PUTTING LOIN-CLOTH ON THE NAKED BOGEYMAN

A Primer on the Silver Basis

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I started writing this piece as the sub-prime crisis was unfolding. I wanted to establish the connection between the silver basis and the budding banking crisis caused by phony bond insurance schemes and the lack of hedging irredeemable dollar debt with metal holdings. My original title was *Putting Clothes on the Naked Bogeyman.* As writing progressed I realized that it would take more than one article to dress up the bogeyman; hence the revised title.

Trading hedged corn

When I tell my audience at Gold Standard University Live that huge quantities of commodities are bought and sold every day *without any reference to the price*, my words are received with an incredulous silence. It appears incredible to the uninitiated that the price risk can be neatly side-stepped. I have to explain to my listeners that when the professional grain trader gives an order to buy or sell corn, he may be unaware whether the price of corn is up or down. He doesn't care. He is buying and selling *hedged corn*, and he takes his clues from the basis, not the price of corn itself. He has replaced price risk with basis risk which he knows how to handle as its behavior is less erratic and more predictable. Most people don't realize that the bulk of grain trading on the futures markets is driven not by the price but by the basis.

In the grain market by basis is meant the difference between the futures price and the local cash price of the grain. Thus the basis varies from place to place, and from one delivery month to another. Trading the basis means buying or selling hedged grain. The merchant goes long on the basis by purchasing hedged grain when the basis is wide, and selling it when the basis is narrow (possibly negative). He goes short on the basis by selling hedged grain first when the basis is narrow (possibly negative), and selling it later when the basis is wide.

The myth of naked shorts

The silver market is similar. Large quantities of silver are bought and sold every day without reference to the price. Professionals trade hedged silver on clues from the silver basis. They are not gambling on the price variation of silver: they want to earn a reliable income on physical silver already in store. They may do this on their own account or, more typically, on customer account. The ever growing inordinate and concentrated naked short position in the face of a strongly rising price is a myth.

I defined silver basis in my earlier articles as the difference between the nearest futures price and the cash price of silver (see references).

It is puerile to assume that most professional traders are naked short in silver, just as it would be sheer ignorance to suggest that most professional traders of grain are naked short in corn. They are not. You may rest assured that their corn is well in place in a grain elevator somewhere. If the elevator is registered with the commodity exchange, then the hedger may post a reduced margin on his position. But the elevator need not be registered, in which case the hedger posts full margin. While this is not typical in the grain trade, it is quite common in the silver trade. Rightly of wrongly, the silver trade is surrounded with far more secrecy than the grain trade. This has to do with the fact that silver is considered a monetary commodity by many in the first place, and an industrial commodity only in the second. We must understand that lots of people are accumulating silver not so much for the ride to $1000, which may or may not happen, but in protest against low interest rates on passbook savings and certificates of deposit. They are happy to post full margin instead of the lower hedge margin on their short position in silver in exchange for anonymity. Of course, the exchange knows that theirs is a hedge position, but must treat this information as confidential. So must the C.F.T.C.

Let's start by reviewing the differences between the grain and silver trade. As most grain is sold to the ultimate consumer within the year of production, the basis has a yearly cycle with trough just before and peak just after harvest. By contrast, the silver basis is not cyclic. Silver is typically accumulated year after year by investors and bullion banks. Instead of an annual cycle following the crop year, the silver basis has a long-term falling trend, a strong hint of a slowly developing shortage. It is impossible to predict when shortage will hit. After every major price advance there is profit-taking by unhedged investors, and after every major price decline there is short covering by hedged investors and bullion banks. Net selling through profit-taking and net buying through short covering may or may not balance out. Accordingly, the trend towards a permanent silver shortage is going to be uneven.

Historical sketch of the grain trade

Farmers produce billions of bushels of grain every year. Most of this grain is sold several times in the futures markets as part of the basis-trading before it is consumed. An understanding of the historical development of the futures markets may be helpful. Standardized futures contracts began trading on commodity exchanges in the late 1800's. Futures markets revolutionized the way cash grain was traded and gave the grain elevators and the farmers the ability to buy and sell more easily and profitably. Grain companies learned how to use futures contracts more effectively to manage risks, and to maximize income from their elevators. The big revolution was the advent of basis-trading, to replace price-trading. This revolution is not mentioned in school curricula; not even in university curricula. This is a pity. The story of basis trading is a story of capitalism triumphant. It teaches how the free market can overcome the capriciousness of nature. As more and more people learn the skills of basis trading, profitability grows and business expands.

The grain business prospered until the 1930's when the Great Depression began and governments became heavily involved in grain trading. Government programs dominated the marketplace. Storage of grain was encouraged and construction of new elevators was subsidized. However, the market was stagnant, to a large extent precisely because the new elevator space was taken up by government-owned grain. This grain was just sitting there in the elevators, until it was ultimately given away to other governments or to charities.

