Gold is Different. What Next?

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Introduction

The price of gold recently plunged against a backdrop of increasing global money printing ("quantitative easing") and increasing demand for physical gold. On the face of it, this is odd. It is however quite rational, due to some perverse incentives in the structure of the gold market that are not well understood.

(If you want to skip straight to the structure of the market, go to page 6.)

The Backdrop

The world went off the gold standard in 1971, enabling much freer manufacture of money because the constraint of possible redemption for gold had finally been removed. The 1970s saw a period of stagflation, ended by 20% interest rates in 1980 that reset the system with low inflation.

Our story begins in 1982, when the great money bubble started. It was a good time to be a banker. Commercial banks manufactured ever more bank money (or "credit"), raising the level of bank money in the economy to record highs. Because bank money is created by the act of lending, bank money is also debt, so the debt levels also rose to historic highs.

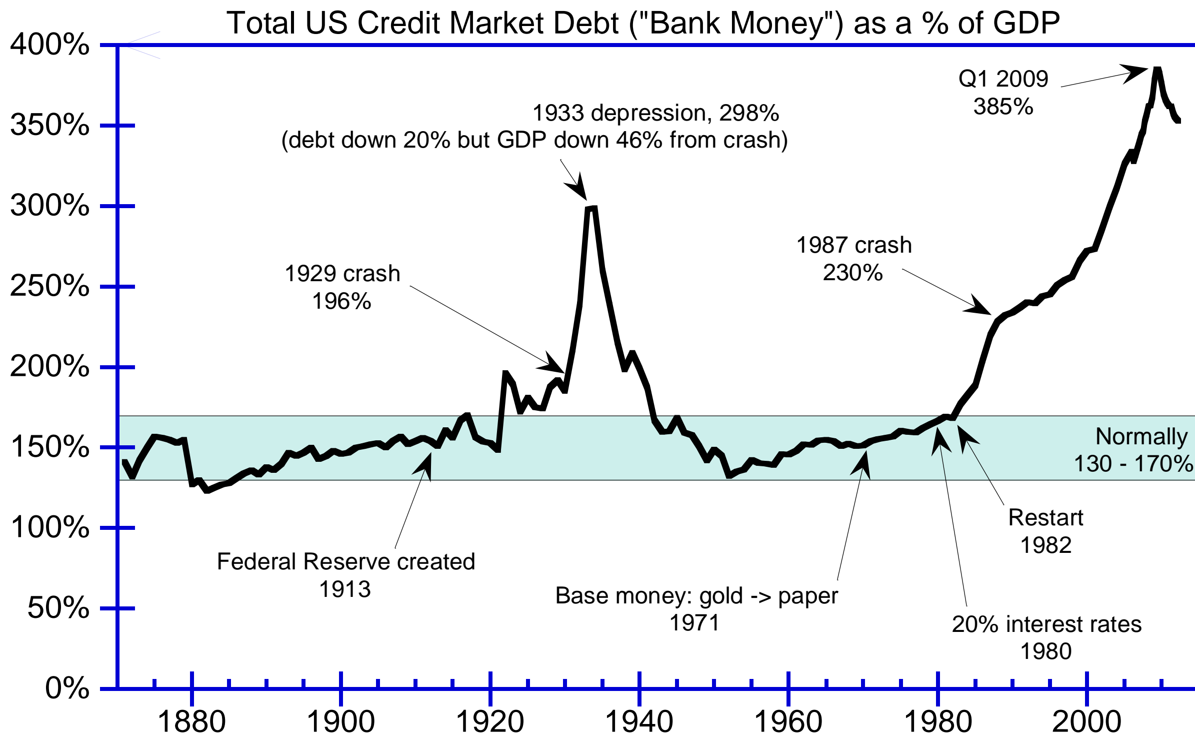

Figure 1: Bank money levels in the US, 1870 – 2012.

The amount of bank money has usually been around 150% of GDP, with two notable exceptions. The first was the roaring 20's. When money levels rose to 196% in 1929 the stock market crashed, the money supply imploded, and the Great Depression followed. (The GDP dived before the money supply, so the ratio of money to GDP went even higher for a while.) Restarting in 1946, money levels were normal until 1982, when for the first time we had a low inflation environment and purely paper currencies. The Great Bubble began.

By 1987 the money supply had risen to 230% and the stock market crashed even harder than in October 1929. In 1929 the central banks had stood back and taken little action, allowing the money supply to fall and banks to fail. But in 1987, led by the newly appointed Alan Greenspan, the central banks flooded the economy with cheap loans for anyone they knew who wanted them. Money supply growth slowed for a couple of years but did not fall, the real economy wobbled but did not buckle, and the bubble resumed. Now we were in unchartered territory from a monetary perspective. How high could it go? Regulations were changed along the way, always in the direction of making money manufacture easier. But finally the bubble stopped growing in 2008.

Why 2008? Perhaps the interest bill had grown too large. Bank money is someone's debt, and at nearly 400% of GDP at an average interest rates of maybe 4%, the interest bill was approaching 16% of GDP.

Apparently that's too much. Also, the world was running low on collateral for new loans. After 2008 governments stepped in to prolong the bubble: borrowing, lowering interest rates (aka "qualitative easing"), and printing new base money (aka "quantitative easing"). We've reached the point where everyone realizes that the private sector is debt-saturated, so new money manufacture is going to have to come mainly from government. Governments cannot borrow much more, so increasingly they have to print.

What if the money supply contracts? The risk is a 1930's depression, only worse because we are starting from a position of more debt, and the bubble is global so there are no unaffected partners to trade with. During the bubble maybe a percent was added to GDP each year by the excess money manufacturing; it was like a credit card spree, and now we have to deal with the debt. To return money levels to the usual 150% of GDP might wipe off 15 – 25% of GDP, which is politically unacceptable. But it has to happen somehow, which poses the main economic question of our age: how is the world ever going to get back to normal levels of debt?

Last year's debt basically has to be repaid with interest, and the "with interest" part is important. It means that there has to be more money around each year or some people cannot pay back their loans, like in a game of musical chairs. (Obviously someone with a mortgage doesn't have to literally pay back their loan each year, but large borrowers have banks looking over their shoulders and if the banks sense they might have trouble repaying then they will be asked to repay.) If the money supply doesn't increase, there will be widespread business failures and then bank failures.

We are now in the aftermath of the great debt bubble, which ran from 1982 to 2008. Apparently the world either has to print and inflate, or not print and risk a nasty depression. Inevitably, politicians will choose inflation. "Austerity" has been a surefire election loser since 2008. Because governments bailed out failed banks and their well-remunerated executives, there is simply no appetite in the West for sacrifice or belt tightening. Inflation favors borrowers because they get to repay in cheaper dollars, and the democratic calculus is simple: lenders are few, but borrowers are many—they vote, and they might riot. In addition, large influential businesses all have debt and would prefer to pay it back in smaller dollars.

