

Commercial Price Capping in Gold for Week Ending

By Dan Norcini
April 18, 2005



Watching the price action in gold this past week and the week before has been most disappointing for the gold community as it seems gold has slammed into a brick wall. What has been particularly distressing to many gold bulls is gold's lack of response to the rout in the U.S. stock markets which for the first time in a long while, has instilled some fear among the general public and has some waking up even if belatedly to the fact that all is not well in la-la land.

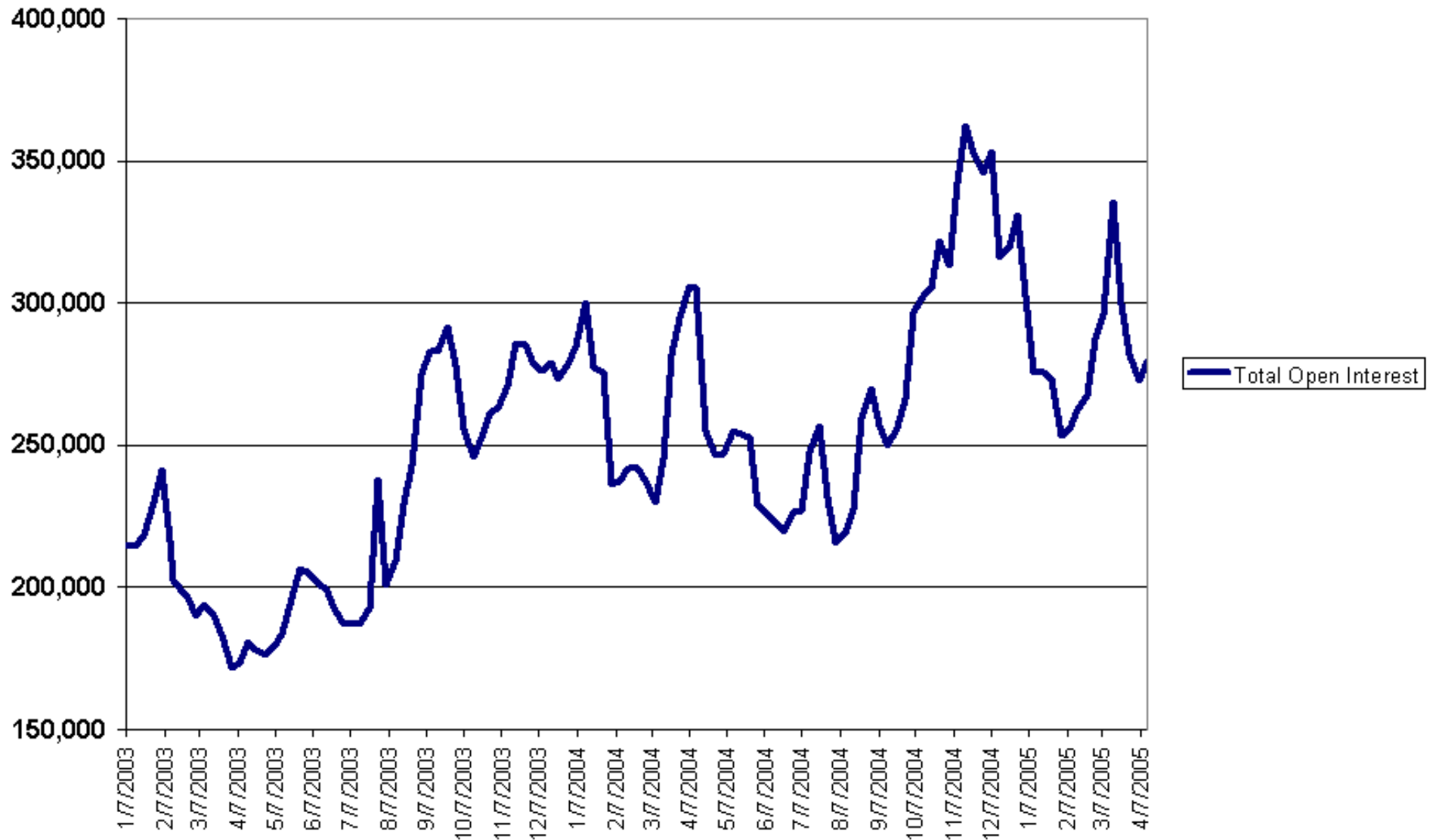
An analysis of this week's release of the Commitments of Traders data reveals the reason.

Most of this short essay will be in the form of graphs to detail what is taking place in the gold market. I will add a few comments hopefully clarifying the situation.

To begin with, what caught my eye was the continued build in the commercial net short position that has accompanied a market in which total open interest continues to decrease. That is a very odd pattern that one does not normally see.

I give up exhibit A, a chart of the total open interest in gold going back to the beginning of 2003.