In the 1970's governments decided to reduce their presence in the grain market. A new era started when market forces were allowed to prevail once more. The grain business re-learnt how to increase efficiency, manage risks, and generate income through basis trading. Generally, the abundance of grain kept the market stable. Under these conditions the opportunity for trading was confined to buying and holding grain. This is known as the „carry trade": buying when the basis is at its highest and selling when it is at its lowest. The basis was following a consistent pattern and as it declined from harvest to the end of the crop-year, the grain trade was provided with a reliable income.

It would take a sizeable drop in production to cause any significant move in the price and a deviation of the basis from the customary pattern. While it did not happen very often, the market came away with the flying colors proving the superiority of trading the basis over trading the price especially under volatile conditions.

The 21st century brought new challenges to the grain trade. The market became demand-driven. Increasing population and improved living standards around the world opened up markets to more people and boosted demand for processed food and other consumer products. There has been a tremendous growth during this first decade of the century. In addition to the carry trade, „value added trade" has put in an appearance and started growing. In this environment grain does not sit around in elevators for a long period of time. The market absorbs it and makes it into all kinds of products for human and animal consumption. Most recently grain has started trading also for use in energy production. All these changes contributed positively to basis trading as it has changed the dynamics of the marketplace.

Of course, not all grain traders are trading basis. A dwindling number still trade price. Most of these traders are barely surviving. They will have to learn the skills of basis trading, or perish. It is a safe bet that no new grain elevator is being built with trading the price in mind. They are built with trading the basis in mind. Those who are still trading price are missing one of the great opportunities of the century by not understanding basis.

Historical sketch of the silver trade

Second only to gold, silver is a monetary metal. This means that above ground silver represents several years' output of the mines. One should not be misled by the propaganda line that this silver „has been consumed by industrial applications". The recovery of scrap silver is a function of the price. As the price of silver rises, the rate of recovery will rise with it, sometimes dramatically. In addition, an unknown but substantial amount of silver still exists in monetary form. Owners do not want to reveal their identity, or the size of their hoard. But this does not mean that monetary silver has disappeared in consumption. There is no support for the claim that silver is in short supply, or that silver has ceased to be a monetary metal. Any apparent shortage simply means that the carry trade holds back stocks from the market in hope of an early price advance. At the right price it will make the metal available.

Prior to 1873 the price of silver was stabilized through monetary legislation at $1.29 per oz. After the Civil War the U.S. Mint was closed to silver. The German government also closed its Mint to silver in the wake of the Prussian victory over France about the same time. Silver was dumped in the markets in unprecedented amounts, driving the price down to as low as 70 cents by the end of the 19th century. Although the price spiked back to $1.29 at the end of World War I, it did not last and during the Great Depression it hit a low of 25 cents. We may add that upheavals in the silver market were a direct consequence of government meddling. Ultimately people have learnt how to neutralize the destructive influence of the government in an effort to control money, and they borrowed a leaf from grain merchandising manuals in trading the silver basis.

Through all this time up to 1965 there was no silver trading on the organized commodity exchanges for reasons of insufficient volatility. By 1965 the world market price threatened to exceed the statutory price, as demonstrated by the disappearance of silver coinage from circulation, and volatility perked up. Silver trading on the organized commodity exchanges started. However, secrecy continued to surround the silver trade as one monetary crises followed another at more or less regular intervals. There was a conception that silver could also be confiscated as gold was in 1933. In the event, the ban on gold ownership and trading was lifted in the U.S. at the end of 1975, allowing gold futures trading to start and giving a boost to silver futures trading already in progress.

Secrecy prevailed and manuals on how to trade basis in the gold and silver markets were never made public. Those anxious to learn basis trading of the monetary metals had to buy the manuals for basis trading in grains, and work it out for silver and gold on their own. This is not as easy as as it sounds, because of pitfalls due to the fact that trading monetary metals differs from trading grains in almost every respect. Having said that, there is no question that basis trading in gold and silver is a wide-spread practice preferred by the most conservative investors, and even the more venturesome cannot do without at least a rudimentary understanding of the underlying principles. We have mentioned above that trading the basis for grain instead of trading the price was a triumph of capitalism. Man has learned how to overcome the capriciousness of nature. The same also happened in the silver market: trading the silver basis increasingly replaced the trading of the silver price. The difference is that here it was not the capriciousness of nature but the capriciousness of governments that has been overcome. Governments want you to believe that they can create and destroy value at will by monetizing debt while demonetizing silver and gold. In effect they cannot do either in a durable way. Government magic goes only so far as gullibility of the people.