Gold

Gold is the old money. Gold is the premium non-government currency, evolved in the marketplace over 5,000 years. We based our money system on gold until 1971, so you can run a modern economy on it. Gold is best viewed as a superior form of cash that debases much more slowly than paper currency. Of great political importance at this juncture, banks and government cannot print it.

Gold is a potential rival to paper currency. We might come to a situation eventually where people conduct day-to-day commerce and pay their tax in an inflating paper currency, but save in gold, and base future contracts or international commerce partly on gold. Gold has the potential to undermine the power and profitability of banks and government.

Gold is not really a commodity like wheat or iron, because it doesn't get used up: people carefully store gold away, for future trading. Central banks don't buy copper or timber, they buy gold—or at least they have since 2009 when they became net buyers of gold again after years of selling.

Long Term Gold Prices

As every currency trader knows, in the long term the relative values of currencies are determined mainly by their relative rates of manufacture or debasement. Since 1982 Western paper currencies have been growing around 5 – 25% each year, while the supply of aboveground gold has increased by 1.7% per year due to mining. So you'd expect the price of gold to go up purely due to the differential in debasement rates.

Indeed it does. The big picture is that gold goes up continually against paper currencies, on average. Taken to its logical extreme, gold will eventually get to a price of one million US dollars per ounce—but will that be in a hundred years or a thousand?

Here is the US true money supply from 2000:

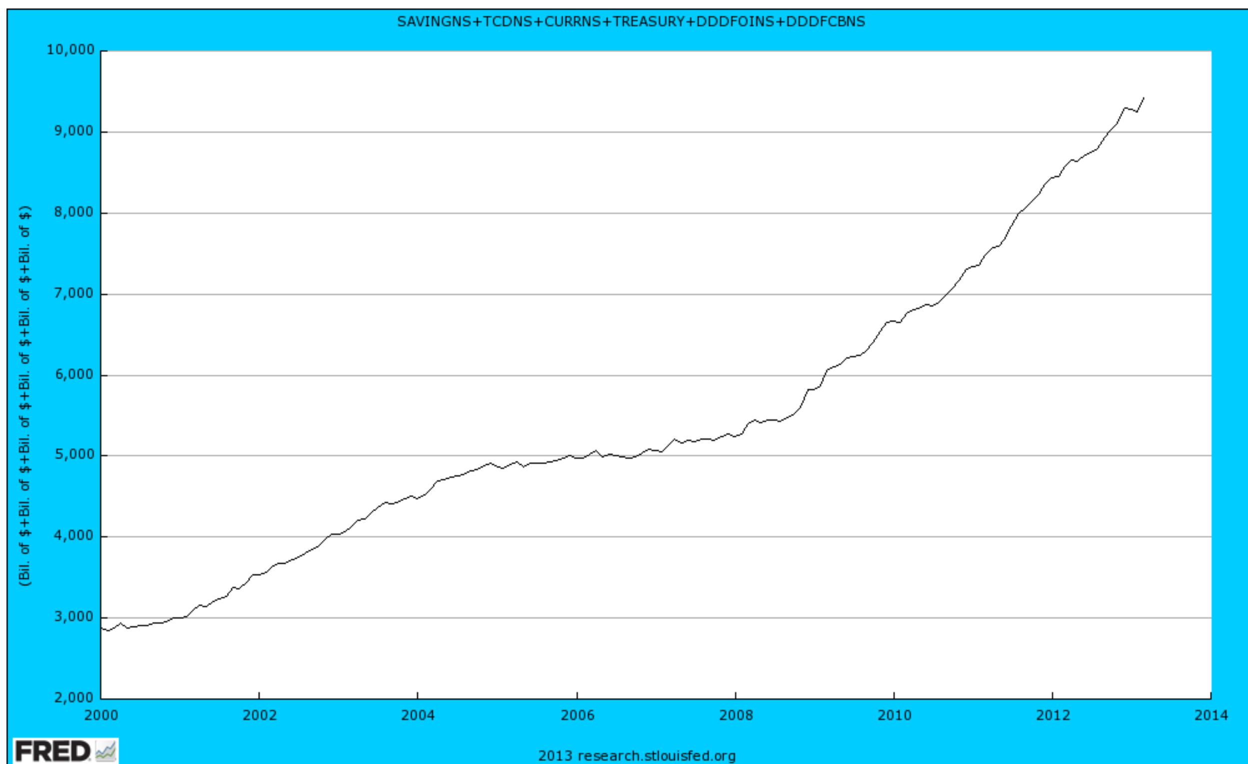

Figure 2: US true money supply from2000. True money supply is an improvement over conventional measures like M1, M2 or M3 because it counts only money that is immediately available for exchange and does not double count.

The average growth rate is just under 10% per year. Notice the flat growth in the three years leading to the global financial crisis of 2008. Since 2009 the US Fed has been quite competent in growing the money supply at a brisk 12%, knowing that a significant slowdown risks another financial crisis or worse.

Throughout that whole period of 10% money growth, the CPI was just 2%. If inflation is an increasing quantity of money chasing a fixed quantity of goods and services, why wasn't it higher? There are three reasons. First, the economy has many parts, like bonds, shares, real estate, and consumer goods and services, and the CPI only measures the latter. Banks create new bank money mainly for asset purchases, areas not covered by the CPI, so much of the new money is invisible to the CPI. Second, if there was no money supply growth, then productivity growth and population growth together would cause prices to fall by about 3% per year. Thus a 2% CPI growth could be a result of 5% money supply growth, by this factor alone. (Falling prices are not a bad thing, the case par excellence being computers. Each year computer prices fall and the quality improves, and I cope with it just fine. I expect you do too, and the electronics industry is cool with it also.) Third, there is some massaging of CPI figures—if they were measured by the same method as they were in 1980, they would probably be 2-3 points higher.

So what was gold doing while the money supply was rising at 10%?

