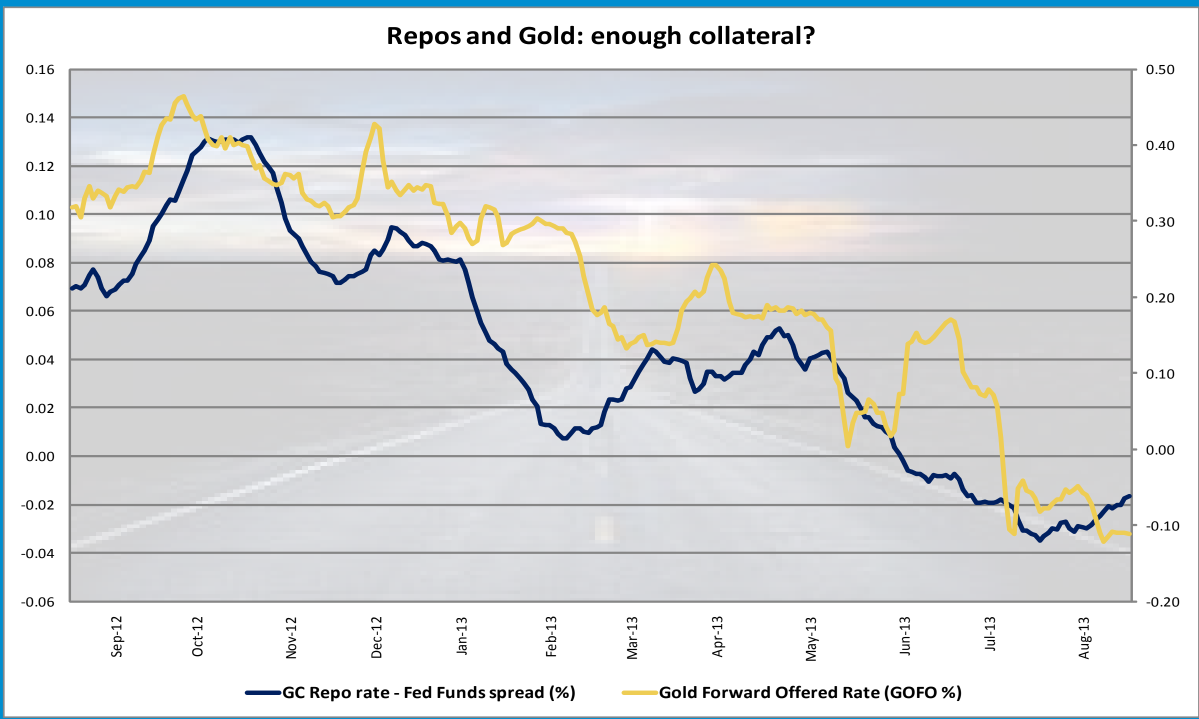
Thunder Road report

Collateral: could the post-Lehman reflation be reaching its limits?



MONUMENT SECURITIES LTD

Strategy

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Collateral: could the post-Lehman reflation be reaching its limits?

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Theme: leverage in the repo and gold markets

It's ironic, or it seems that way to us, that two of the least understood financial markets by equity investors are two of the most systemically important – repos and gold. Even more ironic is how so many investors don't even consider them to be all that important.

In our view, stability in both markets is a pre-requisite for maintaining confidence in the financial system and keeping the credit/asset bubble inflated. The significance of these markets is not lost on governments, central banks and regulators, although the definition of "stability" in each of them is slightly different.

The greatly under-reported repo market sits at the centre of the banking system and the securities markets. It is a primary source of leverage and, therefore, risk. Time after time, the risks remain hidden until events cascade beyond the point of no return. Stability in the repo market depends on confidence in repo counterparties (which can evaporate at near light speed, e.g. Lehman, Bear Stearns, MF Global and Long Term Capital Management), confidence in the valuation of collateral used in repo loans (remember sub-prime etc) and a sufficient pool of acceptable securities (e.g. Treasuries, MBS, etc) which can be pledged as collateral.

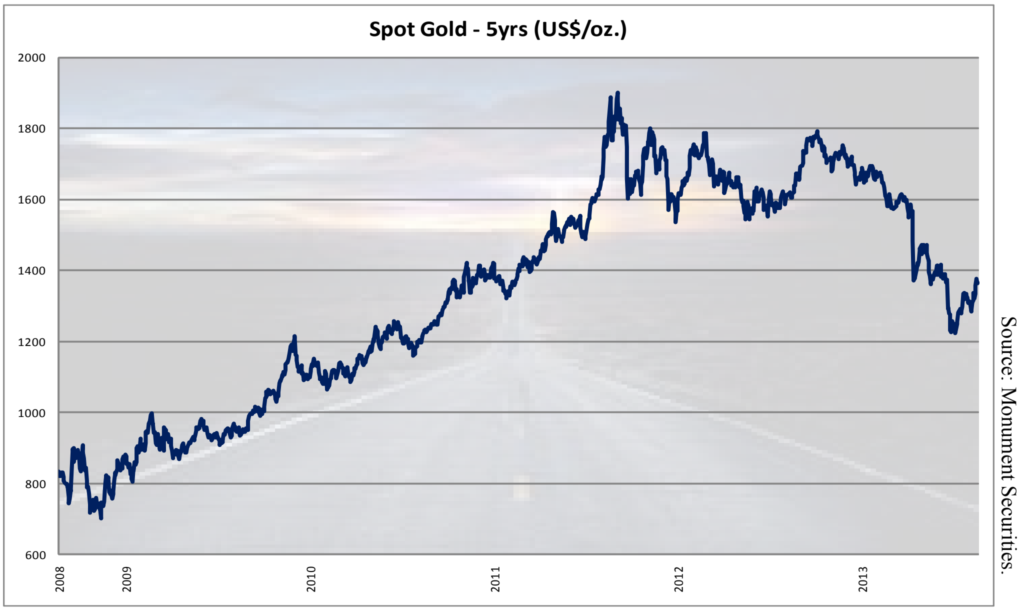
In stressed market conditions, liquidity crunches, declining collateral values and re-hypothecation (i.e. re-use of the same securities as collateral by more than one party) can undermine this market. This results in capital being wiped out, a run on collateral and the telltale sign of spikes in "fails-to-deliver", when a scramble to post eligible securities ensues. Late 2008 was the example par excellence – here is what happened to fails-to-deliver in Treasuries (data is in US$m).

Source: Jesse's Cafe Americain.

When stress emerges in the financial system, the problem with the repo market is its tendency to be (very) "pro-cyclical" on the downside. It also operates pro-cyclically in terms of leverage and asset prices on the upside, which always seems to get forgotten.

Stability in the gold market for policymakers and regulators implies a stable gold price, preferably at "low" levels (i.e. well below all-time highs), an efficiently functioning gold futures market, ample liquidity in the gold lending (leasing) market and no heightened desire among gold buyers to take possession of physical bullion. A surging gold price, backwardations and shortages of physical bullion are proverbial "canaries in the mine" regarding an overstretched system.

It's belatedly dawning on more and more people that the price of gold on everybody's Bloomberg screens is in fact a hybrid price of predominantly "paper" and "unallocated" (convention for LBMA settlement unless "allocation" specified) gold claims together with a much smaller pool (collateral) of physical gold.



The Reserve Bank of India's January 2013 snappily titled, "Report of the Working Group to Study the Issues Related to Gold Imports and Gold Loans by NBFCs" estimated that the traded amount of "paper-linked gold" exceeds actual physical gold supply by more than 92 times.

Gold Futures and OTC Market Vs Physical Market for Gold (million ounces)

Instrument	**2010**
Physical market	120.8
Futures & Options ET vol.	6438.8
LBMA (OTC) clearing volume	4727.7
Total	11287.3

Source RBI

Looking underneath the bonnet/hood, we are doubtful that either of these markets, repos or gold, can reasonably be described as "stable" right now. There also seems to be a paradox where the current low repo rates and gold prices are, we suspect, fooling people into a false sense of complacency.

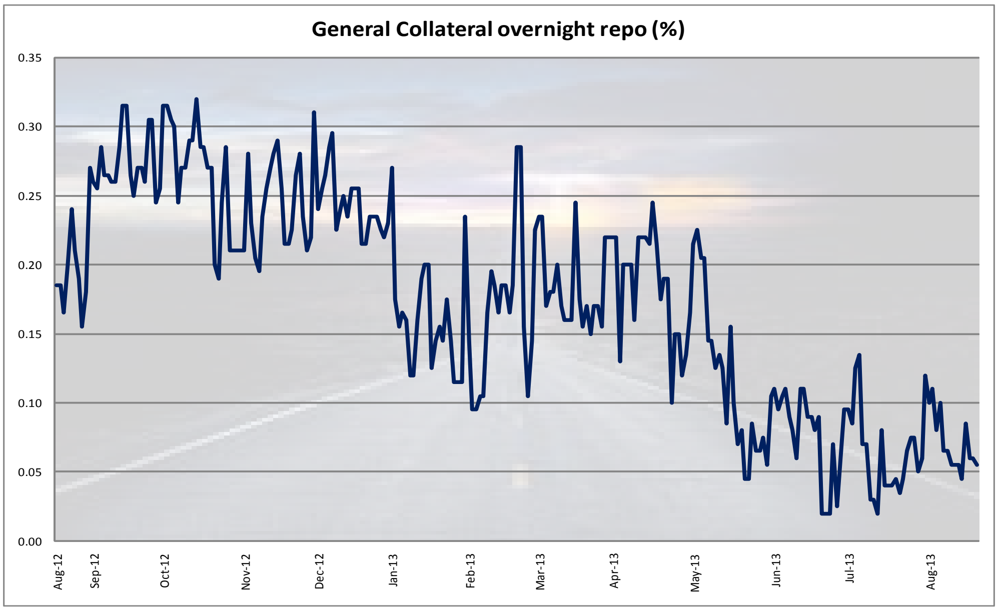
What's really piqued our interest, however, is whether there is a similar issue which is increasingly impacting both of these systemically important markets?

This issue relates to the availability of sufficient collateral – Treasuries and other "high quality" collateral in the repo market and physical bullion in the gold market – and the willingness (or ability) of market participants to either keep expanding the volume of claims against that collateral, or at least maintain the status quo.

We are starting to question whether leverage in repo and gold markets is reaching its limits? If so, does it have implications for the debt and asset bubbles themselves? Readers will draw their own conclusions and we would appreciate feedback.

