"They don't call it the fix for nothing"

Redemption for the Tinfoil Hat crowd; problem more nuanced; going forward: "caveat venditor."

The Amended Complaint against several major bullion banks wherein it is argued that said banks colluded to manipulate the London Gold Fix was unsealed last week. It is a convincing document, and damning of the Defendants. Most galling is the disclosure of chat transcripts amongst traders, exchanges they surely thought would never see the light of day. Choice examples to follow.

This is a touchy subject amongst gold investors, some of whom believe the price is set in Davos every year, and others who refuse to have anything to do with those who believe the price is set in Davos every year. We are agnostic on the topic, but will say that muscle and its enlistment is a fact of life in all markets. However, one thing we do know, having reviewed the Complaint, is that the organizations the gold mining industry depends upon to market its metal did not have their clients' best interests in mind. This may still be the case. Perhaps a gold mining company (or two) will read this note and if they do, by the time they are done, they may well think that there may be a better way to get their product into the hands of the people who want it.

The London Fix is a twice daily auction that started in 1919 when Nathan Rothschild got a lock on South African gold production and needed someone to sell it to. A group of bullion banks were assembled to bid for the metal. The auction works, then as now, by adjusting price until the market balances. This mechanism is similar to that which clears the opening on most equity exchanges, except during the Fix participants were all in the same room and on the phone with their desks.

For a variety of reasons, including those of a contractual nature, gold miners, then as now, have a significant, if not dominant presence on the offer. It also bears noting that the Fix is a little like the "index" of the bullion markets and, as many fund managers can appreciate, gold producers don't want to be too far away from it. Accordingly, gold producer orders tend to be market orders: "5000 ozs to go at the Fix" and this is no matter where the Fix ends up being. We are not sure how long a buy-side desk would last if it were to sell in this way.

There is a great deal of data analysis in the Complaint. What this analysis shows is that, between the years 2004-2013 [check], the years considered under the Complaint, is that the PM Fix fixed lower than ambient prices and did so with a high degree of statistical confidence. Overlay the daily graphs for the time period and you will see an aggregated "spike down" preceding 3:00 London time. As Murray used to say: "They don't call it the fix for nothing."

Figure 1: *This is the Fix room, located at Rothschild's offices on St. Swithin's Lane in the City. We were here once, but only in the capacity of a relative of someone, a producer, who sold through Rothschild's. We had thought it was to be a simple courtesy call. Instead, one of the senior guys there sat us down and brought in the head gold trader. This was back in the heyday of hedging and the producer was one of the very few who did not hedge. They served tea and spent what seemed an inordinate amount of time trying to convince us that said producer should hedge. The gold price was not higher than $270/oz. No matter that we protested that we had no influence over the producer and even if we did they would never hedge anyway, they carried on trying to sell us on the merits of forward selling. In what we took as being the* coup de gras *of the pitch, were invited to excuse ourselves from the Tea Room and walk down the corridor to be shown the Fix Room. We can't say we weren't impressed. The company, of course, never hedged.*

A settlement was reached with one bank and as part of the settlement this bank had to hand over related information. Part of this data dump were chat room transcripts. We provide a selection of them here; they speak for themselves. [Small edits have been made for clarity, but not so many as to remove the charm.]

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BANK-1: Bro, japan holiday today. Think it'll be quiet. Well, illiquid, not quiet, haha. Illiquid means wild west.

BANK-2: okay, when gold pops 1430 we whack it. U sell your 50k. I'll sell my 20k.then we double that up and produce on our own liquidity. Should be enough to cap it on a holiday.

BANK-1: haha yeah. lol.
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BANK-1: I'm a tiny buyer at the mom[ent.]

BANK-2: Think I [am] too.

BANK-1: Means we fix lower.

BANK-1: I kick some out and take it back after the fix.

BANK-2: Yeah, no one else is thinking of that.

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BANK-1: Everyone [short] into the fix I swear it's the only time ppl trade.

BANK-2: hahahahahahahahahah shocking absolutely shocking.

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BANK-1: I was prop trading on the fix. Was quite fun. It's a free option the fix.

BANK-2: oh ok. Did I tell you I saw a 300k loss on a fixing before too?

BANK-1: Wtf? Misscomm?

BANK-2: [No, I] started pushing too early.

BANK-1: Yeah, oh well bro. We tried, man. We are brothers forever.

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BANK-1: Boc sniffing around in gold.

BANK-2: Likewise. [They] passed my bid. Dude, so their round is from you to me. Haha.

BANK-1: Not always. Anyway, good to give each other [a] heads-up. If we find out side, whack it.

BANK-2: Yeah.

This is not an exhaustive list; the Complaint shows more and, apparently, there are more behind that.

The cumulative impact of interacting with what can only be described as a hostile selling environment is difficult to estimate; our sense, though, is that it is significantly greater than what the narrow interpretation of the statistics would suggest.

In July of 2012 the FT broke the story that the daily London Libor fix was also being rigged. From what we understand, a major clean-up process took place across departments at the banks soon thereafter. Cross-market arbitrage was severely curtailed. A friend close to this scene advises that going to work as a trader now is like going to church. Compliance officers follow you around wherever you go. "It is the best time in the world to work with these people." Satisfyingly (from a data analysis perspective), the Plaintiffs show the pattern of anomalous gold fixes ends in 2013.

An episode on January 28, 2016, suggests that while the issue of flagrant front-running may have been addressed, the gold miners may still not be getting the price they should. On this day, silver fixed 6% beneath the prevailing Comex quote. Heads turned and jaws dropped. The "price-is-rigged-in-Davos crowd" pointed to the incident as being yet another flagrant example of the banks' perfidy.

