

MARKETS AT A GLANCE

Sprott Asset Management^{LP}

Caveat Venditor!

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The recent bear raid on silver has left many concerned about the sustainability of its historic run. Silver, being a relatively obscure market for most mainstream commentators, attracted much attention in the ensuing days following the May 1 takedown. Indeed, though the 30% drop in silver occurred over only four days, seemingly all eyes were on silver, with commentators who could've cared less about the silver market only a couple of months ago, suddenly tripping all over one another to make the bubble call. Silver bubble 2.0? Hardly. Anyone who has been fortunate to have been invested in silver over the past few years would unfortunately be used to such blatant takedowns. The Chinese don't call it the "Devil's Metal" for no good reason. With so much talk these days about the risks of investing in silver, we think that perhaps it may be timely for us to weigh in on the matter. The silver market is riskier than ever, but for reasons the vast majority of pedestrian commentators have failed to grasp.

There is no doubt that speculative dollars have been flowing into the silver market. We note that in April record trading volumes were registered in the SLV¹, Comex futures², LBMA transfers³, and the Shanghai Gold Exchange futures⁴. In fact, converting the average daily trading volume in the aforementioned silver instruments to the amount of ounces of silver they are supposed to represent, there were on average, over 1.1 billion ounces worth of silver traded every day in the month of April⁵. Truly a staggering number when contrasted against the actual amount of silver available for investment. To wit, the world will only supply about 979 million ounces this year from mine and recycling of scrap, of which it is estimated that 657 million ounces will be used up for non-investment purposes⁶. So in effect, that leaves roughly only 322 million ounces available this year for investment purposes. Converting to days (recall that at least 1.1 billion ounces traded each day) it leaves only about 1.3 million ounces per trading day of available supply. So, we are essentially trading the amount of physical silver actually available for investment, 891 times over each day! It really begs the question; just what are people trading in these markets?

Consider the largest and most prominent of those markets - the Comex, which we believe has owned an effective monopoly on silver price discovery for decades. In fact, the Comex churned over 800 million ounces of silver futures and options on average each day in April⁷. Indeed, notwithstanding the massive but very opaque over-the-counter silver derivatives market, trading on the Comex dwarfs both the physical and the other (known) paper silver markets, combined. Despite its dynamics being relatively complex and generally not well understood by most, the world's financial community continues to view trading on the Comex as representative of the fundamentals for the physical silver markets. A market

¹ Bloomberg

² <http://www.cmegroup.com/trading/metals/files/MoMU-April2011.pdf>

³ http://www.lbma.org.uk/pages/index.cfm?page_id=51&title=clearing_-_most_recent_figures

⁴ http://www.sge.sh/publish/sgeen/sge_price/sge_price_daily/index.htm

⁵ Source: Bloomberg, CME Group, LBMA, Shanghai Gold Exchange. Figure also includes trading of Comex silver options which had registered a record open interest in the month of April.

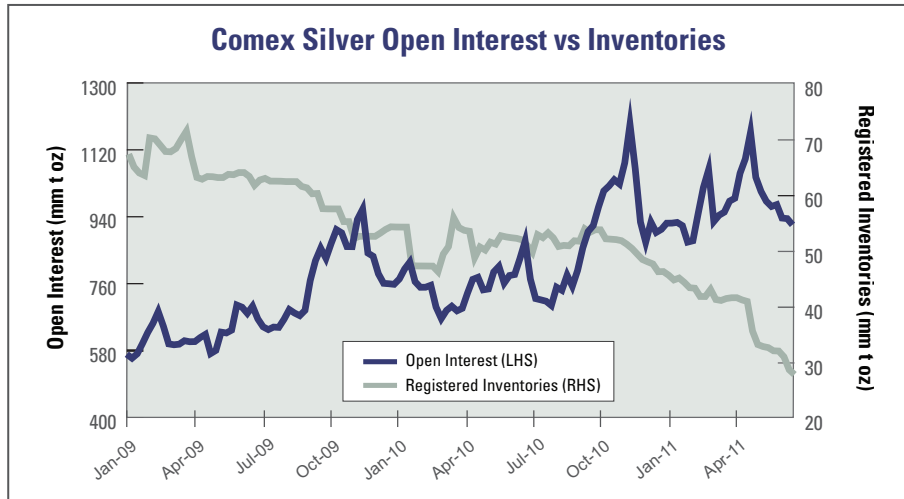
⁶ Andrew Kaip, David Haughton and John Hayes. "A New Paradigm for Silver: Demand is Expected to Outstrip Production Growth," BMO Capital Markets. April 3, 2011, p. 35.

