-off category, with further such gold buying not likely to be repeated, given the extremely low level of gold hedges remaining. It's important to remember that de-hedging by gold miners over the past ten years was one of the principle driving forces to gold's four-fold price increase (others were the introduction of the ETFs and central bank abatement of gold selling.) As an analyst, I strive to be objective, and the end of gold hedge buybacks removes what has been an important bullish prop to gold prices. That said, activity on the COMEX will likely determine the near term price action in gold (and silver).

Physical market indications suggest continued wholesale tightness in silver, with absolutely no tightness in the retail category, judging by recent sales of Eagles from the US Mint for both gold and silver. COMEX silver warehouse stocks remain largely unchanged, but with continued notable in and out movement, indicative of tight wholesale supplies (who moves stuff in and out if you can just take it from inventory?) We've finally started to see some metal deposits into the big silver ETF, SLV, as expected. I previously mentioned that share volume and price action in SLV indicated that metal was "owed" to the trust by unreported short sales. About 3.5 million ounces have come into the trust over the past two weeks, and I suspect an additional amount of that size or more is still owed. The big gold ETF, GLD, has also added some metal recently.

The most recent Commitment of Traders Report (COT) indicated a continued deterioration, or increase, in the total net commercial short position in both gold and silver, also as expected. The latest report, for positions as of Sep 14, showed an increase of commercial shorts of around 3300 contracts in silver to 65,000; while gold's net commercial short position grew by 5300 contracts to almost 293,000. Interestingly, the biggest 4 shorts in each (read JPMorgan) only added a small amount to their positions for the week. The current respective net short positions of the commercials in gold and silver are now at the highest levels in almost a year, with gold's short position close to its all-time high. This has always been a cause for concern.

So, what now, especially for silver prices? We are at a critical juncture and I am unsure of how it plays out short term. (Longer term appears up and up sharply, and maybe the short term as well). Let me try to lay it out so we are all prepared for whatever may happen in the short term. I think it might be instructive if we compare the circumstances in silver today with the last time we were at current price levels, in March 2008. The price really got smashed after the March 2008 highs; is that going to play out again? There are a good number of similarities, but even more differences to then and now. Let's look at the similarities first.

In March 2008, silver's climb to \$20+ coincided with a then new all-time high in gold, to over \$1000 for the first time. The technical funds held massive long positions on the COMEX, with the commercials near record short; very similar to now. There was also an extreme concentration to the short side of silver, which the CFTC was reviewing and would later (in May) state was no big deal. The commercials would succeed, as they always had, to pull the rug out from under the speculative longs and cause the market to crash, buying back short positions in their classic manipulative manner. We would have to wait 2.5 years for silver to reach the price levels of March 2008. Is that our fate this time? Let's look at the differences (not in any particular order).

In March 2008, we were in the midst of a retail silver shortage, the first in history. Availability and premiums for retail silver items were at extremes. A lot of it, I still feel, was due to Izzy, my silver friend and mentor, highlighting Silver Eagles. While Silver Eagles will set a volume record this year, the pace in the past month has been very slow. Back then, wholesale conditions weren't particularly tight, with the exception that the big ETF, SLV, was owed a tremendous amount of metal due to share shorting. Today, while the SLV isn't owed as much metal as it was back then, other market indicators suggest a wholesale tightness not present in March 2008. In March 2008, retail was tight, wholesale not. Today, wholesale tight, retail not. Retail demand is important for silver on a long-term and cumulative basis, but not in the short term. Wholesale is important both short term and long term.

In March 2008, we didn't know the identity of the big silver short, Bear Stearns. Today, we know that JPMorgan is the big silver short, having taken over Bear Stearns. (It still shocks me that the CFTC issued a report in May 2008, which stated that there was nothing unusual about the short concentration in silver, even though if JPMorgan hadn't taken over, silver would have run to \$100+). I believe that knowledge is power and me being able to identify JPMorgan as the big silver short has empowered us. I don't see how it helps them.

In March 2008, there was an enormous COMEX and OTC long silver/short gold leveraged position in place, given silver's run to below 50 on the gold/silver ratio. Subsequently, in the financial crises of 2008, JPMorgan was able to obliterate long silver/short gold holders on margin in a ruthless manner. This spread liquidation put particular pressure on silver prices. I don't see the presence today of large leveraged long silver/short gold positions, given the horrible beating these traders took back then, when many hundreds of millions of dollars were lost. With these positions not in existence today, big liquidation of these spreads is not possible. This difference also applies to the financial crisis of 2008. While I can't guarantee you as to what lies ahead in the future, at least Lehman Brothers won't be going bankrupt again, and the chance of an exact replay of 2008 doesn't seem likely.

Maybe the most important difference between March 2008 and the present is the change in the regulatory climate, as well as our general knowledge base. Back then, the CFTC was a lap dog to the big short traders. Many are still frustrated that the CFTC hasn't moved quicker to end an obvious manipulation in silver. I am as well. However, this is about comparisons and relativity. In March 2008, Gary Gensler was not the chairman of the CFTC. He is today. In March 2008, there was not even a hint that there should be comprehensive financial regulatory reform. The issue of position limits was not even discussed, except by fruit cakes like me. Today, regulatory reform, thanks largely to Gensler, is the law of the land and position limits will soon be a reality. I still find that hard to comprehend, even though I report on it incessantly. Knowledge is empowering. More observers, including the regulators, know the real story in silver than they did in March 2008.

What does this all mean in the short term? We are at extreme COT readings. The commercials are just itching to rig a sell-off so that they can buy back as many technical fund contracts as possible. For the commercials to do this, they have to rig a \$2 to \$3 sell-off in silver. (Back in March 2008, the commercials rigged a \$4 sell-off in a week). Can they do it? I don't know. But the circumstances are very different for the commercial shorts today. For one thing, they are potentially more financially exposed today. I calculate that the almost \$3 move over the past 3-4 weeks has caused a collective paper loss to the 8 big silver shorts of more than \$800 million dollars, with JPMorgan being out \$350+ million. Every dollar up from here in the price of silver will bring an additional \$350 million loss to the 8 big shorts. At some point, these losses may prove too large for some of the shorts (think of AngloGold's recent short covering) and they may rush to cover, setting off a short covering orgy on the upside.

Let me throw something else out here. In March 2008, general credit conditions were favorable, although starting to tighten. In the financial crisis that followed, the credit market got and remains extremely restricted. One of the biggest laments of the day is the lack of credit for small businesses, the job-engine for our economy. Mortgages are restricted due to tougher credit standards and lack of equity. Against this painful backdrop, I question where the big 8 shorts are coming up with the near one billion dollars in margin they have had to deposit over the past few weeks on their silver short positions (much more if you include gold). If banking credit is flowing freely to these SOBs short silver, while regular businesses and homeowners can't get credit, someone should be tied to the whipping post.

The advice to silver investors is still to hold tight to long term positions and confine leverage to call options. Those who did employ options before the recent rally, should look to remove money and risk, if possible, by rolling positions up and out, namely switching any positions if they get deep in the money to higher strike prices and/or more deferred options. Save any cash generated to deploy on any possible sell-off. We are at a critical juncture and must be prepared for whatever occurs short term.

Oh, and many thanks for all who contacted the regulators on my one percent solution for position limits. I think it will make a difference.

Ted Butler

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Silver – \$20.79

Gold – \$1276

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