September 28, 2016 – The Biggest Scandal

The Biggest Scandal

Certainly, any attempt to identify the most serious current financial scandal involves stiff competition and the need for objective measurement. Scandals have become almost commonplace and come in all varieties and sizes and vary in the degree of publicity they attract. But there's a big difference between the scandals that create the most headlines compared to the scandals that financially damage the greatest number of victims. I would contend that the biggest scandal must be defined by the greatest financial damage to the most people and not the amount of publicity a scandal might generate

A case in point is the current scandal involving the bank Wells Fargo. For sure, the bank was fined an attention-getting amount ($185 million) and admitted to firing 5300 employees involved in the fraudulent opening of millions of accounts without the knowledge or permission of customers. No doubt there will be more shoes to drop in the Wells Fargo affair, including compensation claw backs from upper level managers, a variety of lawsuits and possible labor violations, but in terms of financial damage to aggrieved customers, the scandal hasn't amounted to much Â? a few million dollars at best.

I'm not minimizing what Wells Fargo did being wrong, but in terms of actual losses to its customers, this scandal hasn't amounted to much. Its cause is more a case of a well-intended effort to cross sell and offer additional services to existing customers being allowed to go Dr. Frankenstein. Management should be beat with a stick for allowing the system to go so out of control. No one would ever intentionally engage in a fraud of this scale to generate $2 or $3 million in corporate revenue. One of the best explanations for the sordid affair is by Matt Levine, writing on Bloomberg View, who concluded that what Wells Fargo did was more dumb than evil.

https://www.bloomberg.com/view/articles/2016-09-09/wells-fargo-opened-a-couple-million-fake-accounts

Yet, in terms of attention-getting publicity, the Wells Fargo scandal is up there with the best (worst) of them. Surely, the number of people affected, both employees and customers, were large and the fraud was easy to understand. But strictly in terms of the total dollar loss to customers, this Wells Fargo scandal was rather small. But what if I told you that there was another scandal currently in force in which just about every one of the world's 7.5 billion inhabitants were being victimized to the tune of tens of billions of dollars? Further, that this is only one scandal among several similar scandals.

Please know that I am not trying to sensationalize or overstate the matter, but to lay out the facts and logic behind my assertions. Up front, if you have any questions or disagreement with what I claim, please let me hear from you, as it's my responsibility to fully explain any new findings. And while I think the scandal I am about to describe is much more serious than the Wells Fargo scandal in total financial loss, both are similar in origin, namely, as unintended outcomes of a system overlooked and allowed to have gone bad. No big scam designed from the get go, just those who should have been in charge, falling asleep at the wheel.

First, let me outline the scandal. A relatively small number (81) of derivatives traders in sugar futures (traded on the ICE) have purchased such a large number of contracts over the past six months to have caused the world price of sugar to rise from 13 cents a pound to 23 cents, an increase of more than 75% and the highest price in four years. Sugar may be bad for you, but it is widely consumed by nearly all of the world's 7.5 billion people who will be paying 75% more for their collective sugar consumption as a result of the price rise. How much more it will cost in dollar terms is easy to calculate.

The world produces and consumes roughly 170 million metric tons of sugar each year. At 13 cents a pound ($286 per ton), the value of total world sugar production/consumption is $50 billion. At 23 cents a pound, the total value jumps to $85 billion, meaning that the world's consumers must pay $35 billion more collectively or $4.50 individually for as long as prices hold or move higher. I'll get into proving my contention of sugar price manipulation on the ICE sugar market momentarily, but compared to the Wells Fargo scandal, where reported total customer damage was $3 million, the world sugar price rip-off is more than 10,000 times larger.

The primary buyers of sugar futures since February have been the managed money traders which accounted for the purchase of more than 250,000 net contracts or more than 27% of total open interest. This is the largest number of sugar futures contracts purchased over the past six months by any trader category in the COT reports and it's no coincidence that sugar prices have reached four year highs as the managed money traders established their largest net long position in history.

Prices go up when the buyers are more aggressive than the sellers and fall when the sellers are more aggressive Â? this is an immutable market fact. CFTC data prove without doubt that the managed money traders were the big buyers of sugar futures over the past six months. Further, we know that most managed money traders (all registered Commodity Trading Advisors) buy and continue to buy as prices rise and sell as prices fall because they are motivated by technical trading rules and act alike. Therefore, it is easy to prove that managed money buying caused the price of sugar futures higher because they were the largest buyers of all.

The problem and scandal is that no one ever intended that managed money futures traders would set the price of sugar or any other world commodity. These traders are purely and openly speculators out to make a buck in futures trading, not to influence or manipulate actual world commodity prices. Then again, no one at Wells Fargo ever intended that a system designed to increase the number of legitimate new accounts to morph into a scandal destroying reputations developed over years and decades.

In sugar and other commodities, what went wrong is simple to grasp Â? the managed money traders grew too large. Probably as a result of fewer attractive investment opportunities in a near zero interest rate world, the amount of investment money coming into the managed money traders grew dramatically over the past few years to hundreds of billions of dollars. This investment influx caused the managed money traders to greatly increase the size of futures positions taken and in the process making these traders the biggest speculative trading category.

