Paper Manipulation

The easiest way to perform paper manipulation is through COMEX futures. Rigging futures markets is child's play. You just wait until a little bit before the close and put in a massive sell order. By doing this you scare the other side of the market into lowering their bid price; they back away. That lower price then gets trumpeted around the world as the "price" of gold, discouraging investors and hurting sentiment. The price decline spooks hedge funds into dumping more gold as they hit "stop-loss" limits on their positions. A self-fulfilling momentum is established where selling begets more selling and the price spirals down for no particular reason except that someone wanted it that way. Eventually a bottom is established and buyers step in, but by then the damage is done.

Futures have a huge amount of leverage that can easily reach 20 to 1. For $10 million of cash margin, I can sell $200 million of paper gold. We know who the brokers on the floor and the clearing brokers are, but the market is still nontransparent, because we don't know who the players actually are—those doing the buying or selling through the brokers. We don't know who the ultimate customer is. Only the brokers know that, so there is anonymity through the broker combined with high leverage.

Paper manipulation can also be performed through exchange-traded funds, or ETFs, notably GLD. Market manipulations using GLD are more complicated. The GLD ETF is actually a share of stock. The stock is in a trust, which takes your money, buys gold, and puts it in a vault. If you don't like gold or the price action, all you can do is sell your shares.

It's entirely possible to have physical gold trading one way and ETF shares trading another way, thereby opening up a "spread" between the two prices. They should be closely aligned. Still, such a spread or arbitrage does exist from time to time.

Here's what happens. If I'm one of the big banks that are authorized participants in GLD, I look for the arbitrage. I see the physical gold price trade at a premium to the shares (the share equates to a certain amount of gold). I short the physical gold and simultaneously buy the shares from somebody in the market who's been spooked out of it. Now I take the shares to the trustee and cash them in to get the physical gold. I deliver the physical gold to cover my physical short, and I keep the difference. It's an (almost) risk-free arbitrage.

One result of such activity is to take the gold out of the ETF warehouse, reducing the floating supply. The floating supply is the gold available for trading to support the paper gold. If gold is in a bullion bank or a GLD or COMEX warehouse, it's part of the floating supply and available to support paper trading. Once it gets to China and goes into a Shanghai vault or it gets to a Loomis vault in Switzerland it's no longer part of the floating supply. It is a part of the total stock, yet it's not available for trading or other transactions such as leasing and forward sales.

Importantly, the gold in Fort Knox or at the Federal

Reserve Bank of New York or COMEX may be leased or leveraged, if it's not being sold outright. The Chinese are buying gold that's not going to see the light of day for an indefinite period because they're putting it in deep storage. Once it gets to China, it's not coming back out again. The Chinese are not day traders or flippers. They're buying enormous amounts of gold and putting it in storage where it will stay.

Taking all of these flows into account reveals that more and more paper gold trading is resting on less and less physical gold. The inverted pyramid of paper gold contracts is resting on a small base of physical gold, and that base keeps getting smaller as the Russians and Chinese accumulate gold.

Hedge Fund Manipulation

Hedge funds are now large players in the gold market. Historically, that was not the case. Gold ownership distribution looked something like a barbell. At one end, you had the small holder who always felt more comfortable with gold coins or bars in her possession. On the other end were the largest holders, sovereign wealth funds and central banks. In between, you didn't really see institutions much involved one way or the other. That's less true today. Hedge funds are beginning to fill in the middle ground of gold investors between retail and the sovereigns.

To a hedge fund, gold may be an interesting market in which to deploy its trading style. Still, gold is not special; it's just another tradable commodity. To hedge funds, the commodity could just as well be coffee beans, soybeans, Treasury bonds, or any other traded good.

Hedge funds use what are called "stop-loss" limits. When they establish a trading position, they set a maximum amount they are willing to lose before they get out. Once that limit is reached, they automatically sell the position regardless of their long-term view of the metal. Perhaps they don't even have a long-term view, just a short-term trading perspective.

If a particular hedge fund wants to manipulate the gold market from the short side, all it has to do is throw in a large sell order, push gold down a certain amount, and once it hits that amount, these stops are triggered at the funds that are long gold. Once one hedge fund hits a stop-loss price, that hedge fund automatically sells. That drives the price down more. The next hedge fund hits its stop-loss. Then it sells too, driving the price down again. Selling gathers momentum, and soon everyone is selling.

