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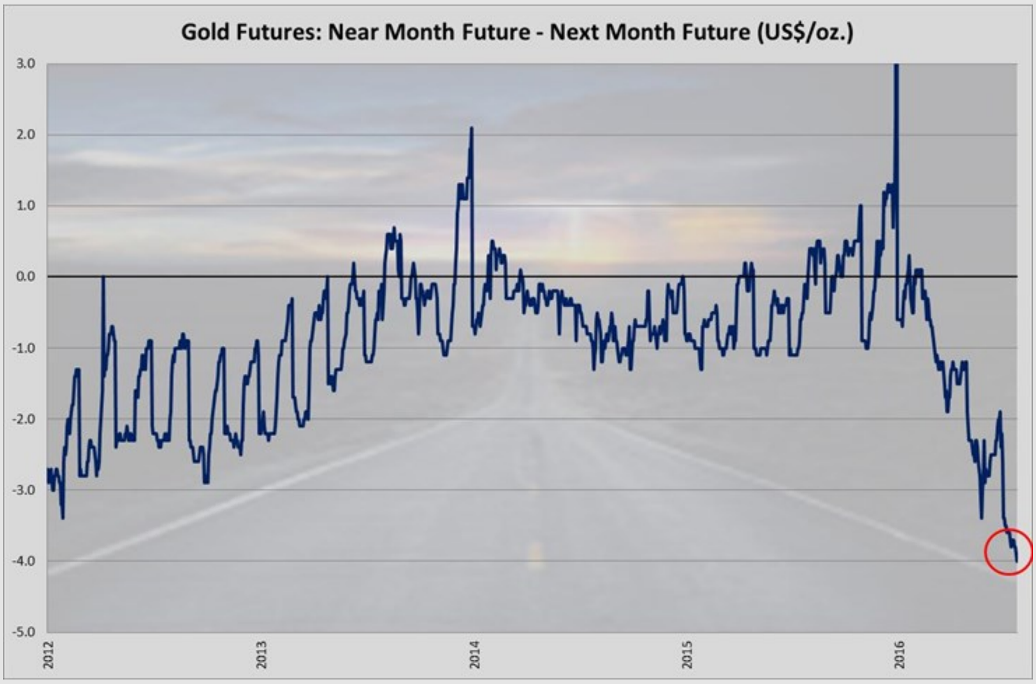
Gold Futures - critical days in the battle (not the war)

We will resist discussing the growing illiquidity in physical gold and focus on certain mechanics in the gold futures market, which are dominating price discovery right now.

The key is the degree to which the spread between the near month future and the next month future – currently August 2016 versus October 2016 - has been widening.

We've been tracking it since 2012 and it's at the highest level that we've seen...



Source: ADMISI, Bloomberg

When this spread is negative, there is a cost for speculators to roll the current futures contract into the next one. Rolling from the August 2016 contract to October 2016 is costly at US $4.00/ oz., when the average has been closer to US$1.00/oz.

Holders of the August 2016 contract have a decision to make with expiration coming on 27 July 2016.

Meanwhile...

Let's put the situation in the gold futures market into perspective, as there is a huge stand-off between speculators and the "Commercials" (mainly banks).