Repos - “the structural backbone for US financial markets”

In the US$4.6 trn (daily outstanding) US repo market, Bloomberg is quoting the repo rate for General Collateral at an extremely low 0.055% – and very close to the lowest rate during the last 12 months.



Source: Monument Securities.

Basically, the rate for which borrowers who can pledge acceptable collateral appears to be trending towards the zero bound – although it’s not reached that level yet. The lowest level up to now has been 0.02% in mid-June and late-July. Borrowers able to pledge gold as collateral can already borrow at negative rates (see below), but there could be a similar trend unfolding here.

It’s worth clarifying that in a General Collateral (GC) repo transaction, the securities pledged as collateral are not designated until near the end of the trading day. The New York Fed defines a GC repo as:

“**a repurchase agreement in which the lender of funds is willing to accept any of a variety of Treasury and other related securities as collateral. The lender is concerned primarily with earning interest on its money and having possession of assets that can be sold quickly in the event of a default by the borrower. Interest rates on overnight general collateral RPs on Treasury securities are usually quite close to rates on overnight loans in the federal funds market. This reflects the essential character of a general collateral RP as a device for borrowing and lending money.**”

Borrowers able to pledge the highest quality collateral, e.g. some Treasuries, in Special Repurchase Agreements can borrow at rates even closer to zero...and in rare cases at negative interest rates. The table below shows the repo rates for GC and various vintages of US Treasuries from 2 to 30 years on 8 August 2013.

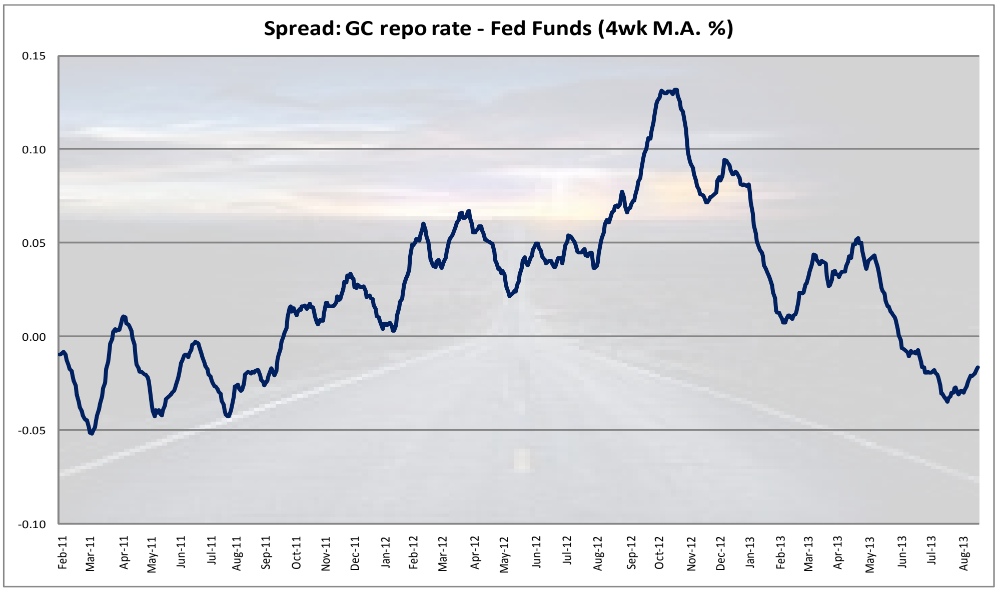
Repo rates on 8 August 2013

Date	Fed Funds	GC	2-year	3-year	5-year	7-year	10-year	30-year
08/08/13	0.10%	0.08%	0.08%	0.08%	-0.05%	0.04%	0.06%	0.08%

Source: ICAP

This suggests that some Treasury collateral, e.g. the 5-year, was in VERY short supply in the repo market, and the 7 and 10-years somewhat less so. Over and above a widespread unavailability of collateral, one might surmise that the 5-year was the most shorted Treasury issue at the time (exacerbating the difficulty in borrowing).

Our focus recently has been on the spread between repo rates and Fed Funds. Since early June, GC repo rates have been trading at a negative spread versus Fed Funds. It's not the negative spread (repos are collateralised unlike Fed Funds), but the trend in the spread which has attracted our attention.



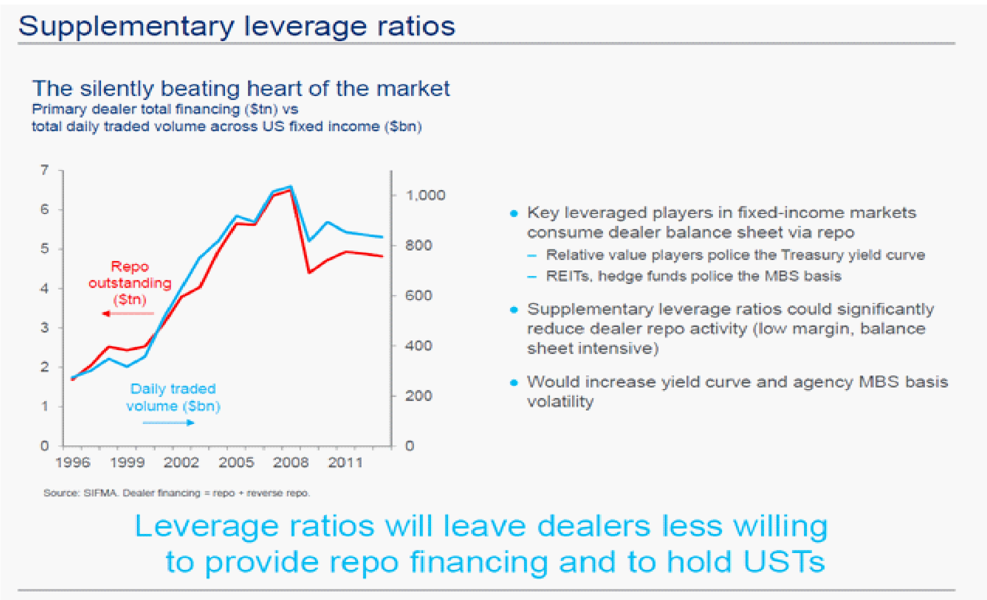
Source: Monument Securities.

The spread between GC repo and Fed Funds peaked at about the time that QE3 was announced last Autumn. We can't say for certain, but the implication is of a developing scarcity of collateral backstopping the repo market. As we reiterate (again) later in this report, QE reduces the flow of high quality collateral which is potentially available to the repo market – currently to the tune of US$85bn per month (pre-taper).

With OTC derivatives moving "on exchange" and new regulations (Basel III, Dodd-Frank), collateral requirements and bank deleveraging are increasing – which is not good for liquidity in the repo market. Will a gradual tapering of QE be enough to offset this? Here is a thought-provoking quote from Reuters last week.

"The (repo) market is very dislocated right now because of regulatory uncertainties,' said Nancy Davis, a managing partner at hedge fund Quadratic Capital, who has worked at big banks as a senior derivatives trader. 'I've never seen anything like it."

What's happening invites the question as to whether the post-Lehman reflation of the credit and asset bubble, especially in terms of leverage via the repo market, is reaching its limits? This slide from the Q3 2013 presentation by the US Treasury to the TBAC (Treasury Borrowing Advisory Committee) suggests that it is.

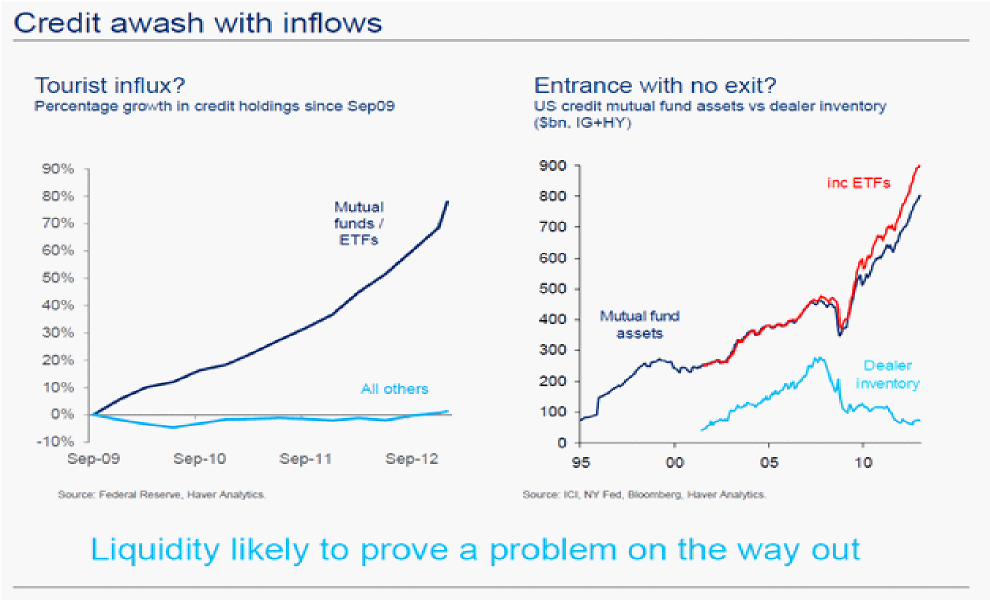


Source: TBAC

Please note the size of the repo market ("Repo outstanding ($tn)") and the comments about the yield curve and leverage ratios.

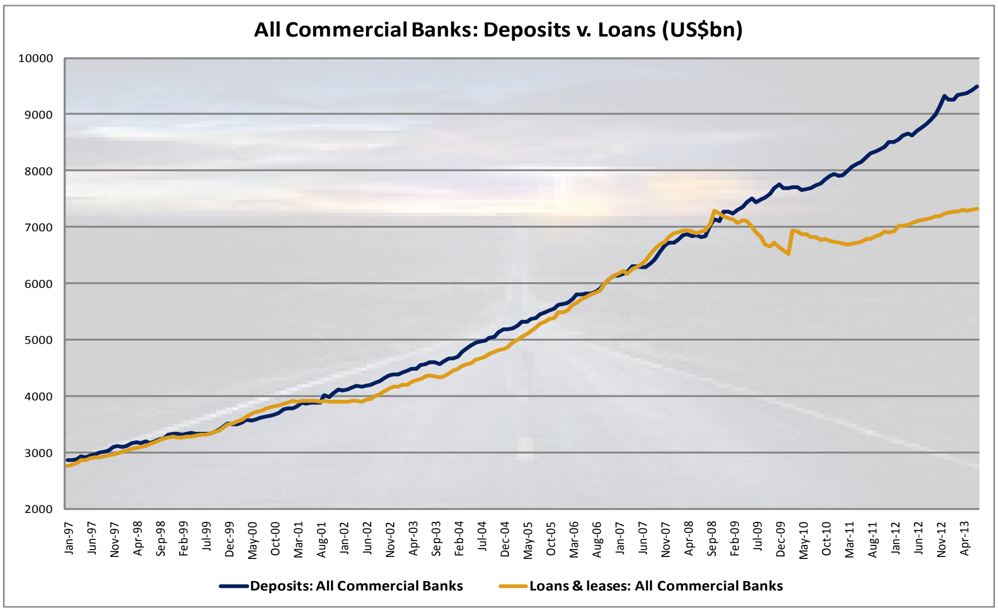
We've been arguing that central banks, led by the Fed, are creating the third major bubble of the last fifteen years. Low interest rates and monetary stimulus cause financial bubbles and we've been maxing out on both in recent years. While equities (not surprisingly) have done well each time, the asset class at the epicentre of each bubble changes – NASDAQ stocks and real estate were obviously the first two – and credit markets are at the epicentre of the current bubble.

