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ADM Investor Services International Limited.

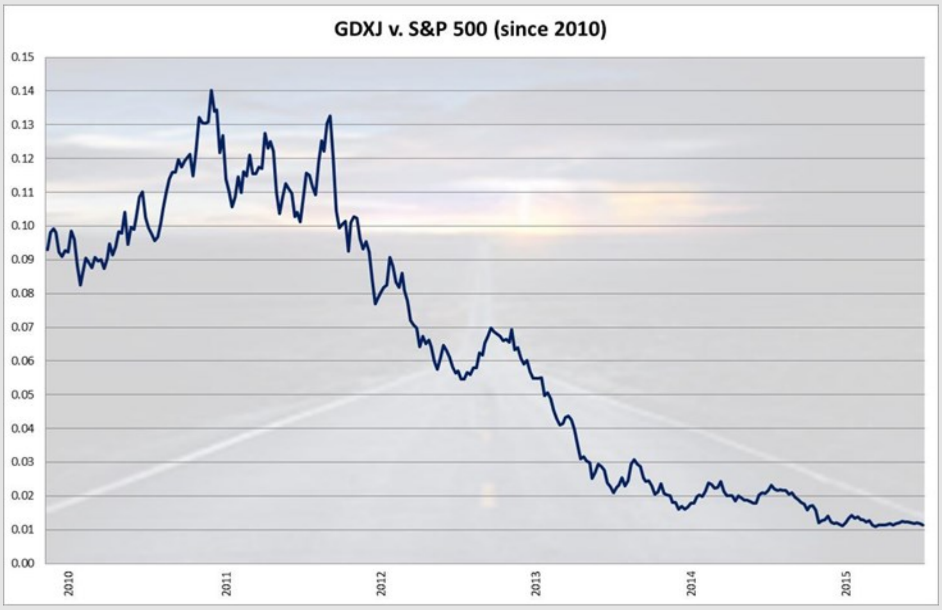
Gold and the Silver stand-off: Demarketing and Deep Value

The demarketing (* see below) of gold may be close to running its course as it seems that sellers of paper gold instruments are attempting to induce one more sell-off to fully cover their diminishing short positions. Indeed, signs are emerging that the long Nikkei/short gold trade, which has done so much damage to gold's price, is becoming problematic.

This could be due to one or more of: less desire to run large paper short positions by some banks/funds; rising cost of repo funding; larger bids emerging for physical bullion below $1,200/oz; and/or a view that the BoJ is reluctant to engage in ever greater stimulus. The gold basis and four major identifiable sources of gold demand (Shanghai Gold Exchange withdrawals, Indian imports, net ETF changes and net central bank changes) are indicating strong physical demand right now.

Anomalies in the silver market, such as large positive divergences in open interest and ETF holdings versus gold, suggest that entities which have been shorting gold may have been hedging (at least partly) in silver. What appears to be a stand-off in this much smaller market means that enormous volatility in the silver price is probably inevitable, especially with physical supply drying up.

It could be argued that a deep value case for gold, silver and related equities is becoming more and more apparent. For example gold, the HUI (NYSE Gold Bugs Index) and the GDXJ (Junior Gold Miners ETF) have underperformed the S&P 500 by 66%, 87% and 91%, respectively, since their peaks.



Source: ADMISI, Bloomberg

* *In the 1971 Harvard Business Review, Kotler and Levy defined demarketing as* ***"discouraging customers in general or a certain class of customers in particular on either a temporary or a permanent basis."*** *This is normally done when there is a shortage of supply or desire to promote other products.*

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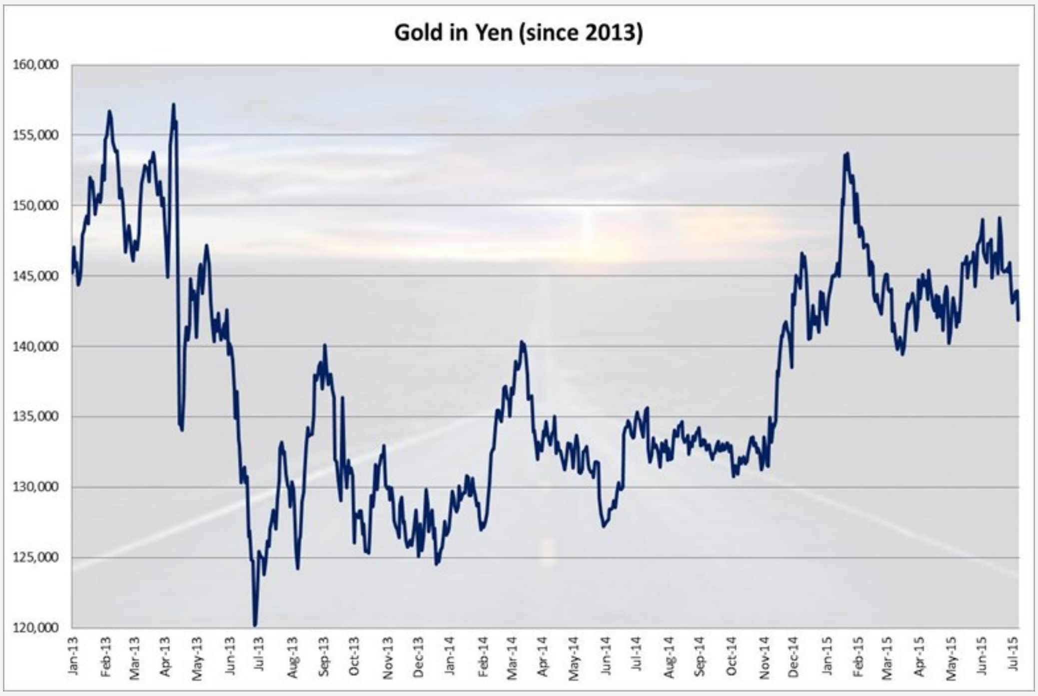
The gold price is still performing poorly in US dollars.

Source: ADMISI, Bloomberg

That said, it is close to being in a bull market in Yen, now 18.2% above its 2013 low…



Source: ADMISI, Bloomberg

…which says something about gold's value (even in today's seriously flawed gold market) in the face of a currency which has been deliberately and cynically debased by the BoJ (QQE running at 17% p.a. of GDP).

Price discovery in the gold and silver markets remains misunderstood by an overwhelming majority of financial market participants. It was been hijacked by two factors.

- The extreme domination of “paper gold” trading vis-à-vis a comparatively tiny amount of physical bullion; and

- Gold has been on the “wrong” side of a long/short trade since about September 2012.

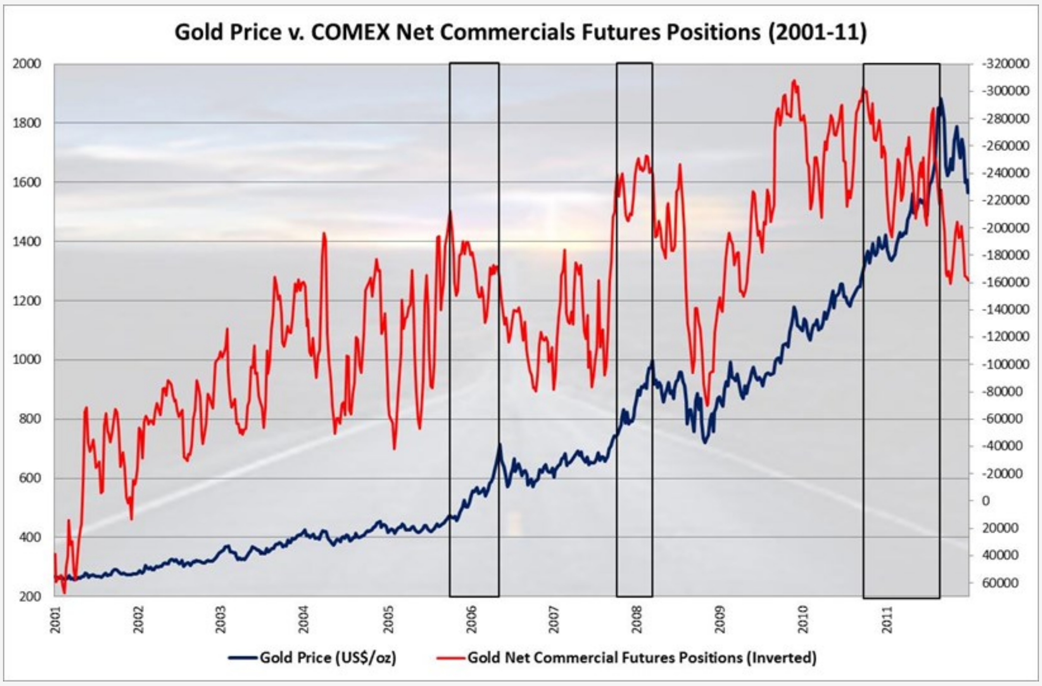
In a January 2013 report “Report of the Working Group to Study the Issues Related to Gold Imports and Gold Loans by NBFCs”, the Reserve Bank of India estimated that the ratio **of paper gold trading to physical gold trading is 92:1**. That is a lot of unbacked paper gold instruments.