Note: "Non-investment" demand includes industrial, silverware, and photographic demand

⁷ <http://www.cmegroup.com/trading/metals/files/MoMU-April2011.pdf>

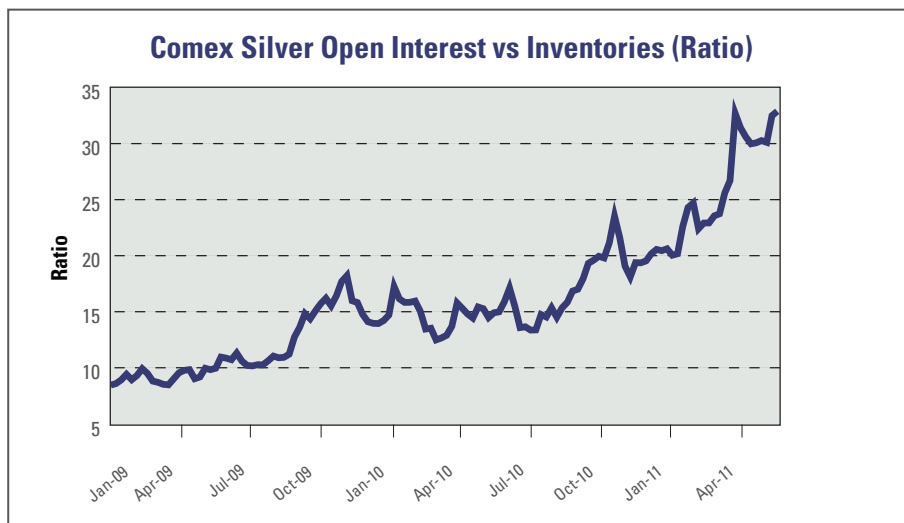
built on a high amount of leverage, both the buyers and sellers of Comex futures and options contracts are able to establish a position in “silver” with pennies on the dollar in collateral and even more astonishingly, no physical silver backing the contracts at all. The following charts illustrate just how unreal these markets have become.

CHART A



Source: Bloomberg, Sprott Asset Management

CHART B



Source: Bloomberg, Sprott Asset Management

In chart A, we compare the total open interest in Comex futures and option contracts to the actual amount of silver held in registered inventories able to be delivered against those contracts, since 2009. In chart B, with the steeply-sloping line shows the ratio of open interest (i.e. paper silver ounces) per ounce of physical silver held in inventory. We believe the historical trend of rising open interest and falling inventories deserves considerable attention from anyone attempting to understand the silver market. And though we do note that since October 2010 the trend of rising open interest appears to have abated, the inventories have been evaporating steadily and thus the ratio of the two measures has continued to trend higher. In fact, since 2009 the ratio of paper silver to physical silver has increased fourfold from approximately 8 times to almost 33 times, where it stands today.

What is the significance of this discord between paper and physical supply on the Comex? Recall, that over 800 million ounces traded each day in April on that market. Further, consider that as at the end of April there were only 33 million ounces of registered inventories to back up all of that paper trading. Just imagine if a mere 5% of all of that buying actually stood for delivery; the entire inventories would be more than wiped out. Yet despite the steady erosion of these already scant Comex inventories - a characteristic which would surely be interpreted as most bullish in other commodity markets - the price of silver has actually declined since April. We endeavour to provide a framework for understanding this phenomenon below.

Those who were following the developments in the silver market in April and May (we note that there were many who were) will likely recall that the CME Group raised both initial and maintenance margins five times within less than a two week span effectively raising the minimum amount of capital required to participate in the silver futures market by 84%⁸. This is significant due to the amount of leverage in the futures market and also due to the losses resulting from the precipitous selloff which began on Sunday, May 1st, when several thousand contracts were wantonly dumped onto the very thinly traded after-hours silver futures market causing the silver price to plunge 13% within the span of less than 15 minutes⁹.