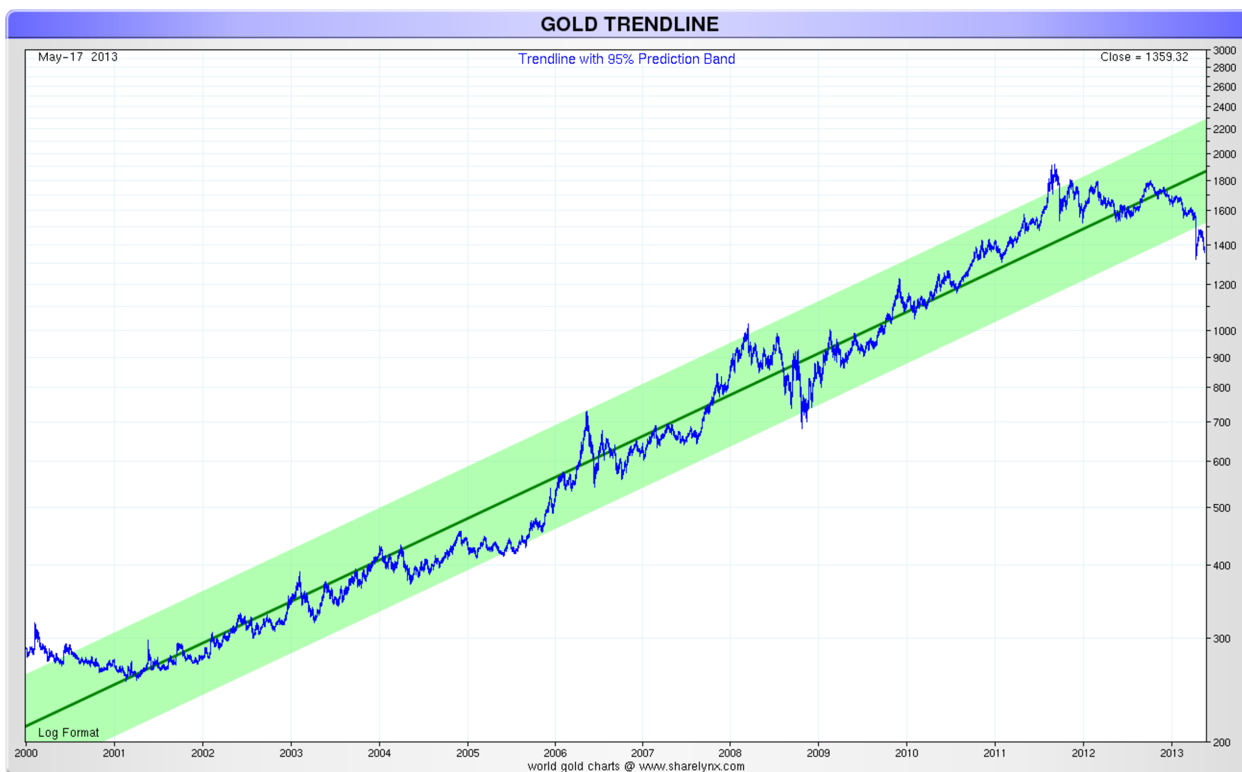

Figure 3: The gold price moved up at a remarkably straight 15% per year from 2000 until April 2013.

Until it fell out of the rising channel in the plunge of last month, the gold price rose at 15% per year for 12 years. The differential in debasement rates was 8%, there was presumably some catch up for the previous 20 years of stagnant prices from 1980, and some expectation of future paper debasement.

The gold price rose by 20% per year from 1968 to 1980 (after decades of blatant price control). What stopped its rise then were the 20% interest rates applied in 1980 to stop the manufacture of new money and wring inflation out of the economy. Fed. Chairman Paul Volcker and US President Jimmy Carter became very unpopular for those interest rates. Today few could afford 20% interest rates, and in any

case nothing like that has happened, so why did the gold price plunge last month? The answer this time lies in the structure of the gold market and, ironically, in the rising demand for physical gold.

The Structure of "the" Gold Market

The gold market is not the monolithic market one would assume, but basically consists of three fairly separate markets with some surprising interactions.

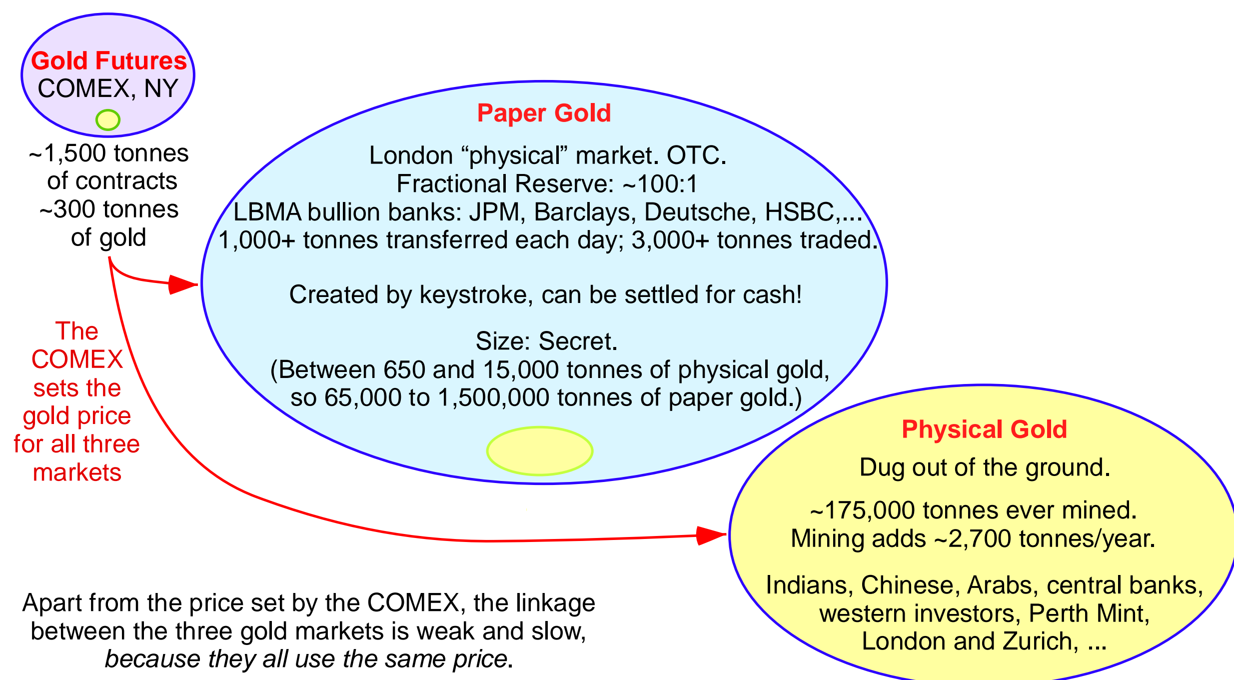

Figure 4: The structure of "the" gold market. The gold market is not the monolithic market that most people assume.

The first market is for physical gold, shiny yellow stuff you can touch. It consists of all the gold that has ever been mined, maybe 175,000 tonnes, and increasing by the annual production of 2,700 tonnes per year. This gold is held in safekeeping, mainly by Indians, Chinese, Arabs, some western investors, by repositories like the Perth Mint, in vaults in London and Zurich, and so on.