Eventually the price can work its way higher again, more funds will begin to acquire gold, and then the short-side manipulators get to play the game all over again, driving the price lower time after time. In the absence of government enforcement of antimanipulation rules, gold holders should expect these games to continue until a fundamental development drives the price to a permanently higher plateau.

Leasing Unallocated Forwards

Another way to manipulate the price is through gold leasing and unallocated forwards. "Unallocated" is one of those buzzwords in the gold market. When most large gold buyers want to buy physical gold, they'll call JPMorgan Chase, HSBC, Citibank, or one of the large gold dealers. They'll put in an order for, say, $5 million worth of gold, about five thousand ounces at market prices as of this writing.

The bank will say fine, send us your money for the gold and we'll offer you a written contract in a standard form. Yet if you read the contract, it says you own gold on an "unallocated" basis. That means you don't have designated bars. There's no group of gold bars that have your name on them or specific gold bar serial numbers that are registered to you. In practice, unallocated gold allows the bank to sell the same physical gold ten times over to ten different buyers.

It's no different from any other kind of fractional reserve banking. Banks never have as much cash on hand as they do deposits. Every depositor in a bank thinks he can walk in and get cash whenever he wants, but every banker knows the bank doesn't have that much cash. The bank puts the money out on loan or buys securities; banks are highly leveraged institutions. If everyone showed up for the cash at once, there's no way the bank could pay it. That's why the lender of last resort, the Federal Reserve, can just print the money if need be. It's no different in the physical gold market, except there is no gold lender of last resort.

Banks sell more gold than they have. If every holder of unallocated gold showed up all at once and said, "Please give me my gold," there wouldn't be nearly enough to go around. Yet people don't want the physical gold for the most part. There are risks involved, storage costs, transportation costs, and insurance costs. They're happy to leave it in the bank. What they may not realize is that the bank doesn't actually have it either.

A central bank can lease gold to one of the London Bullion Market Association (LBMA) banks, which include large players like Goldman Sachs, Citibank, JPMorgan Chase, and HSBC. Gold leasing is often conducted through an unaccountable intermediary called the Bank for International Settlements (BIS). Historically, the BIS has been used as a major channel for manipulating the gold market and for conducting sales of gold between central banks and commercial banks.

The BIS can take the gold it already leased from the Federal Reserve and lease it to commercial banks that are LBMA members. The commercial banks then have title to a certain amount of physical gold. They then sell ten times as much to the marketplace on an unallocated basis. So you can see the leverage at work there. They can sell as much gold as they want and they don't need to have *any* physical gold, just a paper title through the lease agreement.

None of this is speculation. You can go to the BIS annual

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report and look in the footnotes where it discloses the existence of lease arrangements with central banks and commercial banks. It doesn't mention the banks by name, but the activity itself is clearly disclosed. We know who the commercial banks are because they have to be LBMA members, and we know who the central bank lessors are, so there's no need for speculation about what is going on.

The BIS, based in Basel, Switzerland, has an intriguing and somewhat checkered history. It was founded in 1930 as a result of efforts throughout the 1920s led by the Bank of England. It can be seen as a Swiss tree house where children hang out without supervision or scrutiny, except instead of children you have central bankers acting without supervision or scrutiny.

Once a month, the major central bankers in the world gather in Basel, organized in tiers. There's a larger group of as many as fifty BIS members and there's an inner group of seven to ten or so, a relatively small number of central bankers.

The larger group gathers for certain meetings, but the inner group of ten go off on their own, shut the doors, and make their own deals. BIS is the most nontransparent institution in the world. Even intelligence agencies such as the CIA suffer occasional leaks, yet BIS leaks are unheard of. They don't put much on the Web site. They do a lot of technical research you can access and they actually do have audited financial statements. Still, they don't tell you about their deliberations. There are no minutes released of what goes on behind closed doors, and no press conferences after the central bankers meet. BIS is the ideal venue for central banks to manipulate the global financial markets, including gold, with complete nontransparency.