The next slide from the same TBAC presentation seems to be in sympathy with our view about future difficulties in credit markets, making the point that they are "awash with inflows", but (and it's a big "but")..."Liquidity likely to prove a problem on the way out."



Source: TBAC

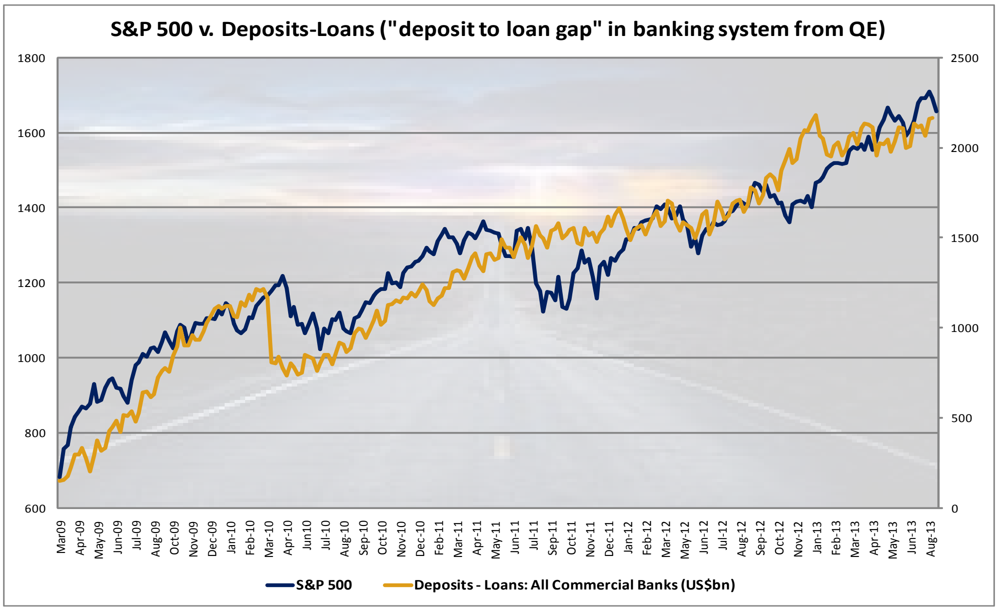
Let's just recap some of the "mechanics" of QE. The Fed creates credit which it uses to buy securities from the private sector. The sale of these securities creates excess deposits in the US banking system – currently over US$2 trillion.



Source: Federal Reserve

In "old" pre-Lehman days, new money (credit) was created in the banking system, although it occurs in the opposite way to what most people believe(d), i.e. new loans created deposits (it's an electronic, credit-based regime) rather than deposits being used to create new loans. Post-Lehman, with near-zero loan growth, money (new deposits) is created by the Fed via QE. This is a very big change, but has largely gone unnoticed.

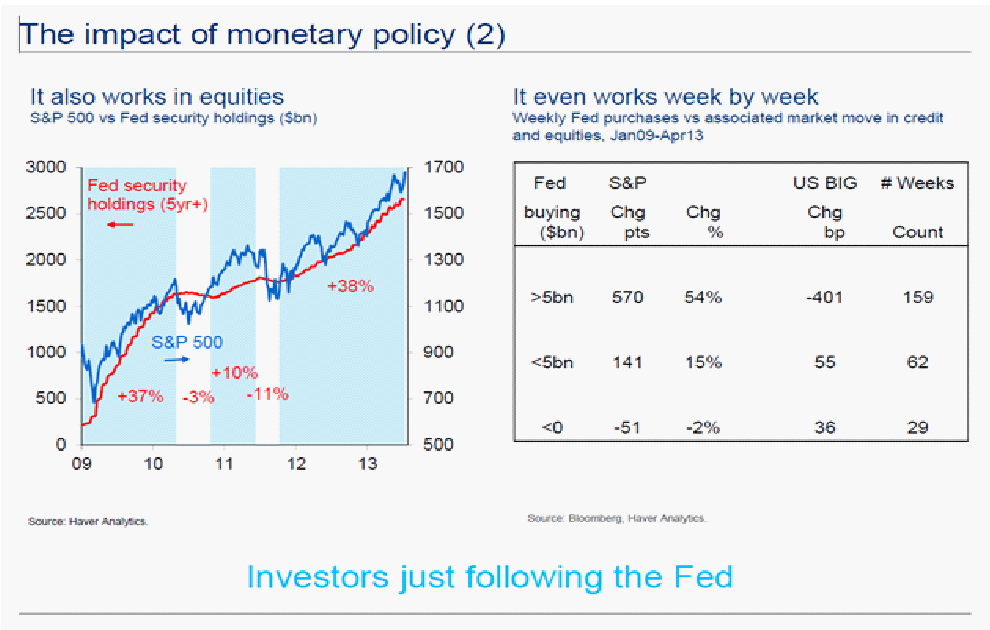
In the last two reports, we have shown a series of divergences between the equity market (usually the S&P 500) and various other assets and indicators, e.g. oil and other commodities, ISM/PMIs, breakeven inflation, the Summation Index, etc. We've also shown an intriguing correlation which has remained steadfastly in place, namely the S&P 500 versus excess deposits created by QE in the US banking system.



Source: Federal Reserve, Monument Securities

The thesis has been that QE creates cash high quality collateral (excess deposits) in the banking system, which leads to an "investment need" for the banks (to quote JPMorgan Chase), which is deployed across asset markets (including equities) - often via shadow banking and the repo market in particular.

Even the recently published Q3 2013 presentation by the US Treasury to the TBAC (Treasury Borrowing Advisory Committee) highlighted the apparent link between QE and rising equity prices. The slide below argues "Investors just following the Fed" whereas our conclusion is that there is some direct causation in the mechanics/fund flows between QE and equities.



Source: TBAC

This was Tyler Durden of Zero Hedge recently on the repo market:

"Most market participants will go through their trading life ignorant of the fact that the leverage in this market is what drives their assets up or down in most cases (because understanding something new is so 'old normal' even if it remains a major potential catalyst for problems ahead). The regulators get it though (kinda)."

Indeed, the Fed is acutely aware of the risks – it just doesn't identify them specifically (for obvious reasons) all that often. This speech, "Regulatory Landscapes: A US Perspective", from Janet Yellen on 2 June 2013 was unusually candid:

"A major source of unaddressed risk emanates from the large volume of short-term securities financing transactions - repos, reverse repos, securities borrowing and lending transactions, and margin loans–engaged in by broker-dealers, money market funds, hedge funds, and other shadow banks. Regulatory reform mostly passed over these transactions, I suspect, because securities financing transactions appear safe from a microprudential perspective. But securities financing transactions, particularly large matched books of securities financing transactions, create sizable macroprudential risks, including large negative externalities from dealer defaults and from asset fire sales. The existing bank and broker-dealer regulatory regimes have not been designed to materially mitigate these systemic risks."

It is curious how poorly understood the repo market is, given its significance. After all, it was at the centre of the 2007-08 financial crisis culminating with the crash of Lehman Brothers and subsequent bailout of the banks. This is Mary Fricker of the Repowatch website.

"The repurchase ('repo') market is where large financial institutions borrow trillions of dollars from each other and from central banks every day, using securities as collateral. If repo lenders lose faith in the collateral or in the borrowers - as they did in the 2007-2008 mortgage securities crisis and in the 2010-2011 European sovereign debt crisis - they will demand more collateral or repayment, which can drive the repo borrowers into bankruptcy. That was a prime cause of the financial panic in 2007 and 2008."

She also made this very pithy comment:

"In 1907 it was called a run on the bank. In 2008 it was called a run on repo."

Reuters agrees:

"A run on Lehman Brothers in the repo market in 2008 was one of the main reasons why the investment bank collapsed."

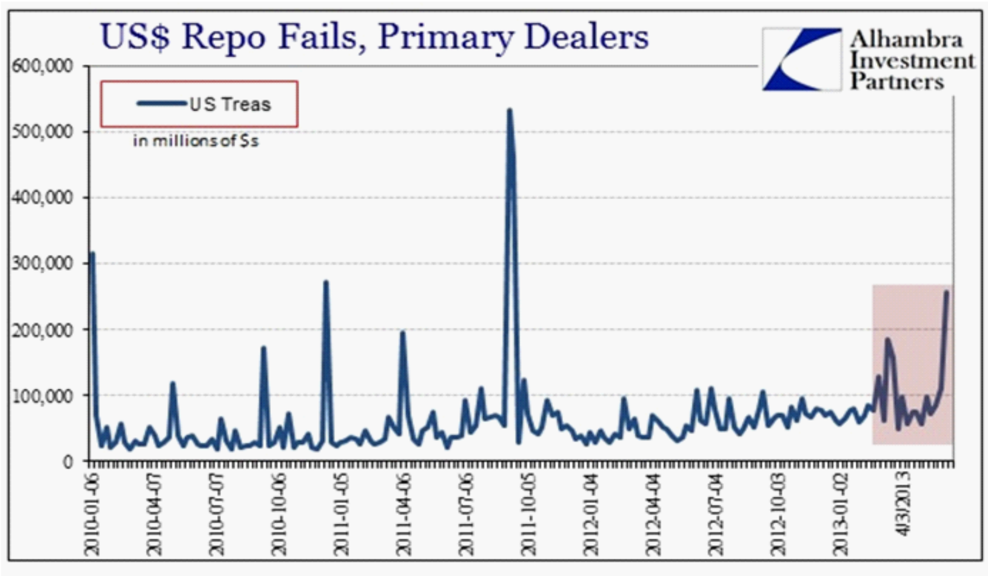
In its April 2013 report, "Enhanced Prudential Standards for Foreign Banking Institutions", the consultancy, Oliver Wyman, commented.