This has **almost entirely separated the “gold price”, such as it is (the clearing price for vast volumes of paper gold “representations” with a fractional backing) from the fundamental supply and demand dynamics for actual physical gold bullion**.

As Mr L. famously quipped.

“Ever get the feeling you’ve been cheated?”

Using the net short position of the Commercials (mainly banks) on the COMEX as a proxy for paper gold supply, the chart below shows how on the three occasions during 2006-11 that more paper gold was NOT supplied into a rising gold market, the gold price went parabolic.



Source: ADMISI, Bloomberg

In terms of the long/short trade, we outlined a thesis in late-2014 which drew together a complex web of interactions between the gold price, Japan’s Nikkei index, repo financing, BoJ policy meetings and anomalies in the silver market.

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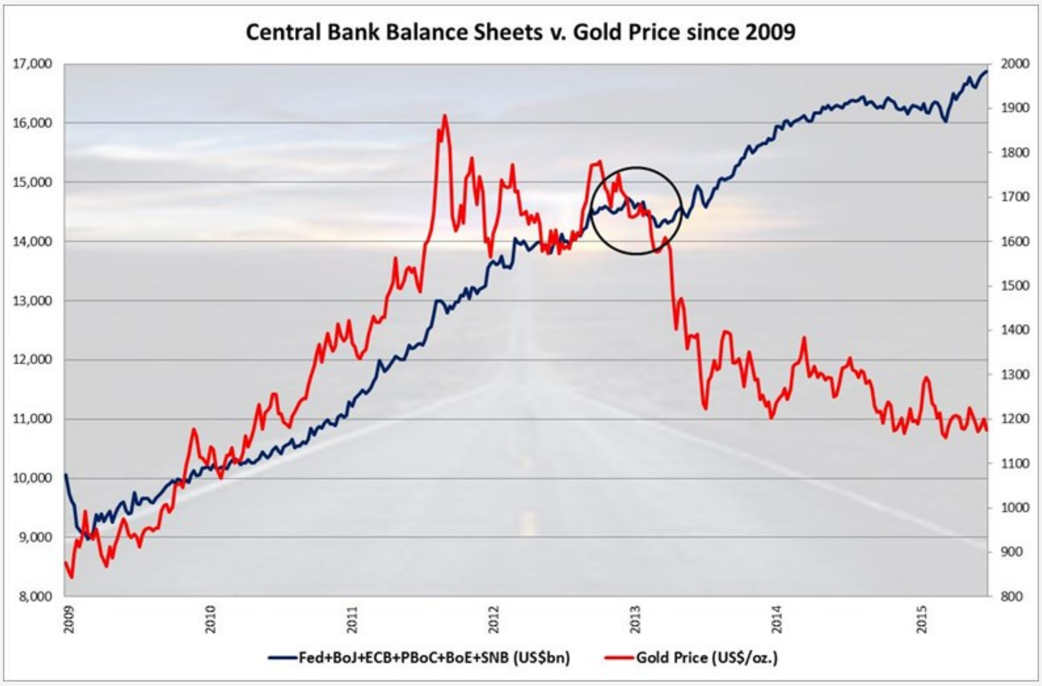
In brief, our thesis was as follows.

The interactions began forming in late-2012, specifically around September, which was a pivotal period in recent financial history, when central banks (notably the Fed and BoJ) embarked on a new phase of aggressive credit creation.



Source: ADMISI, Bloomberg

We believe that at the centre of these interactions is a large, leveraged long/short trade which we think is long the Nikkei index and short paper gold. The more the Nikkei rose, the more the gold price was pushed down and, in many cases, major price moves in both were closely tied to BoJ policy meetings, especially announcements of (even) more aggressive monetary policy under "Abenomics".

We began to suspect that gold might be the short in a long/short trade when we noticed a reasonably close correlation between gold and interest rates in the repo market. In particular, the gold price tended to decline with the cost of repo funding. The repo market is a major part of the "shadow banking" sector and is the nexus for investment strategies involving leverage and short selling.

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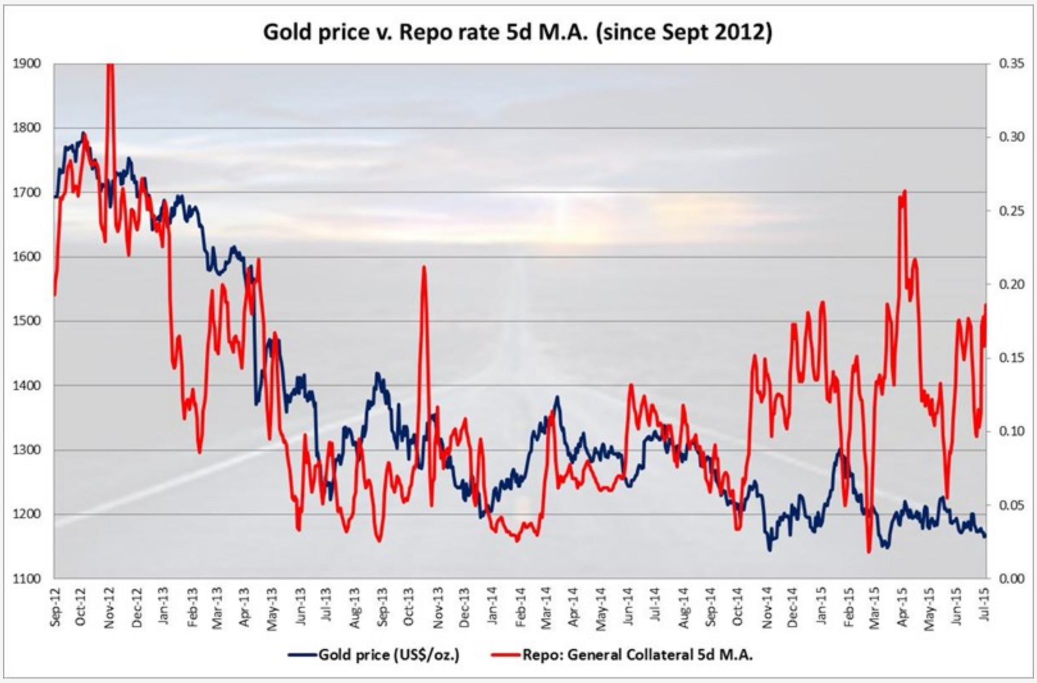
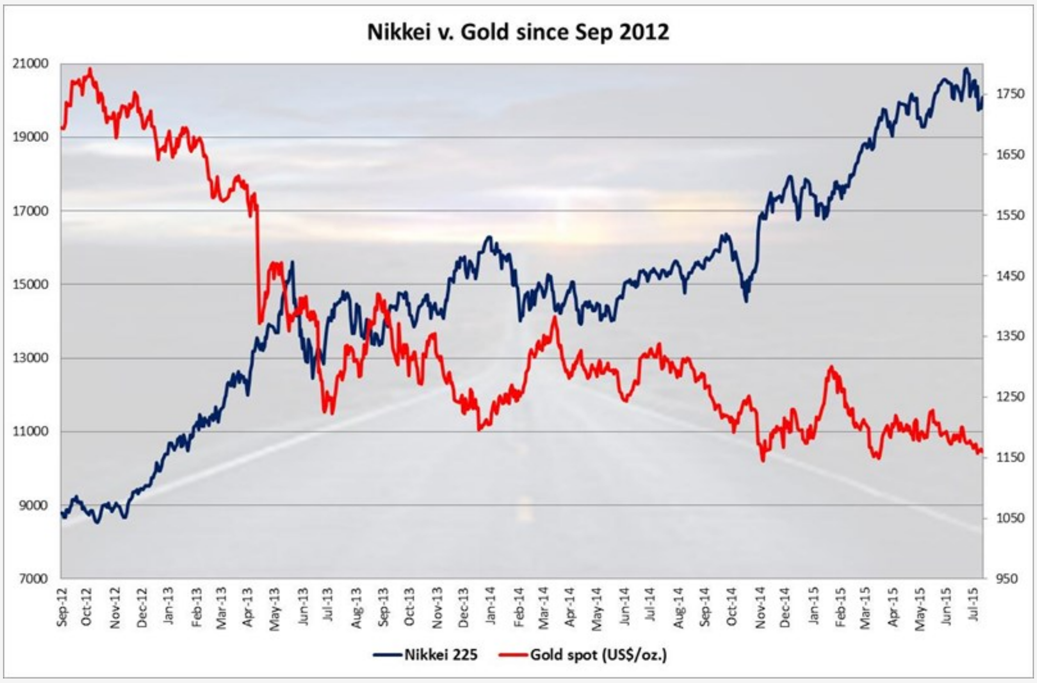
Controlling the short gold/long Nikkei trade may have become more problematic in recent months. For example, repo rates have been on the rise since late-2014. As funding costs increased, the downward pressure on gold has eased somewhat— they may be related.



