FINANCIAL TIMES
ft.com/alphaville

Gold backwardation fears revisited, uh oh!

Posted by **Izabella Kaminska** on Jan 22 11:30.

It's been a while since the gold bugs had a tasty scare-story to feed on.

But those frustrations can now be dispelled.

The Business Insider blog brings to our attention that net gold-lease rates are back on the rise, and more importantly gold-forward rates are dropping fast.

And it's true. The so-called GOFO rate set by the London Bullion Association dropped as low as 0.17167 on Wednesday — although it had perked up a bit by Thursday to 0.18500.

To compare, the rate held firmly above 0.3 for most of December, 2009.

Readers may recall GOFO rates went negative back in November 2008 for three whole days. At the time gold bugs said the move reflected a massive shortage in the supply of gold.

The likes of Professor Antal Fekete, a pro gold-standard monetary economist, meanwhile, claimed it marked the dawn of gold backwardation and the collapse of the world's fiat monetary system.

The reality was that with Libor sky high, and cash-calls coming at banks left, right, and centre — many banks, with bullion in their coffers, saw sense in lending out gold temporarily in return for much-needed cash. And with cash more sought after than gold in a sharply descending interest-rate environment, institutions were happy to pay counterparties to take their gold in return for cash.

Hey presto — GOFO rates went negative.

Here's how Ben Davies, CEO of gold hedge-fund Hinde Capital explained the situation at the time:

> *In stable environments: gold would remain under pressure until the GOFO breaks below 1% or breaks below the Federal Funds Rate. At the moment this is at 1.5%. If the GOFO rate falls below this rate, bullion banks have an incentive to borrow gold and sell in the spot market in exchange for USDollars. Although this puts pressure on gold it also increases demand for leased gold as they have to borrow it. This will eventually lead to a turnaround in GOFO rate.*
>
> *The rising GOFO rate reduces the profitability of the carry trade as money can be borrowed cheaper elsewhere. The low GOFO rate of late is the Federal Reserve Bank's desire to stimulate lending. Normally this would cause the lease rate and GOFO rate to converge. But lack of confidence in the inter-bank lending has most likely resulted in this wide spread as seen in LIBOR-GOFO chart.* ***The Banks will continue to look for sources of funding and this widespread on gold carry trade has attracted bullion banks to borrow here.*** *They sell gold short and it is this short that has chance to be squeezed as physical availability of bullion is scare. We are hence seeing the gold market move into backwardation.*

The best way to understand it is to look at the formula for establishing the gold forward rate — the rate which gold dealers are willing to lend on a swap basis against dollars.

The formula is:

Forward rate = Dollar interest rate — metal lease rate
or
X=Y-Z

So, if the dollar interest rate was to fall swiftly from say 4 per cent to 1 per cent and the metal lease rate — the sum earned from leasing gold, selling it in the spot market and investing the proceeds in Libor — stayed constant at 3 per cent the gold forward rate would go from 1 per cent to -2 per cent. (Not that the lease rate would stay there for long because of the Libor influence.)

But the forward rate is also a function of the metal lease rate — itself part-derived from supply/demand fundamentals via the leasing process (or rather where people see supply/demand fundamentals in one, two, three or six months' time *etc*). So if the dollar interest rate stood constant at 0.2 while the lease rate soared from -0.05 to 2.5 due to supply concerns, the forward rate would go from 0.25 to -2.3 and a negative gold forward rate would ensue.

In the first scenario the negative rate is a response to interest rates, while in the second scenario the negative rate is a response to a supply squeeze (the squeeze making it more costly to lease gold).

Gold prices to fall?

According to Brad Zigler at HardAssetsInvestor.com, however, a falling forward rate could also be indicative of one other thing. As he states:

> *A decline in forward rates implies one of two things: There's either a scarcity of metal available for swap or lease transactions,* ***or there's heavy forward selling.***

In other words, the market expects the price of gold to fall in the future and has been selling forward *so much* that the forward price has moved ahead of the other variables.

In Zigler's mind there's no doubt the current move is indicative of a sell-off rather than any prospective supply squeeze. As he states:

> *The latest Commodity Futures Trading Commission data show commercial accounts engaging in heavy selling and long liquidation. To boot, money managers have built their largest short position since August 2009 (and, if you're a contrarian, small speculators have taken up their strongest long position in a year and a half).*
>
> ***Given all that, the aroma wafting from the gold market seems to be a harbinger of a sell-off.*** *Technically, gold's stalled now. Key support for the February COMEX contract sits at $1,120 after bulls backed off from a test of the halfway point for the contract's December swoon. A close below that level makes the sell-off case.*

However, it is arguable that the GOFO rate could be reacting to an unknown variable altogether.

It's only traditionally assumed, after all, that bullion banks leasing gold invest the proceeds at a Libor return. If Libor is broken — as some speculate it may be — banks might be investing at completely unknown (and presumably higher) rate.

In which case, consider the equation again, remembering this time the metal lease rate might not necessarily reflect Libor. So:

Forward rate = Dollar interest rate — metal lease rate (LIBOR-GOFO)

On January 12th, these numbers would have looked like this :

0.29167 = 0.23313- (-0.05854)

(*We should point out 'leasing rates' have been negative for almost a year, and were even in that state during gold's epic run higher in the fourth quarter, seemingly reflecting no shortage of supply.)

Now consider the formula if banks are earning a higher rate, say 1 per cent on the leasing side.

In which case:

~~**0.29167**~~ = 0.23313 – (1.000-0.29167)

Implying a hypothetical negative 'real' gold forward rate of:

-0.4752 = 0.23313 – 0.70833

In which case could the recent drop we've seen in gold-forward rates to 0.185 be the market catching up to the over-pricing of gold forwards in the first place? Or even the pricing-in of higher interest rates to come?

As we're just speculating we do very much welcome feedback.

Related links:
Libor is useless – FT Alphaville
The gold backwardation theory – FT Alphaville
REMOBILIZE GOLD TO SAVE THE WORLD ECONOMY! – Antal Fekete

This entry was posted by Izabella Kaminska on Friday, January 22nd, 2010 at 11:30 and is filed under Capital markets, Commodities. Tagged with backwardation, gold.

Comments

Typical Brad Zigler BS in this quote.

"The latest Commodity Futures Trading Commission data show commercial accounts engaging in heavy selling and long liquidation."

According to the DCOT, commercials had about 35,000 longs for months and INCREASED their longs to 40,000 recently.

And this quote is worse.
"To boot, money managers have built their largest short position since August 2009"

The facts are that money managers went from 4-6,000 shorts to 11,000 shorts in a market with over 520,000 open interest. That's nothing.

He left off the fact that money managers have went from 150,000 longs to 200,000 longs since August.

---

hmmm, lots of financial voodoo in that post

too many ifs and buts

Best keep things simple

or you don't see the wood for the trees
