Myrmikan Research Update

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The Gold Nightmare Ends

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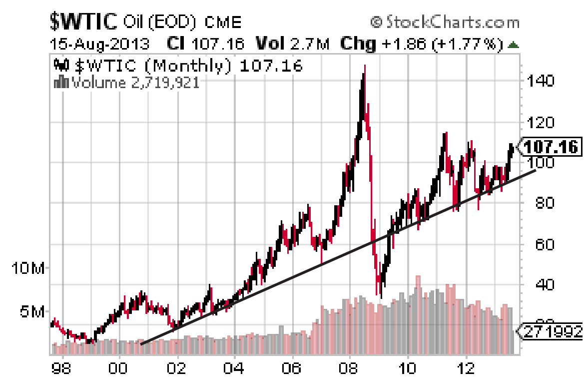
Markets often follow the path of maximum pain. Last Autumn, the fundamental reasons for gold to run higher were manifest: QE-Infinity in September, then Obama's re-election in November, then QE-Acceleration in December, then March brought the Cypriot depositor bail-in, a process that has now quietly become official policy in Europe and the United States. All of these events should have sent gold screaming higher. Yet it fell.

The gold bear case held that 1) the economy is improving, 2) the Fed would taper, allowing interest rates to go higher, 3) which would be bad for gold. Operating on massive leverage, raids on gold during the most illiquid market hours dropped the price below various support levels, forcing long liquidation and still lower prices.

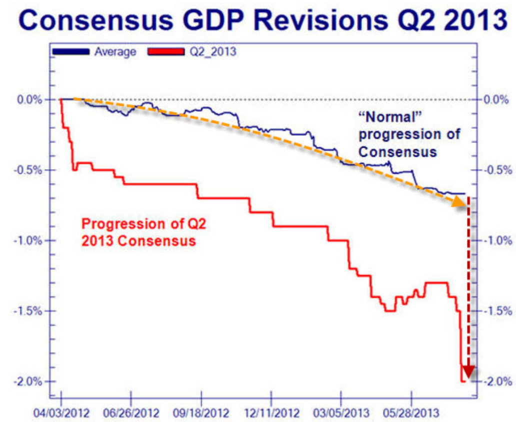
Paper commodity markets developed in the 19th century as a mechanism to add liquidity to the physical markets. Producers and consumers of a raw material may not trade with each other actively enough to create a liquid market, so speculators fill the void. Their goal is to anticipate movements in the underlying market to keep prices stable.



But, money printing by the Federal Reserve combined with massive leverage now allow the paper markets to overwhelm the physical markets. For example, oil is the most important global commodity, and business conditions alone cannot account for its volatility.

This dominance of paper over physical not only causes markets to be less efficient, it actually increases the risk to the speculator. A speculator operating in a heretofore normal environment could engage in deep study of supply and demand to improve his accuracy and quickly learns when he's wrong on the direction of prices, allowing him to escape his position. When paper traders get too powerful, financial markets become completely self-referential. Buying causes prices to rise, self-validating the trade, and the paper gains allow the trader to take additional exposure through margin, pushing the market still higher, even when divergent with the fundamentals. The eventual snap-back causes the traders large losses and increases volatility for the commercial users.

Perhaps the clearest example of a trader entering into a lobster trap of his own making is Bruno Iksil, aka "the London Whale." Operating with huge resources in an illiquid market, Bruno's bets moved the market, confirming his strategy, even though the fundamentals of the market did not support his positions. His ability to move the market earned Iksil his nickname, but also made it difficult for him to evaluate the validity of his own position. Eventually, as reality diverged further from the market price Iksil had set, other powerful paper traders began taking the opposite bet, and the snap-back cost JP Morgan over $6 billion.



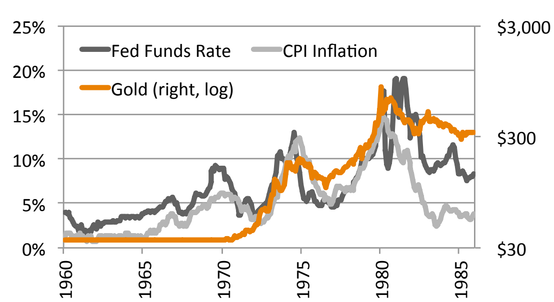
Evidence mounts that the sharp sell off in gold was merely a miscalculation by paper traders, and the snap-back could be intense, for all three of the bear arguments are wrong or specious. The data on the economy continues to disappoint and, as the chart from Zerohedge shows, analysts habitually overestimate future economic activity. Q2 2013 GDP printed at 1.7% , while Q1 GDP was revised down to 1.1%. Economic growth remains just another future promise.

