Of bullion, backwardation and Buffett

Gold lease rates have crept upwards in an environment where liquidity should be plentiful — what gives?

We first learned about backwardation when, in the late 1990's, Buffett decided silver was cheap. After years in the gutter, the metal decoupled from gold and showed some signs of life. Then we started to see a drawdown in the Comex warehouse stocks. Then, as we approached first notice day, the December contract started trading tight against the next delivery month, March. These were the days of high interest rates and fat contangos – to see spreads come in like this was very strange indeed. Come the new year, the March started to trade above May. *What was going on?*

What was going on was that Buffett was buying silver and asking for delivery. This was in London. The traders there laid off their (short) exposure by buying the front month contract on the Comex, which was trading at a discount to London; how could they, the arbs, lose? Of course, they didn't know it was Buffett on the other end and they didn't know he was in the process of buying a billion dollars worth of physical silver. Terms were 30 days. Delivery in May was of no interest — they needed the metal. Hence the unusual behaviour of the term structure. (See figure 1.)

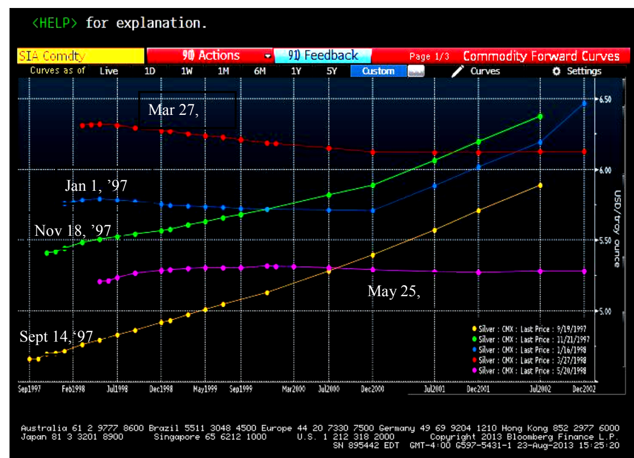

Figure 1: *We show here the term structure of the silver market at different times over the course of Buffett's purchase. In September we see the normal curve strongly in contango. In November, we see signs of flattening (along with a higher price) and by January, near-dated contracts are in backwardation. By March, when most of the silver was due to be delivered, the whole curve is in backwardation. (Source: Bloomberg.)*

There are two schools of thought when it comes to liquidity in precious metals. The first would take the view that, because all the gold that has ever been mined is still extant somewhere on earth, supply/demand at the margin doesn't mean that much. What matters, rather, are "total stocks" of which there are a lot. Opposing this view are those who see shortages everywhere and see these shortages as being indicative of some sort of grander phenomenon. The Perth Mint sells out of coins, small bar premiums go through the roof in Singapore – the great squeeze is on!

Both these schools of thought miss the mark. Local shortages and premiums, while indicative of strong local demand, speak more to distribution and fabrication bottlenecks than a global scarcity of metal. And as for those who think a global scarcity just can't happen in precious metals because there is 5000 years of mine output sitting on surface and all of this is for sale, we point out that all the copper, all the nickel, and all the zinc that's ever been mined is also lying somewhere on surface. Frankly, it is a tiresome argument. Copper comes back to market in the form of scrap just as Grandma's jewelry comes back to market as scrap. And if copper can be in short supply, then so can gold be in short supply.

What has masked this equivalence is the large float in bullion and the liquid paper market that has developed around it. It is easy to trade in front of this apparent inventory, even if it is not your inventory. This is the normal state of the precious metal markets.

Every now and then, however, the kettle runs dry and, when it does, the scarcity of metal becomes manifest in the term structure; and if backwardation is not manifest in the term structure, then the kettle has not run dry.

A simple arbitrage explains this. Assume interest rates are 2% and the term structure is flat (that is, the spot price is the same as the contracted price months out.) If I have a 400oz bar in my basement, I can sell it at spot, put the proceeds out at 2% and immediately contract to buy the (same) bar back a year from now at the same price. Assuming no credit risk and no storage costs, that's a free 2% in my back pocket. Markets abhor any inefficiency, including this one, and so the forward contract gets bid up 2% to the spot price. In this way the free lunch is taken away. A market in balance (or "stasis"), then, has the slope of the forward curve matching interest rates over the same respective time frame and the difference between the two curves is the lease rate, or the cost of borrowing gold.

This market in balance, however, is contingent upon there being suppliers of metal relative to demand willing and able to mobilize holdings for very small returns. Again, as long as "all the gold that has ever been mined", proverbially speaking, sits on a rack somewhere in the bowels of The City, this is pretty much the case.