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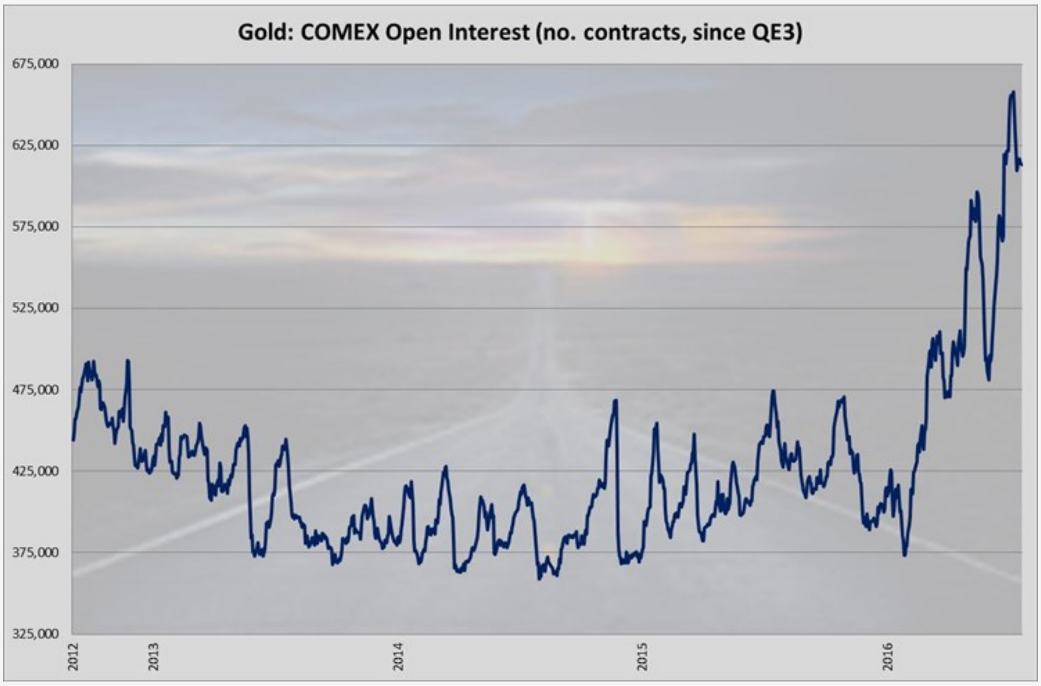
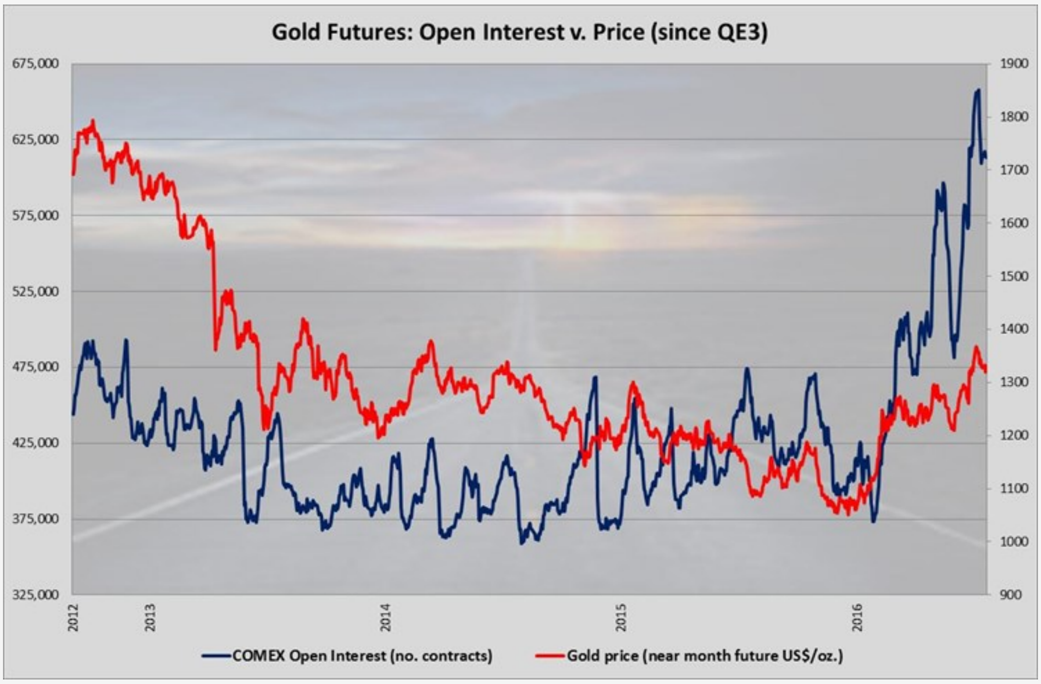
The chart below shows how open interest has "blown out" by about 250,000 contracts since early 2016.



Source: ADM ISI, Bloomberg

Each contract represents 100 oz., so this represents about 25 million oz. or nearly 778 tonnes. This is about 25% of the annual output of the world's gold mines.

The surge in open interest since the beginning of 2016 has obviously coincided with the recovery in the gold price.