Source: ADMISI, Bloomberg

Suspecting that gold was the short in a long/short trade is one thing, finding the corresponding long was another. When we first looked at the charts of gold and the Nikkei, there was nothing to see…



Source: ADMISI, Bloomberg

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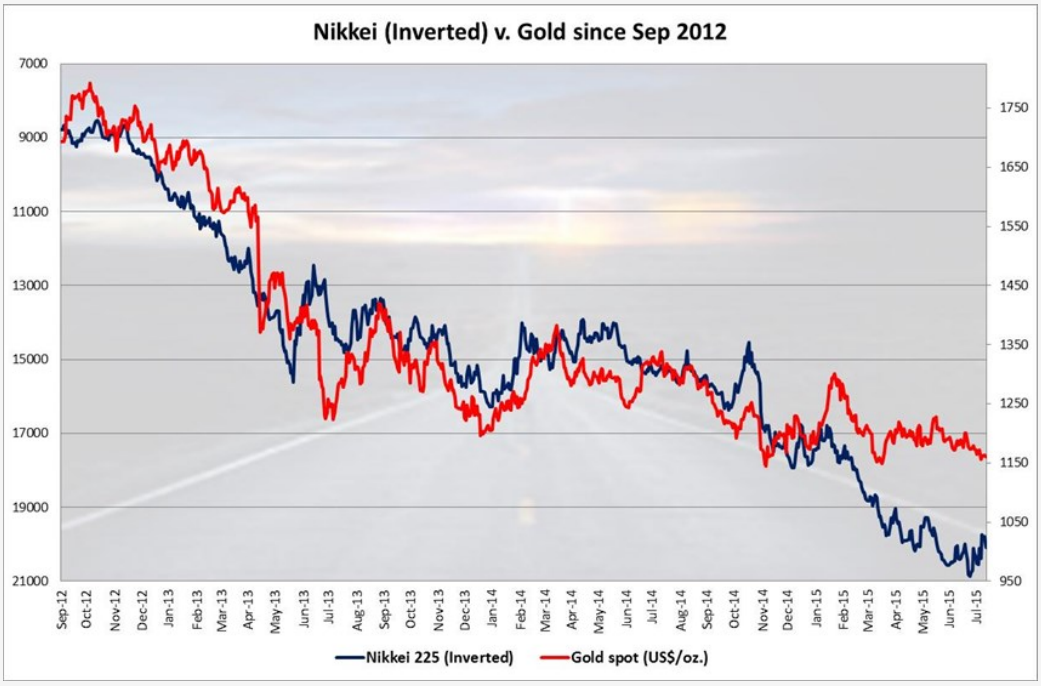
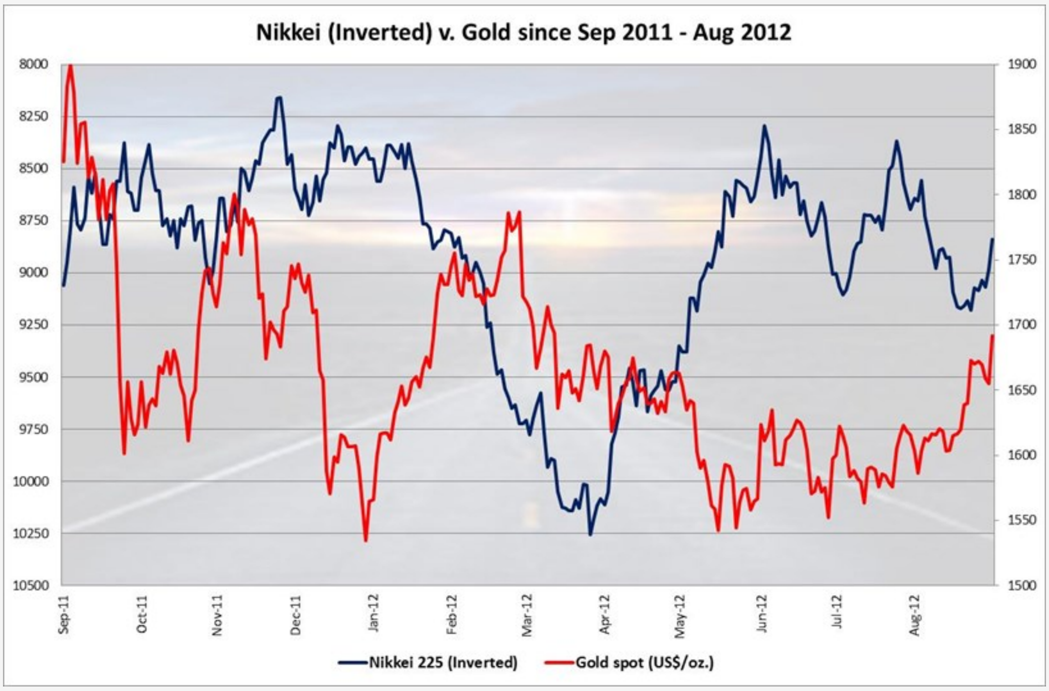
…until we inverted the Nikkei axis. Now can you see it?



Source: ADMISI, Bloomberg

Then the almost perfect correlation between the two was visible from September 2012 until the beginning of 2015.

And one that wasn't there beforehand…either in the previous year (see chart below) or earlier.



Source: ADMISI, Bloomberg

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As we've said before, the long/short could be Yen/gold, rather than Nikkei/gold, although the correlation is not quite as good.

Source: ADMISI, Bloomberg

Since late-2014, the gold price has traded sideways while the Nikkei continued to rise. We can only speculate on why this is, but four possible explanations come to mind.

- The rising cost of repo funding; and/or
- Solid bids emerging for physical bullion, around US$1,200/oz and below; and/or
- A decreasing desire to maintain large short positions by some of the Commercials (banks); and/or
- A view that the BoJ is reluctant to implement even more monetary stimulus with QQE already running at an annualised rate of 17% of GDP - although we wouldn't rule it out given the lunacy demonstrated so far.