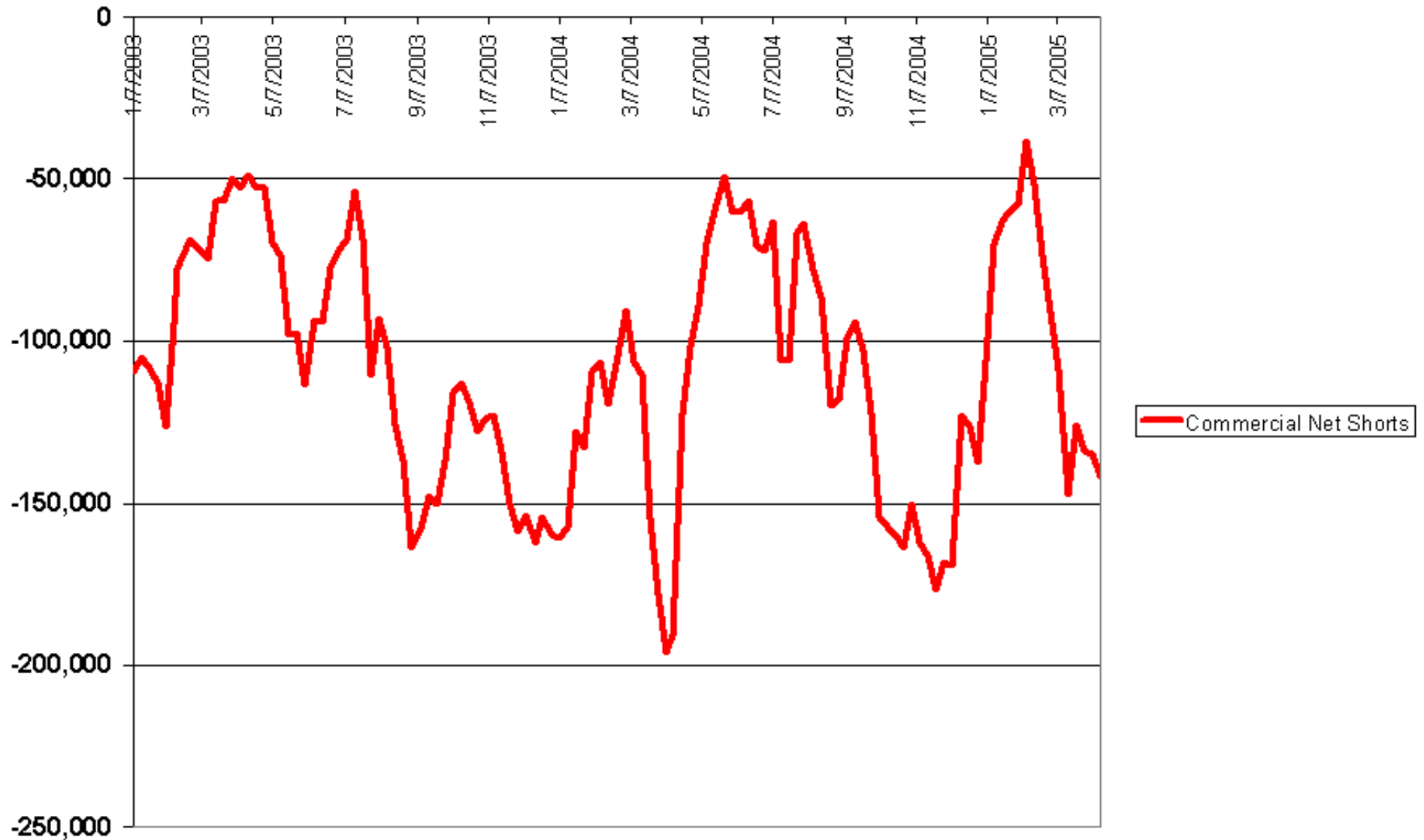
Total Open Interest 2003-April 12, 2005



You will notice that since mid March of this year, the total open interest has declined from its peak of 335,503 to where it currently stands as of this release of the COT, 279,545, or a reduction of 55,958 contracts. Previous to that it had reached a high of 362,336 back in November of last year when it collapsed all the way down to 253,16 before rebounding.

Now notice the following graph, which is a chart of the COMMERCIAL NET SHORT position in gold covering the same dates.