For example, consider a hypothetical speculative trader who went long, say 200 July 2011 SI futures contracts on April 28th. At that time this trader would have been required to post an initial margin of \$2.565 million for a position of one million ounces of “silver” and thus would have been levered 18.5 times¹⁰. Below we present what the trade blotter for this trader might look like over the next few days assuming he maintained his position.

Date	Initial Margin Requirement	Maintenance Margin Requirement	SIN11 Close	Equity Balance	Mark-to-Market Profit/Loss	Required Margin Deposit	Cumulative Margin Deposited	Cumulative Profit/Loss
28/04/2011	\$2,565,000	\$1,900,000	\$47.54	\$2,565,000	-	\$2,565,000	\$2,565,000	-
29/04/2011	\$2,902,500	\$2,150,000	\$48.60	\$3,623,000	\$1,058,000	-	\$2,565,000	\$1,058,000
02/05/2011	\$2,902,500	\$2,150,000	\$46.08	\$1,108,000	\$(2,515,000)	\$1,794,500	\$4,359,500	\$(1,457,000)
03/05/2011	\$3,240,000	\$2,400,000	\$42.59	\$(596,500)	\$(3,499,000)	\$3,836,500	\$8,196,000	\$(4,956,000)
04/05/2011	\$3,240,000	\$2,400,000	\$39.39	\$43,000	\$(3,197,000)	\$3,197,000	\$11,393,000	\$(8,153,000)
05/05/2011	\$3,780,000	\$2,800,000	\$36.24	\$92,000	\$(3,148,000)	\$3,688,000	\$15,081,000	\$(11,301,000)
06/05/2011	\$3,780,000	\$2,800,000	\$35.29	\$2,827,000	\$(953,000)	-	\$15,081,000	\$(12,254,000)
09/05/2011	\$4,320,000	\$3,200,000	\$37.12	\$4,656,000	\$1,829,000	-	\$15,081,000	\$(10,425,000)
10/05/2011	\$4,320,000	\$3,200,000	\$38.49	\$6,026,000	\$1,370,000	-	\$15,081,000	\$(9,055,000)
11/05/2011	\$4,320,000	\$3,200,000	\$35.52	\$3,055,000	\$(2,971,000)	\$1,265,000	\$16,346,000	\$(12,026,000)
12/05/2011	\$4,320,000	\$3,200,000	\$34.80	\$3,602,000	\$(718,000)	-	\$16,346,000	\$(12,744,000)
13/05/2011	\$4,320,000	\$3,200,000	\$35.01	\$3,818,000	\$216,000	-	\$16,346,000	\$(12,528,000)
16/05/2011	\$4,320,000	\$3,200,000	\$34.13	\$2,937,000	\$(881,000)	\$1,383,000	\$17,729,000	\$(13,409,000)
17/05/2011	\$4,320,000	\$3,200,000	\$33.49	\$3,679,000	\$(641,000)	-	\$17,729,000	\$(14,050,000)

*Margin increases highlighted. Source: Bloomberg.

Following the initial trade, each day the trader’s positions would be marked-to-market and any losses or gains would be applied against his account’s equity balance. Should the losses on the position bring the equity balance below the maintenance margin level, the trader would be required to deposit the additional capital required to bring the equity in the account back up to at least the initial margin requirement level.

While the margin increases alone would have forced a decision for this leveraged long to either post the additional margin or close enough positions to bring margin balances in line with substantially higher requirements, the trader was actually fighting a battle on two fronts. This is because in addition to the margin increases, the trader was also experiencing massive losses to his capital due to a rapidly falling silver price. So it is also important to consider the extent of losses to the trader’s equity following the precipitous drop which began on the evening of May 1st. In our scenario, before finding a

⁸ http://www.cmegroup.com/clearing/risk-management/files/SI_2009_to_may_2011.pdf

⁹ Bloomberg

¹⁰ A trader can always post more than the required amount of margin in his account.

