ETF And Futures Trading Activity's Influence On Precious Metals

Like it or not, we live in a world where we are supposed to like what others like. Why else are we informed constantly with various cutesy icons how many others acted upon something they read?

Traders have been engaged in this sort of circular popularity contest for years. Trend-following essentially is a monkey-see/monkey-do game where you buy or sell because others have bought or sold. Sentiment readings, volatility indicators, option skews and various overbought/oversold oscillators are premised on the opposite notion: Your fellow traders are nothing more than mindless dolts who would feel right at home marching off a cliff with the other lemmings.

Volume and open interest used to attract far more attention than they do in our world of high-frequency and algorithmic trading. The old idea used to be increased activity could be used to confirm price direction; this was before increased activity simply could signal one machine was very angry with the other machines.

Finally, while the principle all men are created equal is a venerable one, large segments of the analytic community do not agree all traders' actions should be treated equally. The search for buyers and sellers at the margin or for buyers with a long-term as opposed to a high-frequency horizon often involves distinguishing between commercial and non-commercial traders, a distinction made in the CFTC's Commitment of Traders data or between retail and institutional shareholders. Wall Street is a business of trying to sell the public something and when the public buys it, they are presumed to have acted foolishly for listening to their salespeople.

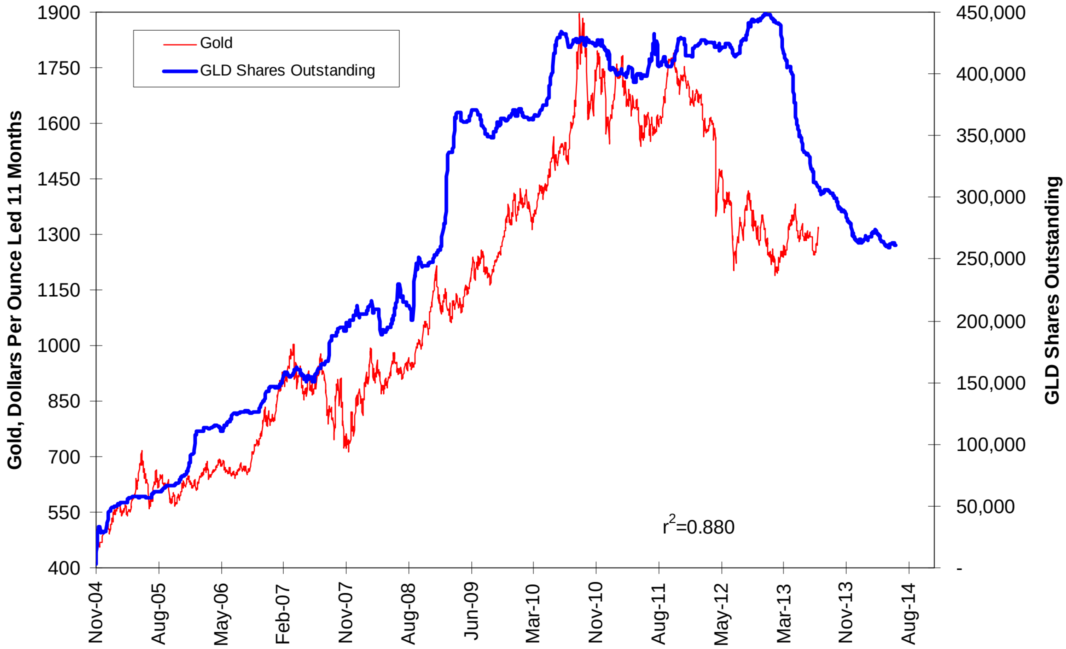
They Cannot Even Spell ETF

It should not have been surprising gold bugs and indeed those who simply rode the 2001-2011 bull market higher sought a scapegoat for the metal's shellacking in the first half of 2013. One of their first targets was a decline in the number of gold ETF shares outstanding. The implication was ETFs such as the SPDR Gold Trust (GLD) were the plaything of weak-handed retail traders who were heading en masse for the exits, presumably after all of them had bought at a higher price. Never mind the largest single holder of this ETF at the time was John Paulson, he of the "big short" against mortgage derivatives during the financial crisis.

There was just a little problem with this theory, however: It did not mesh with the data at all. GLD's shares outstanding rose 10.37 percent between gold's September 2011 top and 9.03 percent decline into December 2012. We were supposed to believe, apparently, the amount of gold held in ETFs had a huge and directly effect on prices when it was shrinking but had no effect when it was rising.

In reality, GLD's shares outstanding have a very long leading relationship to gold prices, both higher and lower. The lead-time since the ETF's inception in 2004 is on the order of eleven months and is surprisingly robust with an r^2, or percentage of variance explained, of 0.880. As hoarding demand increases and removes bullion from marketplaces where it may meet either final demand or be lent out, the gold's available forward supply shrinks and prices have to rise to ration demand in the final market. The opposite occurs when ETF shares are liquidated; gold is taken out of the vaults at HSBC's London depository and made available to the final market.

