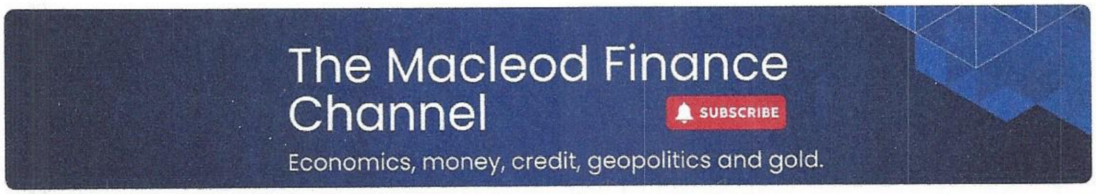

Gold and silver's flash crash

The expiry of February Comex futures was the opportunity for beleaguered shorts to square their books. Almost certainly, it was a one-off scare, because nothing else has changed.

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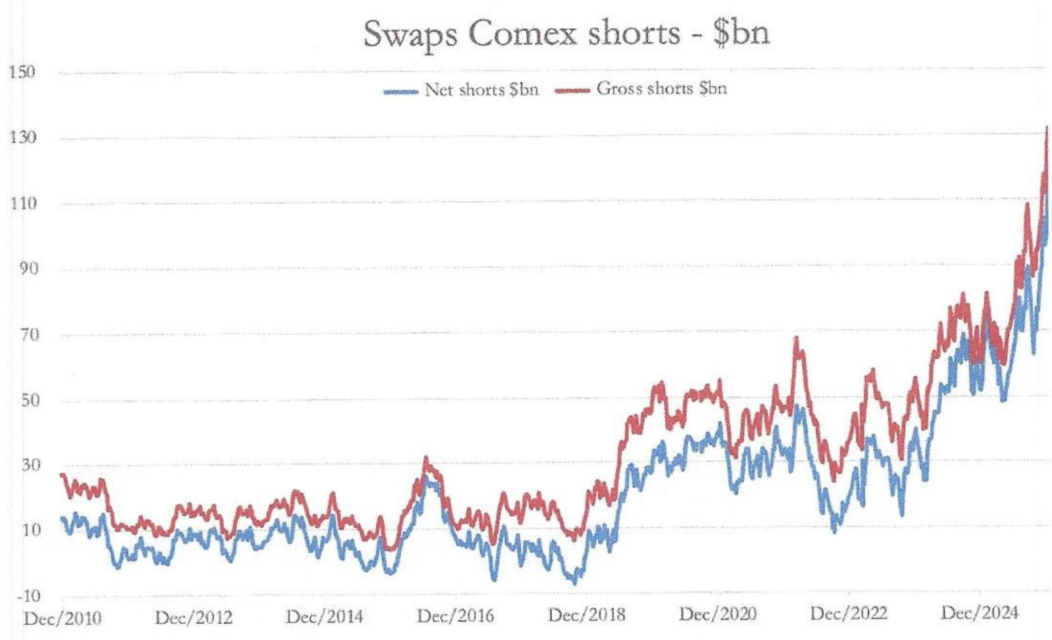
Examination of the facts show that last Friday's action in gold, silver, and platinum was designed to flush out weak holders of paper contracts. This was for the benefit of establishment players in Comex's swaps category, who being desperately short are losing huge sums on mark-to-market valuations. This is illustrated in the following chart for gold:



Source: CFTC, MacleodFinance

We conclude that the operation had limited success, because speculative positions in non-commercial Commitment of Traders categories are remarkably low. Therefore, the swaps on Comex will continue to be squeezed, and we can reasonably expect higher prices for precious metals in the coming weeks.

Introduction

The late Jim Sinclair, speaking at GATA's conference in London 15 years ago told us about his days as a gold trader in the 1970s. Sinclair was probably the most successful gold trader at that time. He recounted how bullion banks conspired to suppress the gold price until they had closed their shorts and accumulated long positions. Only then did they permit the gold price to rise in the greatest revaluation against the U.S. dollar ever witnessed.

The relevance of Sinclair's remarks was echoed in gold and silver in the week just ended. From their forecasts of the gold price, the bullion bank community were net long of derivative gold across London forwards and Comex futures in the last quarter of 2025. But these positions were probably eroded when gold rose strongly from under $4,000 in early-November to touch $5,600 last Wednesday.

In short, the bullion establishment used the expiry of February Comex futures in an attempt to square their books in gold, silver, and platinum. The extent to which they succeeded is the basis of our enquiry. If that was the purpose, then we can expect prices to resume rising in the coming weeks as the short squeeze returns.

Comex shenanigans

There were two events to consider with respect to the expiring February contract. The first was last trade day for options on Tuesday 27 January. This gave granters of calls, overwhelmingly bullion banks and others in the Swaps category, an incentive to ensure that prices are low as possible and call options expire worthless. This explains why silver was marked down on Monday from $117.75 to $101.80 ahead of expiry. Gold hardly moved, presumably because other factors were more important.

