Vlad in the machine

Trip to the Comex, pernicious HFTs, the Guy We Found On The Internet, and geopolitics that won't go away

We dropped by the Comex just before Christmas to see some old friends. It had been at least half a decade since we'd last visited and, man, things had changed. It used to be that you'd be greeted by a wall of noise and knots of brightly coloured waving arms. Now the cavernous hall was half empty and the pits were filled with a few guys and some unattended laptops. Computers had taken over. The place had the look and feel of folks playing bridge in a football stadium. The floor was still littered with paper, as if for old times sake.

A trip to the Comex had been on our guest's bucket list and he wanted to know what it was like when the place used to hop. How did one keep track of all that mayhem? "Counting," said our host. "That and controlling the pit. You walk up to the top ring with a thousand lots to come, you need everyone looking at you. You need presence. Then you count. "

Even in its atrophied state, the heart of the commodity market still beats here louder than anywhere else. And we felt it. We met a dude who apparently owned the energy trade who offered to take us out on a bender, bail money included. We met another who handles more physical metal than we ever will. We asked an option trader who works with the banks how far out he'd write a call. It wasn't that far. There was a weird subliminal rhythm to the place. You'd never know anything was happening at all when, at the 1:30 close, out of nowhere, a lone trader stepped up to the pit and charted shouting "Seventy! Seventy!" Three guys darted from their terminals and started shouting back. It lasted about six seconds and then it was over.

We retired to a local pub. There was a lot to discuss. In particular, we wanted to dry-run our theory about Vlad and his plans for re-shaping the Global Financial Order. The pieces were all coming together. These were our friends and we felt we could talk about it without appearing as though we were stone-cold crazy.

But other things got in the way. For one, the old days kept coming up. The market was now run by algo's. "It's not even a market," said our host. "You can now submit a fill *and* kill order. Show five hundred lots, one gets filled, and the other 499 get immediately cancelled. That's not a market."

"What would have happened ten years ago in open outcry? Showing five hundred then walking?"

Figure 1: *We believe this is a pic of the old cotton exchange. Note everyone is wearing ties. Nowadays, trading isn't quite as civilized. Most of the press around HFTs as focused on equities, but these are just are prevalent, if not more so, in commodities. Quotes and indications don't mean what they used to — instead of reflecting a willingness to buy or sell at a given price, they now are designed to extract the market participants' intentions. Fishing, in other words. And unlike equity exchanges, here there seem to be no rules at all.*

"Losses would have been absorbed. But no one would ever deal with the guy again. He'd never do business here again. Now it is like there is a ghost in the machine, jerking our chain at will. This is not a market."

"Oh, that's Vlad," we suggested, trying to get back on track. "That's Vlad in the machine."

To no avail.

The Comex crowd was bearish, even as they clearly understood the longer-term macro case. I wouldn't say our friends were gold bugs, but they could certainly talk gold bug talk. That said, negative sentiment enveloped the place like a thick fog. It was awful out there, we all agreed.

In the face of the resource blood bath wasn't gold hanging in rather well? This was also true enough. Gold should have been at \$1050 or \$800 or some wipe-out number keeping oil company. Equity indices mounting new highs and a US Dollar on steroids should have added to these headwinds. But gold has actually done rather well as measured against most currencies and most commodities.

This relative outperformance comes at a time when the bullion cash market has been tight. We know as much from the persistent strain the London swap market, or the GOFO rate as this is otherwise known, a condition that is highly unusual absent a crisis. On a cash and carry ba-

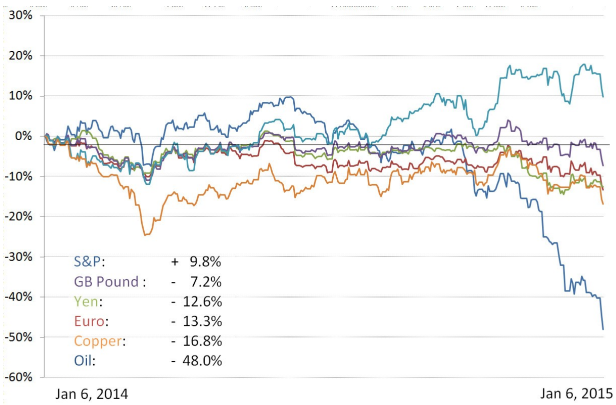

__Figure 2:__ Shown here are a variety of currencies and commodities as denominated in gold. As can be seen, bullion outperformed just about everything last year but the S&P. This cuts directly against the sentiment that is now prevalent in the sector. Shouldn't gold have hitched its wagon to oil and iron ore and, of late, copper and be sitting somewhere with a three digit handle? The USD on fire further confounds the bear case. This was certainly the expectation of many. That it hasn't suggests a bid out there. Someone has been buying the stuff… Who?