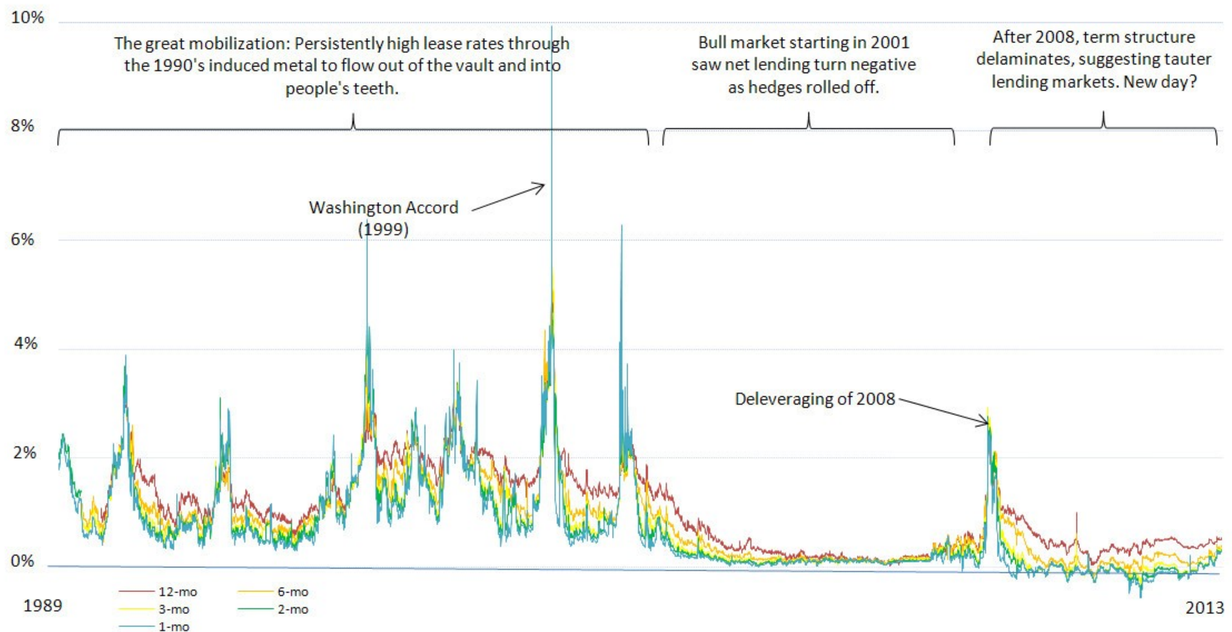

Figure 2: Lease rates over the last quarter century: *Plotted here are the lease rates since 1989 through until the present. Terms (colour-coded) vary from one month to one year. In the same way high prices "cause" production to increase, high lease rates induce metal to flow, either out of the vault and into the cash market (bearish for price) or out of the cash market and back to the vault (bullish for price.) During the 1990's, persistently high rates suggests (central bank) metal flowed out of the vault presumably to be used as a source of cheap finance. This era was interspersed with squeezes that saw the gold called back in (in a hurry, no less.) The Washington Accord caused the most memorable of the episodes—two heavily hedged gold miners were almost bankrupted during the affair. Throughout the bull market of last decade hedges rolled off, increasing liquidity; net gold lending was likely negative over this time, although we can't say what percentage of the total gold out was returned. We saw another spike in 2008 as speculators everywhere were forced to reduce borrowings, including, apparently, gold borrowings. Since this time, we've seen a divergence in rates at different durations. To us, this speaks to more reticence of lenders to lend. And very recently, we've seen rates start to rise again, even as the gold ETFs have disgorged metal. Is something up? (Source: LBMA.)*

It is instructive to look at episodes when this market has not been "normal". A year and a half after Buffett waded into the silver market gold was $250/oz and, in anticipation of the central banks selling all the gold at any price, gold miners were hedged to the gills in preparation for $150/oz. According to the CFTC commitment of traders data, specs were heavily short for likely the same reason. Then came news of the Washington Accord wherein it was announced that central banks would not sell all their gold at any price. Gold spiked $50/oz (a massive day back then) and demand for physical metal surged as borrowers scrambled to repay the gold loans. Two years later, in March of 2001, lease rates spiked again, if more moderately, after gold rallied from $250/oz to $275/oz. With the squeeze of 1999 fresh in mind, a GFMS analyst opined: "[T]he possibility of withdrawal of lending by central banks could contribute to a fraying of the nerves." The most recent spike took place during the great deleveraging of 2008. A shortage of liquidity became manifest as speculators rushed to close out positions, some of which were, apparently, gold positions.