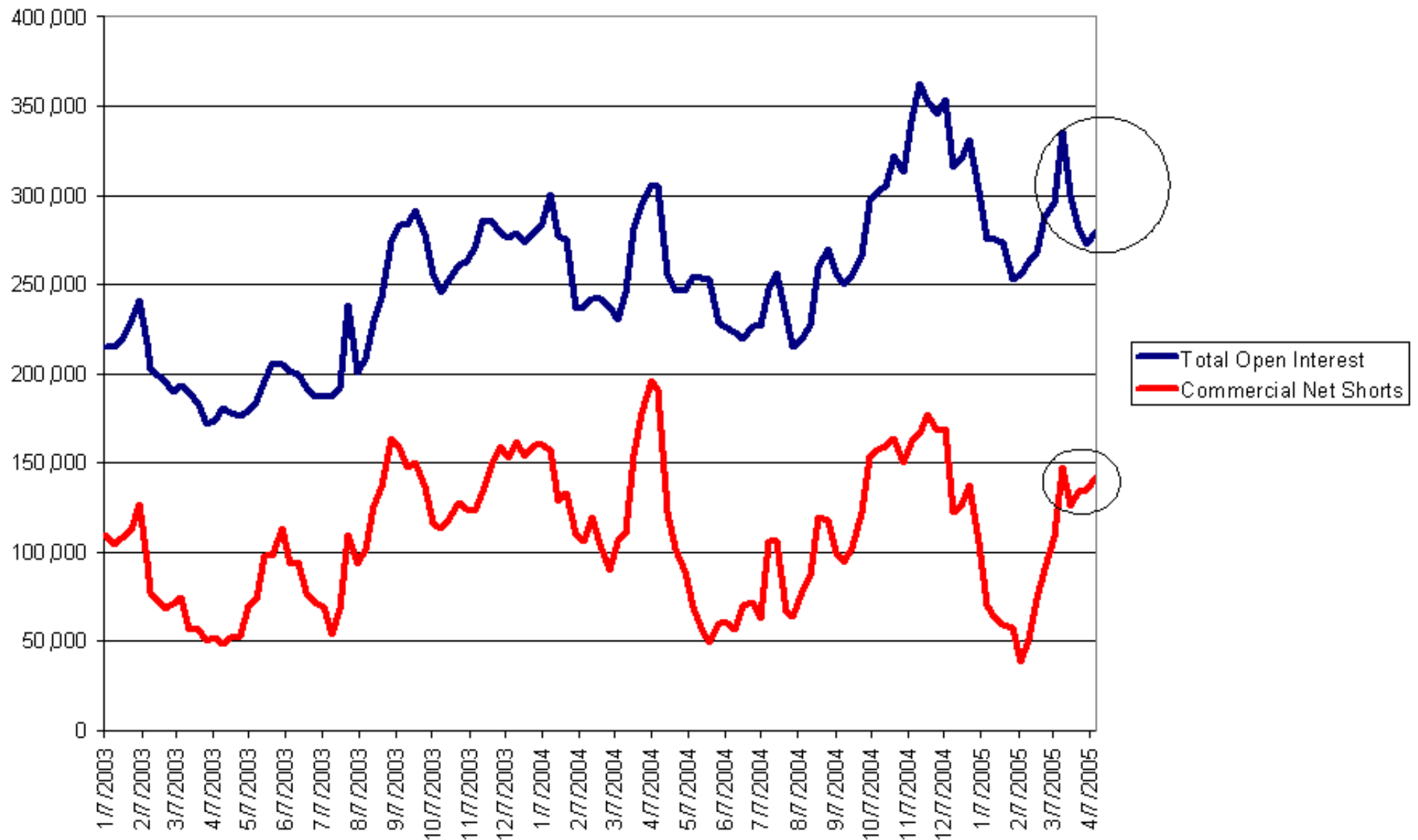
Commercial Net Short Positions 2003 - April 12, 2005



What immediately caught my eye was the inverse relationship existing between this graph and its "normal" relationship to a declining open interest environment.

Let me lay the two sets of data over each other so that you can see it.

Commercial Net Short Positions vs Total Open Interest



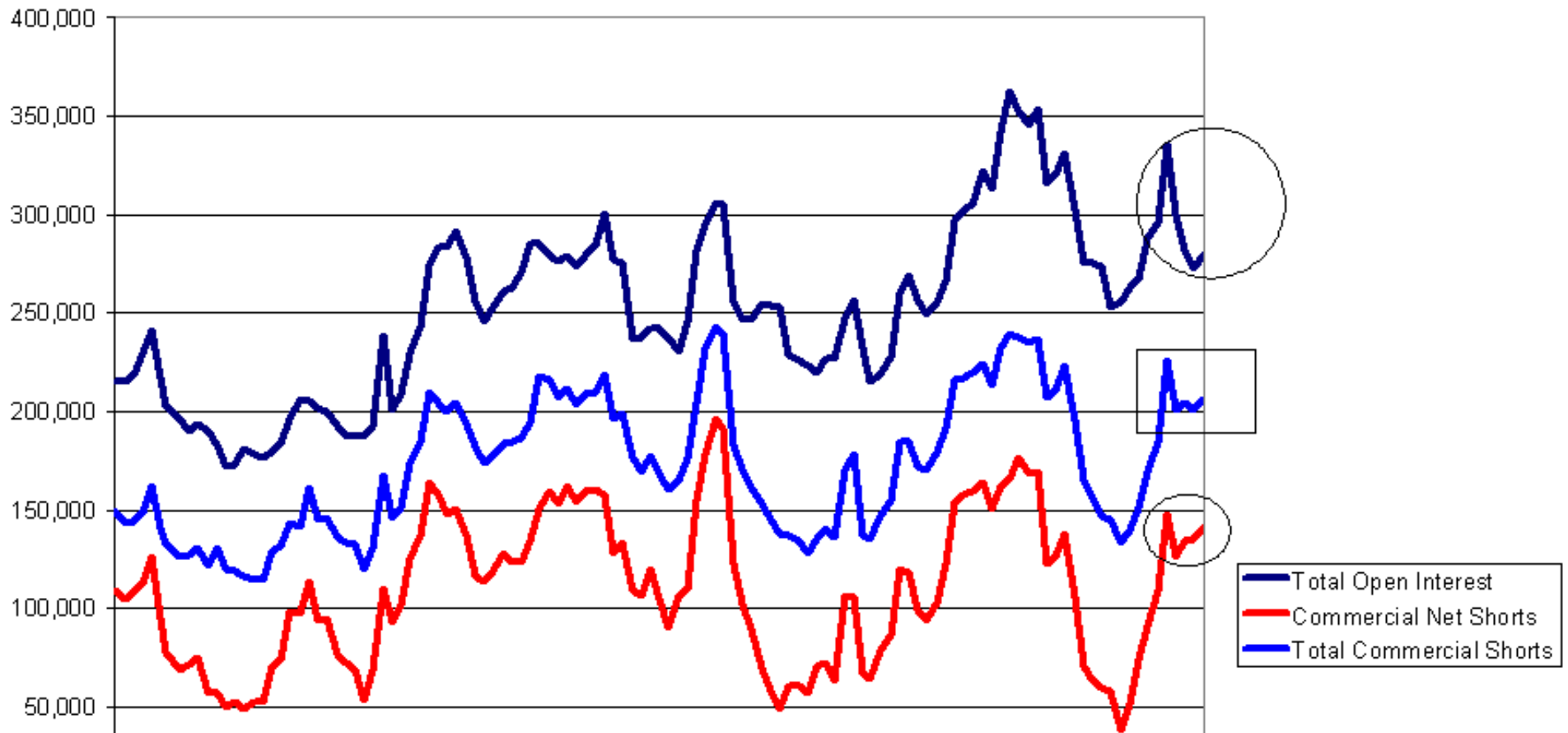
Notice the near perfect symmetry that exists between the two patterns beginning in 2003. As open interest climbs, the commercials would meet all the