Gold And SPDR Gold Trust Shares Outstanding

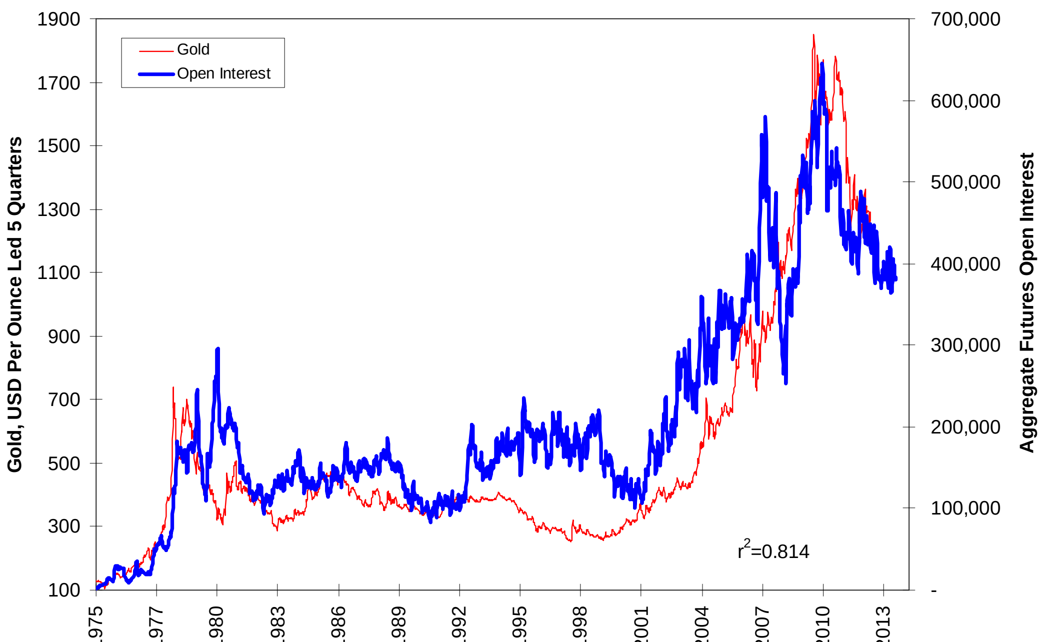


Open Interest

While ETF shares created and redeemed represent changes in actual physical holdings of gold, open interest in a futures contract is an extinguishable claim on future delivery. Not only can a futures trade be opened and closed without any transaction in the bullion represented, most of them are. The open interest in gold futures, therefore, represents something very different from ETF shares outstanding.

The lead-time of aggregate open interest in gold futures from December 1974 onwards centers on five calendar quarters, longer than the lead-time observed for ETF shares outstanding. Even without the physical sequestration of gold in a bank vault, the potential claims of gold futures traders on delivery exert a similar effect but with a smaller r^2.