Even assuming prosperity just around the corner, JP Morgan CEO Jamie Dimon in a recent interview at the Council for Foreign Relations pointed out: "We think corporate America has $1.5 trillion of too much cash. We think consumers have too much cash because they're scared. So, if you have real growth you are going to start to see inflation." Serious inflation is unlikely to be gold negative.

The bears are correct that federal deficits are smaller. Tax revenues have increased modestly, partially because of higher tax rates that hurt the economy. But, much of the deficit reduction comes from the remittances of the Federal Reserve, Fannie Mae, and Freddie Mac to the Treasury. The first hands over its interest income from all the bonds it holds – this is the government's own interest payments returning as revenue, merely an opaque form of money printing. The latter two organizations currently show large profits, their balance sheets stuffed full of marginal real estate loans supported with purchases by the Federal Reserve.

This happy situation is unlikely to persist. Higher interest rates, the second assumption of the gold bear case, threaten these revenue streams. On the July 15 earnings call of D.R. Horton, one of the largest homebuilding companies in the United States, CEO Tomnitz admitted home buyers were "shocked and disturbed" by the jump in interest rates. Very few understand Ludwig von Mises's point that low interest rates are not enough to support an economy based on credit expansion: rates must continually fall. If instead rates continue to rise, the gold bear premise of a recovering economy will prove incorrect.

The Price of Gold is correlated with Interest Rates



As real estate prices weaken, as they must in a rising-rate environment, the remittances from Fannie and Freddie will end. Rising rates will also cause the Fed's bond portfolio significant losses. As Myrmikan has tirelessly explained in various reports, losses at a central bank weaken its currency. The graph at right demonstrates this relationship in the 1970s. And, thus, the gold bears have the third prong in their argument completely backwards.

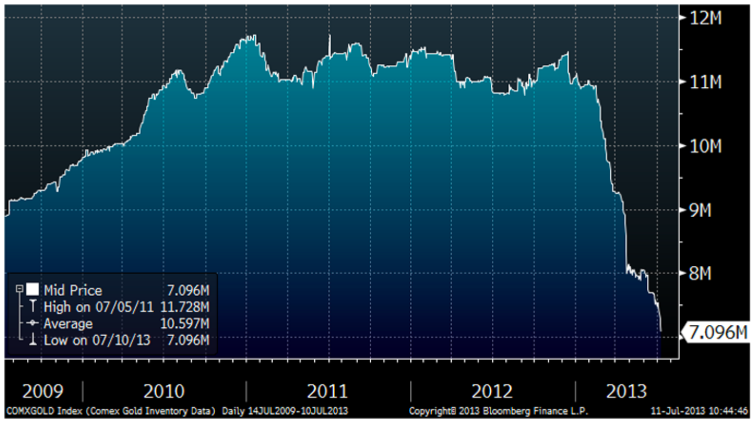
The February 14, 2011 Myrmikan update explained the relationship between gold and interest rates[1] and concluded: "the computer models running trillions of credit dollars, have it backwards. To be sure, when rates first rise, high frequency trading algorithms may well tank gold in the short term due to faulty models. But in the end economic reality always wins." The physical market in gold reveals this is precisely what is happening.

It is basic economics that a below-market price in any good will create a shortage. Since the April smash in gold, the wholesale physical premiums on gold have spiked higher in Asia as consumers scramble to exploit the artificial prices. Most analysts interpret the drawdown in the GLD inventory as a bearish development, but they fail to understand that authorized participants are permitted to redeem GLD shares, take possession of the physical gold, then sell it in Asia to capture the physical premium. It's a wonder any GLD gold remains.