Combining Manipulations

You can combine manipulations. Let's start with an LBMA bank dealer. That dealer sees there's demand for physical gold in China, and there's gold in the GLD warehouse in London. Here's what it can do. First go into the futures market and slam the gold price. This spooks the little guy who starts selling his GLD shares, driving down the share price. Meanwhile, the smart money sees a good entry point. The little guy is dumping his GLD shares while the big players are buying physical gold. Momentum opens up the spread between physical and GLD shares.

The LBMA dealer next sells physical gold short to China. The dealer then buys shares from the little guy who's scared to death. The dealer redeems the shares, gets the physical gold, delivers it to China, and pockets the difference. So a dealer can create its own supply, create its own arbitrage, and then profit from the difference. This type of manipulation arbitrage took place in 2013 when the GLD warehouse disgorged five hundred tons of gold as the gold price went down for the first time in a dozen years. In the course of these manipulations, the floating supply was reduced and more physical gold ended up in China.

Who's Behind the Manipulation?

We've looked at how manipulation works, how it used to be done in the physical market, and how it's done today, primarily through COMEX, ETFs, hedge funds, and leasing and unallocated contracts.

The next questions are: "Why?" And "Who's behind the manipulation?" The LBMA banks are in it for the arbitrage and dealing profits and the hedge funds are in it for the momentum profits. Yet are there larger political and policy interests involved? There are two players in the world with a strong motive to suppress gold prices, at least in the short run: one is the United States, and the other is China.

Many observers have a naïve and, in my view, mistaken analysis of the Fed's interest here. Observers assume the Fed wants to squash the gold price to give an impression of dollar strength. In reality the Fed wants a weaker dollar because it's desperate for inflation. It doesn't want the dollar to go away or collapse, yet a cheaper dollar will cause imports to cost more, which helps the Fed to meet its inflation targets. The United States is a net importer. A cheaper dollar means import prices go up, and inflation feeds through the supply chain in the United States.

A weaker dollar should mean a higher dollar price for gold. Still, there are two constraints on a weak dollar/strong gold hypothesis. The first constraint is that just because the Fed wants a weaker dollar does not mean it automatically gets it. There are countervailing forces, including the natural deflationary tendencies from demographics, technology, debt, and deleveraging. The other countervailing force is the fact that other countries also want weak currencies to help their own economies. Retaliation is the root dynamic of currency wars. Because two currencies cannot devalue against each other at the same time, the need for a weak yen or euro to help Japan or Europe necessarily implies a stronger dollar (and weaker gold), even if the Fed wants the opposite. However, in the long run the Fed does not mind a weak dollar/strong gold policy.

There is a condition on any long-run policy of higher gold prices. It must be *orderly*, not disorderly in the Fed's perspective. Slow, steady increases in the dollar price of gold are not a problem for the Fed. What the Fed fears are huge, disorderly moves of $100 per ounce per day that seem to gather upward momentum. When that happens, the Fed will immediately take steps to rein in the upward price momentum. Whether those steps will succeed or not remains to be seen.

A good example is the July, August, and early September 2011 period. At that time the gold price was skyrocketing.

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It went up from $1,700 to $1,900 per ounce quickly and was clearly headed for $2,000 an ounce. Once you get to $2,000 per ounce the momentum psychology can feed on itself. The next stop could have been $3,000 per ounce; clearly a disorderly process.

The gold price action was getting out of control. The Fed manipulated the price lower, not because it ultimately wanted a lower price, but because it was worried about a disorderly increase. The Fed is perfectly fine with an orderly increase as long as it doesn't go up too far, too fast, and change inflationary expectations. The Fed will be in the market to manipulate when it finds it necessary.

Now let's consider the other major player—China. China definitely wants a lower price because it's buying. It sounds like a paradox—China owns a lot of gold; why would it want the price to go down? The reason is that it's not done buying. China probably needs several thousand more tons of gold before it catches up to the United States. It's precisely because China is still buying that it wants the price to stay low. This gives China a motivation to manipulate the gold price.

The interaction of these U.S. and Chinese preferences has interesting policy implications. The U.S. Treasury to some extent needs to accommodate Chinese wishes because China owns several trillion dollars of U.S. Treasury notes. While the Fed and the Treasury want inflation to help manage the U.S. debt load, China fears that inflation will erode the value of its Treasury holdings.

If inflation breaks out, China's incentive is to dump Treasuries, which would raise interest rates in the United States and sink the U.S. stock market and housing market.