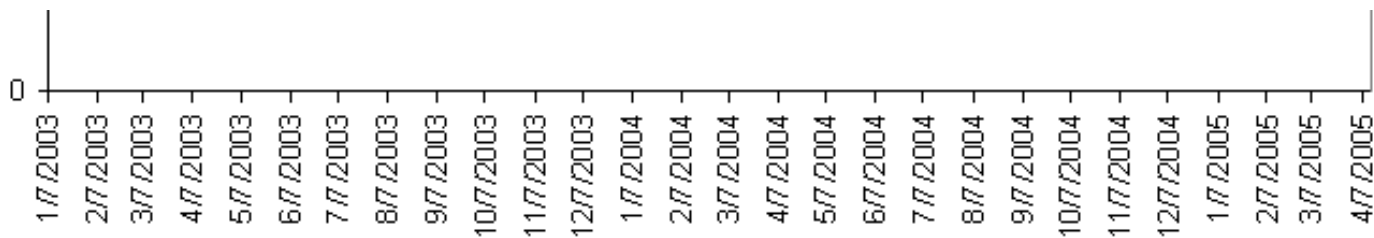
buying with selling and match the funds contract for contract thereby building their net short position. As the open interest peaked and prices set back, the funds began selling and the commercials began covering or buying back their short positions with the result that their net short position decreased right along with the decrease in total open interest. It is almost a perfect correspondence.

The last three reporting periods beginning 3/29/2005, that pattern changed. I have circled the area on the chart for your convenience. As total open interest set back, commercials initially covered their shorts and reduced their short position. However, beginning the week of 3/29/2005, they did something quite unusual - they did not cover instead they actually either held steady or increased their net short position.

To add another perspective, below is the same chart. This time I have added the actual number of Commercial Short positions; not the NET short, but the actual short positions. On the chart below, that is the solid blue line. The area in question has a rectangle drawn around it to single it out and allow you to make the comparison to the falling open interest graph just above it. Again, you can compare the dark blue line with the blue line and if you didn't know better, you would believe you are looking at the same data flow since the corresponding moves are almost identical going back more than 2 years - except for the last few weeks.