The second market is for paper gold. Paper gold is a piece of paper that says you own some gold. The paper gold market is run by banks known as "bullion banks", which hold gold in their vaults, mainly in London. The bullion banks include JP Morgan, Deutsche Bank, HSBC, Barclays and UBS, and belong to the London Bullion Metals Association (LBMA). If you want to buy some paper gold, you go to them and hand over some cash. They type up a nice certificate saying you own some of the gold in their vaults, and you go home with that bit of paper. When you come to sell your paper gold, you hand over the paper and they give you some cash. Both transactions are at the prevailing spot gold price.

You can ask to redeem your paper gold for physical gold, but in the fine print of the contract you signed with the bullion bank, they can choose to give you either physical gold or cash. Although this market is

known as the “London physical market”, it really buys and sells paper. It is an OTC market, without a public exchange trading standardized products—you must do your business with the bullion banks.

Now the bullion banks noticed that most of their customers never see their gold in the vaults (and even if they did ask to see their gold, they could in principle be shown any old gold because all gold looks much the same). Over the years, the bullion banks have, well, sold more paper gold than they have physical gold. Quite a lot more. You can see the temptation. It’s all perfectly upfront, there is nothing hidden or underhand about this, but while many people may *think* they purchased gold, all they own is a paper claim to some gold.

This is a fractional reserve system, similar to a traditional bank, but immune from a “bank run” (or “gold run”) because the bullion banks can settle in cash rather than having to redeem in actual physical gold. But settling in cash would get expensive for the bullion banks if the price of gold had risen and there were more redemptions than buyers of their paper gold (so while paper gold is not a Ponzi scheme, it does bear a passing resemblance).

What is the fraction? At a public hearing of the U.S. Commodity Futures Trading Commission on futures trading in metals in March 2010, Jeffrey Christian of CPM group, a leading gold analyst, insider, and ex-employee of Goldman Sachs, revealed that the fraction was more than 100. That means that for every ounce of gold in the vaults, there are at least 100 pieces of paper out there saying they “own” it—well not really own it, just 100 pieces of paper saying the bullion bank owes them an ounce of gold or the equivalent in cash.

How much paper gold is there? That’s a secret, they won’t tell you.

However we can get a rough idea. There are about 1,000 tonnes of gold transfers daily within the LBMA system, but this figure does not include paper gold trades that are netted out and therefore don’t require a transfer of gold. Traders estimate actual trades at 3 to 8 times the transfers, or at least 3,000 tonnes per day. Many owners of paper gold hold it for years without trading it, so the amount of paper gold must be many multiples of that 3,000 tonnes. Separately, analysts have figured there is a maximum of 15,000 tonnes of physical gold backing the paper gold, which means there could be as much as 1,500,000 tonnes of paper gold (at a fraction of 100 to 1)—which would dwarf the physical market. Others point to a bare minimum of 65,000 tonnes of paper gold, over a third of the size of the physical market, which would require a reserve of only 650 tonnes of physical gold (at 100 to 1). The truth presumably lies somewhere in between.

So the paper gold market is comparable in size to the physical gold market, and quite possibly larger.

Obviously the mere presence of all this paper gold reduces investment demand for actual physical gold. If the money invested in paper gold had been invested in physical gold instead, presumably the price of gold would be higher.

By the way, this sort of scheme can only exist in gold and silver, because all other commodities are produced for consumption. One cannot get away with selling some other commodity that does not exist or will not be produced soon, because the consumer would demand delivery before long.

The third market is the futures market, where contracts for future delivery of gold are bought and sold. This happens mainly in New York at the COMEX. It is a relatively tiny market, but crucial because this is where the price is discovered: the spot price of gold quoted around the world is the latest price on the COMEX. At any one time there are open contracts for about 1,500 tonnes. The COMEX warehouse generally holds about 300 tonnes of gold for buyers to take delivery if they settle their contracts in physical, but most contracts are settled for cash.

The essential fact that links the three markets is that all three markets accept "the" price of gold as the latest COMEX price: gold is traded on the physical and paper markets at the latest COMEX price.

This makes the linkage between the markets both weak and slow, because there is little profit to be made from arbitrage—buying low in one market and selling higher in another. (You might suggest that the prices are the same in all three markets *because* of arbitrage, but there are times when the physical prices are much higher for substantial periods, so we know it doesn't quite work like that. More on that later.) In particular, apart from sharing the gold price as discovered on the COMEX, the paper market is insulated almost completely from the physical market, because the bullion banks don't have to redeem in physical—one market is in paper, the other in gold, so how can you arbitrage between them?

The Big Picture of Gold Pricing

Basically gold prices go down in the West, and up in the East.

In the West we have a paper-based financial economy and trust banks and government, more or less. The Western media consistently denounce gold as an investment option, and hail the bureaucrats at central banks who set interest rates as heroes. (Central planners in the Soviet Union were also hailed as heroes by their press, but how could that possibly be relevant?) The bullion banks prefer a lower price for gold, to limit their obligation in the paper gold market—basically they are massively short gold, because all their customers who gave them cash might come and want to redeem their paper gold.

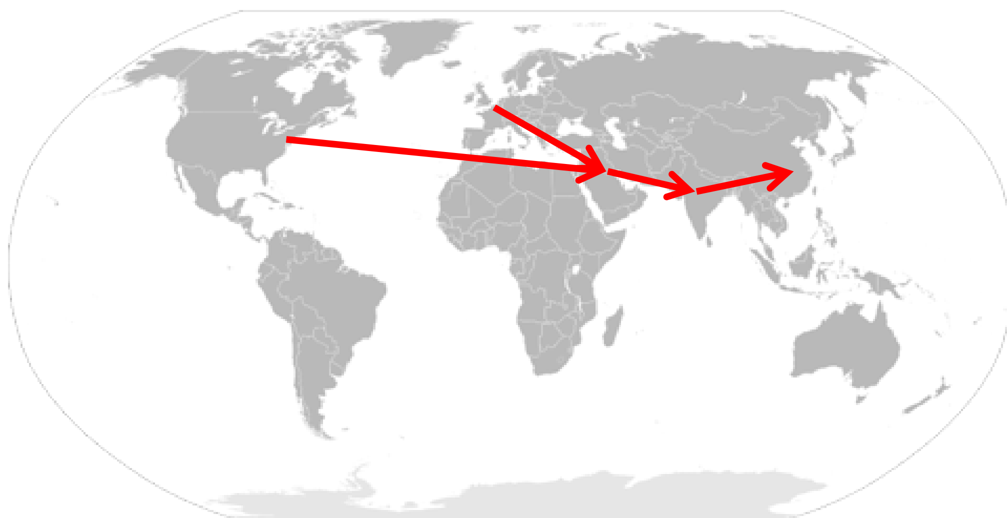

Figure 5: The flow of gold is basically from West to East. It isn't coming back to the West.