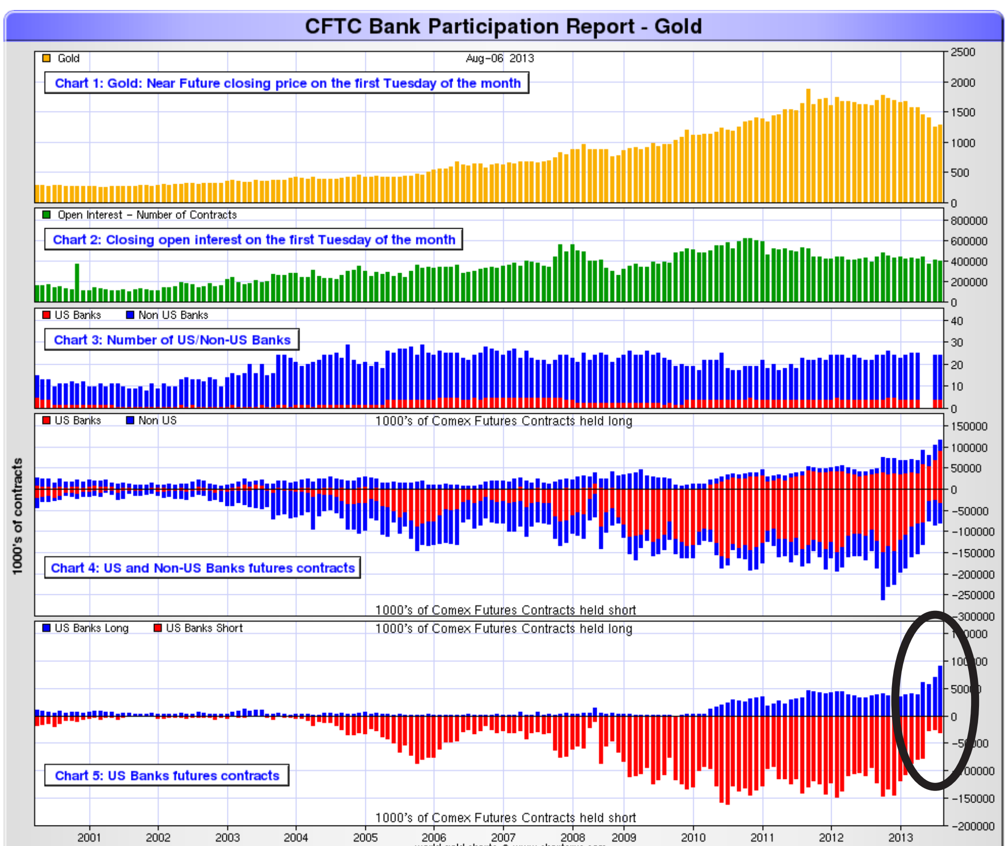
1 For a comprehensive discussion of gold and interest rates, please see Liquidity at http://www.myrmikan.com/pub/Myrmikan_Research_Report_Liquidity.pdf

There is an even easier way for banks to capture the physical premiums besides raiding the GLD. Bullion banks generally warehouse large amounts of physical gold on behalf of customer and house accounts. But, the banks merely "owe" the gold to their customers in the same way that they owe dollars to depositors: neither gold nor dollars need actually be kept on hand, save for the few eccentric clients who demand delivery. If the market is offering a huge premium on physical gold because the paper price is too low, the rational bank will sell any and all physical gold on hand and cover themselves by going long in the futures markets.

This is exactly what has happened. The graph below shows the COMEX gold inventory. Many radical gold bugs interpret this graph as proof of imminent default.



They fail to reconcile the chart above with the chart below. The bottom two rows show that as of August 6 the banks were net long COMEX gold. This should never happen.



The reason banks should never be net long in the futures markets is that those markets exist for participants in the physical markets to hedge their exposure. Banks both warehouse gold and finance gold mines, and so always have positive exposure to the physical metal, requiring offsetting shorts in the futures markets.

The fact that the U.S. banks are now net long suggests that they have shipped client gold to Asia and hedged themselves with long positions on the COMEX, capturing the spread between the paper gold and physical gold. This is no conspiracy: there is no difference between physical and paper gold from a balance sheet and regulatory perspective.

If and when the gold price recovers back to market and the physical premium disappears, then the banks will reverse the trade and replenish their inventory. If instead there is a run on the COMEX for physical, the bullion banks can simply declare a *force majeure* and settle the claims to gold with cash. The non-eccentric clients won't be happy, but banks' balance sheets won't be threatened. The bullion banks will not be caught in a short squeeze.

Nevertheless, the structure of the futures markets suggests a short squeeze is indeed underway. Futures are bets on the price of a commodity and are by definition zero sum games: every long must be offset by a short. Since the banks and physical players are always structurally short gold on the COMEX, it is left to speculators to be structurally long.

Physical operators who are short gold can close their positions either by buying an offsetting long or by delivering physical metal. Speculators who are short have only one course of action: they must buy back long positions from other market participants. Normally when the gold price rises, those holding physical at the bank, or the bank itself, sell short in the futures markets to lock in their profits, giving short-covering speculators someone to buy from. But, all the gold that was in the GLD hoard and the COMEX vaults now adorns the arms of peasants in various Asian countries, whence it will not return. This implies it will be difficult for banks to supply the long contracts that speculators need to cover.

Beyond speculating about changes in warehouse inventories, there is a market signal that reveals the level of physical stress more precisely than examining wholesale physical premiums. Futures markets trade for delivery in future months, and each monthly contract has a different price. For example, the screen below shows a snapshot of the price of gold for various delivery dates: gold for August delivery costs $1377, but gold for delivery in December is 70 cents cheaper, at only $1376.30.

