Thirty tonnes of gold

Recent bounce in gold brought relief to lending markets, then took it away. Who wants the last hotdog?

What drove gold up last week were buyers we hadn't seen in a while, buyers who sought safe haven and weren't afraid to chin up. This is very much unlike the market participants that stepped in to fill the void left when these aforementioned Western macro types left the building three years ago. These buyers – the Russians, the Chinese, the small bar trade and jewellers – have tended to be cheapskates, sitting on the bid and mopping up metal on dips as best they could.

And mop up the metal they did. Late last year with prices skipping off $1050/oz the lending market was once again in a state of distress, the sort of distress that can only speak to an excess of demand in relation to available physical supplies. It is our sense that when the lending market turns this shade of red, every last bar is spoken for and it was this cash-on-the-stump buying into the extreme negative sentiment, rising interest rates, flying equities and plummeting commodities that stopped it from hitting $900 (or what have you) as many had called for. This is unremarkable. What is remarkable is what happened when sentiment changed and the price rallied fiercely.

With rising prices we expect the term structure to normalize and, as we passed through $1100 in early January, normalize it did; this was corroborated by a friend informing us that "the dealers had started to lend again." Then things got weird. As we entered February and the price crested $1150, things began to tighten again. Why was this happening and what did it mean?

Last fall we openly wondered how much gold was left in London. This question has been a bee in our bonnet, for general perceptions have it, from both bulls and bears, that gold trades "differently" than other commodities, that supply and demand don't matter, and that besides, all the gold that has ever been mined sits somewhere in a vault, available for anyone who puts up their hand.

The lending market gives us some insight into gold's float, as it were. How much gold does one have to mop up before there is none left? That is, how *wide* is the underlying gold market? We did see Iraq buy 36t in March of 2014, a move that manifested itself in a tighter term structure amidst rising prices. We have also seen Venezuela and Ecuador swap (or sell) metal into the market in similar quantities and these too had a noticeable, if opposite effect. Consider these "pokes" at the market; action-reaction. More anecdotally, we recently asked a refiner and gold custodian what would it take to make a dent in the market? “”If we called you up and bid for $200mm, would that clear?" He nodded. "$500mm?" He nodded again, but only after hesitating a bit. "A billion?" A billion dollars worth of gold we would have to go look for, he averred. A billion dollars is about 30t of gold.

We don't know who has been buying gold on this last rally – "Europeans", we heard, which would make sense given what has been happening in their banking sector – but we *can* look at bullion ETF holdings. Since the beginning of the year these holdings have increased by about 125t. Since early February, when the market began to tighten up, bullion ETF holdings have increased by about 30t. *That number again.* It is interesting to note that gold rallied sharply in January of 2015 and there was a commensurate increase in bullion ETF holdings then as well. But there was no tightening in the lending market in response. However much gold is left in London, there seems to be less there today than there was a year ago.

This is small beer compared to how much gold has come out of the bullion ETFs since 2013. Almost 1000t, to put a number on it. (See figure A1 in the appendix.) Where did all this metal go? It appears to have been absorbed; cut up and stuck into people's teeth. Or shipped to China. At any rate, gone.

This begs the question: what will happen when or if the sector returns to favour? What will happen if even a small part of this 1000t of erstwhile ETF interest comes back? If a 30t poke stresses the lending market, what will a poke thirty times the size do to it?

One can say: well, why didn't this happen last time? Where did the metal come from then? No doubt there was a surge in scrap and this made a difference. There has been much speculation about bullion rehypothecation. We don't know how many times the same bar was lent or sold, but we would hazard a guess that there was likely more gold sold than well and truly bought. Certainly, it is a fact that banks have settled lawsuits for selling clients allocated gold that was neither allocated nor even bought. We feel at least some "liquidity" came from this "source" as well.