Asia and the Middle East are getting wealthier. People there have a greater distrust of banks and paper currencies, and many are spending some of their new wealth on physical gold. This is creating an accelerating demand for physical gold, which is gradually driving up the world price of gold. People in the Asia and the Middle East are often prepared to pay a small premium over the COMEX price for physical gold, so arbitragers move bullion out of the COMEX and London and resell it for that premium in the physical market. The premiums are small compared to the price movements on the COMEX, so this force tends to be weak and slow, but it has driven the price of gold up five-fold in the last 12 years. The premiums in the Indian market are a good guide to the physical demand; they are generally around -\$2 to +\$5 per ounce, and rarely above \$10 per ounce.

The Prelude to the Recent Plunge in the Gold Price

The story begins with the "bail in" of Cyprus. On March 25, 2013, the EU arranged a €10 billion economic rescue of Cyprus, which included hefty levies on the uninsured portion of bank deposits at some Cypriot banks. The first €100,000 of each deposit was guaranteed, but many depositors lost much of their money beyond that.

Figure 6: This cartoon went viral in Cyprus.

This was a new development in modern banking. Since the 1930s basically no depositors had lost money in a western bank, including in the financial crisis of 2008-9. The Cyprus crisis drew attention to a 2011 change in policy at the Bank of International Settlements (BIS—the central bank of central banks): depositors are now just unsecured creditors, behind the secured creditors, when a bank gets in trouble. The lesson learned: ***Big bank deposits are no longer safe.***

Naturally this led to increased demand for other ways to store wealth, and increased distrust of banks. Scared gold holders raced to get their gold out of the paper gold market, wanting physical gold in their possession. In Europe there are many collaborated stories of high net worth individuals demanding delivery of gold bars from bullion banks. Some said things along the lines of "Please give us our $30m of gold, or we remove our $100's of millions of other business from your bank." After Cyprus, bullion banks faced both increased redemptions for cash (which might have then been spent elsewhere on physical gold), and an increased need to hand over actual physical gold.

Paper gold was under pressure. ABN AMRO, a Dutch bullion bank, told its clients in early April that it would no longer be delivering physical gold, and all redemptions would henceforth be in cash. ABN responded that this was merely due to a re-organization of its business, but in normal circumstances it could have borrowed the gold from another bullion bank—but presumably that was not possible now. In London there were reports on investors taking delivery of 10-20 tonnes of physical gold per day, and there was a rumor in early April that the LBMA system was on the verge of a major default.

The ratio of physical gold to the number of open contracts at the COMEX was low, but has been lower previously so it's not of concern in itself. However the stocks of physical gold used to back trades in the COMEX have been dropping sharply for a few months.

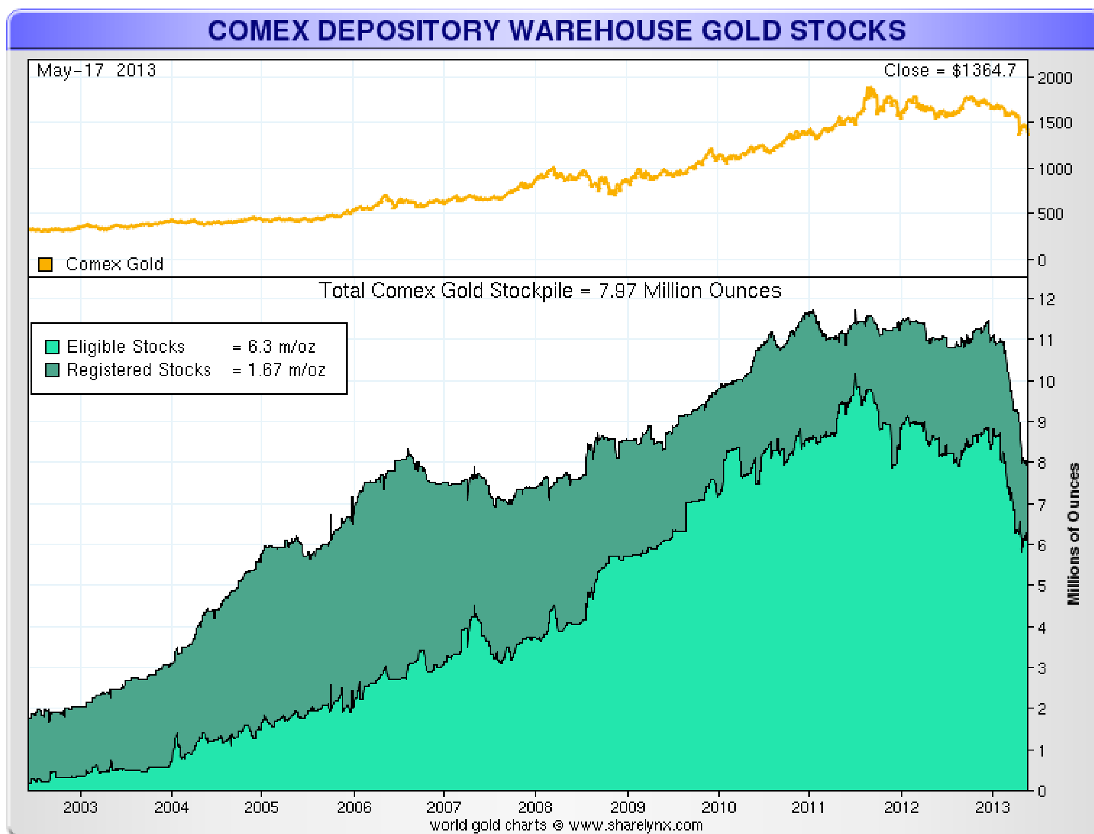

Figure 7: Physical gold at the COMEX has been dropping sharply in the last few months.

By early April the bullion banks were in a precarious position. They were facing increasing redemptions of paper gold, for both cash and physical gold. From their perspective there was a trifecta of benefits if only the price of gold was lower:

- The bullion banks would pay less cash to people redeeming their paper gold for cash.
- The level of redemptions would likely be lower.
- The GLD ETF would likely end up selling gold to the bullion banks, mainly at the lower price. This gold could be paid to the redeemers of paper gold who need to be given physical gold. This is cheaper than having to buy that physical gold at the current higher price on the open market.