Before the renewed gold sell-off in recent days, gold volatility had fallen to a level which was close to a 10-year low.

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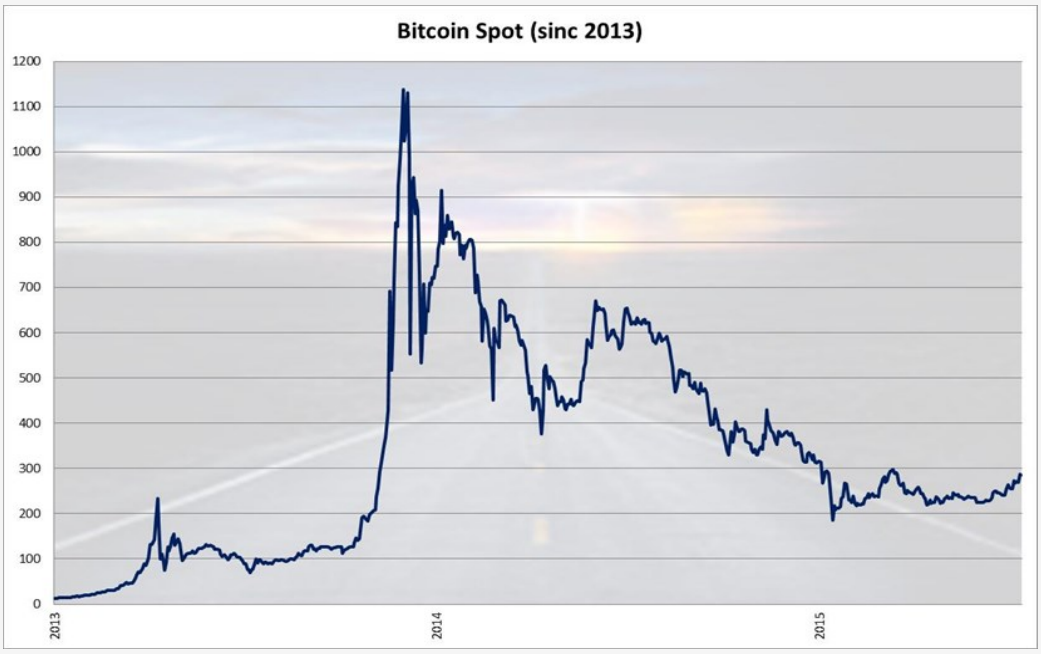
Source: ADMISI, Bloomberg

Gold was/still is due for a significant price move, one way or another. In a free market, this would most likely be up since the Greek crisis led to reports of a strong pick-up in demand from bullion dealers. For example, Torgny Persson, CEO of BullionStar, noted.

“Precious metals demand in the last week leading up to the Greek referendum has been about 150 % higher than normal both in terms of order quantity and order volume…Based on my conversations with the western world’s leading refineries and precious metals wholesalers, they have experienced similar increases in the last week.”

In contrast, Bitcoin, a perceived “gold substitute”, safe haven (maybe) with finite supply (although lacking any kind of “tangible” value and track record down the millennia, has performed much better.



Source: ADMISI, Bloomberg

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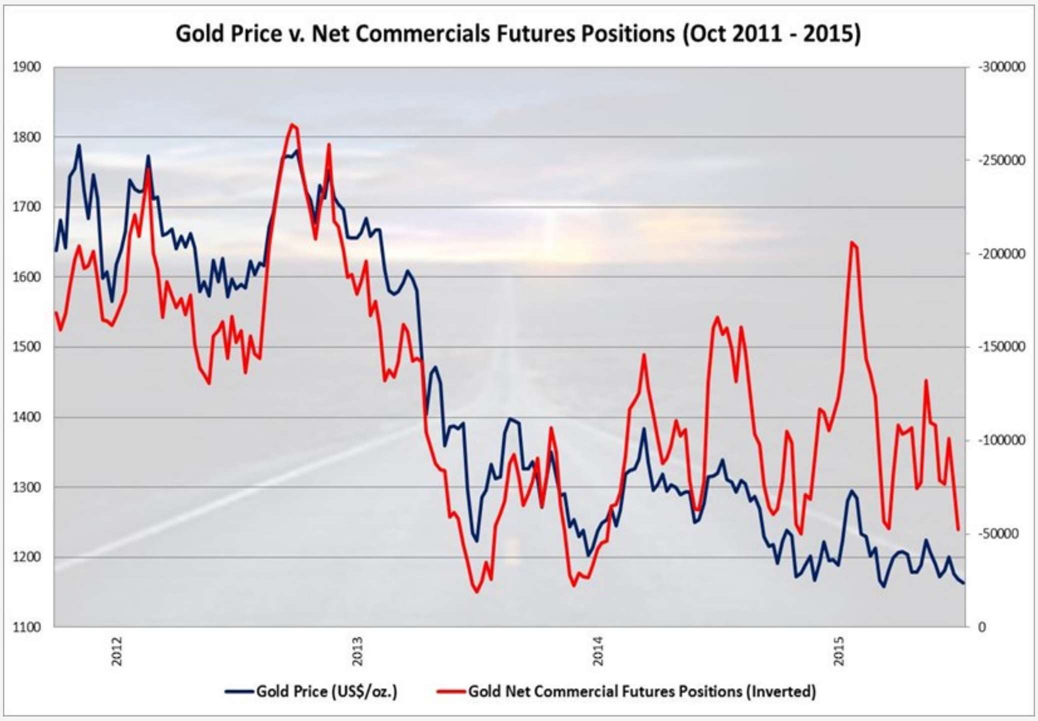
However, a surging gold price is the last thing that anybody who's concerned with maintaining the veneer of financial stability wants to see.

We suspect that the Commercials are hoping that a renewed bout of weakness will attract additional shorting by the Non-Commercials. This would allow further reduction in the Commercials' own net short position - which has been kept on a tighter leash since 2013 (and was facilitated by the price smash in April that year).



Source: ADMISI, Bloomberg

Our guess is that this is the final shakeout in gold's sell-off which has been in progress ever since the gold price peaked on 6 September 2011 - when the Swiss franc, i.e. one of the few safe havens, was pegged to the Euro (and common sense suggests should have been gold positive).

Kotler and Levy, in "Demarketing, Yes, Demarketing" published in the Harvard Business Review in 1971, defined demarketing as.

"discouraging customers in general or a certain class of customers in particular on either a temporary or a permanent basis."

The academic literature argues that this is normally done when (our emphasis).

- There is a **shortage of supply**; and/or
- There is a **desire to promote other products**; and/or
- A product is unprofitable in a particular region.

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A demarketing campaign is usually undertaken via increasing prices, restricting availability or cutting back on advertising.

But…how is this relevant to the gold and silver markets?

What if gold and silver naturally (in free markets) act as Giffen Goods in the latter stages of a global debt bubble? To recap, a Giffen Good is one that violates the normal laws of supply and demand with people buying more of the good as its price increases.

Intuitively, this makes sense. Rising gold and silver prices should naturally reflect increasing risk to the financial system— especially counterparty risk since gold and silver bullion are the only financial assets which have none (i.e. they are not somebody else's liability).

Following this argument, if gold has Giffen Good characteristics, the best way to reduce demand from western investors (eastern investors have a natural affinity for gold) would be to reduce the gold price. **The point being that any sustained demand for physical bullion from the enormous pools of capital in the western world would hasten the inevitable onset of supply shortage**.

It's reminiscent of what happened in the prelude to the end of gold's bear market in the 1990s. This was from a famous (in gold market circles), but anonymous, source on western tactics at the time.

"(They) needed to keep the price of gold down so it could flow where they needed it to flow. The key to free up gold was simple. The western public will not hold an asset that is going nowhere."

This discussion about demarketing in conditions of limited supply raise another point which seems to have gone unnoticed.