Gold Standard University Live is a world leader in offering regular panel discussions and primers on basis trading of the monetary metals. There are plans to run workshops as well on basis trading. The next session is scheduled from July 3 through 6 at the Martineum Academy in Szombathely, Hungary, to be followed by a session in Canberra, Australia in November (see Announcement at the end of this article).

The Last Contango in Washington

Volatility in the gold and silver markets is like a dormant volcano. Unannounced, it erupts periodically with increasing ferocity. As it does, trading the gold and silver price is becoming ever more treacherous. There can be no doubt that the answer is basis trading, that is, buying and selling hedged gold and silver. It is only a matter of time before a trading house or bullion bank will offer this service.

The significance of the silver and gold basis can be found in the role they play as an early warning system. Under normal circumstances backwardation in gold and silver is an aberration. Monetary metals must be sufficiently plentiful in order to serve as such. This translates into contango. But at the time of monetary disturbances, like the one triggered by the sub-prime mortgage crisis, the monetary metals tend to go into hiding. As they do, the cash price goes to a premium against futures prices, and the basis goes negative, indicating the extent of scarcity. If hyperinflation is in store, gold will go into permanent backwardation, foreshadowed by a steep decline in the basis.

In an earlier article I have, somewhat flippantly, described this momentuous paradigm-shift as „the last contango in Washington" (with a bow to the movie *The last tango in Paris*.) The historic contango of gold will give way to permanent backwardation. It will mean that gold is not for sale at any price — not against the irredeemable dollar. Note that while the gold price is open to government manipulation, the gold basis cannot be so easily falsified. It reflects the truth as it is. *The basis never lies.*

Canary in the coal mine

According to one hypothesis, permanent backwardation in silver will precede that in gold. Thus silver is the „canary in the coal mine". But you have to have ears to hear the canary sing. In other words, you must be able to read the message carried by the silver basis. If deflation and depression is in store, then the case for silver is not so clear-cut, in view of silver's extensive industrial applications. It is possible that silver will be dumped by investors fearing that industrial demand is vanishing. But again, it is also possible that the rush into gold, a regular feature of depressions, will spill over as a rush into silver. Whatever happens, the silver basis will provide a reliable early warning sign. The return of contango in silver is an indication that bullion banks are dumping silver. Continued backwardation is an indication that investors and bullion banks are still accumulating silver. Investors and traders would do well to learn all they can about the silver basis to be able to interpret events correctly as they unfold, even if they never intend to trade the silver basis.

The inordinate size of the short commitment of traders indicate that bullion banks actively trade the silver basis. Among their customers are wealthy investors and, possibly, governments or government agencies. C.F.T.C. investigators insist that there is no market manipulation in silver. I am willing to take their word at face value. Basis trading is not a market manipulation, even if done on a large scale. It is dynamic hedging, and hedging is just what the futures markets are for. While futures trading would not work without an adequate speculative following, it is *not* primarily for the benefit of the speculators. It is for the benefit of the hedgers. Speculators are supposed to know this and they should stop crying „foul play!"

What is seen and what is not seen

Those who hold that there is market manipulation are victims of an optical illusion. What appears as an oversize naked short position involving no more than eight trading houses or bullion banks, is just the visible side of basis trading in silver. But there is another, invisible side as well. The invisible side is hedged metal in private hoards, in the reserves of bullion banks and, possibly, in secret government depositories.

It is well-known, for example, that the Chinese government controls large stores of silver, remnants of the long-lasting silver standard in China. A lot of the silver that governments and private individuals dumped in the West after the 1873 demonetization found its way to the East, where the Chinese Mint was still open to silver. At that time China offered the only unlimited market for silver. There is some controversy about the question whether silver was flowing into or out of China between 1934 and 1949. Be that as it may, after the overthrow of the Nationalist government the Chinese Communists inherited untold amounts of silver. If there was an outflow of silver from China before the Communist takeover, it certainly stopped after 1949.

Chinese hedges are no Texas hedges

It is a plausible assumption that the wily Chinese presently trade the silver basis under a seal of secrecy. Some of the world's largest banks are in China, and they definitely have bullion trading desks. Unlike their opposite numbers in Japan and the West the Chinese banks are not brain-dead. While they also have a large portfolio of dollar-denominated assets, they are probably fully hedged by their holdings of silver and gold. The Chinese banks don't have to carry the ideological baggage of anti-gold mentality, so prevalent in the United States. Their financial condition is incomparably superior to that of banks in the dollar orbit.

In order to understand the silver saga it is important that we put ourselves into the Chinese mindset. For the Chinese silver is money, and the US dollar is a dishonored promise. They see no reason to exchange their silver for paper, of which they already have more than their fill. Their perspective on the market is entirely different from that of silver investors in the West. Their participation in the silver market is motivated by their desire to earn a return on their holding of silver *in silver.* A price explosion would frustrate their strategy. They don't want a supply shock in silver. On occasion they have to pacify the restless silver market through selling, with the idea of buying the material back, preferably at a better price. This is not naked short selling; this is dynamic hedging. No crusade of the „insanely bullish" can reclassify it as market manipulation.