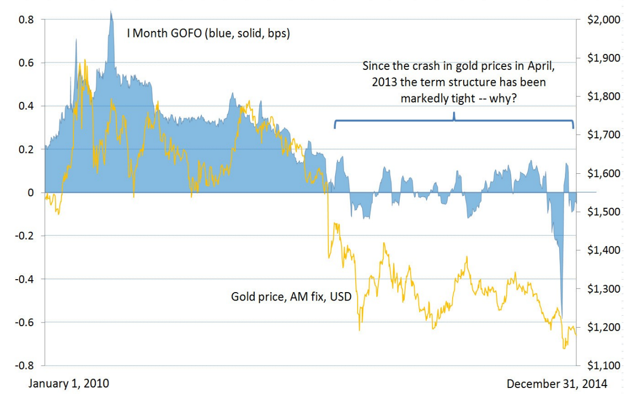

__Figure 3:__ In gold we see the price of gold since the start of 2010 (taken as being the start of the post-Lehman era.) In blue we plot the one-month GOFO. Normally, absent some sort of crisis, gold trades in contango, which is to say that spot trades at a discount to a contract for delivery one or more months out. Since the crash in April of 2013, the term structure has gotten markedly tighter., as evidenced by low or negative GOFO. This is the best evidence that the metal itself is in short supply. When Buffett bought his stash of silver back in the late nineties back up to extreme levels against the out months. We haven't seen this sort of backwardation in gold, but that we see any at all suggests that a buyer is putting down cash on the stump and taking the metal home with him.

sis, the metal seems to have a bid out there.

Our host nodded. "There was a jobs report out a few weeks ago. Gold should have been down $40. It wasn't. Yeah, someone has a bid in there."

"Vlad?", we tried again.

The bait was not taken. Instead, folks wanted to know why the Comex term structure has not gotten bent out of shape as it has in London. That's a fair question, for when Buffet took a shine to silver in the late 1990's, we saw Comex warehouse stocks depleted and, in time, spreads tighten to extreme levels in New York. It wasn't happening this time, even as it would seem straightforward enough to take advantage of clear mispricing. Sell London, buy NY, move metal across the pond on a "risk-free" arb. Why not?

"You need a bank to do this and the banks just aren't there anymore. The post-'08 regulations have hemmed them in. Maybe if the spreads really do gap open we will see more of this." And if you did the math, this made sense. In the days of 60:1 leverage you could make a go of it, but no compliance officer these days is going to sign off on a program to drain the Comex warehouses for a $3mm score, "risk-free" or otherwise.

Hedging. We were equity guys and our hosts were metal guys. Why weren't companies protecting themselves more? Our answer was twofold: A) The disaster of hedging last time around is still fresh in minds and B) We want sub-economic mines to go out of business; we want to the cure for low prices to be low prices.

Instead of hedging, why not help the miners out by selling their gold for them? The metal is in short supply and this group, the miners, accounting for 75% of all physical flow, remain abject price-takers. Show some muscle! Get them an extra $5/oz. Jeez, get them an extra $1/oz. Anything is better than being a mope at the fix.

"Besides, we know Vlad. And Vlad's the buyer. We might be able to fix you up."

We were lying, of course. We do not know Vlad. But finally we had their attention.

We removed the slip of paper from our jacket pocket and, making a show of it, stretched out our arms and looked around the table.