The compromise between the Fed's desire for inflation and China's desire to protect its reserves is for China to buy cheap gold. That way, if inflation is low, China's gold won't go up much, but the value of its paper Treasury reserves is preserved. If the United States gets the inflation it wants, China's Treasuries will be worth less, yet its gold will be worth much more. Having Treasuries and gold is a hedged position that protects China's wealth even as the Treasury tries to destroy U.S. savers' wealth with inflation. The solution for U.S. savers is to do exactly what China has done—buy gold.

Contrary to much speculation, China is *not* buying gold to launch a gold-backed currency, at least not in the short run, but to hedge its Treasury position. The Treasury has to accommodate that or else China will reduce its position in Treasuries.

What remains is a strange condominium of interests where the Treasury and China are in agreement that China needs more gold and the price cannot be too high or else China could not easily afford all it needs. This is an issue I have discussed with senior officials at the IMF and the Fed, and they've confirmed my understanding that a global rebalancing of gold from the West to the East needs to proceed, albeit in an orderly way.

The United States is letting China manipulate the market so China can buy gold more cheaply. The Fed occasionally manipulates the market as well so that any price rise isn't disorderly. Where does the manipulation end? What can individual investors do to weather the gathering storm?

Beating the Manipulation

When we hear about the enormous forces brought to bear on the gold price—with the United States on the one hand and China on the other—how does the individual investor stand up against such forces?

There is an inclination to say: "I can't win against these players, therefore it's not worth the risk of being in the gold market." In the short run, it's correct that you can't beat them, but in the long run, you always will, because these manipulations have a finite life. Eventually the manipulators run out of physical gold, or a change in inflation expectations leads to price surges even governments cannot control. There is an endgame.

History shows manipulations can last for a long time yet always fail in the end. They failed in the 1960s London Gold Pool, with the United States dumping in the late 1970s, and the central bank dumping in the 1990s and early 2000s. The gold price went relentlessly higher from $35 per ounce in 1968 when the London Gold Pool failed to $1,900 per ounce in 2011, the all-time high. There are new forms of manipulation going on now, yet ultimately they always fail. The dollar price of gold will resume its march higher.

The other weakness in the manipulation schemes appears in the use of paper gold through leasing, hedge funds, and unallocated gold forwards. These techniques are powerful. Still, any manipulation requires *some* physical gold. It may not be a lot, perhaps less than one percent of all the paper transactions, yet some physical gold is needed. The physical gold is also rapidly disappearing as more countries are buying it up. That puts a limit on the amount of paper gold transactions that can be implemented.

For example, the manipulation that took place in 2013, when the GLD warehouse disgorged five hundred tons of gold, could not be replicated because by 2014 there were only about eight hundred tons of gold left in GLD. If GLD were to disgorge another five hundred tons, there would not be enough gold left in GLD to make the ETF financially viable for the sponsor. There comes a time when the amount of gold left is so small that the management fees don't cover the costs of insurance, storage, administration, and other expenses.

The third point to consider is that there is an endgame that arrives when China has enough gold so that its gold-to-GDP ratio equals or exceeds that of the United States. It's not there, yet once it is, there will be no political reason to buy more. China will have secured an equal voice at the table the next time a Bretton Woods–style conference is needed to restore confidence in the international monetary system.

Once China has enough gold, the United States and China together could let the gold price go wherever it wants in an orderly way. Inflation could get out of control, and China wouldn't lose. If inflation and the gold price skyrocketed right now, China would be left in the dust. It doesn't have enough gold to hedge the portfolio losses on its Treasury holdings. With the gold price soaring and the Chinese economy growing faster than that of the United States, China would never catch up in hitting a gold-to-GDP target.

China is buying as much gold as it can, but because it's trying to target a gold-to-GDP ratio and has the fastest-growing major economy in the world, it's a moving target. The price has to be kept down until China has enough gold. When it's done buying, when it has approximately eight thousand tons, the United States and China can shake hands and both say they're protected. At that point, a dollar devaluation by a rise in the dollar price of gold can commence.

My advice to investors is that it's important to understand the dynamics behind gold pricing. You need to understand how the manipulation works, what the endgame is, and what the physical supply-demand picture looks like. Understanding these dynamics lets you see the endgame more clearly and supports the rationale for owning gold even when short-term price movements are adverse.

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