It's become alarmingly clear in recent months how liquidity on the downside is drying up in many markets, with Chinese equities being the most grotesque of many examples. In physical gold and silver, we believe the polar opposite is the case, i.e. there is very little liquidity to the upside.

It is impossible to model supply and demand for gold due to the extreme stock-to-flow ratio which renders it entirely different from any commodity (although gold is money not a commodity).That doesn't stop most gold analysts, however. Nevertheless, there are ways to gauge the strength of the physical gold demand.

Firstly, by comparing the spot price with the near-month future, i.e. what's known as the gold basis. Given its stock-to-flow ratio, the gold price should always trade in contango, i.e. with the near-month future at a premium to spot (positive basis). If gold is in backwardation (negative basis), there is a "free profit" for speculators from selling spot gold and buying the near-month future and taking delivery (SINCE SUPPLY SHOULD NEVER BE A CONSTRAINT).

Backwardation in gold should be arbitraged away unless speculators are nervous about the availability of physical supply (IF OFFERS OF PHYSICAL GOLD ARE WITHHELD AT A PREVAILING PRICE WHICH IS DEEMED TOO LOW BY MARKET PARTICIPANTS). The chart below shows that gold has spent much of the time in backwardation since 2013.

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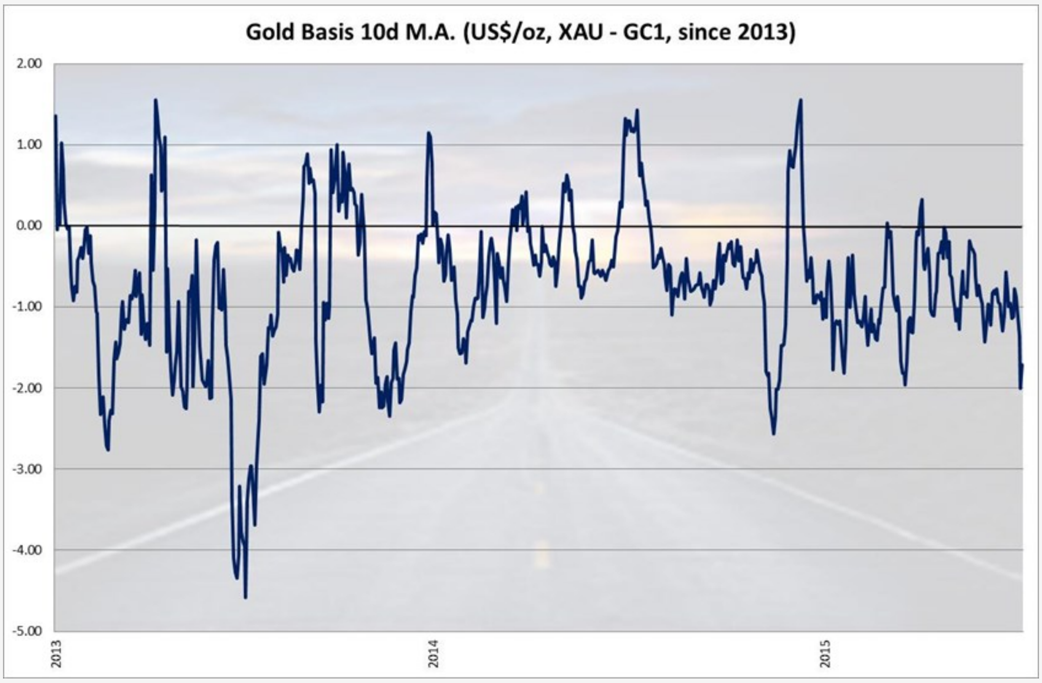

Source: ADMISI, Bloomberg

This was Professor Antal Fekete of Fekete Research writing in 2006.

"We may grant that gold futures trading has materially added to the longevity of the regime of irredeemable currency. But while the central bankers are buying time, sand in the hour-glass of the gold basis keeps trickling down. When it runs out, the trickle of cash gold from warehouses will have become an avalanche that could no longer be stopped."

The run on gold has not reached avalanche scale yet, but it's picking up. While physical gold demand can't be measured in aggregate, we track four major identifiable indicators of physical gold demand to get a sense of demand conditions.

These are.

- **Gold withdrawals on the Shanghai Gold Exchange;**
- **Gross gold imports into India;**
- **Net change in gold holdings of all-known ETFs; and**
- **Net change in central bank gold holdings.**

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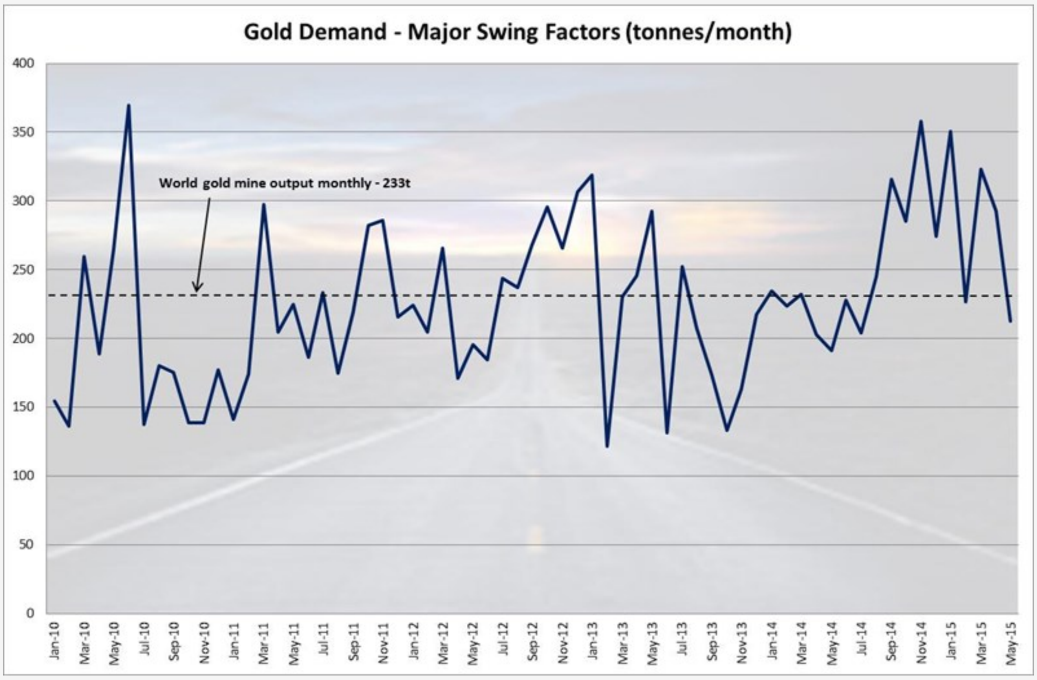
The chart below shows that in aggregate these four sources of gold demand alone have exceeded the output of every gold mine in the world on a monthly basis during most of the last year.



Source: ADMISI, SGE, WGC, Bloomberg

Suddenly, the negative gold basis starts to make sense. It's also important to remember that the PBoC has not disclosed its purchases since 2009 (an update is due this year) and does not acquire gold on the SGE. So PBoC purchases would be additional.

We should take a moment to explain the significance of withdrawals on the Shanghai Gold Exchange. Under Chinese law, all gold either mined domestically or imported has to be sold through the SGE, which allows the Chinese authorities to monitor non-government gold reserves. Once bars are withdrawn from the SGE, they are not allowed to be re-deposited (Article 23 of the SGE rule book). Withdrawn SGE bars which are re-sold have to be recast and assayed as new bars. This gold is counted as scrap supply.

Consequently, SGE withdrawals are a close proxy for incremental Chinese demand. The aggregate of SGE withdrawals was 2,197 tonnes in 2013 and 2,100 tonnes in 2014, which is **equivalent to more than 70% of the world's newly mined gold.** We just want to emphasise that this is Chinese demand EXCLUDING the PBoC.