The premise here is that a low-level state of war now exists between Russia and the US. Some have characterized the state of affairs as a cold war redux. It's not. Rather, it is a warm war, fought primarily in the economic sphere. The most obvious manifestation of this is the program of sanctions, a tool that has been characterized as follows: "Just as air power has evolved from the area bombing of entire cities during

World War II to “precision” drone strikes, so the theory and practice of sanctions has evolved from straightforward blockades into a more ambitious system known as “conduct-based targeting” aimed at the economic paralysis of thousands of designated entities – people, companies and organizations… A ‘benign’ alternative to military action.”

If this is what is happening now, it didn’t start just now. As far back as 1991, before the corpse of USSR was yet cold, Charles Krauthammer declared in a widely cited Foreign Affairs article that America’s “Unipolar Moment” had arrived where the country’s best hope for safety was in its “strength and will to … unashamedly [lay] down the rules of world order and [be] prepared to enforce them.” On cue, Nato has been rolling up former Warsaw Pact countries ever since and now sits abutted to the Russian Federation in several places.

Pushback was inevitable. The West has seen several of its policy initiatives, including those involving Iran and Syria, thwarted by Russia. More recently, this same country then went and offered de facto asylum to Ed Snowden, which can’t have gone down very well in Washington either. From a Western perspective, Russia is surely seen as a hard point when it comes to pursuing foreign policy objectives.

Just as predictably, “regime change” rhetoric began to fill the air. This too started long before most knew it. Senator John McCain tweeted (!) back in 2011: “Dear Vlad, The Arab Spring is coming to a neighbourhood near you.” In 2013, Carl Gershman, the president of the National Endowment for Democracy, a Congressionally-funded think-tank, wrote in the Washington Post that, in the US’ effort to confront Russia, the Ukraine stood “as the biggest prize” and that “Putin may find himself on the losing end not just in the near abroad but within Russia itself.”

Most recently we have Khordokovsky, former oligarch from the Yeltsin days, now holed up in Switzerland’s financial capital, threatening much the same, albeit with more flamboyant rhetoric. A recent Bloomberg Interview teases: “A century after Bolshevik leader Vladimir Lenin plotted revolution from Zurich, Russia’s most famous ex-prisoner Mikhail Khodorkovsky harbours similar ambitions.” In the article proper we hear him reflect: “[Zurich and Russia] are playing the same role as they did 100 years ago… I hope the methods that Lenin used are firmly in the past.” These aren’t isolated examples. It feels like Saddam Hussein all over again.

Mindful of the locale – lower Manhattan, not exactly the best place to express unorthodox views – we paused for some context. “It doesn’t matter who is right. From the perspective of financial markets, what matters is what Vlad and Friends of Vlad think, rightly or wrongly.”

Figure 4: *In 2011, Senator John McCain tweeted the threat of regime change to President Putin, not exactly the most professional approach to diplomacy we would think. Putin was asked about the threat and replied that McCain had spent time in a PoW camp and that this might have driven him to lose some of his marbles. In reply, McCain further taunts Putin, again, over Twitter. That a leading US politician finds it appropriate to exhibit such open hostility for a foreign leader speaks volumes about the mood in Washington.*

We pulled out another slip of paper from our jacket pocket. Hungarian Chancellor János Lázár thinks:

> *“A warlike situation has developed between the United States and Russia, and the Americans want to create a new iron curtain on Russia’s border. ... The [anti-government] demonstrations are as though the American embassy had assumed the role of the Hungarian political opposition.”*

Referring to a parade commemorating the birth of Ukrainian nationalist hero Stefan Bandera on January 1 of this year, Czech President Milos Zeman said: “There is something wrong with Ukraine. … The parade itself was organized similar to Nazi torchlight parades, … “ He goes on to say that many, “with wrong or insufficient information, idealize Ukraine.” Rather, the events of early 2014 saw the installation of “two gangs into power” in Kiev.