"US repo markets serve as the nexus that links major US securities markets and the US dollar money markets...While not as well understood as trading in traditional securities, repo markets have evolved to become the structural backbone for the US financial markets."

The downside of huge QE programmes is that they silo "high quality collateral", i.e. Treasuries and MBS. This disrupts the flow of new collateral and reduces the amount of available collateral to provide liquidity (and leverage) in the repo market.

Aside from Fed Governor, Jeremy Stein's, warning about QE's "risks relating to financial stability", there have been three recent signs of stress in the repo market:

- There has been a substantial reduction in the proportion of recently auctioned "on the run" Treasury issues (the most sought after in repo transactions) which have been purchased by the Fed during the life of QE3.
- On 17 July 2013, the SEC asked money market funds to review procedures should there be defaults in the repo market.
- Many OTC derivatives are migrating to exchanges in 2013, leading to increased volumes of collateral being lodged with central counterparties. This is occurring in three stages and the first two (March and June) led to a spike in "fails-to-deliver" in US Treasury repos. The third stage is next month.



Source: Alhambra Investment Partners

This leads us back to the question which we've asked in previous reports.

Is the decision to taper based far more on the need to alleviate current and future difficulties in the repo market than the alleged strength of the US economy?

It's almost amusing how Bernanke used to emphasise the similarity between QE and targeting interest rates, for example from this speech to Congress in 2011...

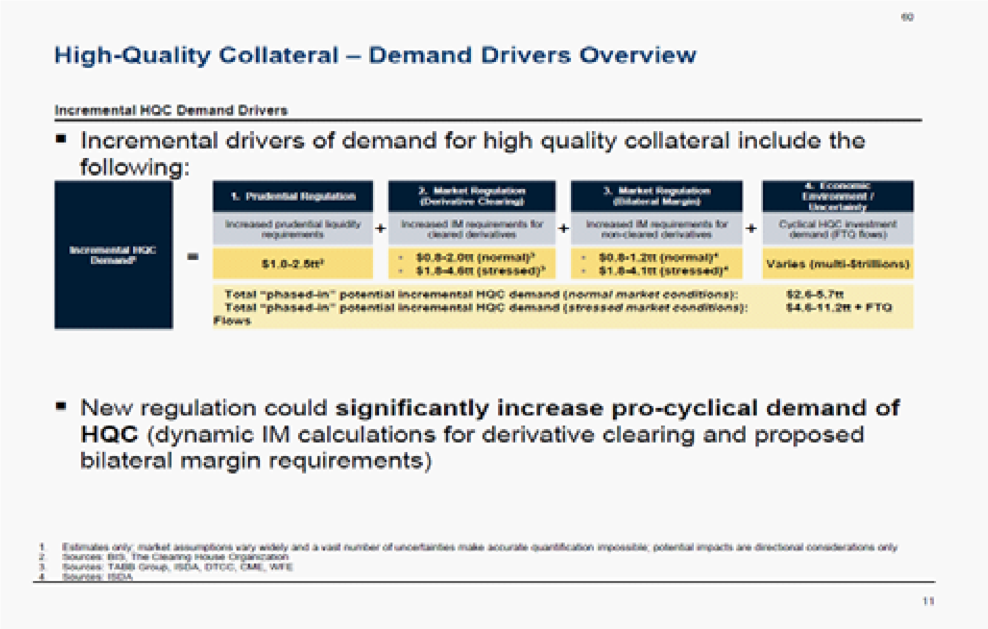
"Although large-scale purchases of longer-term securities are a different monetary policy tool than the more familiar approach of targeting the federal funds rate, the two types of policies affect the economy in similar ways...By comparison, the Federal Reserve's purchases of longer-term securities...By easing conditions in credit and financial markets, these actions encourage spending by households and businesses through essentially the same channels as conventional monetary policy"

...and is now at pains to emphasise that tapering QE is not the same as raising rates.

Why?

Besides Janet Yellen, I've also seen reports in recent months from the IMF, Bank for International Settlements, Bank of England and the US Treasury Borrowing Advisory Committee (TBAC) warning of the risk posed by the repo market.

The most graphic illustration of the systemic risk was contained in the Q2 2013 TBAC presentation. This identified the gross shortage of high quality collateral – between US$4.6-11.2 trillion – under stressed market conditions.



Source: TBAC

Let's hope we can avoid the latter for as long as possible.

The following quote was from a Reuters report on 16 August 2013.

"regulators seek to control a market they see as unstable enough to cause a new financial crisis... One senior regulatory source said U.S. bank supervisors are wary that the repo market is unstable when put under pressure."

No kidding.

Aside from some kind of market "shock", we have to be wary that the regulators don't make things far worse by trying to make things better. This brings us on to the implementation of Basel III and more stringent requirements in the US, relating to Dodd-Frank and Federal Reserve proposals.

We've found three examples of regulators looking to intervene in the repo markets which are ongoing, although there could be more.

Firstly, a Reuters report earlier this month outlined measures being considered by the New York Fed to reform the tri-party repo market.

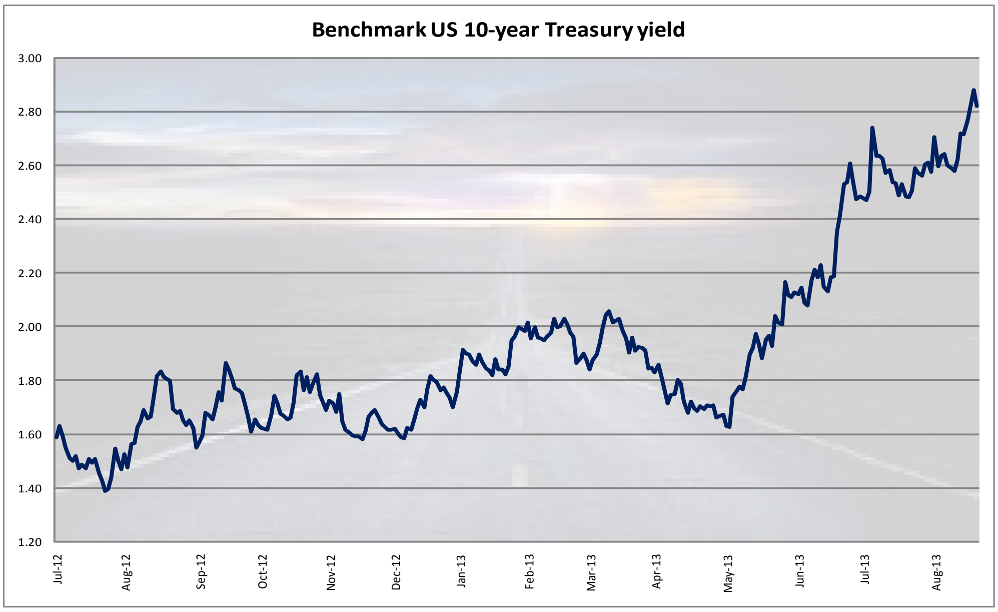
"the New York Fed is trying to defuse one of the riskiest practices in the market - the daily unwinding and rewinding of repo deals, through which brokerages, hedge funds, and other firms exchange collateral for short-term loans. JPMorgan and Bank of New York Mellon are the two big custodian banks that hold the physical securities that are bought and sold in repo transactions. Each day, they lend the securities back to the banks for a few hours. Should one of the borrowing banks land in trouble during the day, the custodian bank neither has the cash, nor the security, potentially leaving it doubly exposed. Working with the two clearing banks, the Fed wants to cap intraday credit at 10 percent of a bank's book by the end of next year, and says it currently stands at 70 percent. The industry is improving systems to make the market more efficient,

and investment banks are also increasingly borrowing more long-term debt, making them less dependent on intraday credit."

Secondly, there is the proposed (Fed with FDIC/OCC) implementation in the US during the next four years of the supplementary leverage ratio for the eight most systemically important banks. The proposal requires a Tier 1 capital leverage buffer of at least 2% above the minimum supplementary leverage ratio requirement of 3% under Basel III. As far as we can tell, the inclusion of additional off-balance sheet liabilities would make this comparable with at least 7% under the Basel III formula.

The banks are, unsurprisingly, protesting this regulation. However, one interesting argument being put forward is that leverage ratios take no account of the differing risks of assets held on (and off) bank balance sheets. In the absence of risk weightings, banks which hold high proportions of low risk assets, like Treasuries, might have an incentive to reduce their holdings (and/or alter the balance towards riskier securities).

Is the prospect of this regulation already having some impact? Some participants in the credit markets believe that it is. More upward pressure on government bond yields is the last thing we need right now since a continued rise in rates is a clear and present danger to the credit bubble.



Source: Monument Securities.

Thirdly, the Federal Reserve proposed new regulations last December which specifically target the activities of foreign banking organisations (FBOs) in the US. Guess which market they would impact the most?

FBOs hold in excess of US$3.5 trn of assets in the US. Five of the top ten US broker dealers are FBO subsidiaries, 12 of the 21 primary dealers are owned by FBOs (with 24-40% of primary dealer trading volume) and FBOs account for 20-30% of the capacity in the repo market.

These proposals were examined in the Oliver Wyman report referred to earlier:

"Our analysis focuses on the potential costs of the rule for the US capital markets, aiming specifically to quantify the effects on the repo markets. We find that these costs are significant..."

Under the Fed proposals, FBOs will have to:

- Establish separate intermediate holding company (IHC) structures for their US operations. Currently FBOs are organized so as to optimise capital and liquidity on a group basis, but this will have to change dramatically; and

- Apply much more stringent US regulations on capital, leverage and liquidity. For example, leverage ratios will need to be at least 7% compared with the 3% minimum under Basel III and liquidity buffers will be required for "stressed cash flow needs."

Oliver Wyman concluded that the likely response of FBOs will be to reduce their US presence, especially in the repo market.

"the proposed rule, in its current form, will make it too costly for FBOs to merely add capital and liquidity to support the activities they are conducting today...We estimate that one of the largest impacts will be on US repo markets...Because of the central role played by repo markets, a substantial reduction in intermediation and market-making capacity would have knock-on effects on virtually all US market participants, as US financial markets became less efficient."

