THE LAST CONTANGO IN WASHINGTON

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When the silver corpse stirs, money doctors run

People from around the world keep asking me what advance warning for the collapse of our international monetary system, based as it is on irredeemable promises to pay, they should be looking for. My answer invariably is: "watch for the last contango in silver".

It takes a little bit of explaining what this cryptic message means. Contango is that condition whereby more distant futures prices are at a premium over the nearby. The opposite is called backwardation which obtains when the nearby futures sell at a premium and the more distant futures are at a discount. When contango gives way to backwardation in all contract spreads, never again to return, it is a foolproof indication that no deliverable monetary silver exists. People with inside information have snapped it up in anticipation of an imminent monetary crisis.

"Last contango" does not mean that the available supply of monetary silver has been "consumed" by industrial applications, as trumpeted by the cheerleaders of the get-rich-quick crowd. Such a notion is at odds with the fact that silver has always been, and still is, a monetary metal. Huge stores of monetary silver still exist, but are kept out of sight and availability by their current owners who, for obvious reasons, want to remain anonymous. "Last contango" is the endgame of the grand tug-of-war between the money doctors and "We, the People". The doctors exiled silver from banking to the futures market hoping that it will drown there in a sea of paper silver. But the silver corpse stirs. People withdraw ever greater chunks of cash silver from exchange-approved warehouses. The money doctors run scared. If futures trading in silver is unsustainable and must end in default, then the flimsiness of the house of cards built of irredeemable promises will be exposed for all to see. Following the last contango in Washington the money doctors, led by Helicopter Ben, will follow the example set by the 18th century Scottish adventurer John Law of Lauriston. He left Paris in a hurry. In a disguise. Disguised as a woman.

Don't kill the goose laying silver eggs

My main argument justifying the claim that the bulk of monetary silver has not been consumed is that silver, just as gold, is far more useful in monetary than in industrial applications. Provided, I hasten to add, that you know what a monetary metal is, and you also know how to make it yield a return. Admittedly very few people do, and fewer still are willing to share their knowledge with others. Nevertheless, monetary applications of silver are real. Industrial applications kill the goose that lays silver eggs. We must also remember that silver consumption is a relative concept. In Newfoundland tiny silver pieces half the weight of a silver dime with 5 cent denomination had been in circulation before 1949. After the country was absorbed into Canada, these pieces were threaded onto a chain to form bracelets and necklaces. You may, of course, say that silversmiths have "consumed" silver but, clearly, these pieces could re-enter circulation if circumstances warrant it, as quickly as overnight. While the labor component of the price of silver cutlery and plate may be greater, again, this is relative. At a higher silver price it may become negligible. There is hardly any form of silver consumption the product of which could not be recycled, provided only that the silver price is high enough.

The hairy tale of naked short interest

Every time the silver price rallies, selling appears and the price falls back. "Aha", the cheerleaders cry, "the 'silver managers' are at it again. They are selling silver naked!" Since the silver managers issue no denial, it is taken as a confirmation of the hairy tale of naked short selling.

According to this fable the silver managers gang up against silver investors in an effort to drive down the silver price, so that they may cover their naked short positions at a profit. But if this were true, wouldn't they sell into weakness rather than into strength? The fact that an increase in the short commitment invariably occurs on rallies and it is then reduced on subsequent dips clearly indicates the absence of malicious intent. Traders simply take advantage of the variation in the silver price in order to derive profits from it, much the same way as hydro plants take advantage of the tides in order to harness its energy. Nobody suggests that the tide-ebb cycle is caused by the hydro plants. It is interesting that the cheerleaders don't complain when the silver managers buy on dips. They put a different spin on it. Purchases are described as the last desperate attempt of the silver managers at short covering.

Soon enough this fable of a huge phantom naked short position will be put to the test. According to the cheerleaders the short interest should cave in under the burden of unbearable losses. The silver managers will throw in the towel, and panic-covering will cause the silver price to go to four digits, non-stop. "Patience, fellow silver investors, patience! Hang on just a wee-bit longer! After this last sell-off the price will go straight up!" Well, we have heard that battle-cry often enough, long enough. It is getting monotonous, perhaps a little boring as well.