So in the face of increasing redemptions of their paper gold, the bullion banks stood to improve their financial position if the price of gold was lower. As it happens, the bullion banks can lower the price of gold without expending any gold, by selling futures contracts on the COMEX. It merely costs them some cash. (The price of gold is set on the COMEX where futures contracts are bought and sold. Traders do not need actual gold to sell gold on the COMEX, just enough cash to keep their margin account open, because nearly all contracts are settled for cash rather than physical gold. If a trader succeeds in moving the price with help of momentum players and speculators, they can even buy back some of their sell contracts at an increased price, so their cash expenditure might be quite low—or even negative!)

At some level of demand for redemptions, it becomes worth the risk and probable cash cost of selling futures contracts on the COMEX, in order to save cash on their paper gold obligations.

It is rational for the bullion banks to push the price of gold lower on the COMEX, in the face of increased redemptions of their paper gold, which was caused by increased demand for physical gold.

How ironic for gold holders.

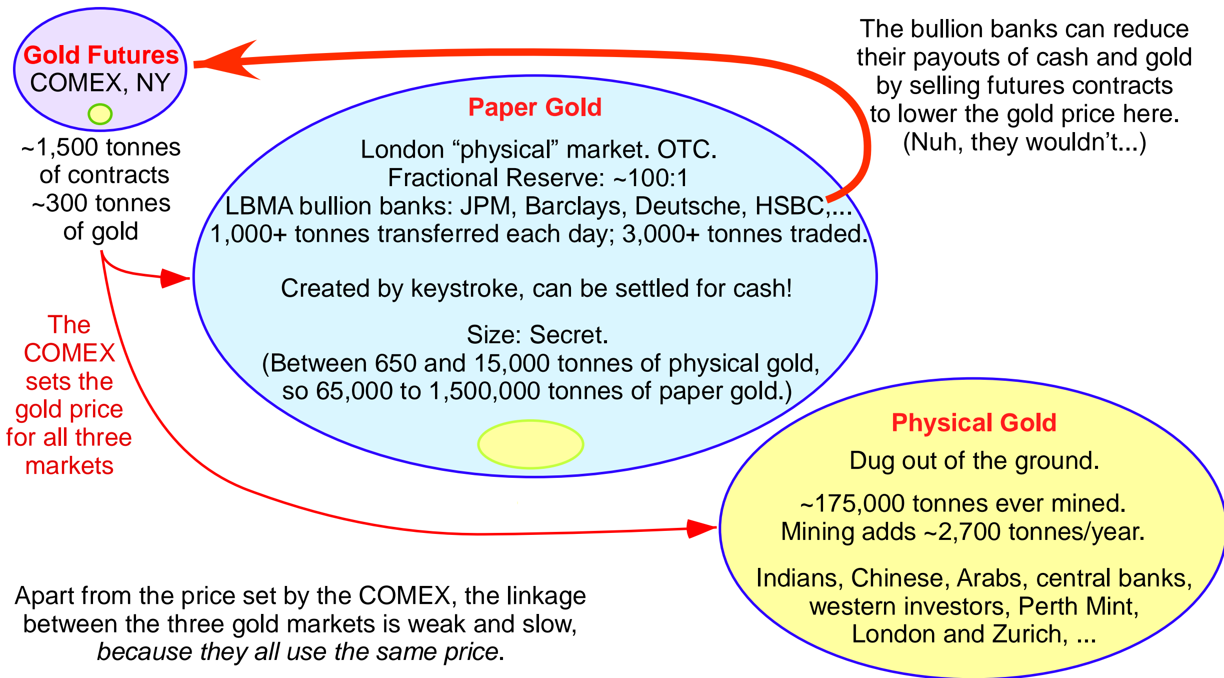

Figure 8: Increasing redemptions of paper gold make it rational for the bullion banks to lower the gold price on the COMEX, if the cash spent to lower the price on the COMEX is less than the cash saved on redeeming paper gold.

The Recent Plunge in the Gold Price

The price plunged on Friday April 12 and Monday April 15, 2013.

The mood was set leading up to that Friday. On April 2, Société Générale issued a report dissing gold, forecasting a gold price of $1,375 per ounce by year end. On April 8, Goldman Sachs forecast gold at $1,450 an ounce by year end, but said the decline could be larger. There was a rumor that Cyprus would have to sell its gold as part of the bailout—Cyprus was only going to sell 10 tonnes of gold, but the way it was talked about made it seem significant. The IMF issued an announcement that the Eurozone economies were improving fast, implying that quantitative easing could finish soon, although that announcement seems a tad premature in retrospect. The *New York Times* published a major article on April 10 questioning the role of gold as a safe haven.

To set the scene for the plunge, note that the average COMEX volume in March was about 600 tonnes per day, and the record was about 1500 tonnes in a day. The COMEX is open 23.5 hours a day.

On Friday morning 500 tonnes was traded, concentrated in two short bursts: one trade sold 100 tonnes in ten minutes, another sequence of trades sold 300 tonnes in 30 minutes. Then in quiet trading on Monday morning, before Europe and America had woken up, a quick sale of 170 tonnes dropped the price $50 per ounce. The total trade on Friday and Monday was over 3,000 tonnes, at record levels. Selling gained further momentum by prompting others to also sell, as traders hit their maximum acceptable loses ("stops") or got margin calls.

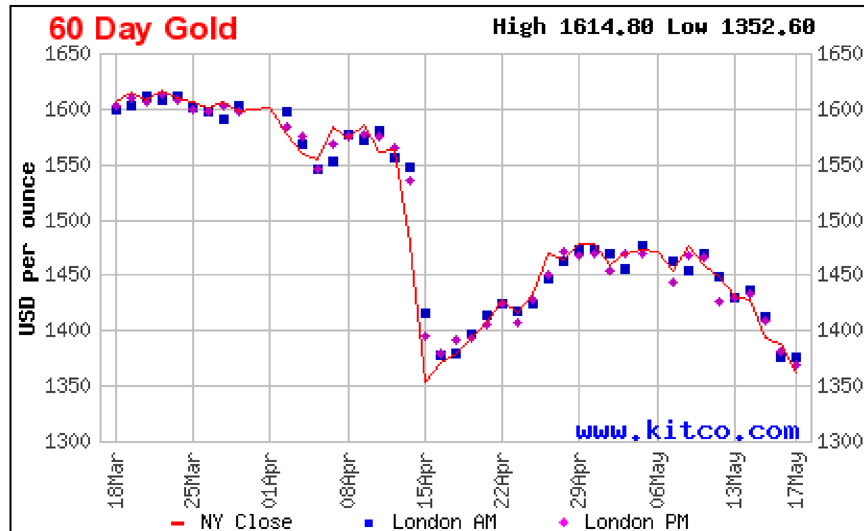

Figure 9: The plunge in the gold price: $200 per ounce on Friday 12 and Monday 15, April 2013.