And:

"We estimate that the proposed rule could lead FBOs to withdraw approximately $330bn of capacity from the US repo markets, representing over 10% of this market...These businesses will come under acute pressure from the proposed leverage requirements...a capacity reduction on this scale would have cascading effects on the liquidity of every other US financial market."

And:

"Beyond its direct effects on US capital markets, the proposed rule has the potential to introduce additional systemic risk to the US financial system..."

Given the existing fragility of the financial system, and the repo market in particular, we need to carefully monitor the implementation of these new regulations. Indeed, Oliver Wyman recommended that the Fed considers an extended implementation period and further study.

According to Reuters...

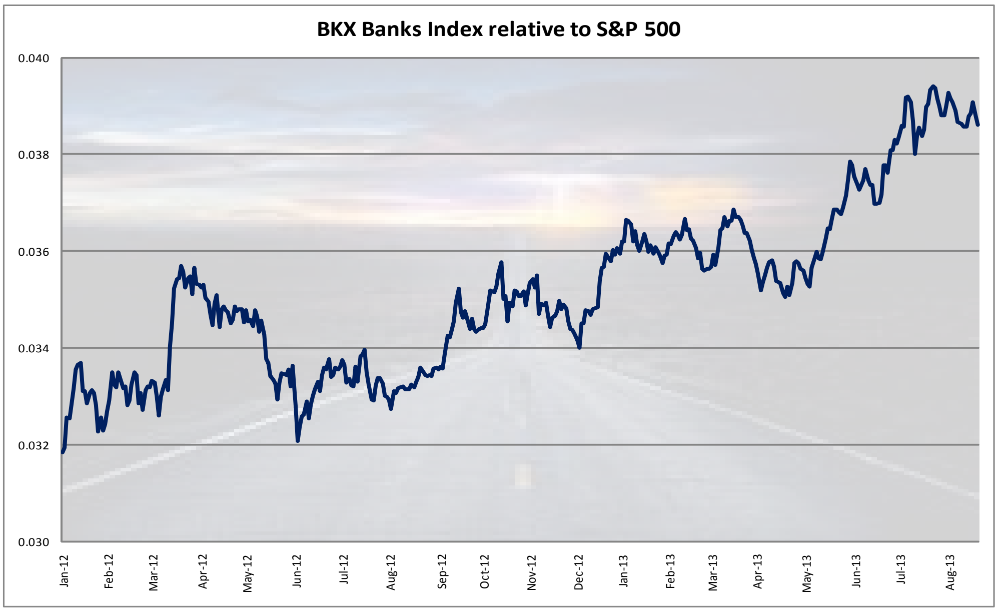
"**Regulators said reforming the repo market remained a top priority, and that they would give markets sufficient time to adapt and avoid disruptions...In September, regulators will tell politicians from the G20 leading world economies how they plan to reform shadow banking at a summit in Moscow. Detailed plans for keeping the repo market on a tighter leash are part of that agenda.**"

The repo market is a major, if not THE major, source of systemic risk. We know it, central banks know it, the regulators know it and the G20 is about to know it. The man on the street doesn't know it, but nor do many equity investors.

Zero Hedge's Tyler Durden does, though.

"it is this aspect of the Fed 'cornering' itself that is the underlying driver of all the behind the scenes tapering discussions, which have nothing to do with the economy. Because while all the rhetoric and regulatory discussion focuses on the economy, the open markets, and deficits – this is all for general popular consumption. What the Fed and the BIS are truly concerned about, and have been for the past four years, is ongoing instability in the repo world, and other aspects of shadow banking."

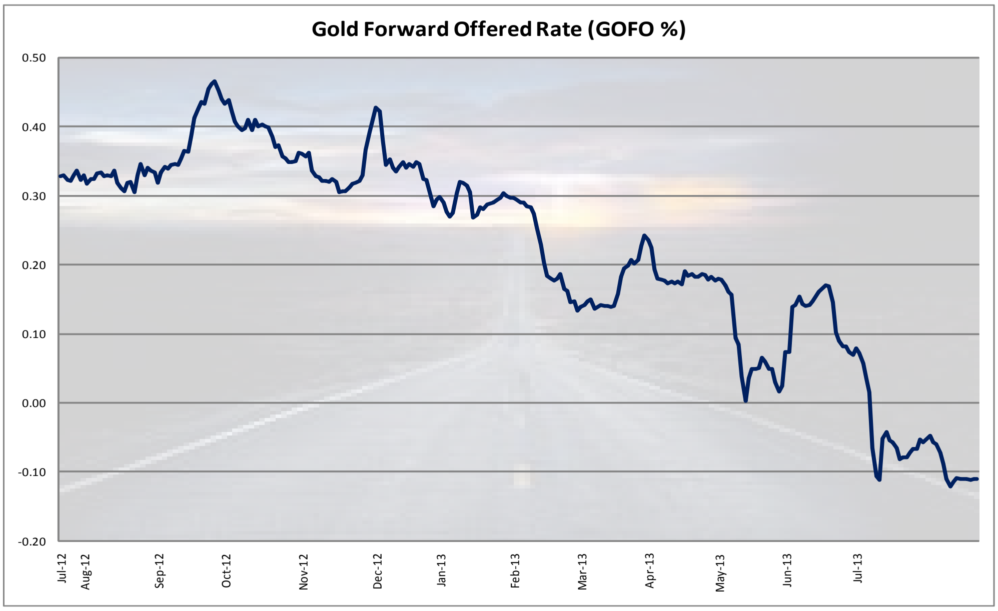
Meanwhile, it would be unwise to forget that debt crises (and this is the biggest in world history) manifest in the banking system, as have dislocations in the repo market in modern times. The banks sector has been on a roll for more than a year but warrants close attention for any clear signs that it is rolling over.



Source: Monument Securities.

Gold - the only financial asset with no counterparty risk (in a debt crisis)

In gold, the futures market has been in backwardation, i.e. the price of the near-month futures contract is below spot (known as a "negative basis"), since early April 2013. The gold lending market has been in backwardation since 8 July 2013, when the GOFO rate (Gold Forward Offered Rate) turned negative. Note: GOFO is Libor minus the Gold Lease Rate.



Source: Monument Securities.

The former implies that gold traders are ignoring risk-free profits by selling spot physical gold and buying the near-month future with the intention of taking delivery. This should not happen in "normal" market conditions, since gold should always trade in contango (it trades as a currency and has an extreme stock/flow ratio). Backwardation in the gold lending market implies that market participants are prepared to PAY someone with gold collateral to borrow dollars in return for having the use of his gold for the duration of the loan.

The logical deduction from both forms of backwardation is that the leverage in the gold market vis-a-vis the exchange between physical bullion and

- **Non-physical gold claims (gold futures); and**
- **US dollars (at least at the current low price)**

is reaching its limit.

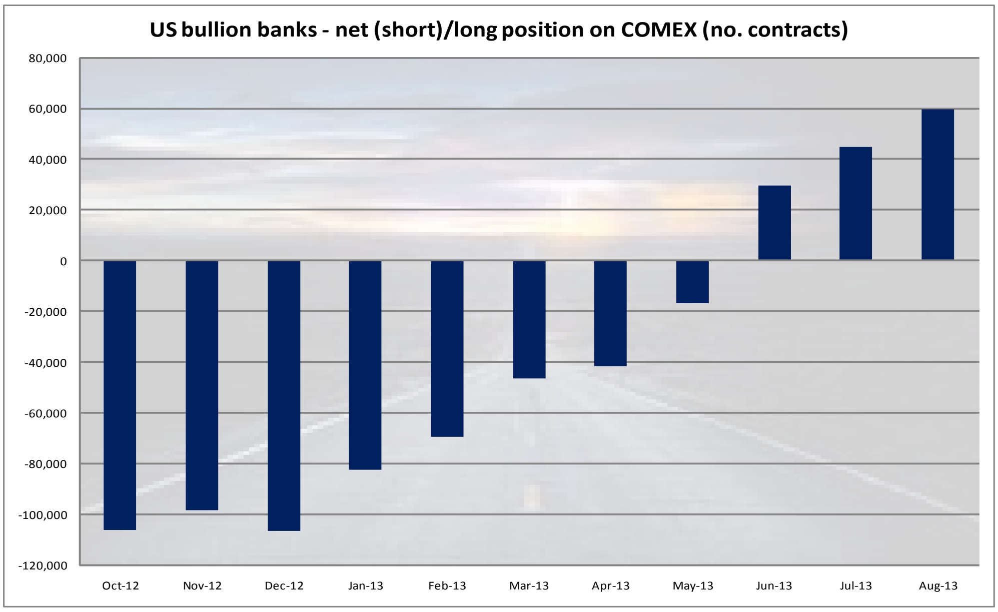
Put another way, the bubble in paper gold versus physical gold and the bubble in US dollars versus physical gold are showing signs of bursting.

Or yet another...there is insufficient physical gold to act as collateral in the system.

Since the most recent peak in the gold price at US$1,792/oz. on 4 October 2012, we have been tracking the transition of US bullion banks from a huge net short position to an increasingly large net long position in COMEX futures.

Last October, the CFTC's monthly Bank Participation Report showed that the net short position of four US banks was 106,184 contracts. This was equivalent to 10.6m oz. and approximately US$19.0bn.

The dramatic turnaround from a net short position of 106,184 contracts to a net long position of 59,473 contracts (5.9m oz. and approximately US$8.0bn) is shown in the following chart.



Source: CFTC

So "net net", that's a shift in trading position from short to long to the tune of 165,657 contracts, 16.6m oz. (515 tonnes) and approximately US$27.0bn by four bullion banks – although it's not inconceivable that the vast majority of that shift is attributable to one or two banks. This was independent analyst, Ted Butler (who is on record with his belief that one bank is now net long 85,000 contracts), commenting on the situation.

"Since we are in the unprecedented position of looking at a corner in the gold market in real time, with little history to guide us, no one can predict how it will end precisely; but end it will."