As for scrap, there is, however, only so many times you can melt down a wedding ring, namely, once. And as for rehypothecation, the regulations imposed on banks as a result of shenanigans around the fix – the Libor fix, the FX fix, and the gold fix – have created a new environment. This is corroborated by the silver fix fiascos of late, a fiasco caused by the refusal of banks to hedge the fix against the futures for fear of being accused of manipulation. According to one

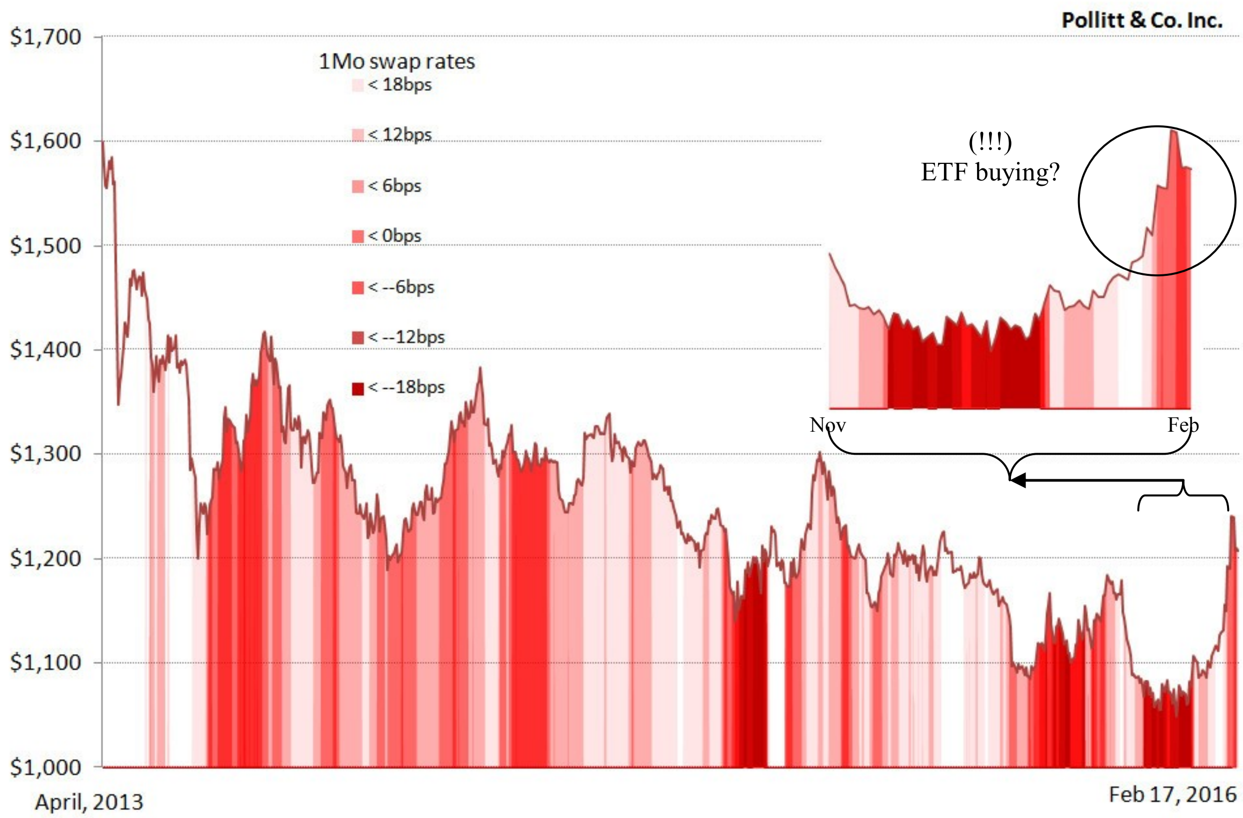

Figure 1: *The gold price since April of 2013; the term structure is textured in red. The deeper the shade of red, the greater the backwardation. A zoom of the plot since November of last year is shown in the inset. For some time now lending conditions have became tight "on the dips", as it were. This is explained by the traditional, price-sensitive buyers of physical standing in when bars got cheap. Also note how this pressure tended to alleviate once prices bounced. For the first time we see the market tighten on a price rally. We attribute this to a thin float and Western physical buying, through bullion ETFs or otherwise.*

commentator, you could now leave a fifty dollar bill on the floor of a bullion trading room and no one would pick it up. This change in regulatory tone has also manifested itself in the term structure. (See Figure A2 in the appendix.)

Before the crash in the spring of 2013 we bumped into a former trader at a large bullion bank downstairs at a food court. "Where's gold going?" we asked. "I think the banks want their gold back. I think they are going to give the market a nudge to see what gets coughed up." Well, a thousand tonnes got coughed up and that's now gone. We don't know whether the banks are flat now or not. Certainly, it is taking a long time to repatriate the Bundesbank's gold, which may give us one clue. But going forward, given the new regulatory strictures, the wherewithal for banks to "print metal" will be severely constrained.