There are clues in the trading. The selling came in concentrated "staccato-like blasts". A seller of a large position in any market who wanted the best price would do the opposite, liquidating as discreetly as possible. But if you were trying to push the gold price lower, you would loudly dump large sales onto the market in bursts, using shock and awe to maximize the price decrease and frighten the longs.

The sellers were clearly not trying to get the best possible price on the COMEX. Therefore they must have been expecting to profit elsewhere by *more* than they were losing by their behavior on the COMEX. The obvious candidates are the bullion banks, who benefit from a lower COMEX gold price by reducing their obligations and payouts to redeemers in the paper gold market in London. That this can happen is not a conspiracy, but simply a systematic flaw in the market structure. It is perfectly rational, an admittedly non-intuitive outcome, but to be expected from the structure of the gold market.

(Of course, the *reason* this structure exists is also due to the bullion banks. They established the paper gold market, and the perverse incentives it creates. You might call it a beautiful piece of financial engineering, if you admire that kind of thing. But that's a different story.)

Unprecedented Physical Demand

India imports 900 tonnes a year, probably over 1,000 tonnes this year. China, in the months leading up to April, has been importing gold at about the same rate as world gold production—in March alone it imported 330 tonnes through Shanghai, while world gold production was only 250 tonnes.

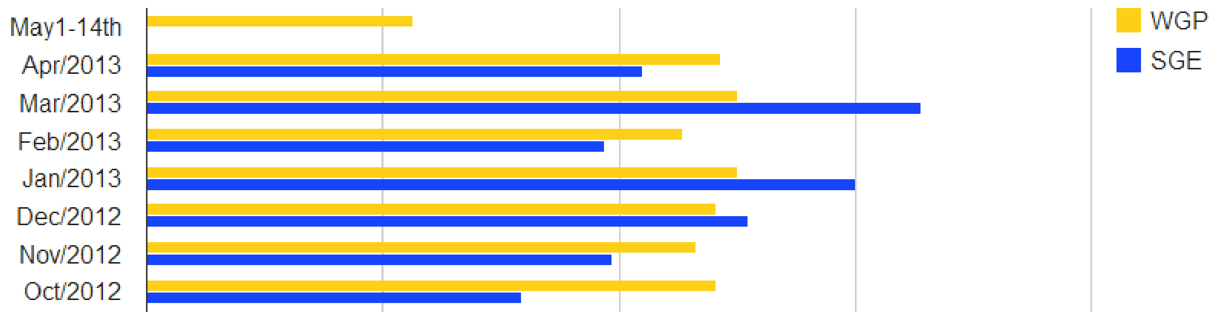

Figure 10: Each gray bar is 100 tonnes. Source.

But in the first two weeks of May, China imported essentially no gold. Was this a sudden change in policy, not wanting gold now that it costs less (cough cough), or is it because they cannot get it? Some clues: Premiums for physical gold are way up throughout Asia and the Middle East, reaching an astronomical high of $48 per ounce in India in April, $30 per ounce in Shanghai, and $25 per ounce in Istanbul. According to the *Economic Times India*, Haresh Soni, chairman of the All India Gem and Jewellery Trade Federation, said banks and trading houses importing gold are getting only 10 percent of their orders as the demand has surged sharply after a sudden slide in gold prices last month. *"If they place order for one tonne, for instance, then they are getting only around 100 kg".*

Retail demand exploded, and all the fabricated stock of small gold items was quickly sold, right around the world. Mints are still making more. Swiss refiners ran out of kilo gold bars (about $48k each). However 400 oz bars are reported to be available in reasonable quantities, so there is apparently no shortage of physical gold at the wholesale level in the West.

The large gold ETF, known by its ticker as GLD, had 1,350 tonnes at the beginning of 2013. It has been drained of over 300 tonnes so far this year, 100 tonnes of it in the three weeks since April 12. When the gold price falls, it generates a lot of sales of GLD shares. If an "authorized participant" of GLD collects 100,000 of the sold shares in GLD, it can use them to buy gold from the ETF. Most of the authorized participants are bullion banks. So a quick fall in the gold price pretty much guarantees that the bullion banks will be able to get some of GLD's gold, much of it at the new lower prices.

It's a Correction Yes, But…

There has obviously been a correction in the long term gold bull market. But it has been accompanied by unfulfilled demand for physical, which is unusual. Easy money is driving the overall stock market higher, yet somehow driving the gold price lower—huh?

The world now thinks that gold demand is down because the price has gone down; "the market" says so. That conclusion would be justified if the gold market was a monolithic whole, but the market is in fact deeply fragmented and contains perverse incentives, so that conclusion is not warranted.

The irony is that the rising demand for physical gold, against a backdrop of accelerating money printing and confiscations of bank deposits in Cyprus, has led to the situation where the bullion banks have the motive to take the gold price down. The paper futures market at the COMEX gives them the means.

Manipulation?

The market is always right. And what is "right"? It is whatever the market does. That's circular of course, but we can always construct post-hoc explanations for any behavior on "the market", no matter what happens. But it's a pretty empty and pointless exercise much of the time. And what is manipulation anyway?

Consider these three questions:

1. Any evidence less than a full admission by the "manipulators" is not enough to prove it to everyone's satisfaction. Are we ever going to get that?
2. Just suppose for argument's sake that some white collar psychopaths worked their way to the top of our financial system. If manipulation was to their advantage, why wouldn't they do it?
3. Central banks routinely manipulate paper currencies, and gold is the old, non-government currency. So why wouldn't they manipulate gold, or turn a blind eye to those who did?

Here's what Barron's had to say (18 May, 2013): *"Gold bugs spy an agenda in all the concerted selling to discredit the metal and burnish the allure of stocks and bonds. The evidence remains circumstantial in that regard,* **but shouldn't be dismissed.** *The huge bouts of selling are irrational for a profit-maximizing investor."* Except for that last sentence, which naively assumes a monolithic market, I'd agree.

In the roaring 20's, before the crash of 1929, share prices were frequently moved up and down by "pools" of brokers, investors, and finance houses, and these machinations were openly discussed in the newspapers. Is this ok? It's a free market, so you can do anything that's rational and makes a profit, right?

Well after the crash it didn't seem like such a good idea. In the US it was outlawed in 1933 and 1934 by the Glass-Steagall Act and by the establishment of the Securities and Exchange Commission (SEC) to oversee "fair trading" in the markets. But the Glass-Steagall Act was repealed in 1999, and the SEC is a toothless tiger when it comes to precious metals (it has been investigating manipulation for several years, but oddly enough cannot bring itself to any conclusion).