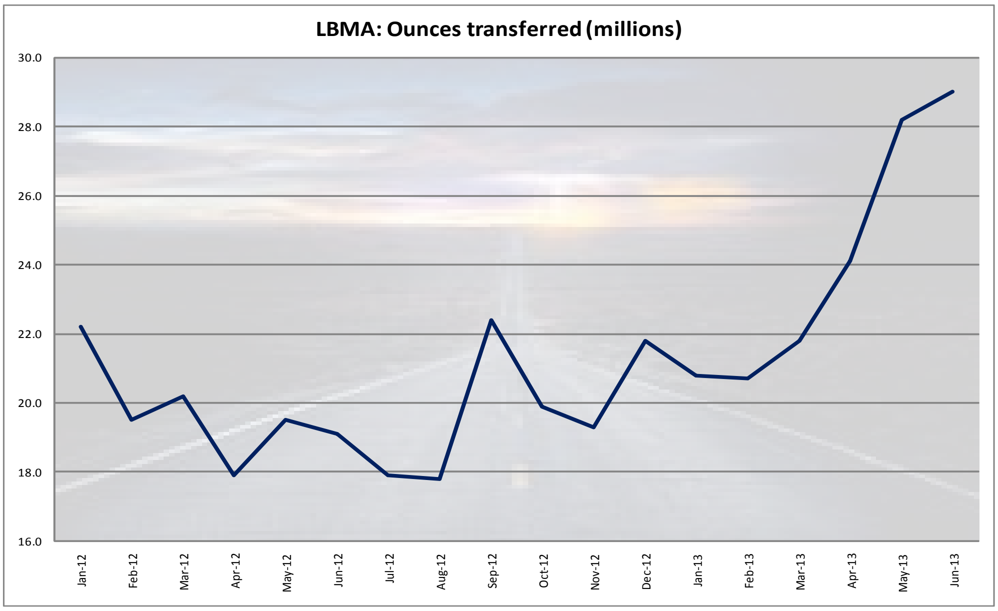
It's also worth noting the recent pattern of COMEX deliveries for both gold and silver. Let's begin with silver and activity in the July delivery month compared with previous delivery months. This quote comes from the TF Metals Report on 13 August 2013.

"For the July silver delivery month, JPM stopped 2,824 contracts into their house account. This represented 82% of the total for all of July...Again and for perspective, for the prior three silver delivery months, the JPM house account stopped a total of 1,250 contracts. This was just 12.7% of the total Dec12, Mar13 and May13 deliveries of 9,864 contracts."

Please note that the term "stopped" on CME's website means that it took delivery.

Turning to gold, the JPM house account stopped approximately half of all December 2012 deliveries. However, it was largely absent in the Feb13, Apr13 and Jun13 delivery months. That changed this month and, thus far, it has stopped 72.5% of all deliveries.

The collapse in the price of gold in April has ignited a surge in demand on the LBMA. The latest clearing statistics showed a record number of ounces transferred – 29.0m oz versus 28.2m in May which was the previous record.



Source: LBMA, Monument Securities

The LBMA commented.

"demand for gold has increased by 39% since January, buoyed by strong physical demand particularly from China and India which has more than offset sales by ETF funds in the western economies"

We find it inconceivable that this increased demand hasn't put considerable strain on supply of physical gold in recent months. The evidence that this is precisely the case is the gold futures and gold lending markets both moving into backwardation.

If you've studied the gold market in sufficient depth, the odds are that you've come across (2006 in our case) a body of work published by Professor Antal Fekete (see the "Popular Economics" articles on the Professor Fekete website). Fekete and his colleague, Sandeep Jaitly, are the world's experts on the gold basis, to reiterate - the difference between the spot price of gold and the price of the near-month future.

While Fekete adapted its use to the gold market, people familiar with the concept of "basis" will recognise its significance in the agricultural commodity markets, where movements in the basis tend to follow established seasonal patterns. Any grain elevator operators out there?

Fekete's study of the gold basis stretches back more than four decades.

"The world's first gold futures market opened in the Winnipeg Commodity Exchange in 1970... In 1971 I went to Winnipeg to be witness to history. I purchased a seat on the exchange. I was interested in studying the variation of the gold basis on the floor first hand."

Back then, interest rates were much higher, gold futures were viewed as perfectly fungible with physical gold and the basis was wide.

"(Gold's) wide basis reflected the popularity of gold futures with gold investors. Buy orders came in a steady stream from all corners of the world. In the absence of gold futures this demand would have shown up as demand for cash gold, the greatest threat to the value of the U.S. dollar. The U.S. Treasury was satisfied that paper gold would do nicely, thank you very much, and gold futures trading in the U.S. was duly allowed to commence in January, 1976."

In the intervening years, Fekete was consistent in his prediction that the gold basis would shrink over time and eventually turn negative. In March 2007 he opined.

"backwardation for monetary metals is a gross anomaly, a red alert. It indicates cumulative mismanagement of the monetary and credit system in the past, and potential breakdown in the not-too-distant future."

There was a brief period of backwardation in December 2008 driven by an unprecedented, but temporary, surge in gold buying at the height of the financial crisis. The gold market moved back into contango and stayed there (apart from very brief flirtations) until 5 April 2013 when the basis for the June contract turned negative.

It was certainly counterintuitive that this bullish signal for gold was (almost) immediately followed by the collapse in the gold price on Friday 12th April and Monday the 15th April 2013.

Years ago Fekete predicted.

"Expect the regime of irredeemable currency to put up a desperate and vicious fight for survival. There may be times when the gold basis bounces back. But its decline, on the average, is relentless."

In the immediate aftermath of April's gold price collapse, the basis for the June 2013 contract narrowed from almost -0.30% to just under -0.10% (i.e. almost eliminating backwardation) before subsequently widening once more.

Despite backwardation, the gold price continued to decline reaching a recent low of US$1180/oz on 27 June 2013. In part, the fall was driven by liquidation of longs and shorting of gold futures on COMEX. Fekete, writing in August 2006, argued.

"Simply put, the role of the derivatives market is to make phantom bonds available to buy, and phantom gold available to sell, for the benefit of speculators... The tricky part is how to make speculators want to sell phantom gold?"

The events of 12th and 15th April 2013 were probably the catalyst in this case. The net long position of large speculators on COMEX was cut from 119,359 contracts to 28,366 contracts between 9 April and 30 July 2013 as these traders moved substantially towards the short side.

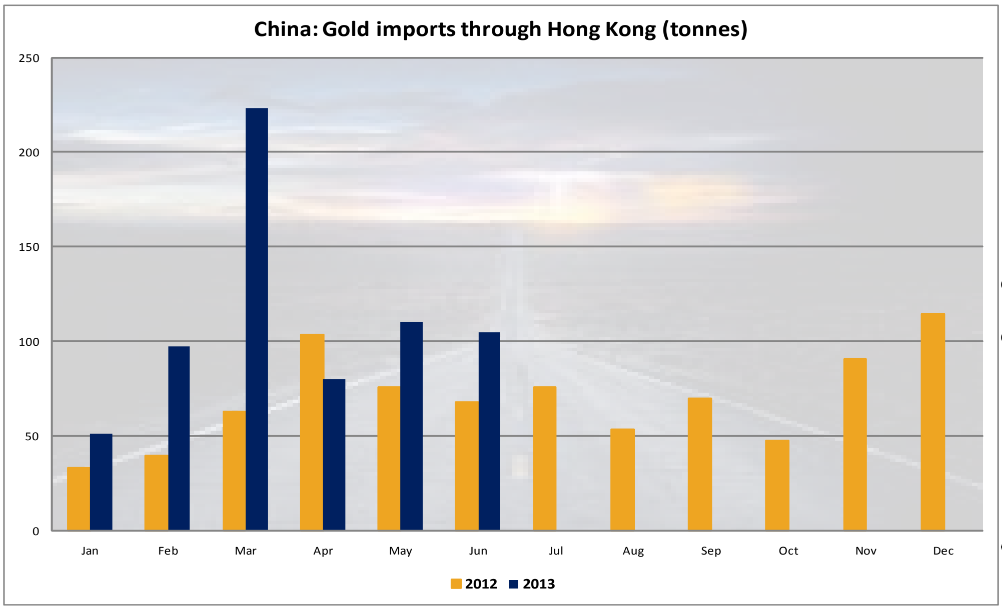
After the smackdown, backwardation continued as the June 2013 contract gave way to August and Sandeep Jaitly commented in his Gold Basis Service.

"The backdrop established by the June contract viz backwardation is being carried forward with the August contract."

You can see the negative gold basis (blue line) in this chart.

Source: Gold Basis Service / Sandeep Jaitly

It's been widely reported, even in the mainstream financial press, how demand for physical gold has strengthened, especially in Asia, this year. This is the trend in Chinese gold imports through Hong Kong in 2013 compared with 2012.



Source: Hong Kong Census & Statistics Dept.

The truly staggering statistic is the volume of physical gold delivered on the Shanghai Gold Exchange so far in 2013. In just over 7 months, through early-August 2013, 1,385 tonnes were delivered. Here is a chart from Koos Jansen's "In Gold We Trust" website comparing Shanghai gold deliveries with world gold mining output.

Source: Koos Jansen/In Gold We Trust.

With Shanghai deliveries accounting for nearly 100% of world gold mining output at times in 2013, the obvious implication, when you add in demand across the rest of the world, is a substantial deficit versus annual mining production. Add in Indian demand and you start questioning whether new gold supply is being cornered?

So where is all this gold coming from? GLD and central banks perhaps? Probably, since one thing is for sure, that a significant amount of it is coming from London. Data from Eurostat showed that the UK exported 797 tonnes of gold to Switzerland in the first half of 2013 compared with 92 tonnes in the whole of 2012. The figure for May 2013, after the price collapse, was 240 tonnes. You have to suspect that 400 oz. London Good Delivery bars are being recast in Swiss refineries into kilo bars for Asia.

What's happening is alarmingly similar, but in a largely unreported manner, to the events which preceded the collapse of the London Gold Pool in 1968.