Commercial Net Short Positions vs Total Open Interest



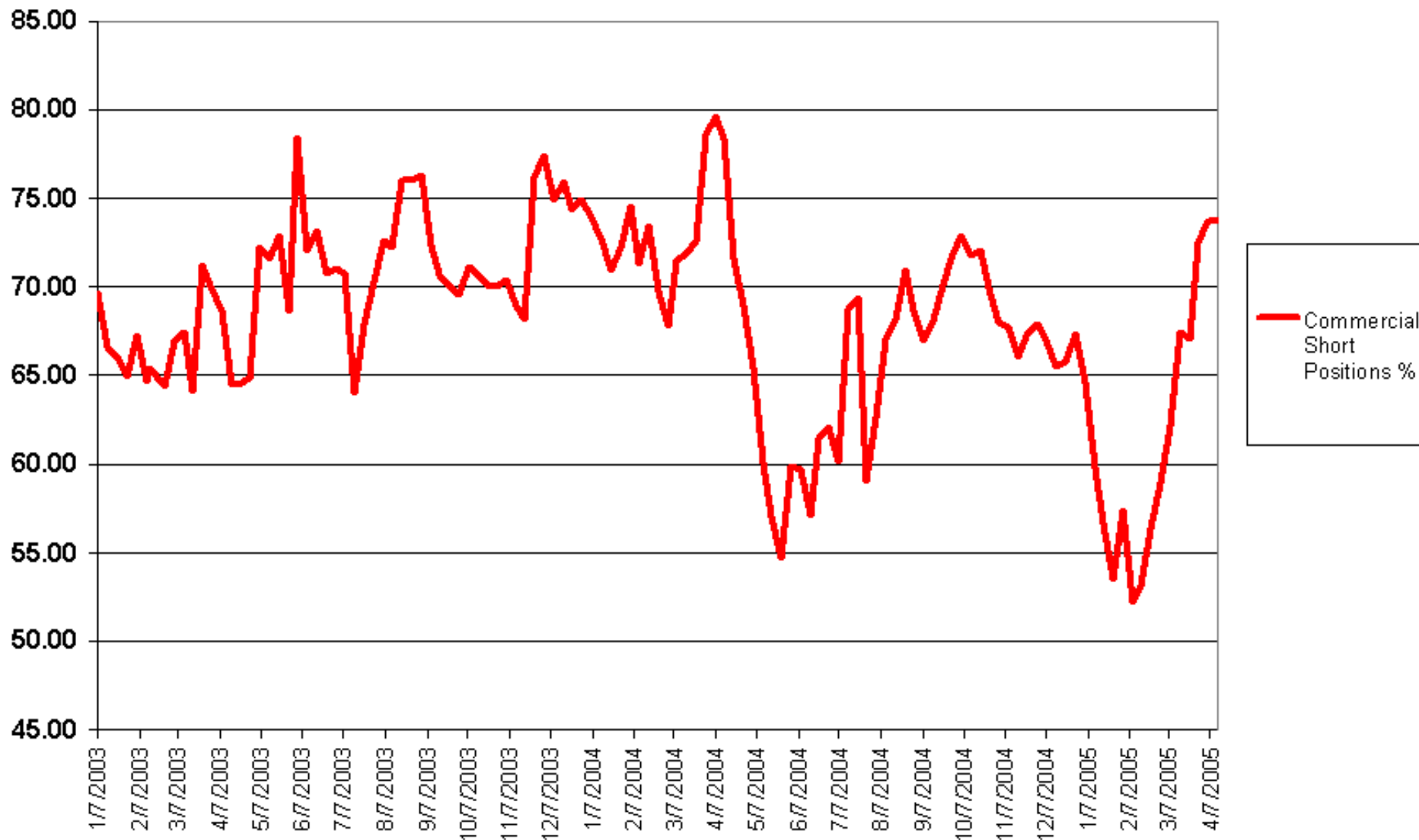


It is very obvious that the commercial shorts thus far have not let up their pressure on this market in the last three weeks. Typically, we can count on them to buy as gold descends from its highs. Their buying helps to offset the fund longs who bail out. This time they are not buying but appear to be sitting tight or adding more shorts. Granted it is only a few weeks where this pattern has emerged but to me it appears that someone is very serious about keeping the price of gold from moving up as the news concerning the U.S. economy continues to deteriorate.

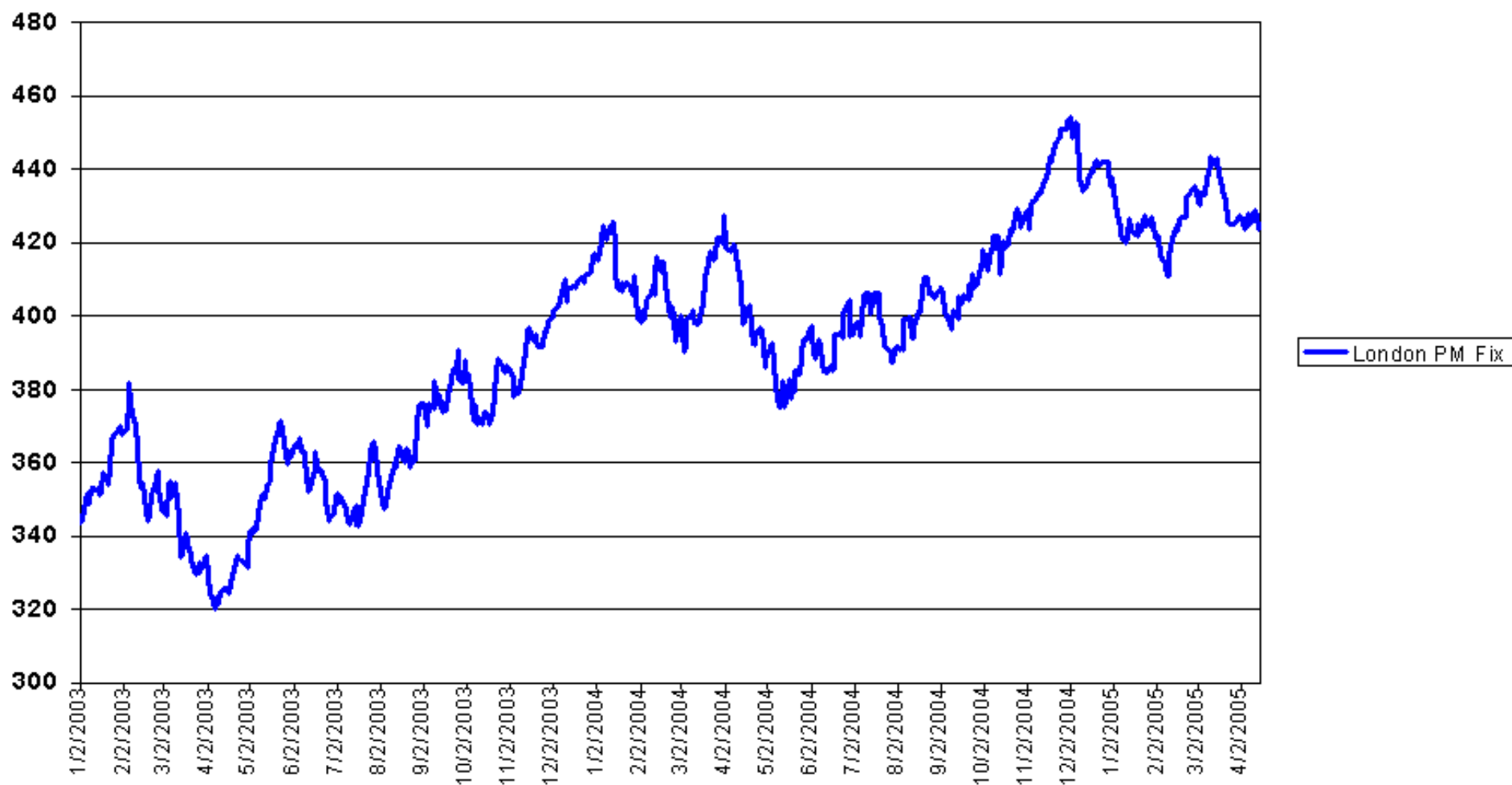
Once again, another chart provides a perspective. This time it is the Commercial Short Positions as a Percentage of the Total Open Interest. As you can see, the commercials have the largest number of short positions as a percentage of the total open interest since April 20 of last year. They are currently sitting at 73.75%. In other words, the commercials make up 73.75% or nearly $\frac{3}{4}$ of the total short positions in gold with the specs holding the other 26.25% or $\frac{1}{4}$. (please note, I am ignoring the spreaders for analysis purposes). Readings of this magnitude typically accompany price peaks in gold although they have always occurred as open interest has been increasing, not falling as it has of late. By comparing this chart to the chart of the gold price directly underneath it, you can see that each time the commercials have built a short position of this magnitude percentage wise, the gold price has moved down within a short period of time if not almost immediately.

