POLLITT & CO. INC. MEMBERS: THE TORONTO STOCK EXCHANGE, THE INVESTMENT DEALERS ASSOCIATION OF CANADA

IMPORTANT NOTICES

1. A FUTURES CONTRACT IS A LEGALLY BINDING OBLIGATION TO MAKE OR TAKE DELIVERY OF A SPECIFIED COMMODITY AT A FUTURE DATE. ALL CONTRACTS FOR THE PURCHASE OR SALE OF ANY COMMODITY FOR FUTURE DELIVERY SHALL REMAIN OPEN AND IN FORCE, AND SHALL CONTINUE TO BE BINDING UPON THE ORIGINAL PARTIES UNTIL LIQUIDATED BY ACQUIRING AN EQUAL BUT OPPOSITE POSITION, OR BY MAKING OR TAKING DELIVERY OF THE COMMODITY. THESE TRANSACTIONS ARE MADE IN ACCORDANCE WITH AND SUBJECT TO THE ….

To date, most of the financial worries, here and elsewhere, have emanated from the sub-prime markets. The numbers have been huge, disconcerting and relentless. A month ago Countrywide Financial was $20, now it's $13 and falling. Still to come, however, will be the mess resulting from the derivatives markets. The Citibank stock price chart is almost a mirror image of the gold chart; we will soon find out if there is a more fundamental relationship between the two.

Derivatives cover more than commodities, but they are often based on commodities. The clip above is drawn from a standard commodities contract and is instructive. The party named in the contract (any contract) undertakes to "make or take" delivery of the commodity named. Or else liquidate it. This is a legal obligation. However, probably 95% of all commodity trades are entered into for purposes of speculation or investment without any contemplation of "making or taking" delivery. Rather, the hope is to either a) liquidate at a profit before maturity or b) keep "rolling" the position forward (Dec to Jun, Jun to Dec, on and on) to effectively maintain an investment position. And this is where the potential problems lie; for every open position there are two sides, and just because somebody wants to liquidate a position doesn't mean somebody else has to accommodate him.

Take gold. For most people gold is a commodity, a form of money or savings. Buy it, put it away. But for many banks gold is just another currency, low interest-bearing and subject to love/hate attitudes from Central Bankers. Borrow it, lend it, go long, go short. As in forex markets, banks dominate gold markets. Comex open interest is now over 500,000 contracts, climbing to record highs almost every day. Some of this is redundant (as in long Feb, short Jun on a spread basis) but a good guess is that at least 300,000 contracts represent real longs and real shorts. 30 million ounces of gold, a fat number when compared to mine production of 75 million ounces. However there's more: Tocom in Tokyo, the electronic market everywhere and the OTC (over the counter) market in London and New York. These last two markets do not disclose volumes, but are reckoned to be much bigger than the Comex, so it's a pretty safe bet that there are well, well over 100 million ounces of long, and short, positions. And superimposed on these are the options. Options on futures.

This brings to mind the story of the failure of Barings. In that situation, when the inspectors from London finally arrived in Singapore to ascertain the damage caused by rogue trader Nick Leeson, they saw the futures contracts (pretty well all long the Nikkei Dow) and about a three-quarter billion dollar loss. Then somebody checked a drawer somewhere and found a file filled with options contracts.

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Leeson had written (sold) "put" options on the Nikkei and used the proceeds to meet margin calls on his long futures position. The liability on the puts was also hundreds of millions and would rise rapidly if the Nikkei continued to fall. There might have been a remote chance to unwind the futures position (or at least get it under control) but there was no bid at all for the options. So ended Barings.

When diagnosing the gold market one must note the contango, the forward premium over the spot price, currently about $40/oz or 5%, pretty flat with money (i.e. Eurodollars). This means that it doesn't pay a) to borrow gold, sell it spot, invest in Euros and buy forward Comex contracts at a low contango (the flavour of the month ten years ago) or b) to borrow Euros, buy spot gold and hold it while selling forward Comex contracts against the long gold position (the natural trade in the late 1970's when the gold price was screaming and the contango was very high).

Today the big question is: who is long the 100 million ++ ounces of futures contracts? Scenario a) does not apply. Some speculators of course are long,* but our guess is that the vast majority of these positions are held by banks on behalf of investors who have actually bought gold but are not in a hurry to take delivery. For example, if somebody buys $10 million of gold ETF's, the seller (invariably a bank) hedges himself and the easiest way is to buy 120 contracts, taking out two or three dollars on the way through. GFMS points out that in Q3 2007 investment demand continued its healthy increase.

But the big, big question is: who is short the 100 million ++ ounces of futures contracts, a number that is rising steadily? Does it really make sense that increasing buying (of contracts) should be met with increasing selling of contracts? The short side is not the mining industry, and it's not the public. It's not people with gold in the vault; scenario b) doesn't apply. It's not Central Banks; when they sell they tend to deliver the metal. By the process of elimination, it appears the short side must be big banks, maybe hedge funds: the sort of people who use the word "algorithm" and have brought us structured notes, sub-prime debt, big spec positions in natural gas, and all manner of derivatives. It appears they are becoming ever more extended as they try to contain the price to "protect" existing short positions. They probably expect friendly Central Banks will "protect" them. They shouldn't.

Being offside on ten or twenty million ounces of gold may not make a big dent on a bank's balance sheet (some would say "rounding error") but what if the gold doesn't exist?

* There is little evidence of widespread bullish speculation. The recent upward move, like copper rising through $1.50 a few years ago, has caught most people by surprise. BankAmerica recently closed down its commodity department, suggesting losses, in turn suggesting having been short the metals. But if the contango were to open up to, say, 1% or more over money (as in the 1970's) that would suggest a resurgence of bullish speculation.

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Toronto, Ontario
November 16, 2007