Contract	Last	Change	Chg %	Volume	Bid Size	Bid	Ask	Ask Size
GC Aug'13 @NYMEX	1377.50	+15.90	1.17%	172	3	1376.60	1377.00	3
GC Sep'13 @NYMEX	1376.80	+15.70	1.15%	713	11	1375.90	1376.30	3
GC Oct'13 @NYMEX	1376.20	+15.10	1.11%	5.68K	11	1376.00	1376.30	3
GC Dec'13 @NYMEX	1376.20	+15.30	1.12%	157K	11	1376.10	1376.30	3
GC Feb'14 @NYMEX	1377.00	+15.20	1.12%	2.1K	11	1376.90	1377.30	3
GC Apr'14 @NYMEX	1378.30	+15.40	1.13%	323	11	1378.00	1378.30	3
GC Dec'15 @NYMEX	1384.60	+2.80	0.20%	1	2	1397.00	1397.80	2
GC Dec'16 @NYMEX	C1407.90				5	1420.70	1427.10	3
GC Dec'17 @NYMEX	C1448.10				1	1463.20	1477.90	3

This future discount on price is called backwardation and, even though very small, it should never happen in gold, just as the banks should never be long gold in the futures markets. Backwardation frequently occurs in other commodities. For example, wheat is harvested in the summer, making it plentiful, and is scarce in the winter. So, in the winter, future prices are lower than spot as traders anticipate the next harvest.

Gold is different. There is no flow of seasonal supply against fluctuating demand. Gold exists as money to be hoarded. When the future price is less than the spot price, anyone holding gold can sell it at spot, immediately enter a contract for future delivery for less, capturing the spread. Even better, the gold hoarder off-loads the storage costs for the period until contract delivery, and has use of the money until the repurchase date. In other words, when gold is in backwardation, the market is offering gold hoarders free money to part with their gold temporarily.

Efficient markets should not offer an opportunity to make free money, leaving only two possible explanations for a backwardated gold market. First, if gold hoarders fear a collapse of the exchange – i.e., they fear default before their gold is returned leaving them stuck with the dollars – they will forgo the chance to make free money.

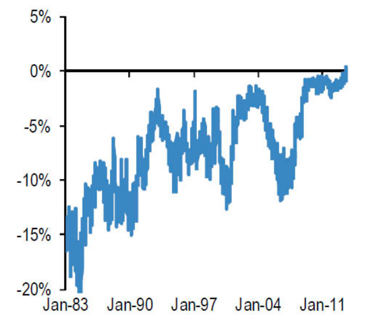
Presumably, the more distant the re-delivery date, the greater the risk of default. Therefore, default risk should manifest itself by all futures contracts being successively more backwardated. Currently, gold is backwardated only through December 2013 – the 2017 contract trades for far higher – suggesting the state of the market is not being driven by default risk.

The other explanation is scarcity of metal. If there is a shortage of unencumbered gold, then there is no supply to relieve the backwardation. The more backwardated the gold market, in terms of price and time frame, the greater the underlying stress in the physical market.

In fact, as gold has risen from its June 28 intra-day low of $1183, backwardation has increased. This suggests that physical buyers were willing to delay purchases as long as the price was in free-fall, but are scrambling to lock in purchases before the prices fully rebound. The only other times gold has been backwardated to the current extent were at gold bottoms in 1999 and 2008, and then only for brief periods. As the chart at right shows, this is the first time gold has ever been backwardated in U.S. dollars over a four week time frame.

GOLD BACKWARDATED FOR A MONTH

Annualized % difference between the 1st and 2nd COMEX gold futures contracts. 4-week average.



Source: J.P. Morgan, Bloomberg

Meanwhile, the gold shares have responded vigorously to the short squeeze in gold. Gold shares, properly considered, are long-term call options on gold. The two main factors that influence the value of an option is its duration and the proximity of the underlying market price to the strike price. As gold passed through $1350 on the downside, not only did the market blow through the strike prices – i.e., the full costs of production – of most miners, but liquidity concerns meant the duration of the option shrank from years to months, cratering valuations. With gold now moving higher, these dynamics are reversing.

Like the London Whale, the speculative shorts are now caught in a trap of their own making. As the paper gold price rises to converge back to the market price, they will begin to get margin calls. As long as physical premiums are high and gold is backwardated, banks will be unable to replenish their vaults and thus will not be able to supply exiting gold shorts with counterparty trades. The shorts will be forced to buy contracts from long speculators, who are long precisely because they see the stresses in the physical market. As long as the physical bullish signals persist, speculative longs as a class are unlikely to exit their positions to relieve the shorts. The path of maximum pain for gold is now up.