The second event was "first position" in the February future on Thursday, 29 January. When traders do not wish to stand for delivery, they must close or roll over their positions the day before to avoid being caught up in the delivery process. This involved 38,672 gold contracts on Wednesday night, and 2,572 silver contracts. For the shorts, it is always an opportunity to shake out flaky bulls or force them to crystalise a loss if they roll over into the next active contract.

This was the motivation between driving gold lower from the overnight level of $5,590 to $4,895 on Friday, and silver from $121 to $85. It was further facilitated by Asian markets already closed for the weekend, giving the short establishment an opportunity to move prices to anywhere they liked.

Gold's speculative position

Before we examine the detail, here are the main Commitment of Traders category definitions to help the lay reader:

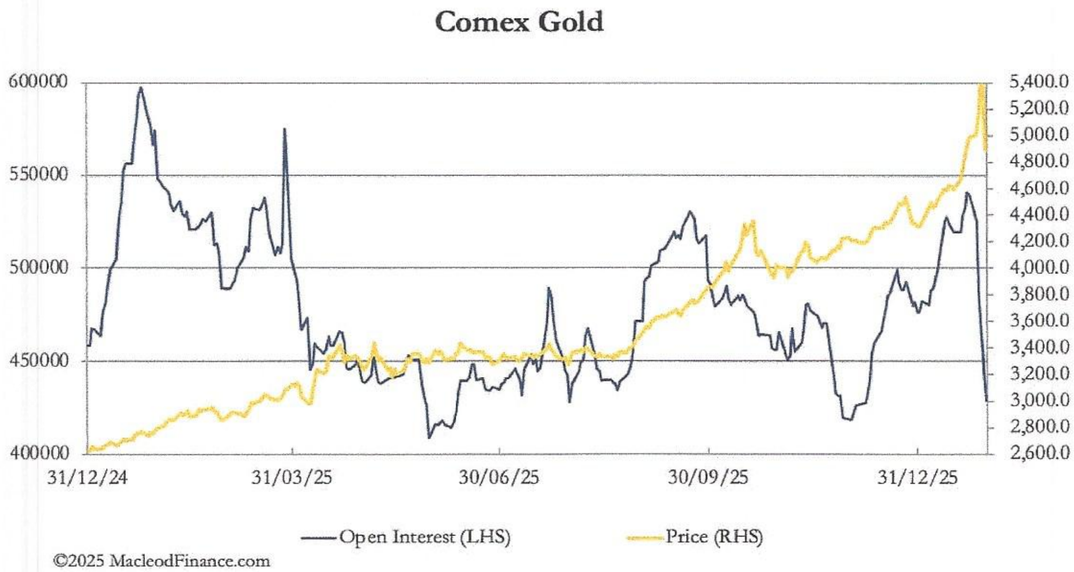
-- Producers and merchants. Categorised as commercial, who use futures to hedge price risk.

-- Swaps. Consists mostly of bullion bank traders and market makers. Categorised as commercial providing market liquidity.

-- Managed money. Non-commercial, mainly hedge funds that rarely stand for delivery.

-- Other reported. Non-commercial not otherwise classified.

Comex exchange reports show Open Interest. Open Interest consists of one long and one matching short futures contract. The term contract can also refer to a specific commodity. Thus, we have gold and silver contracts. Generally, when there is significant speculative interest in a contract, there will be more contracts than average outstanding, indicating an overbought condition for that contract, and if less than average it will be oversold.



Open Interest in Comex's gold contract had increased by 69,973 contracts between its low point on 2 December and last Tuesday 27 January, initially reflecting trend-chasing by non-commercial categories. But they had started reducing their positions from mid-January and Open Interest overall then declined sharply to below average levels. This can be seen in the chart above.

Within this activity, we find from Commitment of Traders statistics that hedge funds in the Managed Money category had increased their longs since 2 December by a paltry 3,178 contracts, while gold rose from $4211 to $5180.

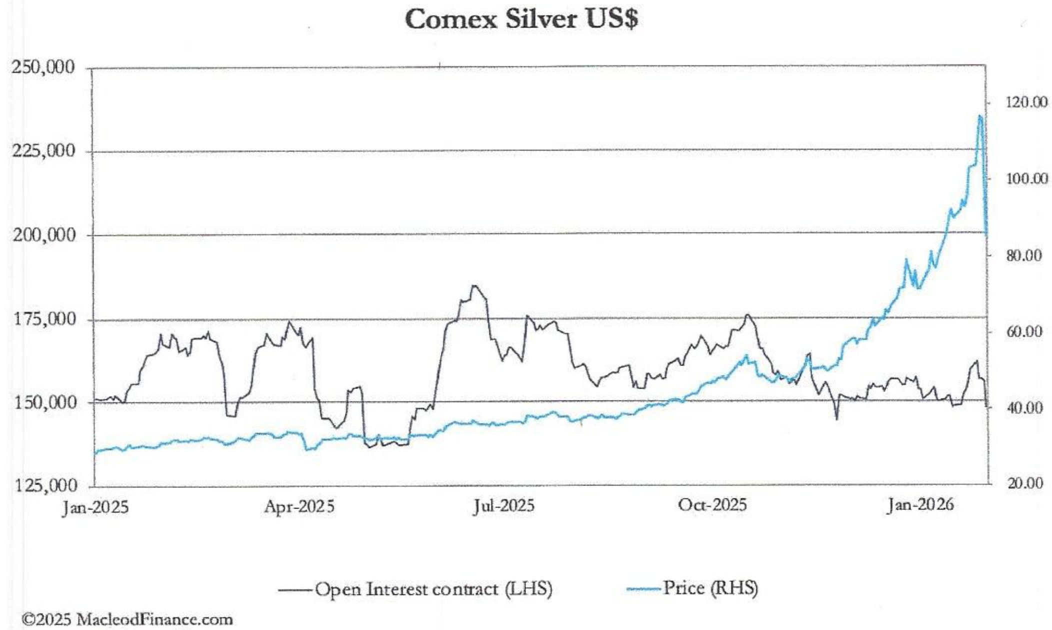
At the same time their shorts had increased even more over the period, leaving them less net long since 2 December by 2,165 contracts. They increased their spread positions by 24,966 contracts, but that is hardly relevant and should be ignored. A spread consists of two opposing contracts where there is an arbitrage opportunity so does not reflect a long or short position.