The difference between the Chinese banks and their Japanese and Western counterparts is that the Chinese hedge *paper with metal*, while the Japanese and their American mentors hedge *paper with paper*. Theirs are Texas hedges (with reference to the anecdotal rancher who hedges his herd with *long* live cattle futures contracts).

Silver basis and the banking crisis

The present banking crisis necessitating unprecedented bailouts of multinational banks is not unrelated to silver basis trading. By now it is clear that *the cause of the crisis is the banks' inordinate portfolio of assets concentrated in debt denominated in the irredeemable dollar, unhedged by gold and silver*. By contrast the Chinese banks, which also have large dollar assets, are hedged in metal. The Chinese banks are in no need of a bailout. So much for diagnosis. The prognosis: more bank failures in the West and in Japan; further relative strengthening of banks in China.

It is unreasonable to expect that exchange officials and C.F.T.C. investigators disclose the hedging activities of bullion banks, Chinese or otherwise. I repeat, trading the silver basis is *not* market manipulation. The high concentration of short positions is due to the fact that governments and wealthy individuals wanting to earn a return on their silver holdings prefer to take their business to a select few trading houses and bullion banks with the necessary expertise and capital to trade the silver basis on a large scale. This offers them the best chance to preserve anonymity. The sluggishness of silver deliveries is explained by the long lines of communication. It takes time to get the silver from the East for delivery in the West. One should not read imaginary shortages into this. Presently silver is not in short supply. If it were, silver could not drop in price as much as $5 an ounce or 25 percent in a matter of days, and continue trading at the lower end of the range. Paradoxically, sluggishness of deliveries is the very proof that there is no corner in the offing — not yet. If there were, the metal would move from East to West in supersonic aircrafts.

The best little warehouse in Comex

I strongly disagree with the tactics of Comex in putting a limit on long positions in silver and on silver deliveries, which looks like an admission that there is a shortage. Silver in approved warehouses is there to be delivered on demand. Let the chips fall where they may, and let's see what the market will do if the last bar of silver is removed from the warehouses. Limit on deliveries does not prove shortage; it only proves that the exchange is inefficient and does not favor transparency. In limiting delivery it undermines its own usefulness. The exchange should oblige hedgers to keep sufficient silver in the warehouses ready for delivery at all times, in return for protection of their privacy. Failure to comply should be penalized with margin call on short hedge positions, possibly higher than the value of the underlying contract. This would enhance the credibility of the exchange more than anything else. As it is, the best little warehouse in Comex is for window-dressing only. For serious business, such as you know what, you had better go to another warehouse.

Bleeding to death in the bull ring

It is not in the interest of wealthy individuals, bullion banks, and governments with large stockpiles of silver that the price go to $100 overnight, which could happen if secrecy were breached and anonymity blown away. As they can derive an income from their silver holdings already, these owners of silver prefer a controlled rise in the price. And that's exactly what we've got.

Failure to understand this may lead one to all kinds of superstitious beliefs concerning the power of the bullion banks to manipulate the price of silver. The panicky short covering predicted when silver was trading below $5 never materialized during the run to $20 and higher. There has been and will be a lot of short covering, but nothing what could be called a short squeeze. Not until the curtain falls on the Last Contango in Washington.

As a quick back-of-the-envelope calculation shows, if the naked silver bogeyman were real, he would have by now lost an arm and a leg after losing his shirt. He would have bled to death in the bullfight. Let's be generous and admit that he does have, at the very least, well, a loin-cloth to wear in confronting the charging bull.

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These and other papers of the author can be accessed on the website

www.professorfekete.com

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Session Four is to take place in Szombathely, Hungary (at Martineum Academy where the first two sessions were held). The subject of the 13-lecture course is *The Bond Market and the Market Process Determining the Rate of Interest* (Monetary Economics 201). It will be followed by a panel discussion on the topic: *The Silver Basis and the Present Banking Crisis: Phony Bond Insurance Schemes and the Lack of Hedging Irredeemable Dollar Debt with Monetary Metals.*

The date is: July 3-6. For more information please see www.professorfekete.com/gsul.asp or contact GSUL@t-online.hu. Registration can be made by e-mail upon payment of the pre-registration fee. The remainder of the registration fee is due 3 weeks prior to the session. Space is limited; first come, first served.

Preliminary announcement: Gold Standard University Live is planning to have its Session Five in Canberra, Australia, in November, 2008. This Session will include a Primer on the gold and silver basis, prerequisite for a Workshop on the basis offered at Session Six (planned to take place in the Spring, 2009).

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