bottom around May 17th, the cumulative losses would have amounted to over \$14 million, or over five times the initial margin deposit of \$2.565 million that was required to take on the position on April 28th. This meant that with margin call after margin call, the capital committed to the position ballooned almost 700% by the time the silver price finally bottomed in mid May. The significance of such a dramatic erosion of capital on a leveraged position cannot be overstated, particularly in the context of rising margin requirements. The CME Group would know this very well, and so it strikes us as particularly suspect that they would continue to raise margin rates in the face of such a sharp selloff. A selloff, we might add, which emanated from highly unusual trading activity on May 1st that, in our opinion, just reeks of manipulation. How else can one explain the dumping of several thousand SI futures contracts within the course of 15 minutes, in one of the most illiquid hours of trading, without seemingly any regard for price or a fundamental catalyst to speak of¹¹? Though we will let the reader connect the dots as to what the intent of the CME Group and the seller's of SI futures contracts on May 1st really was, we can certainly observe what effect these actions had on the market by looking further into the weekly Commitments of Traders (COT) reports published by the CFTC.

The COT provides us with the weekly open interest held by various categories of silver futures market participants, and thus gives us clues as to how these participants reacted in response to these margin increases and ensuing volatility. We present the following table showing net open interest for the various categories, converted into silver ounces, which we obtained from the COT report for selected dates.

Commitments of Traders

	5/18/2010	3/29/2011	4/26/2011	5/17/2011
	(net positions, mm t oz)			
Producer/Merchant/Processor/User	-267.6	-251.0	-211.7	-192.9
Swap Dealer	-28.5	-25.5	-1.0	22.8
Commercial	-296.1	-276.5	-212.7	-170.1
Managed Money	194.5	155.5	116.2	77.7
Other Reportable	19.5	30.2	8.8	9.5
Non-reportable	82.1	90.8	87.7	82.9
Speculative	296.1	276.5	212.7	170.1
% of open interest held by the 4 largest Shorts	39.6%	31.9%	25.4%	29.3%
% of open interest held by the 4 largest Longs	12.5%	10.6%	11.1%	13.5%

Source: CFTC

First, note how in the three weeks following the margin hikes, the speculative¹² net long position dropped from 212.7 million ounces to 170.1 million. This very clearly indicates that the speculative longs, when faced with rising margin requirements and losses to capital, did close out a substantial amount of their long positions. The commercials who were short those 212.7 million ounces appear to have been taking every opportunity to cover their own positions. Rather than shorting further into the ensuing weakness, the commercials covered approximately 42.6 million ounces in the three week period.

Another piece of information gleaned from the COT data is that despite what many commentators were hailing as a bubble caused by excessive speculation in the futures markets, the net speculative long positions had in fact been dropping over time. Even during the April run up preceding the five margin hikes, the net speculative long position actually **decreased** by 23%.

That commercial short position deserves further mention. What is unique and of interest to many silver market observers is not only the size of the short position on the Comex, which is dominated by those "commercials", but also the concentration of the short interest. We provide the percentage of the total open interest held by the four largest short sellers on a net basis in the table above.

¹¹ http://www.cmegroup.com/clearing/risk-management/files/SI_2009_to_may_2011.pdf

¹² For explanatory notes including definitions for each category of trader listed on the COT, please visit: <http://www.cftc.gov/MarketReports/CommitmentsofTraders/ExplanatoryNotes/index.htm>

Note that the net position of the four largest equates to 29% of the total open interest as of May 17th. Further we would also note that the concentrated short interest of the big four, though still quite high has actually dropped substantially over the past year coinciding with the signing of the Dodd-Frank Wall Street Reform and Consumer Protection Act and the resultant public discourse on position limits. Comments from CFTC commissioner Bart Chilton acknowledging the “repeated attempts to influence prices in the silver markets,” and that, “violations to the Commodity Exchange Act (CEA) have taken place in silver markets and that any such violation of the law in this regard should be prosecuted,” perhaps have also had an impact on the behavior of silver market participants.¹³ And though the CFTC’s investigation into the silver futures and options market remains open after three years, we remain hopeful that its findings will further serve the interests of the investing public who rightly expect a fair and transparent silver market void of manipulative forces.

Could the drop in open interest and the reduction of the concentration in the commercial short open interest be perceived as an indication that those top four short-sellers are positioning for the inevitable imposition of position limits rules? Perhaps, and if so, it would follow that likely the short sellers seized the opportunity to further reduce their “liabilities” by buying up contracts in early May at a 30% discount.