But because most of the managed money traders operate on a disciplined and rigid technical basis, they all tend to buy and sell at the same time since they are all following similar trading systems, based primarily on moving average penetrations. Not for a minute am I suggesting that the managed money traders set out to intentionally and deliberately come to manipulate real world commodity prices. Just as with Wells Fargo, this is strictly in the unintended consequences category. Regardless of intent, however, the collective managed money futures positions have come to dominate price in many world commodities. Why is this so?

This is so because all, or nearly all of the world's commodity producers and consumers (certainly including individuals) are price takers, not price makers. And the price most taken is the price most widely known to all. In the case of sugar, silver, gold, copper and crude oil, among other commodities, the price most widely known is the price most visible and advertised. Anyone wanting to know the current going price of any commodity can do so instantly by phone or TV or on the Internet and the price will invariably be based upon the leading futures market. The futures market price has become the price most taken by nearly everyone in the world, producers and consumers alike.

By default, those trading in futures markets have become the sole price makers to the actual commodity price takers, although these futures traders are likely unaware of their influence in the real world. Since the managed money traders have become the largest trader category in buying on rising prices and selling on declining prices, more often than not, they set or make the price. Not for a moment am I suggesting this is the result of some evil conspiracy designed to manipulate prices, but rather is the result of unintended consequences arriving from unrelated factors, i.e., an influx of investor money into managed money funds causing them to take massive positions.

My objection to managed money futures traders (and their commercial counterparties) dictating prices to the world's actual commodity producers and consumers is that it completely upends the functioning of the law of supply and demand, which happens to be the cornerstone of any free market system. Prices are supposed to rise as real demand presses against real supply and vice versa to the downside, providing accurate price signals for increasing or decreasing real production and consumption. If prices are set by futures market speculators based upon chart or technical considerations that will send false signals to the world's producers and consumers. The real law of supply and demand has been replaced by a paper market version divorced from factors in the real world.

At heart, I'm a commodities guy with a futures market background and I am most interested in silver, not sugar. But the same set of circumstances that led me to discover the silver price manipulation has spread to other commodities on which futures trading occurs. I've singled out sugar futures trading because the facts are so similar. I'm not complaining about the price level of sugar (or silver for that matter), I'm complaining about how prices are set. Just like the tail shouldn't wag the dog, futures market speculators shouldn't dictate prices to real world producers and consumers. It should be the other way around.

Most at fault here are the regulators and the exchanges. Just like upper management at Wells Fargo, the commodity regulators and exchanges are supposed to be the adults making sure everything is on the up and up. But just as Wells Fargo management failed miserably, the CFTC and the CME Group have failed miserably in regulating silver, gold, copper and crude oil. To the failure list we can now add ICE and sugar trading. It took years and outside influence (local newspaper stories) to crack open the Wells Fargo scandal, but when it was opened, it was hard to believe it could have continued for as long as it did. This commodity pricing scandal has been going on for far longer than the indiscretions at Wells Fargo, but may be close to being cracked open.

One thing you won't see is any strong counter argument explaining how managed money price influence is beneficial in any way, except to increase trading revenue to the exchanges. You won't hear anyone saying how it is proper and righteous for futures market speculators to dictate prices to real world producers and consumers. Instead, once the biggest scandal comes to be fully known, most will marvel how it was allowed to continue for as long as it has.

On to developments since Saturday's review. As of Friday, gold and silver prices had surged back above their critical 50 day moving averages, setting off significant managed money buying and commercial selling that I estimated to be as many as 40,000 net contracts in COMEX gold futures and 10,000 contracts in silver, pushing the market structure back to historic bearish extremes.

With yesterday's price plunge in gold and silver back below the 50 day moving averages on high volume, the managed money technical funds sold and the commercials bought a significant number of contracts. I would now estimate that Friday's COT report will indicate a reduction in the total commercial short position of around 25,000 contracts in gold and around 7000 contracts in silver. Complicating any COT predictions this week is the possibility of actual reporting or compilation delays since yesterday's active trading ended the reporting week

More important than the actual numbers is the fact that the commercials whipsawed the technical funds in that any commercial contracts bought yesterday were purchased at lower prices than they were sold a week or so earlier and, therefore profitable to the commercials. Any technical fund contracts sold yesterday were sold at a lower price than purchased a week earlier and involved losses. Fresh, salami slice new price lows were established today, suggesting additional technical fund selling, albeit on slightly less trading volume. What next?

It all comes down to what the commercials intend and whether they are in control. Up until now, the commercials have been content to milk the managed money technical funds in the price trading range of the past several months, which I refer to as scam within the scam short term trading forays, all the while with the commercials sitting on significant unrealized losses. But sooner or later, a more decisive resolution will need to occur, with either the commercials buying back massive numbers of short contracts on lower prices or getting overrun on sharply higher prices.

On Saturday, I estimated the open and unrealized combined and collective loss on commercial short positions in gold and silver to be $2.3 billion, up a sharp $1.1 billion for the week. Based upon the lower prices this week at time of publication, the commercials regained around $700 million, making the total running open loss around $1.6 billion.

The most remarkable feature to what's going on in gold and silver and commodity pricing is the influence of managed money and commercial futures positioning. That influence has become stronger and so noticeable that I have trouble fathoming how all commentators and analysts don't see it and report on it, although many do. Perhaps I should be content that at least I see it and report on it, but knowing that this a scandal that can't stand the light of legitimate scrutiny, I'm hopeful more will come around.

Ted Butler

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Silver – $19.24 (50 day moving average – $19.57)

Gold – $1323 (50 day moving average – $1333)

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