And then there is Putin himself. In a major policy speech last November we heard:

> *“The measures taken against those who refuse to submit are well-known and have been tried and tested many times. They include use of force, economic and propaganda pressure, meddling in*

Figure 5: *This is Obama's expression the instant he was asked whether or not he had anything to do with the price of oil being cut in half. That the question could be asked by a serious journalist is one thing — no one to our knowledge has ever suggested that NPR is a hotbed of conspiracy theorists — but the response was more telling yet. We will never know exactly what happened, but we can say that the US knows that the low oil prices in the mid to late eighties was a critical factor in bringing the USSR to its knees. We can also say that "arranging" for a lower oil price would be consistent with the US program of economic aggression against Russia. And we also know that this is causing Russia and Putin a large headache. If this thesis is correct, we can expect oil prices to stay lower for longer. Given the taut nature of the global financial fabric, knock-on effects could be more serious than current market levels discount.*

> *domestic affairs, and appeals to a kind of 'supra-legal' legitimacy when they need to justify illegal intervention in this or that conflict or toppling inconvenient regimes. Of late, we have increasing evidence too that outright blackmail has been used with regard to a number of leaders. It is not for nothing that 'big brother' is spending billions of dollars on keeping the whole world, including its own closest allies, under surveillance."*

Very clearly, there are those on the far side of the fence feel under attack. Call them crazy.

If you felt the way they do, what would you do?

Maybe the same thing the West is trying to do to Russia. Insofar as Moscow controls the largest tactical nuclear arsenal in the world, shock 'n' awe *a la* Baghdad is not on the table. Hence, the sanctions and, of late, certain financial constrictions. Here is Obama in a year-end NPR interview:

> ***[Obama]*** *You'll recall that three or four months ago, everybody in Washington was convinced that President Putin was a genius ...*
> ***[NPR]*** *... for taking Crimea ...*
> ***[Obama]*** *And he had outmaneuvered all of us and he had, you know, bullied and, you know, strategized his way into expanding Russian power. And I said at the time we don't want war with Russia but we can apply steady pressure working with our European partners, being the backbone of an international coalition to oppose Russia's violation of another country's sovereignty, and that over time, this would be a strategic mistake by Russia. And today, you know, I'd sense that at least outside Russia, maybe some people are thinking what Putin did was not so smart.*
> ***[NPR]*** *Are you just lucky that the price of oil went down and therefore their currency collapsed or ...*
> ***[Obama]*** *Well ...*
> ***[NPR]*** *Is it something that you did?*
> ***[Obama]*** *If you'll recall, their economy was already contracting and capital was fleeing even before oil collapsed. And part of our rationale in this process was that the only thing keeping that economy afloat was the price of oil. And if, in fact, we were steady in applying sanction pressure, which we have been, that over time it would make the economy of Russia sufficiently vulnerable that if and when there were disruptions with respect to the price of oil — which, inevitably, there are going to be sometime, if not this year then next year or the year after — that they'd have enormous difficulty managing it*

In other words, starve them out and hope the torch mob leads to a "popular uprising." It's an old script.

And Russia knows it. Here is VTB-Bank head Andrei Kostin, as recently quoted in *Handelsblatt*:

> *"Of course, there is a plan B [in the case of Russia being shut off from the SWIFT bank system], but in my personal opinion it would mean war – if Russian banks' access to SWIFT will be prohibited, the US ambassador to Moscow should leave the same day. Diplomatic relations must be finished. Banking is the most vulnerable part of the Russian economy because the system is based so strongly on the dollar and the euro."*

We don't see how this ends early or well. On the one hand, the West's involvement in the Ukraine is only the latest in a long line of heads-on-a-stick efforts to make the world a little more in the State Department's own image. Indeed, apart from temporary setbacks (eg. Vietnam), the US has never been pushed back from anywhere, ever. It is as though the Monroe Doctrine did them well so why not just keep going?