But the problem was not that the bankers had a hand in this spike-down. Rather, the underlying problem that precious metals companies were, apparently, happy to sell too much metal at any price. Under the old rules, the bankers would have faded the incoming order flow on other exchanges (eg. the Comex) and, for their efforts, pocketed a small clip along the way. (There was a saying in the pits: "I will buy you lunch but I won't buy you lunch and dinner.") Now these people were forced to sit on their hands. It was this passivity that exposed the miners' folly.

There was actually some sense to the producers' decision to entrust the marketing of their gold to a handful of London banks. Back in 1919, when the world turned on fixed exchange rates, price stability was worth paying for. It is often forgotten that for a spell in the 1950's, when massive new orebodies in South Africa came on stream, the London banks, to preserve the $35 peg, mopped up the excess supply. It worked both ways – what the banks took one day they were willing to give back the next.

This common purpose between seller and buyer is now long gone. Yet the means by which the producers sell their metal remains the same: they ask the London banks what they can get for their gold and then, all too often, they take it. No gold company CFO ever got fired for doing as much.

Pierre Lassonde apparently once said that gold companies' marketing efforts consist of "waving the

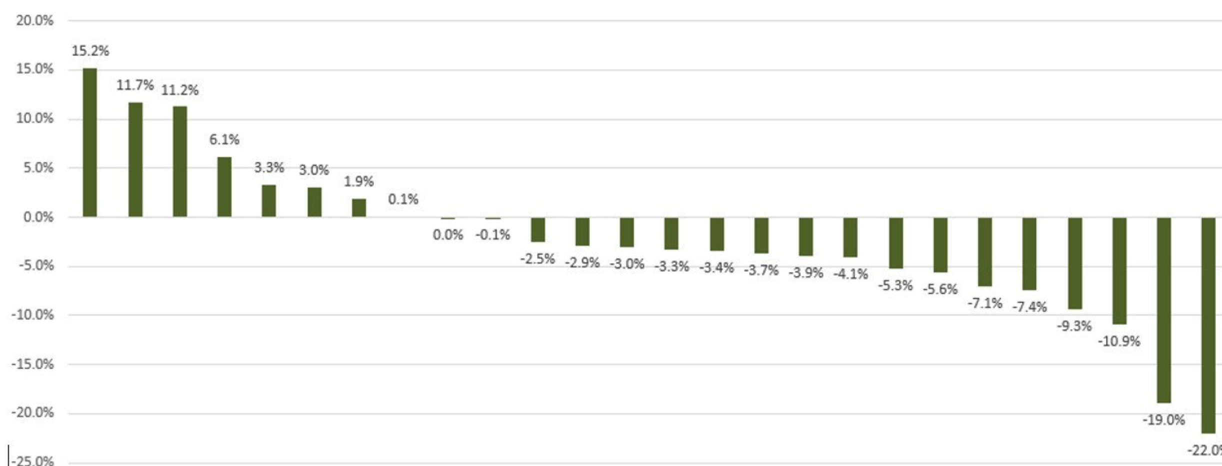

Figure 2: *We have a problem, Houston. Shown here are the 5-year annualized return on capital statistics for 26 gold mining companies encompassing most of the world's production. Of this lot, only seven show a positive return on capital. The average return of capital of this set is negative 2.3% annualized and this is in a high risk business where hurdle rates on the debt side are often 15-20%. One can chalk this performance up to a lack of competence, but operating efficiency has been far less of a problem as compared to building sub-economic mines in the first place. It remains then that, to see returns that match risk, we need either higher prices or fewer (sub-economic) mines. The latter would contribute to the former.*

Brink's truck goodbye." Compare this with the efforts of the base metal companies – would BHP or Rio call up the Chinese, ask them what they'd pay for iron ore, and then just say 'ok'? Efforts by uranium and potash producers go further yet. Then there are, of course, the oil producers who, sensing that their very survival was at stake, recently announced that they would collectively not sell as much oil as they could at any price.

In figure 2 we show the ROC for the sector and it is not difficult to ballpark where the average is. Things are actually a lot worse on a go-forward basis, for the gold that they sell now at any price is not being replaced and it is that production will fall precipitously in the years ahead. This speaks to many things, one of which is that the price of gold has been too low to make a living.

There are some who argue, both in the bull and bear camps, that gold miners don't matter. Price is set by stocks, not flow and in this way, it is contended, the miners, the largest suppliers of flow by far, don't impact price at all. There was a piece on Seeking Alpha over the weekend that predicted gold would go "post-bubble" back to its "equilibrium price" of $500/oz. There was no mention in the piece about what $500/oz would do to the economics of gold mining. Of course, $500 gold would be met with a Soup Nazi reply from the producers: no gold for you. And insofar as flow matters in extremis, it surely matters at the margin. (Certainly, it mattered to those who front-ran it.) Gold miners have market impact, except that, as currently formulated, it is the wrong kind of market impact.

The banks may have cleaned up their act; for one, we doubt they are still using traceable chat lines. A best case estimation is that these buyers now act in a manner of indifference. Others see things more acutely. Private equity groups, groups not generally known to overpay, as part of more comprehensive financing packages, have paid gold companies for offtake agreements. Glencore and Trafi built lucrative businesses around offtakes. Yet right now the gold companies give these offtakes away for nothing and do so to a group that hasn't had their best interests in mind for years.

Gold is down $200 in five weeks and some equities are back where they started from. Yet the sector's survival instinct remains difficult to discern. Maybe they don't feel, like the $500/oz Seeking Alpha guy, that they can do anything about it. Maybe price-taker mentality is burned into their collective brain.

N. M. Rothschild's walked away from the fix in 2004. After almost 100 years of operation, maybe it is time the gold producers showed a bit of pride and did so too.

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