ULTRACREPIDARIAN MUSINGS

Antal E. Fekete
Professor, Memorial University of Newfoundland
aefekete@hotmail.com

A letter from a reader takes me to task for my missive "Bull in Bear's Skin?" saying that I am an "ultracrepidarian" out of my depth. This rarely used English word covers a person who exceeds his competence in passing judgment on matters about which he knows little or nothing. The etymology of the word goes back to the story of a cobbler who, while standing in front of a painting in a gallery, made loud and disdainful remarks about the sandals in the picture. Unaware that he was overheard by the painter Apelles standing nearby, he went on to finding faults with the legs, too. Whereupon he was upbraided by Apelles: "*Ne sutor ultra crepidam judicaret*" (don't let the cobbler criticize anything above the sandal). My correspondent Mr. Northeast, who is an off-the-floor professional speculator, suggests that I, too, have transgressed the limits of my competence when I called the shorts in monetary metals "arguably the smartest lot on earth" for they could what Aristotle had said was impossible to do: making gold beget gold. I include his letter in its entirety:

Professor:

Your latest commercial promoting the "smartest traders on the planet" is badly off the mark. Here is a recent headline from REUTERS: Fertilizer producer Agrium slips into red on natural gas hedging losses...

With all due respect, if I were you, I would take back the admiring words you have heaped upon commercial traders. You simply haven't got sufficient experience as a trader in the markets to be making these remarks. I have seen far too many examples of commercial floor traders who short the market habitually on every rally, only to get their heads handed to them on a platter in the end when the supply/demand fundamentals ultimately assert themselves. So, forgive me, but I can't take anyone with such outpourings of adoration seriously.

You may say that *bona fide* hedgers, as distinct from naked shorts, do not often miscalculate. But this is far cry from the glowing praises you heap upon the shorts *ad nauseam* in your essay.

A man of your intellect stands to lose credibility in no small measure whenever he makes unwarranted statements about something of which he knows nothing. Stick with economic theory and leave market analysis to us traders.

Sincerely, etc.

Dan Northeast

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Dear Mr. Northeast:

Your point is well-taken that an ultracrepidarian is running the risk of becoming the laughing stock of his peers. However, you yourself are in danger of becoming the pot that calls the kettle black. You are a commodity speculator who know about live cattle and frozen pork belly futures trading. That is your competence. I am a monetary scientist who know about monetary commodities such as gold and silver. That is my competence. You analyze the supply and demand for oxen and pigs before you make a trade. That is all very well. On my part, it is incumbent upon me as a monetary scientist to warn people (those who have ears to hear and brains to think anyway) that gold and silver are not at all like live oxen or dead pigs. They are monetary commodities to which the so-called supply and demand equilibrium model does not apply. If you criticize me for saying so, then my answer to you has to be: *Ne sutor ultra crepidam.*

To understand the dynamics of the gold and silver market you need a different kind of model and you must employ different concepts than supply and demand. You want to know about basis and backwardation. If you trade the gold and silver markets, then you may ignore the teachings of monetary science only at your own peril. You may suffer heavy losses, no matter how bullish you are in the midst of a bull market. For example, if you assume that all short covering in silver takes place in desperation by naked shorts and none in calculation by shorts acting on behalf of principals holding the stuff, then you are a pig-headed bull ready to have your head to be handed to you on a silver platter. You see, in addition to pig-headed shorts there are also pig-headed longs, and you may suit yourself to decide which are more numerous!

It is not my business to pass moral judgment on the shorts who deceive the market pretending that they sell naked and foster bearish sentiment deviously. Science is not concerned with moral considerations. But I reiterate my opinion that the shorts who sell covered calls and puts, whether on their own account or on that of others, act more intelligently than the longs who jump in and out of the long side of the market on signals generated by stochastic oscillators, or take cover behind their delta-hedges. Blind faith in the Black-Scholes formula for option pricing will not save their skin. Their defense is a fair-weather system: it breaks down under stormy market conditions, that is, just when needed most. It is not unlike a compass that only works in calm seas, but gives false readings in ship-wrecking storms.

All the shorts in gold and silver are certainly not geniuses. Nor are all the hedgers. Even geniuses among them make colossal blunders. You need not go farther than Warren Buffett who let himself be tricked out of his huge position in silver just before the ride was to become fun. His mistake was that he did not hide his intent to derive a silver income from his silver holdings. We can be certain that other similarly well-heeled bulls are not making the same mistake: they don bear's skin.