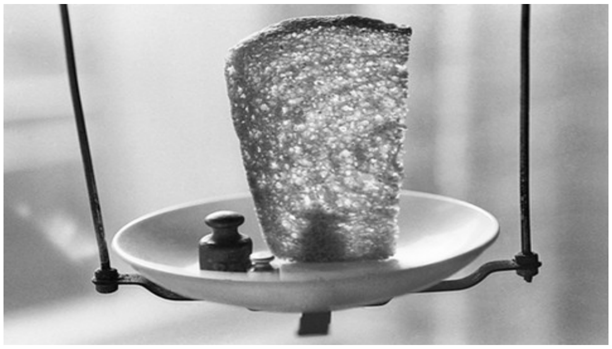

Figure 6: We wonder if the sanctions team at the State Dept has done any research in the siege of Leningrad. This was probably the worst siege in history, lasting almost three years and through two and a half hard Russian winters. The population was almost totally cut off from outside supplies. Food was rationed to 125g of bread per day and this bread consisted of one part bread and one part sawdust. (The picture above shows how the rations were meted out.) About seven-hundred thousand people died, this out of a city of three million. It was not uncommon to see corpses on the street. Rumours of cannibalism were rampant. And yet the city did not surrender. In total, about twenty million Russians died in the war. With this for context, does the sanctions team at the State Dept really think Russia is going to fold because of the hardships now faced as a result of the measures now being imposed? Moreover, the history of sanctions show that it brings a country together (eg Iran), as opposed to fomenting revolt. All of this is to say that we don't see this conflict resolved early with capitulation on Russia's part.

Figure 7: This is Mikhail Khazin, aka The Guy We Found On The Internet. Khazin runs an economic consultancy and one of his clients is apparently Kazakhstan.. We don't know how close he is to the Kremlin — indeed, as far as we know, Moscow may see Khazin in the same way most of you would, namely, as a way-out-there economist with decidedly non-mainstream views. That having been said, these views get right to the heart of the issue as we see it. The spread of the Dollar has conferred immense benefits to the US in particular and the West in general, benefits that have not been shared by all. But to sustain the Dollar standard requires that there be ever more markets to dollarize. This is not unlike a junior promotion that needs evermore investors to keep its shine on. The world is very quickly running out areas to dollarize. Moreover, there political strings that come attached to the Dollar are becoming increasingly resented. Moscow may see him as a crank, but it is our strong sense that his views would be far more accepted over there than they are here in the West, where we are entirely oblivious to these matters altogether.

Smart analysts of the so-called the "Realist School", in particular John Mearsheimer at the University of Chicago, see US foreign policy here as being misguided at best. We disagree. The US has benefitted immensely from sitting atop a unipolar world. It is said that the US Dollar derives its backing from the US military but how would this military have ever been paid for were it not for "exorbitant privilege" of being able to issue the reserve currency in unlimited quantities with apparent immunity? Trade surpluses? <cough>. Should the Dollar ever have to compete on fundamentals, as it would in a multi-polar world, that privilege dissipates overnight. It is clearly in US interests to pursue global hegemony. Failure to corner the market, as it were, would see the monetary edifice that has served the US so well come tumbling down.

As for Russia, they lost 20mm men in WW2. We don't see them being easily subjugated. Russia is not Grenada.

Put like this, the intractable nature point of the conflict became somewhat more clear. We felt like we'd laid sufficient groundwork to bring out The Guy We Found On The Internet.

Mikhail Khazin's name popped up on a blog devoted to "Novorussian affairs," Novorussia being the self-dubbed appellation of the breakaway republics in Eastern Ukraine where the all fighting has been. Khazin runs an economic consultancy in Moscow and, apparently, advises the Kazakhstan president, among others. He certainly presents himself as being close to the Kremlin although we cannot vouch for that. The following was pulled from an interview and, likely, poorly translated. The following snippets seem germane:

> *"We have to understand the current events from an economic perspective, whose current model is the Bretton Woods economic and financial system. Many mistakenly believe that this system died after August 15, 1971, when the US made the second default of the twentieth century by refusing to exchange dollars for gold. But this is not quite true. The Bretton Woods system is a mechanism to expand the dollar zone which created it's own special institutions: the IMF, the World Bank, and the [WTO]. All are still here.*
>
> *"They define the Bretton Woods system by which all assets are linked to the dollar.*
>
> *The model of the modern economy works in the*

following way, as a mechanism for income redistribution which is formed when the Federal Reserve prints dollars to purchase new assets that are part of the Dollar system. In the beginning, it was the countries of Western Europe, then Japan, Taiwan, Singapore, then Korea China and later the countries of the socialist Commonwealth.

"Today, this model has come to a natural end. All of the world's assets, including Russia's oil, are already denominated in Dollars. That is, they are part of the Dollar capitalization share of those companies, which own those fields. The world has no more Dollar assets left.

"It means that it's impossible to continue "printing dollars" – there are no assets [left.]

"There are no more profits to extract from the global economy. Some participants in this process, including Russia and China, say: "Guys, where is our share? We didn't agree to [this]."