When China's purchases of copper and other metals were ramping up 50-60% of world supply in the "go-go" years of 2003-07, the investment world was transfixed by the potential of commodity investing in all its forms. This author was a Mining sector analyst at the time. Fast forward today and gold advocates like us are as rare as hen's teeth in today's financial markets.

Chinese demand of c.2,000 tonnes was higher than the World Gold Council figure, but was confirmed by official Chinese sources. The China Gold Network reported a speech by the Chairman of the Shanghai Gold Exchange (SGE), Xu Luode, on 15 May 2014 in which he stated.

"Xu pointed out that the current gold market, especially the physical gold market, is actually in the East, main-ly in China. Last year China's own gold-enterprises produced 428 tons; at the same time China imported 1,540 tons of gold, adding up to nearly 2,000 tons."

BullionStar's Torgny Persson attended the LBMA forum in Singapore in July 2014. He reported on comments made by Xu Luode in another speech which Koos Jansen published on the "In Gold We Trust" web-site.

"In the speech Mr Xu mentioned and I quote from the official translation in the headphones 'as the Chinese consumption demand of gold hit 2,000 tonnes in 2013."

So, in summary, physical gold demand remains strong while the screen price of gold is being shorted into the ground…which brings us to anomalies in the silver market.

We don't mean price anomalies…yet.

Source: ADMISI, Bloomberg

Instead…

Look at how open interest in silver diverged from gold from late-2012 onwards – which is when we believe the short gold/long Nikkei trade was put on. Silver open interest is at an all-time high and note that the scales of the axes on the chart below are (almost) identical.

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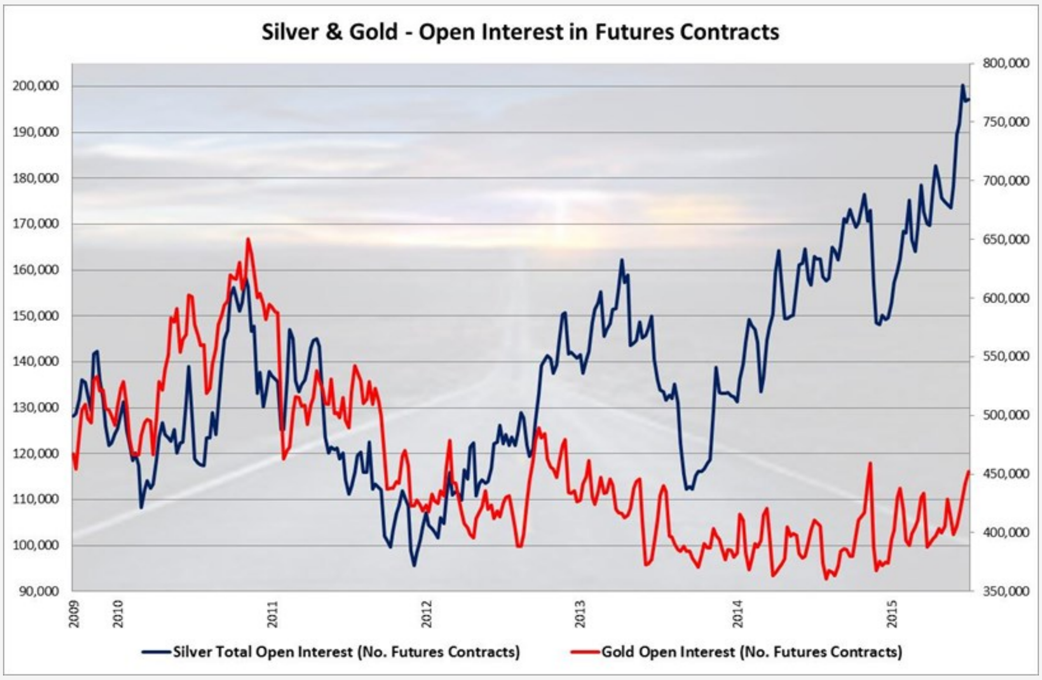
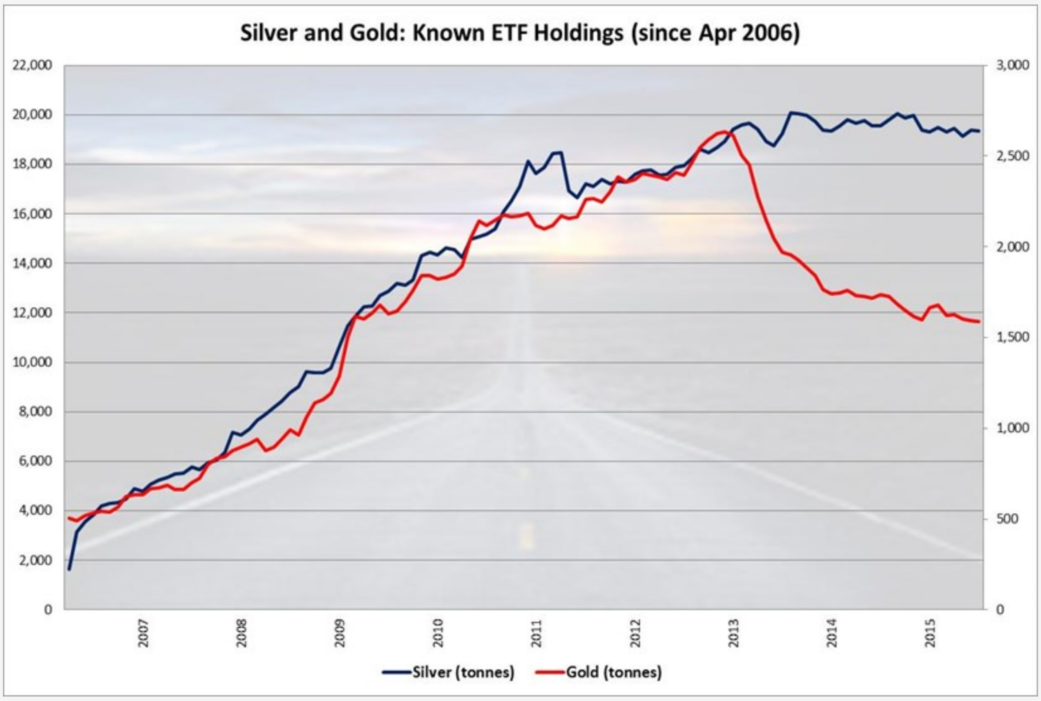


Source: ADMISI, Bloomberg

The open interest of about 200,000 contracts is equivalent to 1.0 BILLION ounces of silver, which is approximately 114% of all silver mined worldwide in 2014. In contrast, the open interest in gold is equivalent to approximately 49% of all gold mined last year.

Since almost all the gold ever mined remains as inventory (potential supply) while the majority of silver is consumed in industrial fabrication, there appears to be **huge instability coming in the silver market**.

The second anomaly in the silver market relates to ETF holdings of silver versus gold. Gold peaked at the end of 2012 (!) while silver holdings have remained at high levels despite the sharp fall in the silver price, even more than gold in percentage terms.