Source: ADM ISI, Bloomberg

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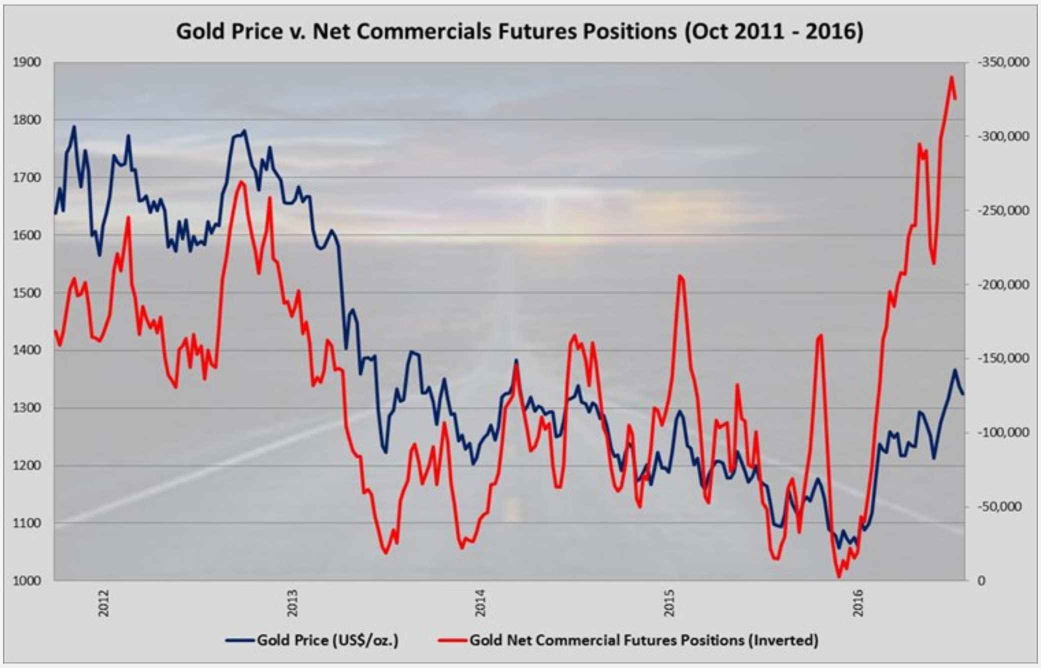
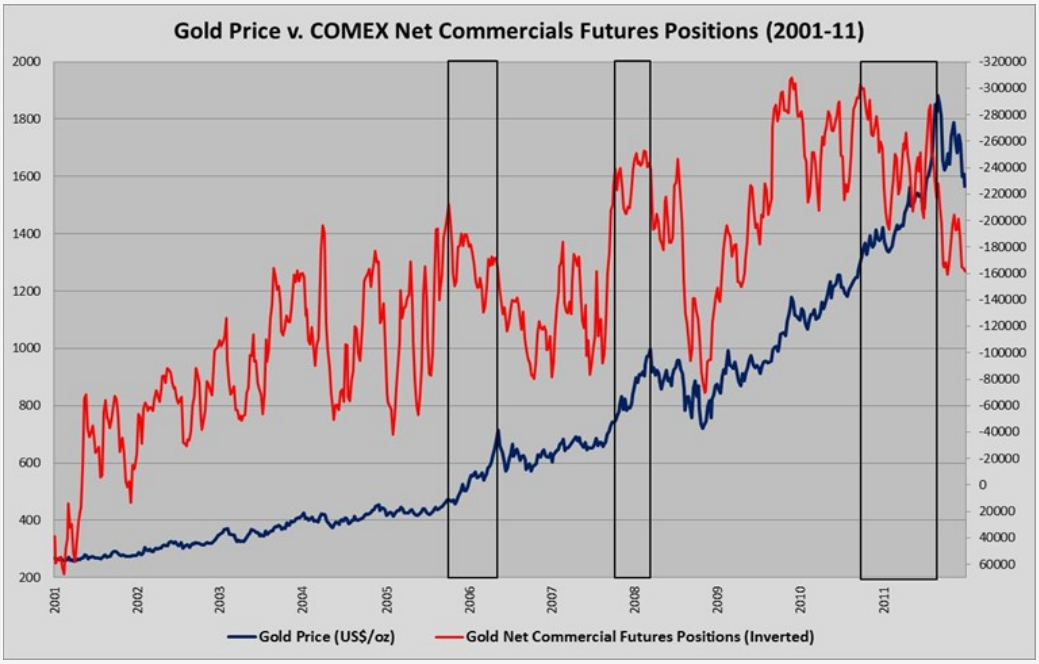
The Commercials (mainly banks) have seen their net short positions on COMEX surge. Presumably some of this is naked shorting, in an effort to contain the price. The banks could be forgiven if they underestimated the durability of gold's recent rise and the tenacity of speculators.



Source: ADM ISI, Bloomberg

As we've shown numerous times, the Commercials have a history of shorting into a rising gold price, waiting for speculator buying to exhaust itself in order to smash the price and cover.

Having said that…there were three occasions during the 2001-11 bull market when the Commercials stopped increasing net short positions into a rising gold price. In all three, gold went parabolic.



Source: ADM ISI, Bloomberg

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The Commercials net short on COMEX is now very close to the all-time high…

Source: Bloomberg

With huge open interest and a record net short on the part of the Commercials, we are seeing a major stand-off in the gold futures market.

Until this battle (within a much larger war) is resolved, the gold market will remain highly unstable...far more than is implied by the current level of the GVXX - CBOE/COMEX Gold Volatility Index.

Source: Bloomberg

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Going back to the recent sharp widening in the spread between the August-October 2016 gold futures, our suspicion is that the bullion banks are deliberately making it expensive for speculators to roll forward their gold futures.

Multiplying US$4.00/oz. by 6 implies a current annualised cost of US$24/oz.—not inconsequential.

The banks must be hoping that speculators liquidate long positions, as we've seen so many times in recent years, and the gold price sees a sharp (but probably brief) correction. However, speculators have been proving far more resolute in rolling gold futures exposure in recent months.

We saw on three occasions during 2001-11 that if the speculators didn't cave, the bullion banks did. We should get a sense of what's going to happen on this occasion in the coming days.

Meanwhile...

Behind the scenes, the larger war continues with growing pressure on London's gold vaults and the ability to deliver 400oz. LGD bars by LBMA banks (more on this soon).

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