

## **August 30, 2010: All That Glitters is Not Gold**

Here's a riddle: when is gold not really gold? The answer: when it's made of paper. This conundrum is at the heart of something sinister that is occurring right now in the markets.

Let's back-up and discuss how gold is bought-and-sold. The gold market has two distinct segments. Almost all trading of *physical* gold takes place on the over-the-counter market (OTC), centered primarily in London, New York, and Zurich. OTC trades are direct unstructured transactions between principals - mining companies, central banks, and industrial consumers. The standard size of OTC gold trades ranges from 5,000 to 10,000 ounces. Investors and speculators can also trade in OTC derivatives similar to those discussed below.

### **And Into the Futures**

What most people think of as the gold market is actually the gold futures market, the trade that takes place on exchanges such as the Commodity Exchange (COMEX) division of the New York Mercantile Exchange (NYMEX), the Chicago Board of Trade (CBOT), and the Tokyo Commodity Exchange (TOCOM). Investors in these exchanges speculate on the movement of the price of gold. The principal indicator is the spot price - the quote price for gold to be delivered and paid for on the settlement date two days into the future.

### **Exit Gold, Enter Paper**

In something reminiscent of alchemy, gold is typically converted into paper as one of the following three securities.

*Derivatives*, instruments that settle further into the future than the spot settlement date, were introduced into the gold market to hedge against adverse movement in the spot price. There are two basic types of derivatives, although each has numerous complicated variations.

*Futures* are contracts to buy or sell a specified quantity of gold at a set price on a fixed future date. Delivery dates and unit quantities are standardized by the exchange. Futures trade is buying and selling futures contracts; physical gold is rarely delivered.

*Options* are a variation on futures that give the holder the right - but not an obligation - to buy (call option) or sell (put option) a specified quantity of gold at a set price on or before a specified date. Options are also standardized by the exchanges.

### **Out of the Exchange and Into the Stock Market**

In 2003 the exchange-traded fund (ETF) introduced a form of gold trade into the stock market. These instruments are backed 100% by gold, **although the holder never has possession of the physical asset (uh-oh)**. Similar instruments backed by futures are also

available. Although ETFs may appear to simplify investing, they introduce another layer of risk while having none of the benefits of owning physical gold. And this is at the heart of the riddle.

In the past two weeks I've read articles from several gold experts who claim there's a major disconnect between the amount of physical gold held in the system and the amount of paper claims on it. Adrian Douglas, Editor of Market Force Analysis, estimates that for each ounce of physical gold in the vault the bullion banks (the half dozen banks that make the worldwide gold bullion market) have loaned or sold 45 ounces. Douglas says that "when 45 ounces of gold are sold but only one real ounce is sourced the result is a massive suppression of the gold price. But the converse is also true; when 45 ounces of gold are demanded for only one that is in the vault the price explosion is beyond imagination."

Hmmm...45:1 leverage in a non-regulated market. What could possibly go wrong?

The lack of physical gold in the market is causing prices of gold coins to increase 25-30% over their paper gold value. At the same time, supplies are dwindling. With all this going on, it's strange the paper gold price hasn't reflected these circumstances. One might be tempted to think that either the price of paper gold is about to change in a major way, or that the bullion banks are seriously underwater. Or both.

So you might want to consider holding only physical gold. And if you hold paper gold, you might want to think about converting it to physical gold, if possible. Because one thing is fairly clear to me: all that glitters is not gold.

-Rob

PS: Thanks to Nation member Roger McClure for alerting me to this gold imbalance situation.

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