Let there be no mistake, we view the current setup as extremely bullish. In our view, whatever froth and excess was present in the paper markets has likely been shaken out in the recent selloff. The remaining longs do not seem willing to part with their silver at these prices. These are the strong hands with longer time horizons that are likely not overly leveraged or are willing and able to withstand substantial volatility. Moreover, perhaps the “game” on the paper silver markets which has been meticulously documented over decades by Ted Butler¹⁴ and others, will soon be coming to an end.

What is perhaps most important is that despite what has recently transpired in the paper silver markets, the robust demand fundamentals for silver have not changed in our view. For confirmation of this, look no further than the physical silver market (i.e. the real silver market) which is providing us with evidence almost daily of a sustained bull market for physical silver. The US Mint recently stated that, “demand for American Silver Eagle Coins remains at unprecedented high levels.”¹⁵ Likewise for the Perth Mint¹⁶, the Austrian Mint¹⁷, and the Royal Canadian Mint¹⁸ as well. The Chinese, who were net exporters of silver only four years ago, imported 300% more silver in 2010 than 2009 and such large quantities of imports are expected to continue¹⁹. Last year, Indian silver imports increased nearly six-fold, and this year consumption is expected to rise nearly 43% according to the Bombay Bullion Association²⁰. In Utah, silver (along with gold, of course) will now be accepted in weight value as legal tender²¹. According to Hugo Salinas-Price, a prominent Mexican billionaire, there is now “very strong support for the monetization of silver” in the Mexican congress²². We suspect the Europeans are likely to account for an increasing amount of silver purchases going forward as well. In fact, we just can’t imagine a better outlook for silver fundamentals. This really makes us question who could be short such massive quantities of silver and why? Particularly in those leveraged paper silver markets, where as we demonstrated, only a fraction of the outstanding notional ounces are actually available in physical quantity.

We have a very tough time understanding those bearish arguments against silver. We look at the real silver market, and based on the supply and demand data coming from the real, physical markets for silver, the fundamentals are only getting stronger. And yet there exists another silver market, which as we’ve shown, is not very connected to the physical realm at all. And though silver investors have for decades suffered the tyranny of a rigged paper monopoly over silver price discovery, it appears to us that the tides are turning. In the age of QE to infinity, investors are being more scrupulous with their capital and as such they are demanding physical silver in quantity. With more and more dollars flowing into the silver markets and a finite supply of physical to meet that demand, the theoretical losses for the paper silver short-sellers are near infinite. And with such a skewed and obvious risk/reward payoff vastly favoring the longs, we pose the following question. Who is most at risk in the silver markets: the buyers of a scarce and real asset that serves a growing multitude of purposes, or the sellers, who are short a quantity of silver which may very well not even be obtainable at anywhere near current prices? Let the Seller Beware! 🚩

For more information about Sprott Asset Management’s views on silver and its silver bullion funds, please visit www.sprott.com.

¹³ <http://www.cftc.gov/pressroom/speechestestimony/chiltonstatement102610.html>

¹⁴ For further information please visit <http://www.butlerresearch.com/archive-free.asp>

¹⁵ http://www.usmint.gov/pressroom/?action=press_release&id=1251

¹⁶ http://www.perthmintbullion.com/blog/blog/11-02-23/Sales_Record_For_2011_1oz_Silver_Kookaburra.aspx

¹⁷ <http://www.bloomberg.com/news/2011-05-13/silver-boom-continues-at-austrian-mint-gold-demand-retreats-on-price.html>

¹⁸ <http://www.ft.com/intl/cms/s/0/7f316ac4-3acc-11e0-9c1a-00144feabdc0.html?ftcamp=rss#axzz1Nvybz2Te>

¹⁹ Andrew Kaip, David Haughton and John Hayes. “A New Paradigm for Silver: Demand is Expected to Outstrip Production Growth,” BMO Capital Markets. April 3, 2011, p. 17

²⁰ <http://www.ft.com/intl/cms/s/0/e64ca6b2-65e5-11e0-9d40-00144feab49a.html#axzz10ijZiJ4o>

²¹ <http://www.nytimes.com/2011/05/30/us/30gold.html>

²² http://www.kingworldnews.com/kingworldnews/Broadcast/Entries/2011/5/18_Hugo_Salinas_Price.html

Sprott at a Glance

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