

## Contango

We wrote a few weeks ago on gold lease rates and the suggestion by a Financial Times blogger that some Central Banks have lent gold to keep pressure on the price (after all, anybody who borrows gold sells it with the idea of doing better than the lease rate).

In the 1980s the big bullion banks persuaded many Central Banks to “mobilize” their “sterile” gold (by leasing it to them) and the lease rate (as we know it today) came into being. It’s been with us ever since. Some entities borrowed gold a) to go short, b) as a cheap source of working capital (Lehman?) but c) perhaps the bulk was borrowed (in the 1980s) to facilitate the brand new business of hedging future gold production, a business enthusiastically encouraged by the banks.

A typical hedge transaction would have a bank borrow gold (lease rate  $x$ ), then sell it to invest in Eurodollars (LIBOR  $y$ ) and simultaneously contract with a mine to buy a like amount of future production. This contract would be based on the forward premium for gold, the contango, which is the market time premium ( $z$ ). The bank’s profit would be (approximately)  $y - z - x$ . At the peak, total gold mine hedge positions totaled over 120 million ounces.

People talk about lease rates, but in the gold world the contango is probably more important. Let’s say Dec gold is trading at 1800 and Jun gold is trading at 1806. That’s \$12 annualized or over 60 basis points (bps). This number has been climbing slowly in recent months and compares to LIBOR and the gold lease rate which are about 40 and 20 bps at this time. (Estimates of gold lease rates vary a lot. The banks that run this business are a pretty tight club and don’t publish much).

This leads into one of the big businesses of bullion banks. There are large gold futures markets in New York, London and Asia. Tens, even hundreds, of millions of ounces are traded every day by a) speculators (long or short), b) kids in the one-acre trading rooms who think nothing of going long or short 1000 contracts (as though they were Yen or bonds) with no real idea that this represents 3 tonnes which may ultimately be moved by Brinks and c) serious

investors and real players who sometimes use the Comex as a warehouse or reservoir.

Let’s say an ETF or Central Bank buys 3 tonnes spot and the agent (say HSBC) doesn’t have the metal on hand. No big deal. The agent just contracts spot, receives the money and protects itself by going long the futures. As time goes by the process is reversed — say a mining company sells 3 tonnes, the agent pays the mine, delivers the gold to the ETF and unwinds the futures position.

The open interest on all these exchanges is hundreds of millions of ounces (a multiple of annual mine production) and the big questions are: who is long (see above) and who is short? Who is on the sell side of all those positions? In some cases, the bullion banks. If the contango is as described above, a bank can borrow Euros (–40 bps), buy gold (and maybe lease it to someone (+20 bps?)) and short the futures (+60 bps). We have no idea how much of this goes on, but it’s sizeable. The rest of the sell side on these big exchanges may be short.

In the 1970s the trade described above was pretty universal. The only forward sellers were banks and premiums were fat. Borrow at 5%, buy cash gold and sell the contango at 7%. No bps in those days. The beauty of that situation was that a speculative purchase of, say, a silver contract (requiring a small margin payment) led to a bank on the other side of the trade buying the whole 5000 ounces spot for many thousands. Buying a futures contract triggered a cash purchase of the underlying amount. Hence the Hunt Bros fireworks because there wasn’t enough silver lying around.

The gold lease rate depends utterly on whether an entity is willing, or able, to lend and whether another entity is willing and able to borrow. Normally the market is pretty quiet but a crisis can cause big change. In late 1999 some European Central Banks, which had been steadily selling gold into the market, announced they would limit sales to about 500 tonnes a year (about 16 million ounces). This caught the market by surprise and was seen as bullish (the bears had been expecting even greater sales) and the market experienced a serious short-covering rally.

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Gold jumped almost 20%, the lease rate popped and some companies (such as Ashanti, which had more near-term hedges than gold) were in real trouble.

It didn't take more than a day or two before a lot of gold was lent into the market (Central Banks?) and the price was pushed back down.

Generally the lease rate will only have market significance if it moves aggressively higher as this would signify a reluctance or an inability to lend. More important is the contango. If it starts increasing, and in particular if it starts increasing against LIBOR, this would likely indicate a growing reluctance to supply the futures markets rather than a reluctance to buy. In

1979 this happened to silver. The sellers gave up and went to the authorities to have the market closed.

At some point, perhaps soon, the willingness of somebody, somewhere, to contract to supply gold in the future will abate. Italy for one, with its huge gold holding and huge debts, may soon be the first G8 country to advocate a higher, not lower, price.

But if we see some serious action on the contango front (which may signify progress on the remonetization front) our guess is the real bull market will be starting in earnest. And when it does, the 1970s will seem tame.

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