View from the Bridge an alternative look at the investment world

By Clive Hale

Where's my metal?

"You have a choice between the natural stability of gold and the honesty and intelligence of the members of government. And with all due respect for those gentlemen, I advise you, as long as the capitalist system lasts, vote for gold." George Bernard Shaw

A previous edition of the "View" ended with this quote but it deserves further analysis. Gold is one of the most stable elements in the universe but its price of late has been anything but; although that wouldn't be obvious from a long term chart. The only significant "blip" here was during the "flight to quality" in 2008; the final hurrah for bonds?

The rise since the low in 2001 has been inexorable and far from the exponential blow off that is often associated with precious metal peaks. The low came at the end of the infamous selling of 400 tons of the UK's reserves by our former Prime Minister, then Chancellor, and is still known irreverently in the gold market as the Brown bottom.

The decision to sell was announced by a junior Treasury minister, Patricia Hewitt, by way of a written parliamentary answer in May 1999. The intention was to sell 125 tons via of a series of auctions, every two months ending in mid 2000. Having been given the heads up, the market went short, sending the price down 13% by the time of the first auction, in the knowledge that there should be a ready supply of gold to enable them to close their positions at a profit.

There then followed a massive bear squeeze, between July and October, raising the gold price by 35%. By way of explanation, if you are short (ie have sold gold you don't own) and the price rises, your losses are theoretically infinite. Add in an element of gearing (the margin on a futures contract is a small percentage of the whole) and the squeeze became painful to the extent that some UK bullion banks got very close to the edge. They needed the price to fall to "get out of jail" and miraculously the Treasury decided to up their sales of gold to 400 tons, which had the desired effect, bringing the price back to around $250 by the time the auctions ended.

One suggestion for Brown's decision to sell bullion was to buy the fledgling euro to diversify the UK's reserves and support the new currency. Charitably, let's accept this to be the case as far as the initial 125 ton offering is concerned. Or did he just want to support those suppressing the gold price as practised since the gold standard was abandoned, but who had got into "a bit of trouble" by overdoing it; hence the additional sale of 275 tons to end the bear squeeze? One thing is for sure he didn't just wake up one morning and tell the Treasury to sell the family "silver"; there's always a hidden agenda unless you believe everything written in the newspapers...

Despite a recent all time high in gold, but, importantly, not even close in inflation adjusted terms, the story of suppression continues. Why should that be? Gold is the ultimate currency and store of value. There is a strong correlation between the price of gold and the dollar index. If you are the "protector" of the world's reserve currency then you will not wish to see an accumulation of gold in the "wrong hands". The former President of Tunisia understood this when he extracted 25 tons from his central bank and apparently the Egyptians intercepted similar shipments before the recent events in Cairo. In a real crisis gold is acceptable anywhere in lieu of paper "fiat".

On such occasions the detractors will be heard to say that you can't "eat gold", but have you tried eating paper currency? When it loses its value completely as in the Weimar republic days and more recently in Zimbabwe a stack of worthless paper was at least cost efficient when compared with the rising price of lumber (fire wood). Could we return to a gold standard to back our currencies? Yes we could, but only with a gold price massively higher than it is now.

So keeping the price of gold down is an imperative for government policy to allow them to keep hold of a semblance of control. If there was a free market in gold there is little doubt that the price would be substantially higher and the same goes for silver; silver is gold with "attitude". (The long term ratio of the gold price to silver is around 16 but is currently closer to 50.)

The recent price action has seen brief but regular down drafts, often in the Globex market, when the main protagonists are asleep and liquidity is meagre. As a result a relatively small amount of aggressive selling can go a long way. Many can see here the hand of the banks, beholden to governments for bail out, TARP and QE money, which is propelling equity markets ever skyward. As the quid pro quo can you chaps please keep the lid on the precious metals for us?

The Chinese who have been accumulating gold by buying up production from their own miners (they are the largest global producer of gold and the third largest silver miner after Mexico and Chile) have also come in for some stick.

Why would they want to suppress the price of gold? For the same reason as the bullion bank shorts. You keep persistent downward pressure on the price and eventually you will shake out a lot of weak holders, who will sell to you at a lower price.

So if the bulls are facing the bullion banks, which have backing from the US government on the basis that they are too big to fail, and the Chinese, who are just "big in spades"; can their optimism be justified? The problem for the shorts is that their persistent selling is not increasing the supply, especially in the silver market where many bullion dealers no longer have the more popular bars in stock. The $600 million Sprott Physical Silver Trust launched last year has taken delivery of almost all the silver bullion it has purchased but they admit that it was not an easy task.

Another reason given for the January drop in silver was to allow the accumulation of March contracts to be held for delivery at a lower price. Most metals futures contracts are settled for cash with no physical delivery taking place. However if metal exchange stocks are low (which they are) then if there is a move into contracts held for delivery then the price is only going to go one way!

A further problem for the shorts is that the bullion banks operate a fractional reserve system in much the same way as the commercials. If you deposit $1,000 in an account the banks know from experience that you will not draw on all of that money for some time so they lend it out. The borrower deposits the money and he won't draw on all of it either and so it goes on. In the bullion markets it is alleged that the ratio of gold lent to that actually in the vaults is 100 to 1.

Even if it is not that extreme, (of course it could be a bigger number!), what happens when the contracts held for delivery exceed the physical available? "Where's my metal" will be the cry. If requests to audit the gold holdings in Fort Knox continue to be denied you have got to wonder haven't you?

"Gold has worked down from Alexander's time ... When something holds good for two thousand years I do not believe it can be so because of prejudice or mistaken theory." Bernard Baruch

Chart courtesy of Fullermoney – www.fullermoney.com

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