Again, what makes this so strange is that it is occurring not as open interest builds but rather as it decreases.

Commercial Short Positions as % of Total Open Interest



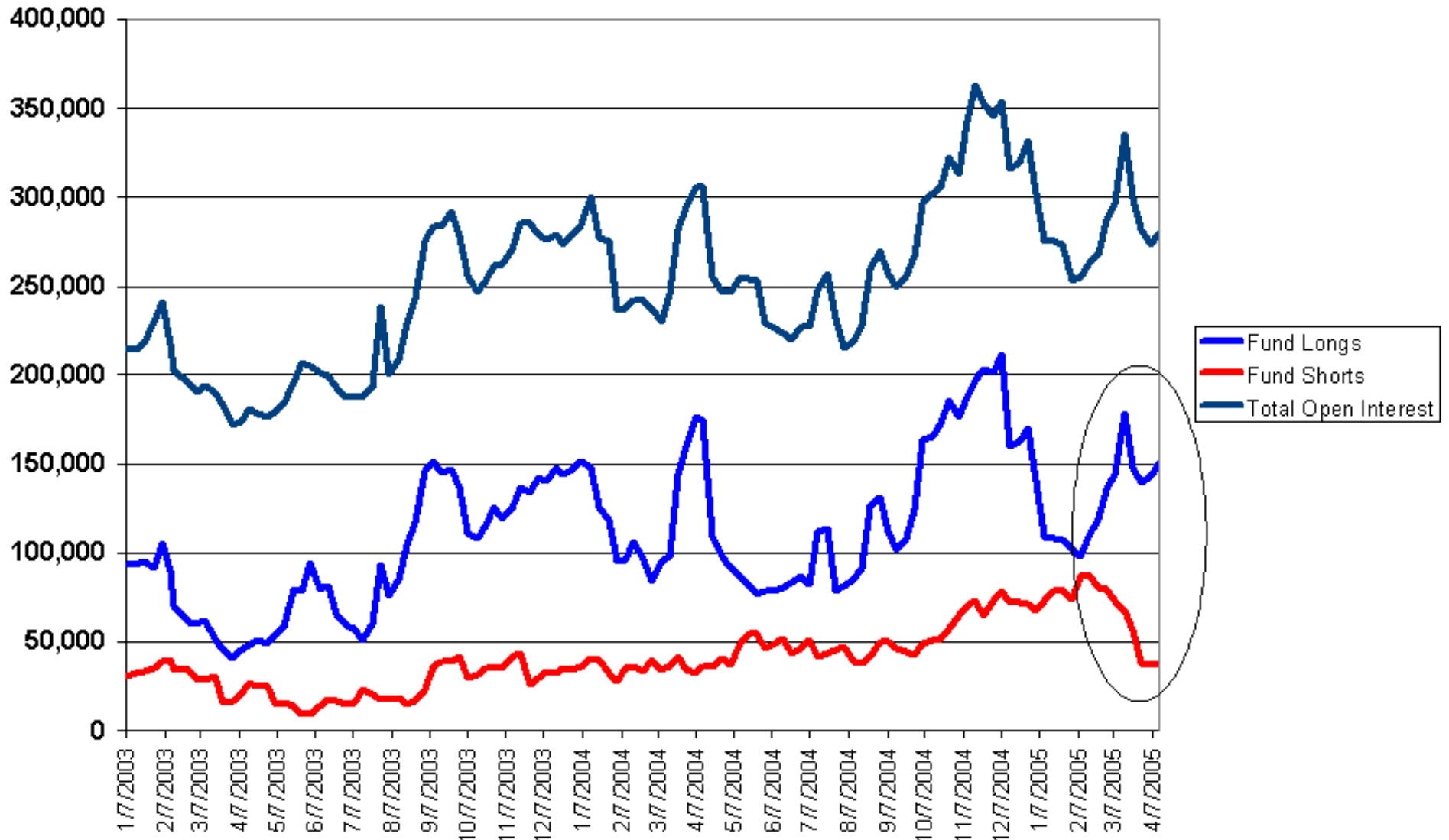
London PM Fix



The final two charts reveal exactly what is going on in this market. The first chart contains only the positions of the trading funds against the open interest. The blue line is the total number of fund longs; the red line is the total number of fund shorts. The Dark blue line is the total open interest.

It is not that easy to distinguish but if you observe closely enough you will see that in the majority of instances, as open interest climbs upward, there are always some funds who prefer to play gold from the short side. They have always been in the minority during this gold bull market but nonetheless, they are there. Typically what we see is funds piling in on the long side (blue line) and some funds joining them with new short