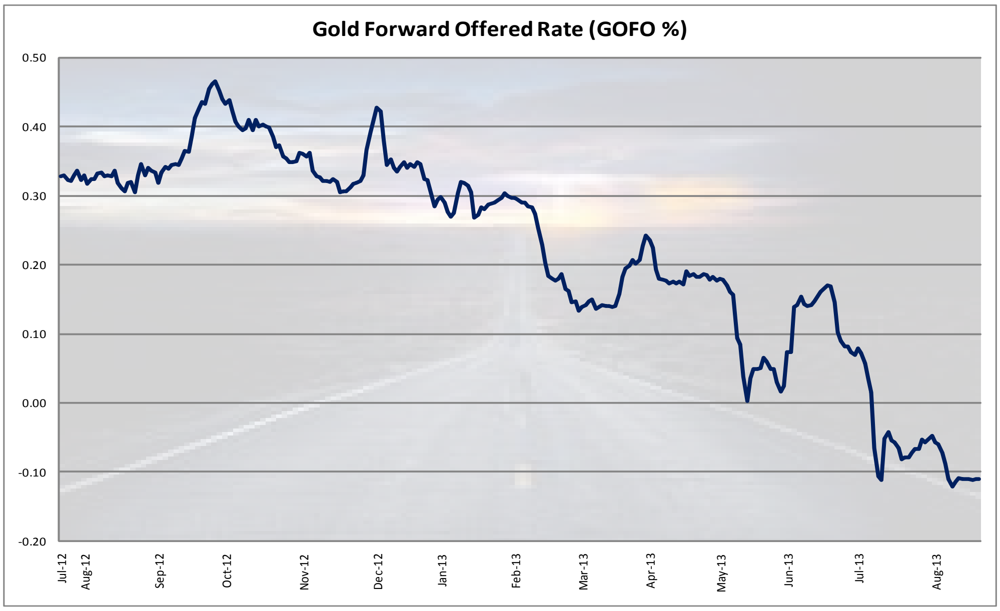
It's consistent with Fekete's prediction of what would happen when gold futures moved into backwardation...a rapid increase in physical gold demand versus paper gold demand. This was written in December 2008.

"**I have argued that we must carefully distinguish between a fiat money regime with an undisturbed flow of gold to the futures market; and a fiat money regime where the flow of gold to the futures market has been blocked by an unprecedented surge in the demand for cash gold. In the first case confidence in fiat money is high; in the second, it is low and waning fast. In the first case paper gold is an effective substitute for physical gold in most applications; in the second, paper gold has been unmasked as a fraud, and discredited beyond repair.**"

This was his warning back in the pre-crisis days of June 2006.

"We may grant that gold futures trading has materially added to the longevity of the regime of irredeemable currency. But while the central bankers are buying time, sand in the hour-glass of the gold basis keeps trickling down. When it runs out, the trickle of cash gold from warehouses will have become an avalanche that could no longer be stopped."

The last sentence resonates with what we've been seeing with the depletion of COMEX inventories in recent months.



Source: Monument Securities.

As does this (if a little dramatic).

"The fall of the gold basis tells us that God's gold cannot be drowned in a sea of paper gold. The price of the former will tend to infinity while that of the latter will keep falling to zero. The genie of the gold basis will crush the government through demand-shocks waiting in the wings of the gold market."

It is far too premature to declare that the gold market has moved into a permanent state of backwardation. Still, we have moved a long, long way in the direction envisaged by Professor Fekete more than four decades ago.

In his most recent essay on gold, "Who Said the Hydra Would Take It Lying Down?" published in April this year, he argued.

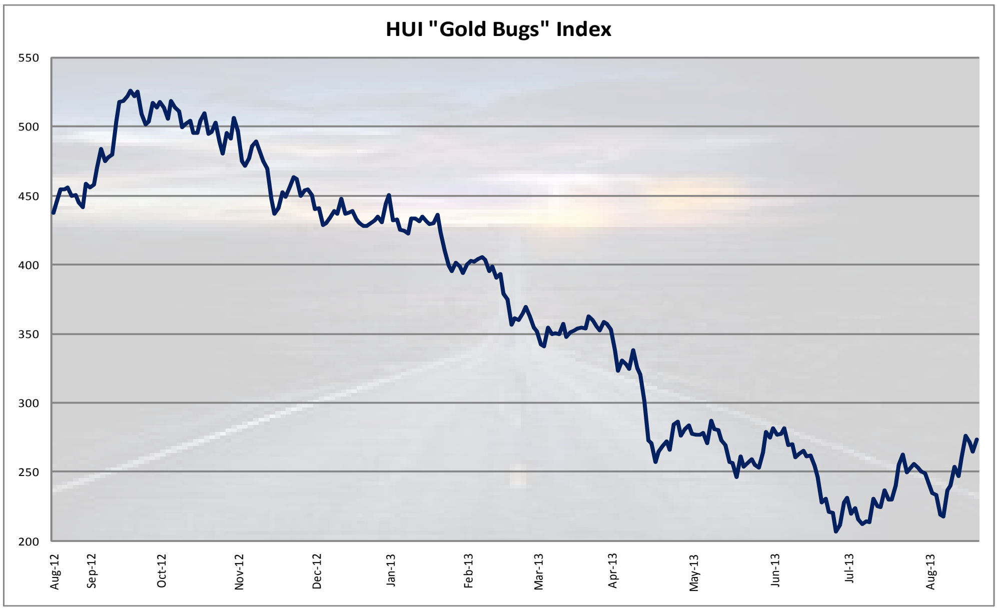
"**Knowledgeable market participants realize that persistently falling basis means increasing scarcity which, in the case of gold, is not and cannot be alleviated by current output from the mines. Output ultimately proves no match for the mass movement of gold going into hiding, first gradually, eventually reaching crescendo when the threat of permanent gold backwardation starts looming large. At that point all deliverable supplies of physical gold would be gobbled up by gold hoarding.**"

Let's consider a couple of "ifs":

- IF, as we postulated, earlier, there is insufficient physical gold to act as collateral vis-a-vis gold futures and US dollars; and
- IF we are heading towards permanent backwardation and mine output (which is probably declining now, given the low gold price) will not be able to make up the shortfall.

Logic suggests that it just might be worth revisiting the much-reviled sub-sector of gold mining companies (could China be doing the same thing?) - even if it's to do nothing more than "dip one's toe in" at this point.

The HUI (Gold Bugs Index) is more than 55% off its high of August 2011. It could be significant that the correction earlier this month saw the HUI make a higher low for the first time since July 2012.



Source: Monument Securities.

Looking at the big cap North American names, I'm drawn back to Goldcorp at the moment. Although it has significantly lower grades than Agnico Eagle, for example, the latter has to address the closure of its largest mine, Meadowbank, after 2018. The vast majority (over 85%) of Goldcorp's production comes from large mines producing c.200,000 oz. per annum or more.

GOLDCORP

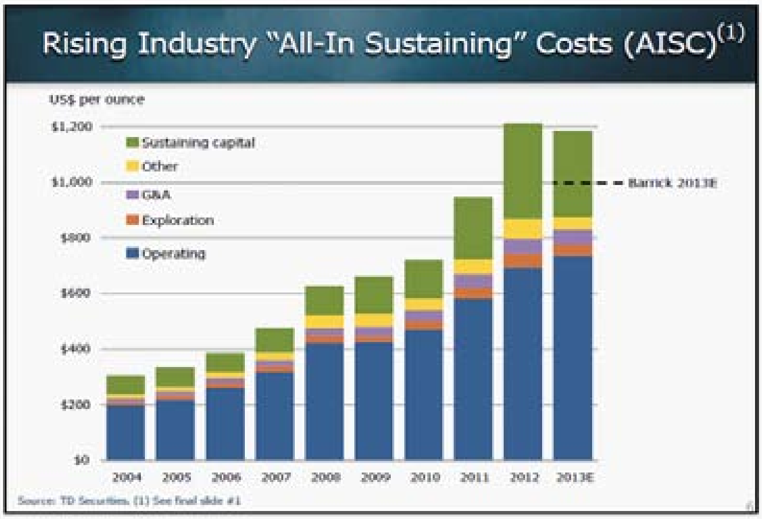
APPENDIX B - 2013 MINE BY MINE GUIDANCE

	2013 Guidance	2012 Actual
Red Lake	475,000 - 510,000	507,700
Peñasquito	360,000 - 400,000	411,300
Los Filos	340,000 - 350,000	340,400
Pueblo Viejo (40.0%)	330,000 - 435,000	44,700
Porcupine	270,000 - 280,000	262,800
Musselwhite	250,000 - 260,000	239,200
Marlin	185,000 - 200,000	207,300
Alumbrera (37.5%)	120,000 - 125,000	136,600
Marigold (66.7%)	95,000 - 100,000	96,300
El Sauzal	70,000 - 80,000	81,800
Wharf	55,000 - 60,000	68,100
Total	**2,550,000 – 2,800,000**	**2,396,200**

Source: Goldcorp

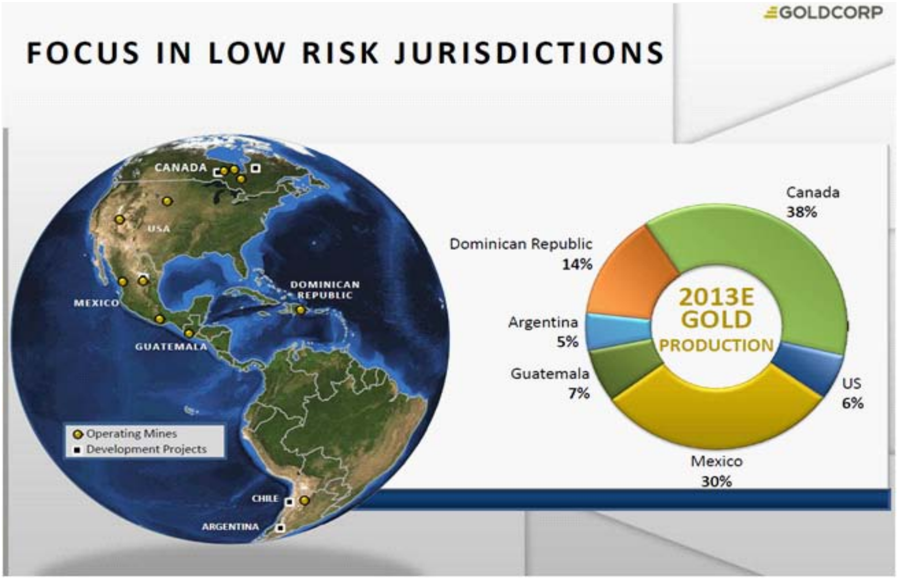
I was slightly surprised (shocked?) by the company's estimate for the "all-in sustaining cash costs" of US$1,279/oz. in Q2 2013. However, this should fall back significantly into the range US$925-975/oz. in H2 2013 as the large Pueblo Viejo mine ramps up towards full production.

This slide from a recent Barrick Gold presentation suggests that the belated response by the industry to the dramatic cost inflation of recent years is beginning to bring some benefit.