We would expect gold lending conditions to relax as the price comes off the boil after the recent move. If we go low enough to attract the bottom feeders, expect it to tighten back up. The float is now being eaten away at on both sides of the market and likely getting smaller by the day.

Current macro conditions are an obvious setup for gold. The global financial system is groaning under the prospect of further hikes (which means they won't happen), Europe's banking system is being seen for what it is, and "Peak San Francisco" now has its own hashtag. It would be 1999 all over again except that, with thirty percent of all sovereign bonds now trading at negative yields – an utterly astounding fact – the monetary pedal has nowhere left to go but through a rusted floor plate. Frankly, these conditions never really went away, but other people's perceptions count far more than our own. The second leg in the bull market appears nigh.

But that's not what is interesting. Rather, should the sector return to favour, should even a small fraction of that negative yielding sovereign debt spill into the one remaining financial asset that cannot be adulterated, the more interesting question is this: next time, where will they find the metal?

Douglas Pollitt

Toronto, Ontario
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Figure A1: *This is a plot of total bullion ETF holdings for the last five years. About a thousand tonnes were disgorged over this period. This thousand tonnes has been absorbed and now sit in someone's teeth or in China or wherever. Call it off-market. The bounce in holdings we see since January is remarkable only insofar as the 125t apparently mopped up all the spare liquidity. Note the asymmetry here. What would happen if this thousand tonnes of interest were to return?*

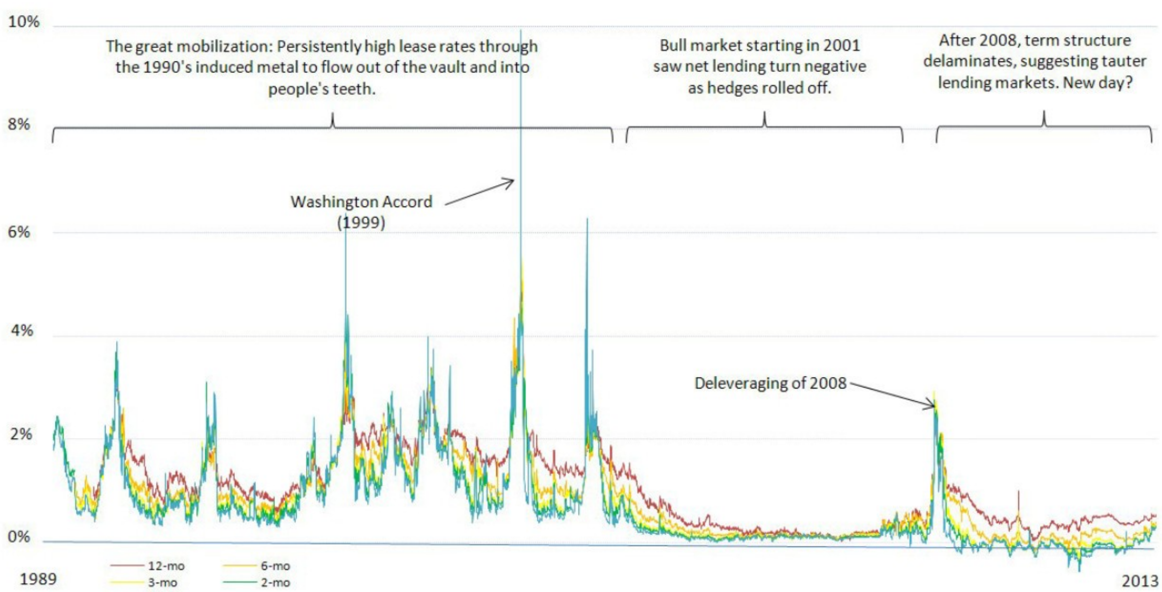

Figure A2: *A long term chart of lease rates (copped from an old piece.) We point out two things here: #1: the bull run from 2001 to 2008 showed no signs of lending market stress; hedges rolled off and paper dominated. #2: In 2008, something changed. Note the bifurcation amongst the lease rates for respective durations. What changed in 2008? Bank regulations. These have only gotten stiffer with the various fix scandals since. It is our sense that the banks will be on a short leash going forward and that the stress shown here will pale in comparison to what comes next.*

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