Is the Fed involved in gold manipulation? I've no idea. But if it is, the picture is a whole lot tougher for gold. Central banks have a vested interest in paper money: the Fed owes its existence and power to the use of paper money, and gold is potential competitor. Paul Volcker, the Fed Chairman before Greenspan, said in 2009: *"Gold is my enemy. I am always watching what gold is doing."* Ok, that's clear enough. The bullion banks and government are intertwined, frequently exchanging personnel, especially the "too big to fail" banks like Goldman Sachs (nicknamed "Government Sachs"). The problem for gold holders is that the Fed is powerful: "don't fight the Fed." The Fed can create infinite money at the press of a button, so in theory its agents could sell futures contracts forever on the COMEX to drive the price

as low as they wanted, without ever using up any gold, merely burning up cash—so long as the traders on the COMEX settle their contracts for cash.

Any perverse incentives in the gold market, and any gold price manipulation scheme, can be overcome if the physical market takes control of the price – by simply wiping out the physical gold underpinnings of the COMEX and the paper gold markets. Simply take physical gold for delivery, do not settle for cash. ***Gold is special: you actually have to have it in your possession***, or in your mining lease, or as allocated gold in a trusted repository that is not running a fractional reserve scheme. ***A piece of paper is not good enough.***

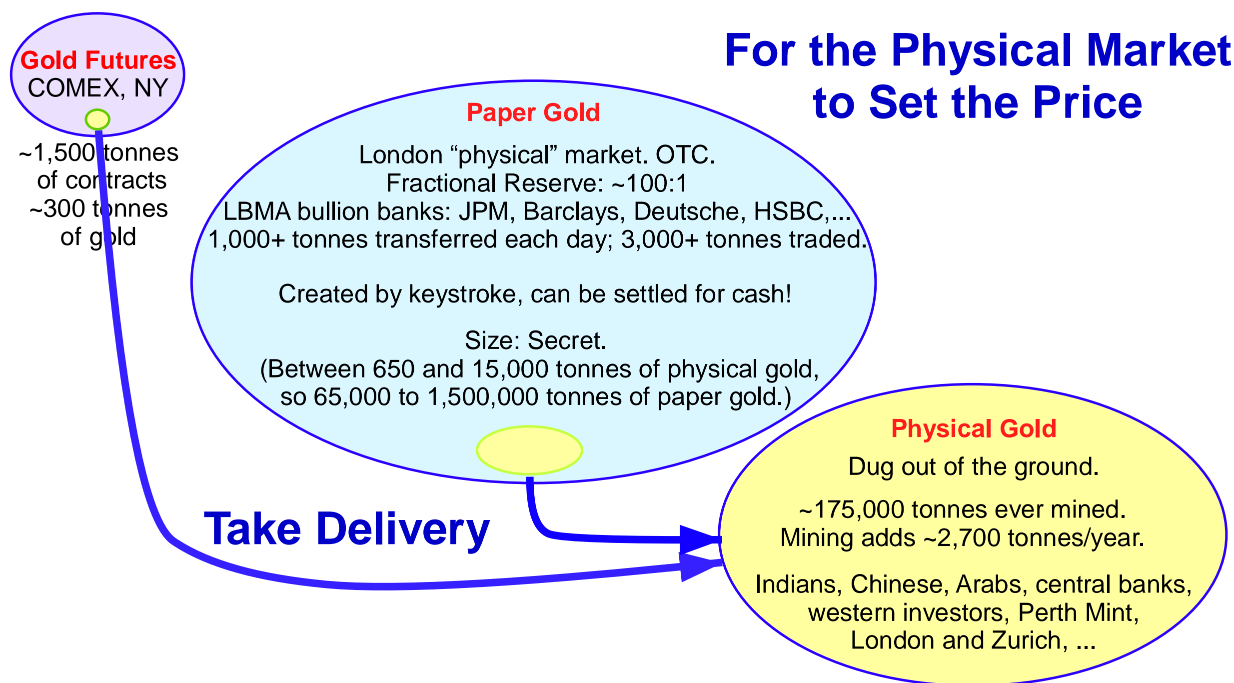

Figure 11: Gold is a special financial asset: you actually have to have it in your possession. A piece of paper is not good enough. Taking delivery of gold will overcome any perverse incentives or manipulation.

What Did You Expect?

Since we went off gold in 1971, the financial sector's share of corporate profits has inexorably risen and finally eclipsed all other sectors of the economy. It used to be that manufacturing, farming, mining, and producing real stuff used to be where the action was, but now the smarties are lining up to go into finance. Through their manufacture and control of the commodity that is half of nearly every economic transaction, banks and central bankers rule the modern Western paper economy.

Why wouldn't the suppliers of paper to our paper universe fight to the death to preserve their power, lifestyle, and, above all, their privilege to manufacture money? They would be crazy not to.

Technicals

Gold has broken down out of its bull run channel (Figure 3). Current prices for gold miners suggest that gold is going to go even lower, or stay this low a long time. Sentiment towards gold is at historically poor levels in the West. But are these technical factors relevant in "the" gold market? If gold was a monolithic, free market, it would be past time to get out. But technicals do not work well where major participants are *not* trying to buy low and sell high.

Some Reasons for Pessimism about the Gold Price

Only a few gold mining companies around the world can make real profits at the current gold price, when taking into account their all-in costs and overheads. If the gold price stays at these levels for a couple of years, few will survive. If it drops further, the gold mining industry will be obliterated. The lack of new production won't necessarily put great upward pressure on the price, because all the aboveground stocks of gold are still available for sale.

Heck, they could confiscate gold and outlaw gold mining – you know they want to!

Some Reasons for Optimism about the Gold Price

If Western governments confiscate and outlaw gold, all pretense of a market or free society is gone. Asian countries will roar ahead of us because we no longer have a free economy; our allocation of capital will be less efficient due to a monopolistic and overly-bureaucratic money system.

Meanwhile the debasement of paper money is proceeding apace, and the debt overhang (Figure 1) and the electoral unpopularity of austerity pretty much guarantee that the paper money debasement will continue in some form or other for the next decade or more.

George Soros, the consummate political insider investor, bought $25m of call options of the North American GDXJ Junior Gold Miners Index in Q1 2013. He also increased his GDX shares by 30% to $100m, but reduced his shares in GLD by 20% to $82m.

Finally, here at GoldNerds we analyze all the gold and silver companies on the Australian Stock Exchange. We have noticed in the last couple of years that Chinese interests have taken large positions in many gold companies. But the positions are *all* in companies that have large resources of cheap gold ounces in the ground, and are *nearly all not viable* at the US$1,600 per ounce gold price before the recent plunge. Do they know something?