So where do we go from here? The cycle of profit-taking/bargain-hunting/short-covering will, of course, continue as before. Volatility will grow, quite possibly faster than the moving averages, maybe far exceeding anything we have seen so far. The silver price could be up $100 one day, and down $100 next day, so that a relative top may be indistinguishable from an absolute top. Lots of investors will be bumped from the band-wagon prematurely, and they may find it impossible to climb back. But silver to go to four digits in one fell swoop? No way. Unless Helicopter Ben's deeds are as good as his bluffing, and the air-drop of Federal Reserve notes does start in earnest.

Hedging or streaking?

I do not deny that naked short sellers exist. They do. I prefer to call them "streakers". Remember "streaking", the fad of the 1970's? Young men derived excitement through exhibitionism as they ran short distances stark naked in busy streets. If the commercial traders ever run naked, it is likewise for fleeting moments only. They cover at the first opportunity. Then they may streak again and cover again. It must be exhilarating. I am not so sure about its profitability, though.

I go further. What passes as "hedging" by gold and silver mining concerns is also streaking. If the miners were hedgers, then they would plow output into a monetary metal fund and write covered call options against it. But this is not what they do. They sell forward their future output, essentially selling naked, sometimes going out as many as 5 years. Then they cover part of their short position through purchases of call options. You can hedge cash gold, but you cannot hedge gold locked up in ore deposits deep underground that will take 5 years to bring up and unlock!

"Hungry pig dreams of acorn"

To call the gold miners' forward selling "hedging" is a gross abuse of language. It should not be permitted by the watchdog agencies. It is an instance of wilfully misinforming the public. According to a Hungarian proverb "hungry pig dreams of acorn". The wheat farmer selling wheat futures before harvest is not hedging. He is selling forward in order to lock in a favorable price. He is barred from selling anything in excess of his current crop. It would be tantamount to selling dreams. Likewise, the gold miner should also be limited to selling forward one year's production.

In any case, it is not the producer who hedges but the warehouseman. If the producer calls his forward sales "hedges", then he is obfuscating. He wants the buyers of futures contracts to believe that they are buying something more substantial than the dreams of a hungry pig.

Streaking as practiced by gold and silver mining concerns, in contrast with hedging proper, is a deeply flawed strategy animated by Keynesian and Friedmanite precepts. The basic assumption is that spikes in the gold and silver price are an aberration and, hence, must be temporary. Prices, as everything in economics, are bound to revert to the mean. The regime of irredeemable currency is here to stay. The money doctors have perfected methods whereby we can avoid the pitfalls into which the early pioneers of fiat currency fell. Take, for instance, the helicopter. The money doctors of the French Revolution had to labor without the benefit of air drops of *assignats*.

Helicopter and guillotine in aid of monetary policy

This is not the place to refute Keynesian and Friedmanite fallacies. Suffice it to say that the helicopter is a dubious asset in the hands of the Federal Reserve Chairman anxious, as he is, to get his freshly printed "I-owe-you-nothing" notes into the hands of the public instantaneously. On the liability side the Chairman does not have the benefit of another great invention readily available to the managers of the *assignat*, namely the guillotine. As is known, during the French Revolution the guillotine was used, among others, for the purpose to cap the price of gold with good effect. So much for hi-tech. As for lo-tech, absolutely nothing has been learned by monetary science during the past 200 years to justify the claim that money doctors can indefinitely entice people to give up real services and real goods in exchange for irredeemable promises to pay. The dictum of Lincoln still stands: you can fool some people all the time; you can even fool all the people some of the time; but you cannot fool all of the people all of the time.

Money is not what the government says it is but what the market treats as such. Silver and gold have been demonetized by the government through trickery and chicanery: silver in the 1870's and gold a century later, in the 1970's. Markets have never ratified these government measures and, presumably, never will in view of the disastrous record of fiat currencies. Witness the helicopter and the guillotine, the carrot and stick of monetary policy.

The principle of reversal to the mean doesn't work for monetary metals. Silver and gold mining concerns will find to their chagrin that their streaking strategy is backfiring. They are facing horrible losses on their naked short positions. They can thank their plight to their Keynesian and Friedmanite mind-set, and to the brainwashing that passes as research and education in economics departments at all the universities and think tanks of the world today.