The Other Reported category also reduced its exposure ahead of the price smash by a far larger 12,409 contracts and also their short positions by 2,410. Shaking out remaining speculators in these categories would have yielded very little.

Ironically, the largest increase in net longs was in the Producers and Merchants category at 8,118 contracts. And the Swaps increased their net shorts by 1,055 contracts, reflecting a failure to derisk their positions.

Therefore, the squeeze rebounded on bullion bank traders in the Swaps rather than flushing out weak holders in the non-commercial categories. This is confirmed in gold's preliminary open interest numbers for Friday, which declined by only 22,646 contracts. Admittedly, we are ignoring London's forward market because the numbers are not available. However, activity on Comex can be considered to reflect the overall position.

Silver



Judging by Open Interest, the chart above shows that speculative interest in Comex's silver contract is extremely low, suggesting that not much was to be gained by shaking out non-commercial longs.

On 2 December, silver was $58, subsequently doubling. Between then and last Tuesday, Open Interest had increased by only 5,805 contracts. The Managed Money category reduced its longs by 15,342 contracts, the largest change in any category other than irrelevant spreads, and it also reduced its shorts by 4,067. Furthermore, in the history of this category's exposure, this represents a very oversold condition.

This absence of speculative interest is confirmed in the chart above. In the commercial categories, Producers and Merchants reduced their net short exposure by 5,526 contracts and the Swaps increased their net shorts by 7,057. As in the case with gold, very little has been gained by the establishment manipulating silver prices into a crash. That is the stark reality they face in the coming weeks: They have shot their bolts to little effect.

In silver, we now return to the reality of no liquidity in London while broad-based public demand from Asia coupled with industrial buying is creating a liquidity crisis. For Swaps, it appears to have been the last throw of the dice.

China reopens on Monday

Before the Western establishment pushed gold and silver prices lower, Shanghai spot silver closed on Friday at $123 and gold at $5,210. They had both declined from earlier highs, perhaps reflecting speculators closing longs ahead of an uncertain weekend. With probable evidence of some speculator positions remaining, we can expect China to open lower than its Friday closing prices on their Monday morning.

Remaining speculator long positions are unlikely to be very significant, because the two Shanghai exchanges have taken steps to contain them by increasing margin requirements and other measures. But despite this, further falls on Monday in Shanghai are likely, and at a guess they will not fully reflect developments on Comex and London.

February's contracts will no longer be a factor affecting prices. Furthermore, it is clear that there was not much speculator interest to shake out, so the operation mounted by the Swaps was an abject failure.

Regarding the dollar and associated fiat currencies, given that nothing has really changed, the priority for the Swaps is to not let their short positions increase. Therefore, the squeeze resumes: squeezes in both gold and silver that are driven from Asia and particularly China.

It is worth noting one statistic. China's household savings are in excess of 30% of GDP. That means over $5.5 trillion dollars annually are being invested by the public. Property is now unfashionable, and Shanghai's stock market is not attracting these flows. There are only two places where these funds can go: bank deposits, where interest rates have been steadily reduced, and gold accumulation accounts. A Chinese resident with a bank account can open a gold accumulation account alongside yuan deposits.

As well as buying gold and silver coin and small bars from dealers, the flows into these gold accumulation plans are significant. They operate as unallocated gold accounts.

It was reported last week that savers with these plans attempting to encash them for underlying gold now face a wait of at least a month and probably more. This reflects two possibilities. First, banks are being overwhelmed by demand for plan encashments. Possessing large bars, the banks cannot quickly recast them to satisfy retail withdrawal requests. And secondly, some or all of these banks do not possess sufficient gold to honour their delivery commitments.

In the latter case, banks will be forced to beg, borrow, or steal bullion to deliver or face a developing run on their supplies. For everyone's sake we should hope that this is not the case, and that the former condition of the difficulty turning large bars into small ones is the problem.

Either way, China's gold and silver rush looks like continuing despite this market hiccup. And therefore the squeeze on Comex and London can and will recommence in earnest.

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