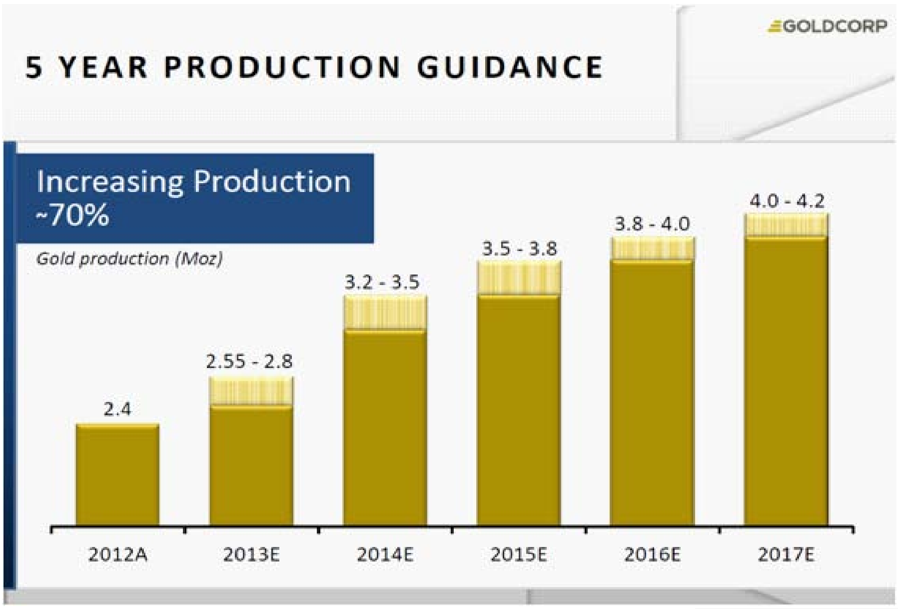
Source: Barrick Gold

Goldcorp has a broad spread of geographic exposure, most of which is perceived as "mining friendly."



Source: Goldcorp

And strong growth potential, although it's advisable to treat mining company production targets as "best case" (a bit like upstream oil producers). Still, most large gold companies are struggling to increase production... Barrick (with the Pascua Lama debacle) and Newmont spring to mind.

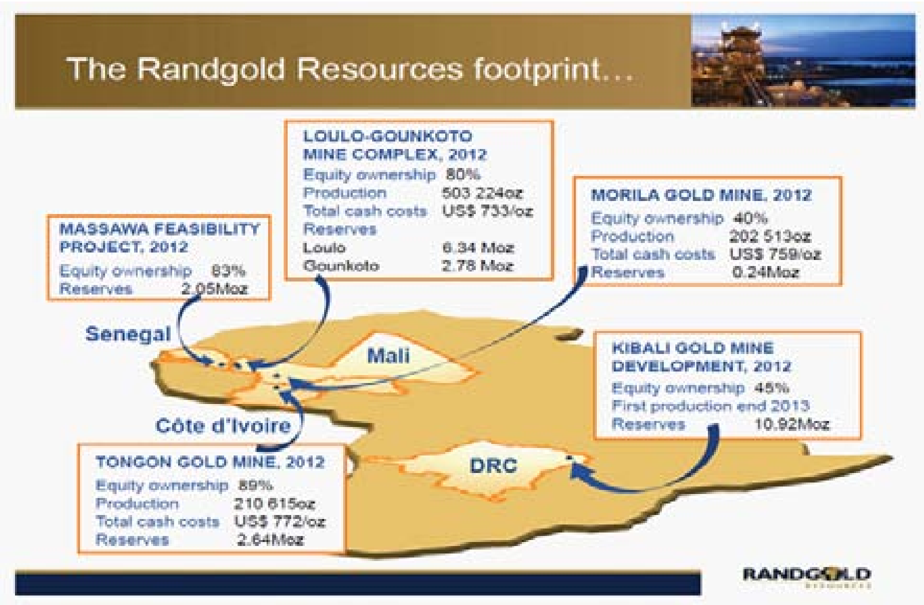


Source: Goldcorp

Goldcorp also has a strong balance sheet with net debt of only c.US$0.9bn compared with a market capitalisation of US$24.0bn and shareholders' funds of US$20.8bn. Even with very depressed gold prices in Q2 2013, the ratio of net debt/annualised EBITDA was approximately 0.8.

In Europe, there are few mid/large cap options but Randgold Resources and Polymetal do stand out with impressively high grade ore bodies. Randgold, for example, is producing at an above-average 3g/tonne compared with about 1.6g/t for the industry.

This slide from the recent Q2 2013 results presentation shows the footprint of Randgold's mining activities in Africa. There are three operating mines, Loulo-Gounkoto and Morila in Mali and Tongon in the Ivory Coast, in addition to the the Kibali project in the DRC (which should pour its first gold this October) and the Massawa feasibility study in Senegal.



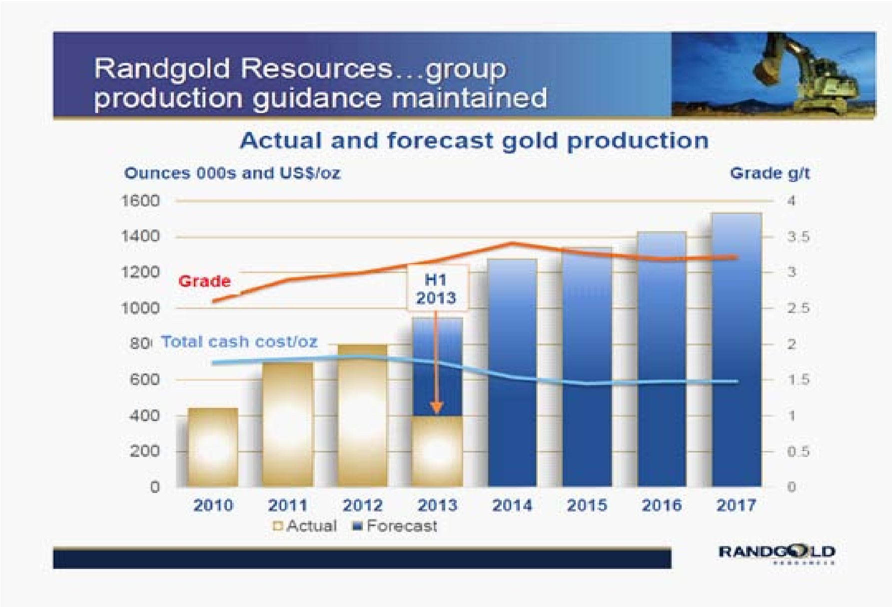
Source: Randgold Resources

Chris Bailey, founder of the excellent Financial Orbit website, has followed Randgold closely for several years. In his view.

"the company is a strong believer in joint ventures with local partners, who are usually the government. This is why they do not own 100% of any of their mines. However, by retaining operational control whilst fostering community relations via employment and home building programmes, the company has an attractive set-up. The company appears popular with governments in the region because of these attributes. This is very important in a region which has seen civil strife and political uncertainty (at this point it is also worth noting that such issues in Cote d'Ivoire in 2011-2 and Mali in 2012-3 did not see the Randgold mines miss a single day's production)."

The state of Mali owns 20% of both the Loulo-Gounkoto and Morila mines, the Ivory Coast's government owns 10% of Tongon and a state-owned DRC gold company (Sokimo) owns 10% of Kibali.

The commissioning of Kibali will lead to a significant step up in gold production in 2014.

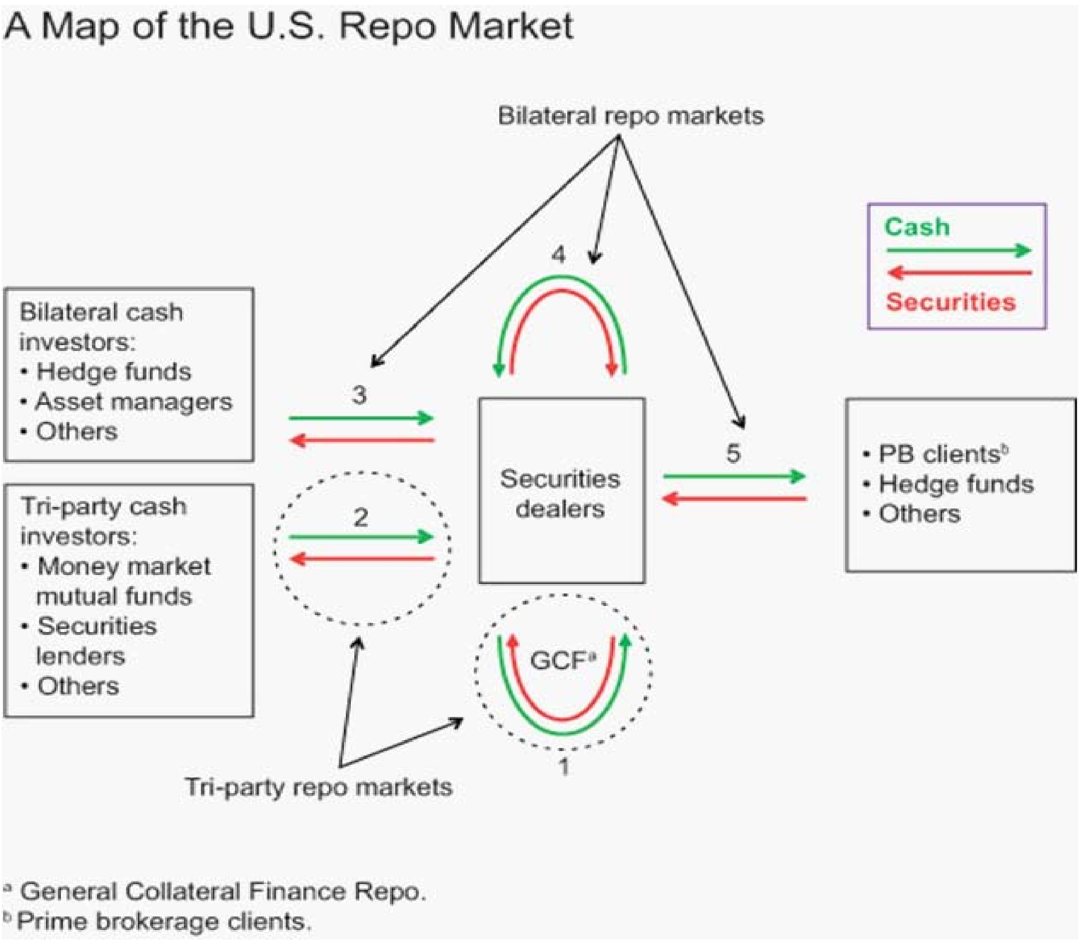


Source: Randgold Resources

Randgold's financial metrics are sound. The total cash costs were US$818/oz. in H1 2013 and all-in total production costs are approximately US$1,000/oz. The balance sheet had net cash of just over US$40m on 30 June 2013.

Appendix

From the New York Fed.



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