Source: ADMISI, Bloomberg

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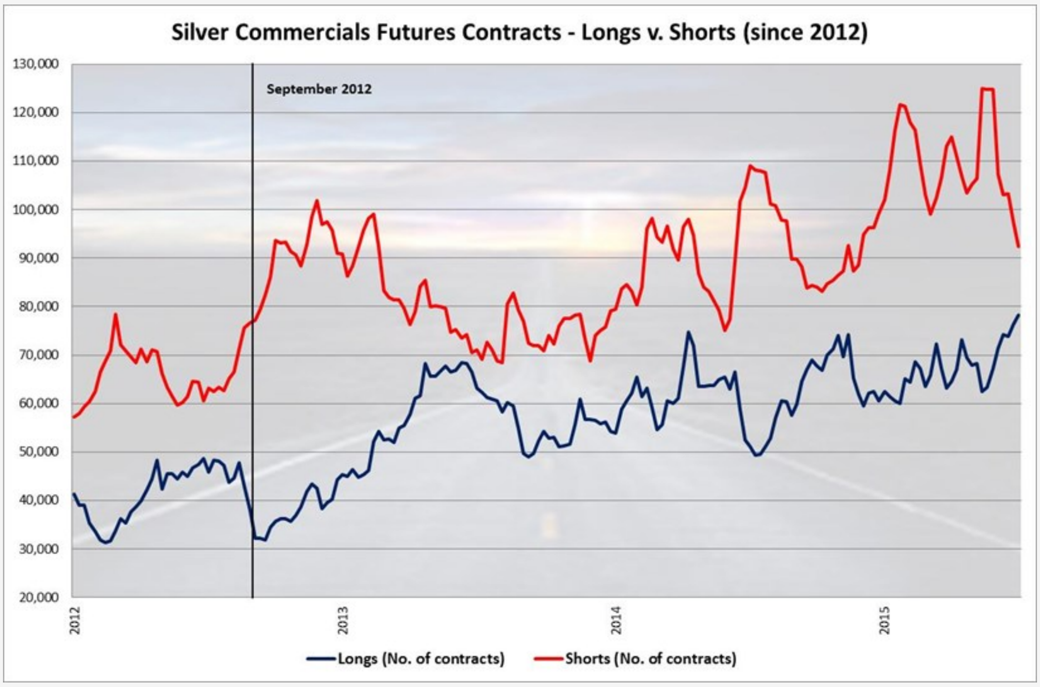
It's not easy to reconcile these anomalies, but **one explanation is that some entity/entities is/are building a long position in silver**.

If so, why? What if the "somebody" who is shorting the gold market is hedging themselves in silver, knowing that when these metals turn, the silver price moves like gold on steroids.

Let's speculate for a moment. If the silver market had to be "controlled" for as long as possible…a long hedge built up in silver would need an equally large and offsetting increase in short positions by another "controlling" entity. This might explain the "blow out" in silver open interest.

Let's look at the long and short positions of the Commercials since QE3 in September 2012. Until (very) recently, they had both increased by about 40,000 contracts, i.e. 200 million oz. or nearly a quarter of the world's annual silver supply.



Source: ADMISI, Bloomberg

It looked like a stand-off was developing. Now it looks like the shorts are using the price weakness to cover their positions.

A third anomaly in the silver market was highlighted by Zero Hedge in its analysis of the latest report on the US derivatives report from the Office of the Comptroller of Currency. In the precious metals segment, gold derivatives were excluded and placed in the foreign exchange category instead (without explanation). The remaining precious metals derivatives are primarily silver. At the end of the first quarter of 2015, Citigroup's precious metals derivatives exposure rose from US$3.9bn to US$53bn, a nearly fourteen fold increase.

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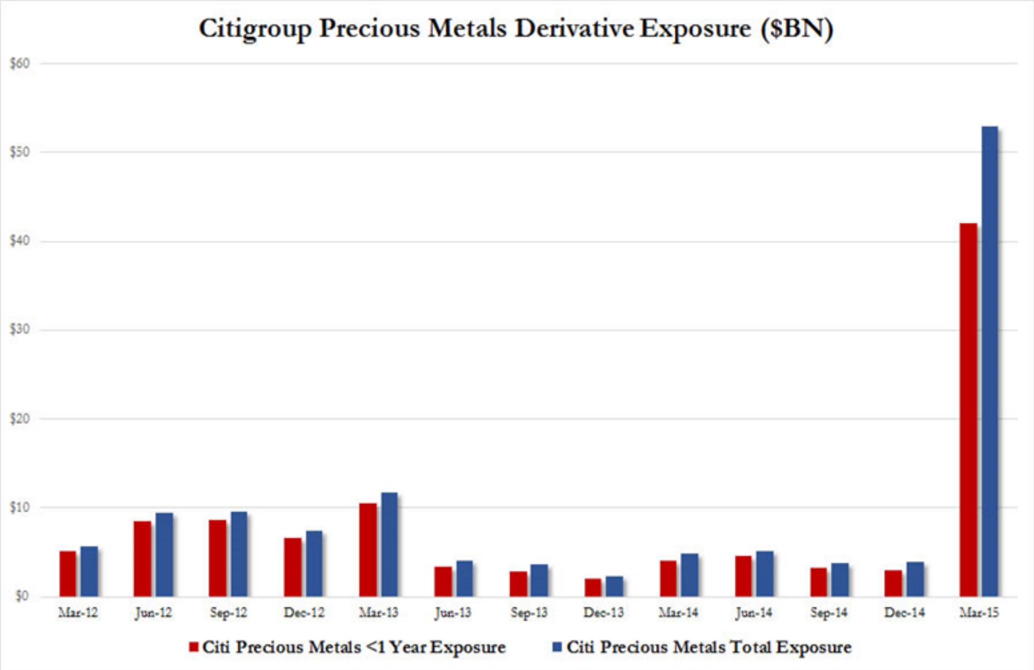

Source: Zero Hedge

It's far too opaque to discover what Citibank is actually doing but, if we assume that 90% of it is silver, the notional derivatives value is equivalent to 3.06bn oz, or three and a half years of world silver mine output, every single ounce of it. As a percentage of total precious metals derivatives outstanding, Citibank increased its market share from 17% to 70%.

Calling the regulators…

This was Zero Hedge's comment.

"there is just one word for what Citigroup has done to what the Precious Metals ex Gold (i.e., almost exclusively silver) derivatives market. Cornering."

Silver is volatile at the best of times, but enormous volatility in the silver price is probably inevitable.

In our opinion, we are in the latter stages of gold and silver price discovery which is (almost) entirely dominated by related paper substitutes. The emergence and recognition of supply shortage will begin to alter the balance of price discovery, slowly at first, then rapidly.

Having looked at trends in the gold market, what about indications of the strength of physical silver demand? Like gold, **there is evidence that physical silver supply is getting increasingly tight**.

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The silver basis has been in almost continuous decline in recent years and has recently moved into backwardation.

Source: ADMISI, Bloomberg

Nobody knows the volume of above ground silver inventory although it is believed to be about 1.0 billion ounces (over 30,000 tonnes). Three points are worth considering in terms of the emerging tightness in physical silver supply:

- There is considerably less above ground silver inventory compared with gold inventory (approx. 6.0bn oz.);
- Central banks do not have silver reserves that can be leased into the market; and
- Unlike gold, the majority of silver is consumed in industrial applications with silver being unique in terms of its dual nature of being both a monetary metal and an industrial metal.

Finally…

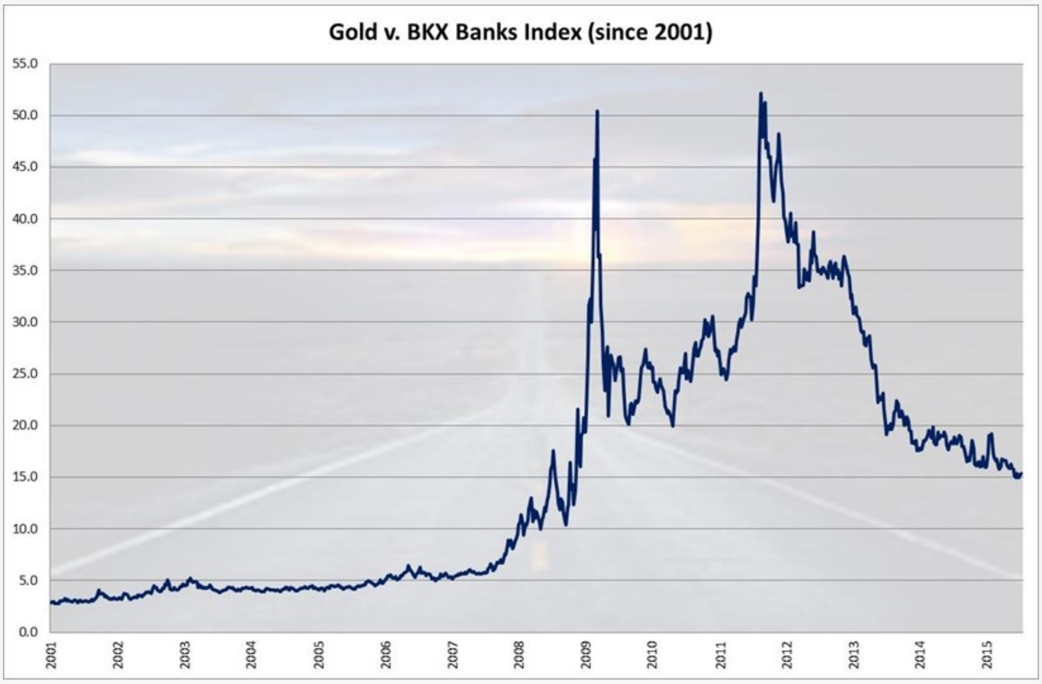
There is a deep value argument for gold and silver and the related equities. In a debt crisis, as we saw in 2007-08, counterparty risk becomes critical.