One should carefully distinguish between naked shorts and other sellers. A commercial who shorts the gold or silver market on behalf of his principal who owns the physical (but wishes to remain anonymous) cannot be considered a naked seller, even though he is represented as such in the COT reports. Nor can the trader who shorts the market against the unreported physical in his possession, putting up full margin rather than taking advantage of the reduced margin available for hedgers, in order to conceal his true identity as a bull. The bottom line is that the COT reports can in no way reveal the true size of net short positions in gold and silver futures because of the bulls camouflaging themselves as bears. Whatever it is, the true size must be much smaller than that conjectured by Butler and other analysts.

I am also dubious about the conspiracy theory of Butler, according to which the shorts collude and act as a "wolf-pack" in dumping paper silver in order to massacre the bulls. While not impossible, this theory leaves a plausible explanation out of consideration. The idiosyncrasies of the regime of irredeemable currency are such that the smartest traders (and only the smartest) can read the mind of policy-makers, treasury officials, and central bankers. They set out to outsmart these gentlemen who, come to think of it, are just hired hands risking nothing, while they risk their entire capital. No wonder they come up with similar conclusions. Therefore it is quite possible that they act in a similar fashion, without deliberate collusion.

This observation does not make me a sycophant of the bears. I admire only the smartest of the smart.

Yours, etc.

Antal E. Fekete

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Here is a different kind of comment.

Dear Mr. Fekete:

Thank you for your thoughtful essay on Kitco entitled "Bull in Bear's Skin?"

I have been fully invested in gold since 1997. For most of that time I have been perched on the edge of my chair waiting for gold's meteoric rise that will wipe out those evil shorts for good.

Now you have made the whole picture much clearer. The parties that represent the short side of the market covet the gold, and covet it badly... all of it... yours, mine, and everybody else's... And the longs have been meekly and foolishly giving it to them... at bargain prices... with buckets of tears... and disbelief... and continue to do so even after their fellow longs have been devastated...

I am curious to know why you have waited so long to present such a compelling hypothesis? I would be interested to read more of your essays if they are available for public consumption. If so, then could I please ask you to provide a weblink for further investigation.

Thank you, Sir. Best to you.

Yours, etc.
Kevin Southwest
Dear Mr. Southwest:

Thank you for your kind words. A much more detailed paper on the same subject entitled "What Gold and Silver Analysts Overlook", one of my lectures in the Gold Standard University series, was put on the Internet just over two years ago, see:

www.gold-eagle.com/gold_digest_04/fekete050404pv.html

For your information, the Gold Standard University lecture series will resume publication under the aegis of the Lips Institute in Switzerland, starting in September next, as part of the inaugural celebrations. Stay tuned for further announcements.

Central to my thesis is the critique of Keynes' theory of speculation and of Friedman's monetarism. In spite of Keynes, markets are not symmetric. There is an inherent bias favoring the bulls to the prejudice against the bears. The limited risks of the former are contrasted with the unlimited risks of the latter. This explains the shorts' fox-like quality of cunning, deception, and wiliness, acquired in consequence of the Law of the Survival of the Fittest. On the other hand the longs may become complacent, even obtuse, pampered as they are by the inherent bias of the market favoring them. All this is convincingly demonstrated in the present situation by the profit/loss statement of the bullish tech-funds.

The market bias just described is well-known and goes under the name "price-risk", which is limited on the downside. Less well- known is the "basis-risk" which is limited on the upside. Let me elaborate. The basis, much like the price, varies up and down. But whereas the variation of the price is bounded from *below* (as the price cannot be negative), the variation of the basis is bounded from *above*. It can be negative (in case of backwardation), but it cannot exceed the upper limit set by the *carrying charge* (interest plus storage plus insurance costs). If it did, warehousemen could reap riskless profits. It would be cheaper for them to carry the commodity in their warehouses than in the form of futures and, accordingly, they would keep selling the futures while buying the physical until the contango dropped back to the level of the carrying charge.

However, there is no lower limit to contain the variation of the basis so that *all the producers hedging their production face what is known the downside basis-risk which is unlimited*, just as the upside price-risk is. This fact is extremely important if you want to understand the gold market. Ask Barrick how they could have forgotten about the fundamental law of the markets, the unlimited downside basis-risk. I do not speak for

Barrick, but if they deigned to answer your inquiry, their answer would probably run along the following lines.

"The basis, like all economic indicators, is subject to the Rule of Mean Reversal. In the long run, even after extreme swings, the basis must revert to its mean, and if you are well-heeled financially, as Barrick most certainly is, then you can weather the storm. Remember, Barrick can never get a margin call for fifteen years!"