The three instances of higher lease rates described above were associated with (sharply) upward movements in the gold price but it is not axiomatic that higher lease rates mean higher gold prices. Throughout the 1990's gold lease remained persistently elevated and throughout the 1990's the gold price generally sagged. How to explain this? We know that it was during these years that gold mining companies strapped on large hedge books. This is how Barrick explained it in their 1997 Annual Report:

> *"While Barrick has developed sophisticated tools for its hedging program, the core process is straightforward. The Company sells its gold at the current spot price while the ounces are still in the ground, and earns interest on the proceeds from the spot sale before delivering its production against the contract. The Company works with a bullion dealer and a central bank, which lends gold from its reserves to the dealer for the sale. ... Current contracts will earn over 7% interest on the proceeds from the spot sale while paying 2% interest on the borrowed gold, generating a premium of over 5% a year."*

If Barrick and other gold mining companies took delight in seeing its "ounces in the ground" earning "free money", then surely this trade was attractive to others as well. Who else borrowed gold at 2% to earn 7%? The persistently high lease rates over the course of the 1990's suggest strong demand relative to available stocks. It is

reasonable to assume that this period, induced by attractive lease rates, saw the mobilization of a fair amount of "all the gold that's ever been mined" sitting on racks, "doing nothing" in the bowels of London, and by this we mean the metal was sold into the spot market and stuffed into someone's teeth. The lease rate spikes during the following decade speak to episodes of strong demand to get that gold back.

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Over the summer, in lock step with gold's decline, we've seen lease rates start to rise. Short-term rates are now at about 0.3%, which doesn't seem like much, but against short interest rates (Libor) at very low levels, it has been enough to tip the term structure at the short end into backwardation. This has generated some buzz amongst gold commentators. That stocks in certain Comex warehouses are being drawn down has helped stoke the conversation. On this point we want to emphasize that just because spot is trading ahead of the December contract does not mean there is no physical metal left, it does not mean we are on the verge of systemic default. It remains, though, an interesting development.

Interpretations vary, but two things that can't be denied: 1) with the term structure in backwardation, it now pays to own physical and it now costs to borrow. No more earning income your "ounces in the ground" as Barrick used to put it. This said, lease rates are not high enough to move a lot of metal — between transportation and what-not, 30 bps does not compensate one to ship metal to London to sell spot.

That said, 2) we also know that demand for physical in relation to available supplies has risen. Is this bullish or bearish? Is this a result of increased demand, reduced supply or some combination of the two? The bears will argue "increased demand" and cite a renewal of hedging as the culprit. We agree that with the slump in prices some companies have returned to old habits. According to reports, the total amount hedged of late does not exceed 70 tonnes. For sake of comparison, there has been about 500 tonnes of physical disgorged from the bullion ETFs this year, which is 500 tonnes of liquidity that was not there before. If after this, the liquidity needed for 70 tonnes of hedging backs up the term structure, then it strongly suggests that gold in the bowels of London, relative to demand, is not as bountiful as many thought it to be.

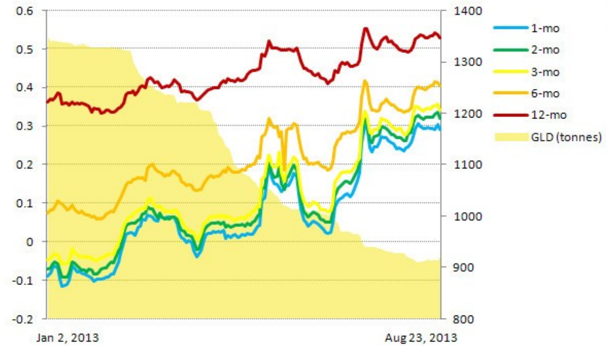

Figure 3: *Lease rates this year, especially on the short end, have risen steadily. This would be far less noteworthy had it not been for the large drawdown in the various bullion ETFs. Shown here are the GLD holdings, which are down almost 500 tonnes. This is a lot of liquidity, certainly more than the 70 tonnes of hedging that has taken place. Why the tightness in the physical market then? Maybe it's not just the miners borrowing metal? Or maybe lenders feel they've lent enough? (Source: LBMA, WGC)*

One of the main push-backs we get when peddling gold is that *there is so much of it*. Many bulls feel this way too; for them, gold is going up not because it is not plentiful, but rather because paper money is more plentiful. Market behaviour corroborates this: producer margins in the gold sector pale in comparison to producers of base metals and petroleum – why provide a profit incentive to produce more when we already have vaults full of the stuff?

But vaults can and do empty. Let's go back to Buffett: in early February, 1998, Berkshire Hathaway came out of the woodwork and announced that it was *they* who had been buying silver; the Company had taken delivery of 87mm ounces and it was standing for delivery of an additional 43mm ounces. The market reacted violently, especially the front month contract. Those short immediately appreciated that this was not just another bluff – *they'd have to find the metal!* All hell broke loose.

It turns out Buffett likely never did take delivery of the entire 130mm ounces. The 1997 Berkshire annual report showed holdings of only 110mm ounces. It is fair to speculate he settled for the rest in cash. The cupboard was, apparently, bare.

Gold is certainly a deeper market than silver but the notion of there being infinite supplies is a mirage just the same. Keep your eyes peeled on the term structure. If there is to be a run, it will manifest itself here first. Indeed, it might have already done so.

Douglas Pollitt
dpollitt@pollitt.com

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