Physical gold and silver are the only financial assets with no counterparty risk at all.

Gold has underperformed the S&P 500 by 65.8% since the peak.

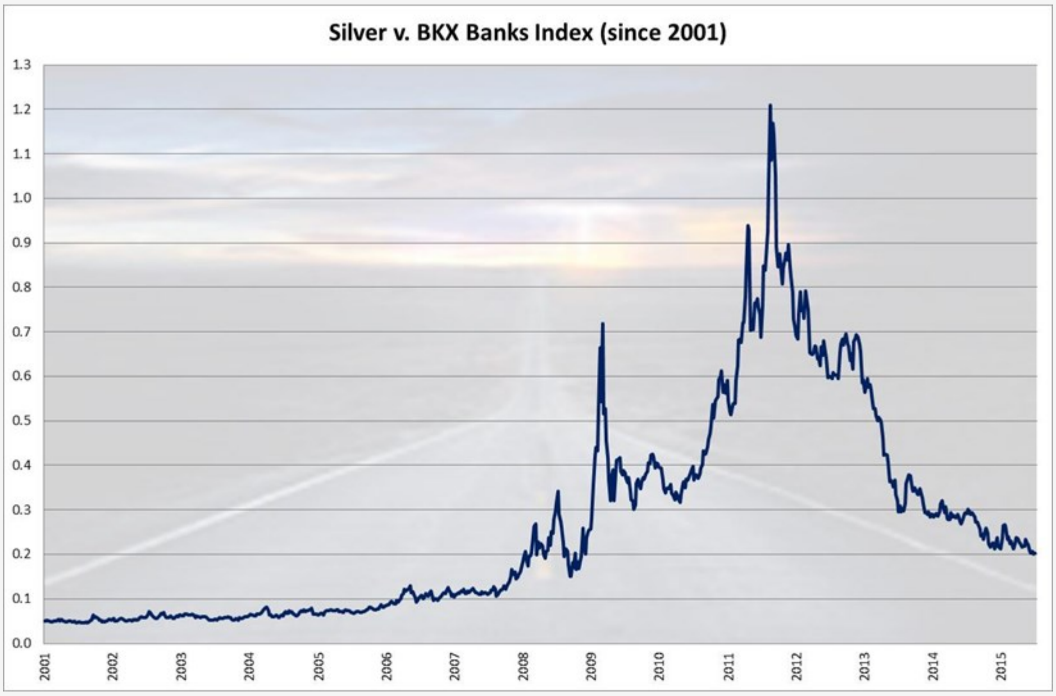
Source: ADMISI, Bloomberg

Banks, in contrast, epitomise counterparty risk. Gold has underperformed the BKX banks index in the US by 70.6% since the peak in 2011.



Source: ADMISI, Bloomberg

Silver has underperformed the BKX banks index in the US by 83.2% since the peak in 2011.

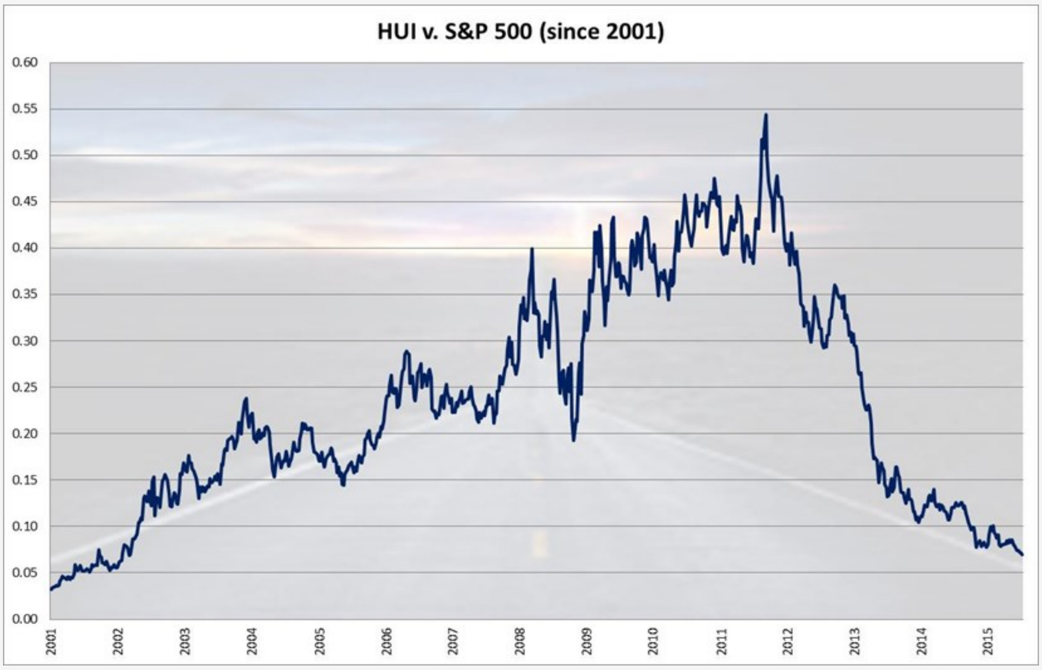


Source: ADMISI, Bloomberg

Gold (and silver) equities have suffered far worse than the respective metals. The HUI Gold Bugs Index, for example, has fallen 80.3% versus the gold price since the peak more than a decade ago now.

Source: ADMISI, Bloomberg

Relative to the S&P500, the HUI has underperformed by 87.1% since the peak.



Source: ADMISI, Bloomberg

The GDXJ ETF of small cap. gold mining shares has underperformed the S&P 500 by 91.4%.

Source: ADMISI, Bloomberg

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The quote below is from (in our opinion) one of the best road movies of all time, but one that is masquerading as a war movie. It's the story of American soldiers in World War Two who travel deep behind German lines to recover $16m of gold from a bank. When they get close to their goal, they find that the gold is guarded by three Tiger tanks while they only have one Sherman. It reminds us of how it's felt to be a gold investor during the last few years.

Kelly: Well Oddball, what do you think?

Oddball: It's a wasted trip baby. Nobody said nothing about locking horns with no Tigers.

Big Joe: Hey look, you just keep them Tigers busy and we'll take care of the rest.

Oddball: The only way I got to keep them Tigers busy is to LET THEM SHOOT HOLES IN ME!

Crapgame: Hey, Oddball, this is your hour of glory. And you're chickening out!

Oddball: To a New Yorker like you, a hero is some type of weird sandwich, not some nut who takes on three Tigers.

Kelly: Nobody's asking you to be a hero.

Oddball: No? Then YOU sit up in that turret baby.

Kelly: No, because you're gonna be up there, baby, and I'll be right outside showing you which way to go.

Oddball: Yeah?

Kelly: Yeah.

Oddball: Crazy... I mean like, so many positive waves... maybe we can't lose, you're on!

From Kelly's Heroes (1970, MGM, Kelly = Clint Eastwood, Oddball = Donald Sutherland, Big Joe = Telly Savalas, Crapgame = Don Rickles)

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