Barrick is wrong. Gold is a monetary metal the basis of which is not subject to the Rule of Mean Reversal. Barrick may have to wait till doomsday for the gold basis to revert to the mean. Here is why. The Rule of Mean Reversal is valid for ordinary commodities because the shrinking basis acts as a powerful incentive for warehousemen to sell the cash commodity from inventory and replace it with futures. They can take profits and wait for the new crop to come out of the pipelines with which to replenish inventory. It is precisely this selling that makes the basis to revert to the mean. What makes gold a monetary metal is precisely the fact that its basis is exempt from the Rule of Mean Reversal, so that the downside basis-risk is in no wise mitigated. For ordinary commodities it is: the greater the fall in the basis, the more likely it is that it will be reversed.

The gold basis behaves perversely: the greater its fall, the more likely it is that further falls follow. The falling basis tells the longs to take delivery of their gold and stop recycling it in the futures market, however attractive the terms may be. It also tells owners to be most reluctant to exchange their gold for futures, no matter how cheap the latter may be relative to cash. As the gold futures market is not designed to make deliveries on 100 percent of the outstanding futures, it will go belly-up. And, incidentally, so will Barrick, as it will not be able to lift its hedges at a profit as hoped, not now, not in fifteen years, not ever. Unless Barrick is a front for a government, a hypothesis that cannot be ruled out, its name will go down ignominiously in the annals of gold mining.

The hypothesis that Barrick has been set up as a decoy by a certain government is tempting indeed. The 1 million ounce of hedge (out of a total of 20 million at peak) that was lifted recently cost the company $384 per ounce, higher than the gold price was when the hedge was put on, yet the company reported a profit and declared an end-of-quarter dividend exceeding the previous. Just think of it: a gold producer goes into the market and buys gold at $384 and promptly gives it away for nothing, to the tune of millions of ounces! Does this not smack of a gold laundering scheme, run for the benefit of a government? Clearly, that government could not accumulate tens of millions of ounces through buying in the open market without upsetting the apple-cart. Try gold laundering, then. No wonder that shareholders of Barrick shed buckets of tears.

The perverse gold basis constitutes the self-destroying mechanism for the regime of irredeemable currencies. Previous descriptions of hyperinflation purporting to explain the descent of a paper currency into the abyss of worthlessness do so in terms of the quantity theory of money, trying to explain a non-linear phenomenon in terms of a linear model. My theory is very different. The persistently falling gold basis explains how it is possible that, in spite of the huge stocks of monetary gold in existence, zero supply can indeed confront infinite demand.

Ted Butler thinks that the recent sharp rally in gold was due to the de-hedging activities of Barrick. It was the largest hedger by far when hedging was fashionable, it is the largest de-hedger by far now since fashions have changed. However, Butler is putting the cart before the horse. According to a regression analysis calculating the impact of de-hedging on the price, prepared by Mitsui Global Precious Metals and Virtual Metals, released by Mineweb, 1 million ounces worth of de-hedging boosts the gold price by a paltry $5.50. What then is driving the gold price? I suggest it to you that it is the gold basis, the shrinking of which is not mitigated by mean reversal.

What to expect now? Sooner or later exchange officials will declare "liquidation only" policy. Thereafter the longs can close out their profitable positions only through cash settlement. The shorts are absolved of their obligation to deliver as contracted. At that moment all offers to sell cash gold will be withdrawn around the globe. Gold is not for sale at any price. Producers of essential commodities such as grains and crude oil will refuse to accept payment in dollars and will demand gold in exchange for their product. The same goes for providers of essential services such as doctors and lawyers. Scales will fall off their eyes and they will decline to give up real goods and real services in exchange for irredeemable promises to pay. The dollar, and all other paper currencies along with it, will go the way of the *assignat* and *mandat*.

Nowhere in this argument did we have to refer to supply, demand, or "more money chasing fewer goods". At any rate, Friedman's theory of monetarism won't tell you when exactly the metamorphosis of the dollar from money to trash will take place. Nor will the COT reports give you a clue or advance warning. *The gold basis will*. I hereby challenge all gold and silver analysts to start educating the public on this subject. I call on all PM websites to run yearly, monthly, weekly, daily, *and hourly* charts showing the variation of the gold basis.

Please add your voice to reinforce this challenge of mine.

Yours, etc.

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Antal E. Fekete
Professor Emeritus
Memorial University of Newfoundland
St.John's, CANADA A1C 5S7
e-mail address: aefekete@hotmail.com