positions on the short side (red line). Fund interest is increasing from players on both sides of the market. This continues until the open interest peaks and the gold price declines and the funds begin to bail out. The fund longs begin to sell and decrease their positions; the fund shorts begin to buy back their shorts and decrease their overall exposure. Then the pattern begins all over again as the gold price begins to recover and move upward.

Fund Positions



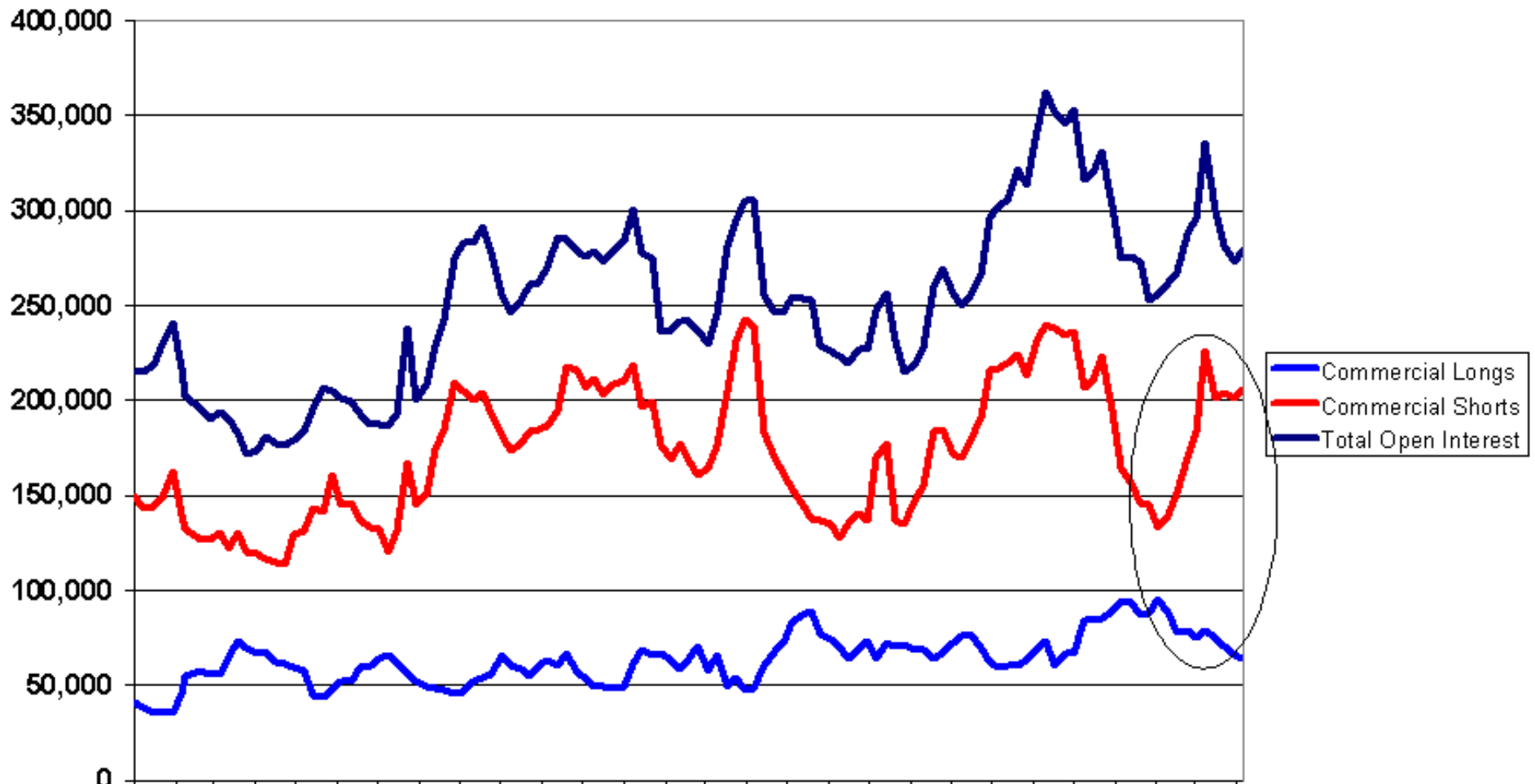
You will notice that there is a glaring discrepancy that has taken place this time however. Observe the area inside the ellipse and you can see it. Open interest bottomed in February this year after the setback from the peak and began its climb. You can see that the funds began to plow back into the gold market by observing the blue line climbing as the dark blue line increased. However, this time around, the funds who had been playing gold from the short