Basis, the best kept secret of economics

How many gold mining executives are familiar with the concept of basis? Maybe one in ten. And how many can use it effectively in marketing gold? Maybe one in a hundred. Don't look for a chapter on basis in Samuelson's *Economics.* It is not there. Don't try to find its definition in *Human Action* of Mises. It is not there either. You have to go to obscure manuals on grain trading produced by professionals for the benefit of professionals to learn what it is. As far as I can tell no economist has ever written about it for the benefit of laymen.

The basis earns its name by serving as the most basic trading tool and precision instrument of the grain elevator operator. In buying and selling grain he is not guided by the *price* and its variation. He is guided by the *basis* and its variation. He stands ready to buy or sell 24 hours a day, 7 days a week. If you wake him up in the dead of the night with an offer, he won't ask your price. He will ask your basis. If he likes it, then it's a deal, regardless of the price. Professional buyers and sellers of grain do not quote their bid/asked price. They have no use for it. They quote their bid/asked basis.

Recall that basis is the spread between the nearest futures price and the cash price. The grain elevator operator buys cash grain during the harvesting season to fill his elevators to the brim. He tries to buy cash grain at the widest possible basis (known as carrying charge). He is planning to sell it when the basis is getting narrower. His profit is just the shrinkage of the basis. What is the explanation of this peculiarity? When the grain elevator operator buys cash grain, he sells an equivalent amount in the futures market. He must hedge his inventory because the capacity of his elevator storage space is so huge that even a minor fall in the grain price will wipe out his entire capital, if his cash grain is left unhedged.

During the growing season the basis keeps falling as inventories are being drawn down. The grain elevator operator tries to sell cash grain at as low a basis as possible, because he expects to replace it at a wider basis when the new crop becomes available. It goes without saying that in tandem with selling cash grain he lifts his hedges, i.e., buys back his contracts to deliver cash grain in the future. I repeat, from the point of view of profitability, the prices at which he bought and sold cash grain don't matter. The only thing that matters is the variation of the basis. Sometimes he buys cash grain at a *higher* and sells it profitably at a *lower* price. How can he get away with this prestidigitation? Well, he has correctly anticipated that the basis will shrink faster than the price will fall. He is aware that he cannot predict the variation of the price, which is at the mercy of nature. But he may divine the variation of the basis that depends on human need, which is more predictable.

Rationing warehouse space

Moreover, the basis also helps the grain elevator operator to decide what type of cash grain to buy and store. Other things being the same he will buy the grain with the higher basis, and sell the one with the lower. In this way he can maximize his profit derived from the shrinking basis. If the basis is higher for wheat than for corn, then he will keep buying cash wheat in preference to corn until the basis for corn catches up. Or, suppose, the news is that corn blight has hit the growing regions. The astute grain elevator operator will respond by accelerating his sales of cash wheat, in order to make room for more corn in his elevators.

The best way to think about the business of the grain elevator operator is to assume that he is marketing warehousing services, including the rationing of warehouse space between competing uses. His guiding star is the basis. High and rising basis tells him for which purposes the demand for scarce public warehouse capacity is the most urgent. Low and falling basis tells him for which purposes the demand is slack, as people prefer non-public solutions for their storage problem, e.g., by keeping supplies closer to home, as often happens in troubled times. Including digging holes in one's own backyard.

The idiosyncracies of the basis with regard to monetary commodities, since they *can* be buried in holes, are quite different from those with regard to non-monetary commodities, which *cannot*. This will be the subject of the last of this 3-part series on the basis.

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Acknowledgement

I am grateful to Dr. Theo Megalli for calling my attention to the work of the German monetary scientist Heinrich Rittershausen (1898-1984) who apparently was the first to make the distinction between monetary and non-monetary commodities, observing that the former fails to follow the conventional demand/price schedule, in his treatise *Monetary Theory*, now also available in English translation, see: www.reinventingmoney.com/Ri_MT.php

Dr. Megalli also quotes the remark that has earned many enemies to Rittershausen in banking, commercial, and industrial circles, not to mention political circles, a remark that deserves to be better known: *"It was not the gold standard that failed, but those to whose care it had been entrusted".*

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