Gold And Aggregate Futures Open Interest



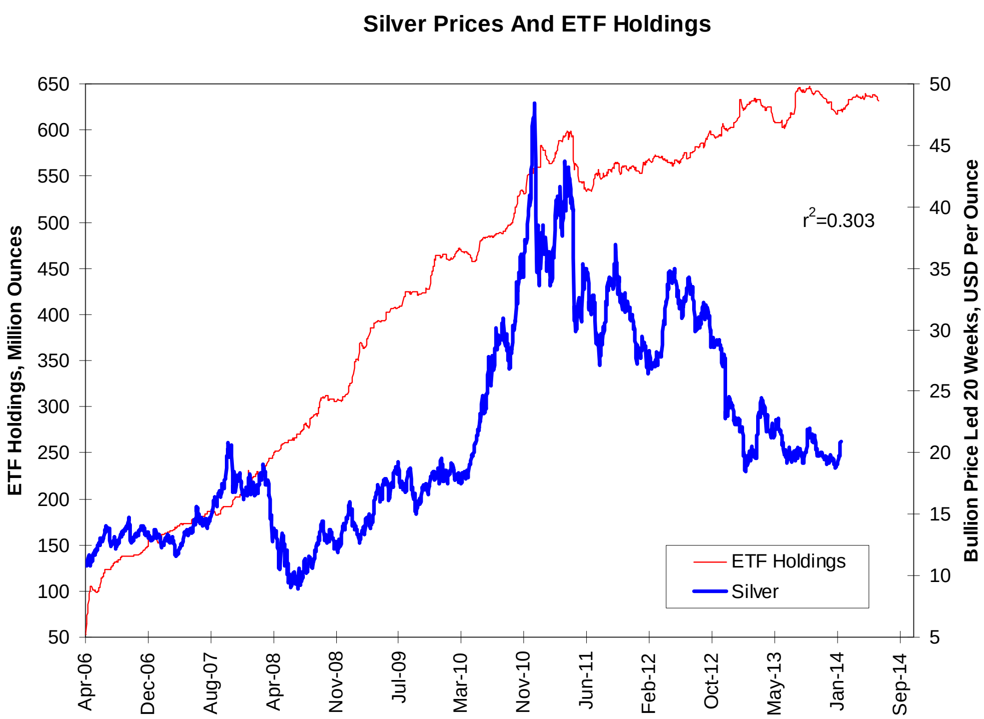
Silver Is Different

Too many traders treat gold and silver as if they were two sides of the same coin, pun intended fully; gold has a definite monetary role as part of central banks' reserve holdings while the more abundant silver is more of an industrial metal. Whether silver should have a monetary role as well has been a thread in American history going back to the Free Silver movement in the late 19th century, William Jennings Bryan's famous Cross of Gold speech in 1896 and the eventual cessation of silver certificates circulating alongside Federal Reserve Notes in 1964.

Gold's monetary role gives it a strong long-term buyer in the form of central banks. If ETF liquidators are selling gold, central banks may be stepping up and buying it at a lower price, the classic sign of a distribution of ownership from weaker hands to stronger ones. As an aside, many commentators puzzled how U.S. equity prices rose between 2009 and 2013 in the face of mutual fund outflows; here the answer was an accumulation of shares by stronger, long-term buyers willing to acquire shares at a higher price in the belief prices were headed higher still.

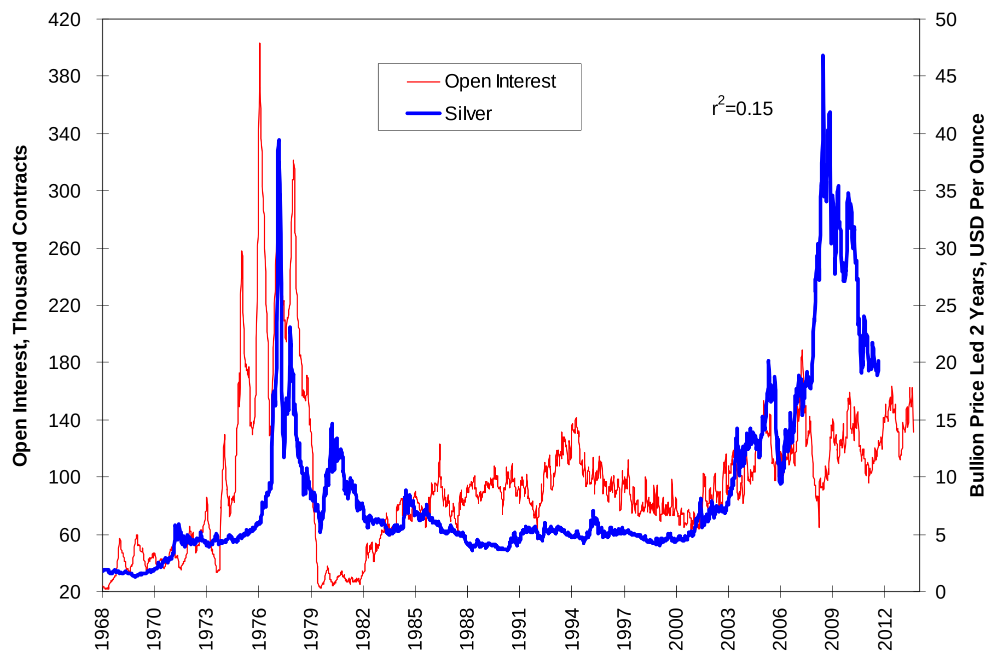
Let's map silver prices against ETF holdings and aggregate open interest as we did for gold. We should expect the relationship, if any, to be much weaker as silver lacks gold's long-term buyer at the margin, central banks. This very much appears to be the case. The lead-time for silver ETF holdings to bullion prices is a much shorter 20 weeks and the r^2 is a weak 0.303.

Please note how ETF holdings of silver have increased and remained high irrespective of price trends in silver. No one can or should argue the decline in silver prices from May 2011 onwards was driven by weak hands selling in the ETF market. In fact, non-ETF sellers such as miners and scrap dealers have been using the ETF holders as a buyer of last resort. Restated, the ETF holder is the strong buyer in silver, the one willing to accumulate metal at a lower price.



The ETF history only extends back to 2006, but silver futures have been trading in the U.S. since 1968. The lead-time here is the same five calendar quarters seen for gold but the r^2 is a completely insignificant 0.15.

Silver Prices And Aggregate Futures Open Interest



One size does not fit all when it comes to explaining prices with the holdings and flows of various classes of buyer; each market has a different structure, a different supply/demand balance and different buyers and sellers at the margin. Simply following the herd and liking what others like is, like, a poor trading and investment strategy.