side decided they wanted nothing to do with it. Look at how they decreased the number of short positions they had been playing. Do you see the diverging blue and red lines as the overall open interest continued to increase? What this means is that the selling that had been provided by those funds who prefer to play gold from the short side has been disappearing from the gold market. The question is who has been providing the selling then to absorb all this buying from the funds who like the long side? It is not the small specs as they are net long themselves. The answer is the commercial category. That is why the open interest had initially begun to build even though the gold bear funds were not interested. The commercials were more than willing to absorb the buying in this market and take their place.

One more chart and we are done. This chart contains the commercial category positions as over against the total open interest. Notice the area within the ellipse as we did with the fund category. Do you see a similar pattern?

This time it is the commercial long category that has been unloading their longs and selling while the commercial short category continued to plow into the market on the short side - Exact same pattern only in reverse.

Commercial Positions vs Total Open Interest



1/7/2003 -
 2/7/2003 -
 3/7/2003 -
 4/7/2003 -
 5/7/2003 -
 6/7/2003 -
 7/7/2003 -
 8/7/2003 -
 9/7/2003 -
 10/7/2003 -
 11/7/2003 -
 12/7/2003 -
 1/7/2004 -
 2/7/2004 -
 3/7/2004 -
 4/7/2004 -
 5/7/2004 -
 6/7/2004 -
 7/7/2004 -
 8/7/2004 -
 9/7/2004 -
 10/7/2004 -
 11/7/2004 -
 12/7/2004 -
 1/7/2005 -
 2/7/2005 -
 3/7/2005 -
 4/7/2005 -

Put these two charts together, the fund chart and commercial chart, and here is the explanation. The gold price bottomed in February this year near \$411 (see the London PM Fix chart). From that time until March 15, 2005, open interest began to rebuild. While the open interest was building both the funds that prefer to play gold from the short side were bailing out while the commercial longs were selling out. These two groups were more or less offsetting each other. That left the fund longs to do battle against the commercial shorts who I believe along with GATA are involved in rigging the gold price. These two groups continued to increase their position size resulting in an overall increase in the total open interest.

Once the gold price stalled, or should I say was capped near \$442 in mid March, both the fund shorts and the commercial longs continued their abandoning of the gold market. Initially so did the fund longs and the commercial shorts who both began covering as well. That resulted in a decline in the total open interest; however, neither the fund long category nor the commercial short category have heretofore bailed out proportionately near the amount of contracts that they are prone to do under similar circumstances.

Since about March 25, gold has been trading in a range bounded by \$432 near the top and \$425 near the bottom. It cannot seem to escape from the upper side but has been thus far held at the lower side as well. Since both the gold bear funds and the commercial longs are exiting, the open interest and commitments data tells us that fresh buying has been provided by the funds who continue to add longs and fresh selling or price capping has been done by the commercial shorts. The fund short category has probably been using the lower side of the range to close out their shorts and the commercial long category has been using the upper side of the range to sell out their longs. The net effect is that the commercials, both stale longs and fresh shorts are selling up near the \$432 region while the funds, both stale shorts and fresh longs have been buying near the \$425 region or slightly below.

What we are witnessing taking place at this point seems to be some sort of a showdown in gold. The longer it continues to trade in this range while both the fund longs and commercial shorts continue to increase their position size, the stronger the move gold is going to make when it finally breaks out decidedly one way or the other. We have not seen this sort of activity surrounding the open interest and COT data taking place thus far in the gold market. Rather we have witnessed players adding positions as the market rallied and then dumping them as the market set back. This time around, the funds are getting increasingly long on a percentage basis while the commercials are getting increasingly short on a percentage basis at the same time. Something has to give as this cannot continue indefinitely. One side or the other is going to either have to blink or somehow recruit more converts to its side in this war to end the stalemate and break gold out of this range.

I come back to the point I made at the very beginning of this short essay. Gold has not responded to the deteriorating U.S. economic picture thus far as many in the gold community has expected, especially with the stock indices now in the red for this year. The explanation can be seen in the fact that the commercial short category appears to be digging in their heels in an attempt to hold it from responding. Again, the question must be raised - what category of seller is it that in the face of a determined buyer refuses to sit back and let that buyer drive the price higher so as to maximize their selling price but rather instead feels obligated to do everything in their power to squash the price from moving upward?

The answer is as clear as the noon day sun for those with an open mind and GATA has it.

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