"Furthermore, in order to protect their economy the United States began to use Bretton Woods, [primarily] its financial system, not to give, but to take.

"Now we have a world in which 3rd world countries no longer have Dollar investments, but rather have their capital flow back into the United States. In this system, which is satisfactory to no one, it will be impossible to expect stability. Most likely, everyone will rock the boat. And the US [will] attempt only token responses.

"Therefore, I am inclined to expect that an explosion [will] tear apart what remains of the Bretton Woods system will happen very soon. Possibly within the next twelve to eighteen months.

If we no longer have access to the Dollar investment mechanism then we must build our own regional issue center and an investment mechanism."

In other words, if this Guy We Found On The Internet was right, this fight would be a fight over the monetary system as we knew it. Crazy goldbug talk, we know. But if you're Russia, and the US Dollar amounts to the weapon that is being used against you (and it is), what tool do you use against that?

Is this guy a crank or not? Or are these views more broadly held? Putin's Sochi speech adds more context here:

"Sanctions are already undermining the foundations of world trade, the WTO rules and the principle of inviolability of private property. … [The Americans] now risk losing trust as the leaders of globalization. [T]he United States' prosperity rests in large part on the trust of investors and foreign holders of dollars and US securities. This trust is clearly being undermined and signs of disappointment in the fruits of globalization are visible now in many countries. … We already see that more and more countries are looking for ways to become less dependent on the dollar and are setting up alternative financial and payments systems and reserve currencies. I think that our American friends are quite simply cutting the branch they are sitting on."

We pulled out the last piece of paper from our jacket pocket. It was a lengthy Tass interview with Putin from late November. Towards the end, Putin, in passing, refers to Americans as "our friends". The interviewer cocks an eyebrow – "The Americans are our friends?" Putin's reply is fascinating:

"Surely, they are our friends. Americans are printing dollars and have turned their national currency into a global currency, although they gave up the gold equivalent several decades ago. But all the same, the printing machine is held by them and they're obviously capitalizing on this."

Note the question never-asked. Rather, this was like a Rorschach test. Americans? They print money. Boom. Vlad clearly sees America's weakness. Vlad gets it.

We sat back and took stock:

1. The West has is engaged in a long term confrontation with Russia (most obviously) but Russia would surely have quiet the support of others when it came to resisting the US' plans for a unipolar world. Note China's offer to provide Russia with a swap line to help defend the Ruble speaks to as much. This confrontation will not be resolved early or easily.

2. This confrontation is taking place primarily in the economic sphere. In particular, it is taking

place in the financial sphere. The US sees the Ruble as being Russia's Achilles heel but remarkably, Russia sees the Dollar as being the US' Achilles heel.

3. Gold has performed noticeably well. We all agree there is a bid out there. The term structure is tight, suggesting the bid is for the metal and not the paper. At the same time we see a recent trend for European countries, after years of complacency, to ask for their gold back – Austria, Belgium,. Holland and less successfully, the Germans. And the Indians relaxed their import restrictions even as their trade situation hasn't changed. And China continues to buy hand over fist. And so does Vlad – even as the Ruble was crumbling, even as their FX was being depleted and speculation ran amok that they'd have to sell their gold, in late December, it was announced that Russia, once again, added to their bullion reserves.

If one is going to pivot out off the Dollar, one needs to pivot on something that has as much or more credibility than the Dollar, and that can only be gold. If the US was mounting a spec attack on the Ruble, then is Vlad, along with those fatigued and disgruntled by Dollar hegemony, mounting a backdoor spec attack on the Dollar? How else to bootstrap an alternative monetary framework? For that clearly seems to be their intention.

We would have hoped at this point a reaction more enthusiastic to this grand theory. It surely explained a lot. It all fit.

"You're right," we hoped they'd say, "that bid? Of course it is Vlad."

"We should get him out of the machine," another would pipe up. "Get him out of the machine and bring him down here. Old school."

"Top ring! Eyes front! *Presence!"*

"Then count. Then let him start counting!"

"With his shirt off!"

But this didn't happen. Instead, we got the bill and flagged a cab up to midtown. New York is a magical place around Christmas time. A few of us peeled off to grab a bite and chat about the year to come.

Happy New Year and best regards to you all

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