BACKWARDATION THAT SHOOK THE WORLD

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On Friday, December 12, backwardation on gold was still in force at an annualized discount rate hovering around 2% in the December contract, and 0.3% in February contract. Many readers have asked me how it is that so many other observers fail to see the backwardation. The discrepancy is due to differences in methodology. Most analysts calculate the basis as the difference between February and December futures prices which gives them a positive reading. They use the December futures price as proxy for the spot price. This is clearly wrong. The December futures price is *not the same* as the spot price, even though we are in December.

My methodology is to calculate the basis as the difference between the *asked* price for the December futures and the *bid* price for spot gold. The logic behind this is that if you wanted to transfer your costs of carrying gold to the futures market, then you would have to sell physical *at the bid price* of spot gold and buy it back *at the asked price* of the December futures.

The opportunity cost of carrying physical gold is known as the *carrying charge*. It covers interest, insurance, cost of storage, and all other incidental costs including taxes and fees, if any. The carrying charge is the upper bound of the range within which the gold basis can vary. Arbitrageurs would never allow the basis to exceed the carrying charge. If it did, they would keep buying cash gold and selling the futures until their arbitrage would eliminate excess contango.

The same theoretical argument can be used to prove that the basis cannot go negative. Holders of gold would keep selling cash gold and buying the futures until the backwardation disappeared. Indeed, backwardation never lasted for more than a few hours that it takes to send out a wake-up call to alert sleeping arbitrageurs. That is to say, not until December 2, 2008. On that ill-starred day gold went to backwardation for the first time ever in history, and got stuck there. This gave rise to a controversy that is still raging. What is the significance of this event? The majority of observers shrugged: so what? Others, including the present writer, warned of the extremely serious consequences threatening the international monetary system and the world economy because of the highly corrosive nature of the backwardation in gold.

Why is it that the same theoretical argument is foolproof in the case of full contango, but it is fallacious in the case of backwardation? The reason is that full contango in gold (maximum reading on the gold basis) implies full public confidence in fiat money; backwardation (minimum reading on the gold basis) implies the collapse of public confidence in fiat money.

Let us put this into context. We have had a strange and ominous phenomenon lasting well over three decades which mainstream economists have been utterly unable (unwilling?) to explain. When gold futures started trading in the United States in 1975, the gold basis was close to full contango. Since that time it has shown a stubborn falling tendency, steadily increasing its deviation from the carrying charge.

This is as if, after a brief honeymoon in 1975, holders of physical gold started to go on strike against the clearing house of the commodity exchange in ever greater numbers, refusing to take the ever increasing wage offers on the bargaining table. They would rather go without any wages at all.

Of course, strikes are not out of the ordinary, so the phenomenon of the vanishing gold basis could be, and was, swept under the rug. Mainstream economists could still lull themselves in the belief that the gold basis would never go negative. Come to think of it, if it ever did, it would be the equivalent of employers offering to take over from the unions the responsibility of making strike-pay available to workers on the picket line. Now, there, such a thing would truly be unheard-of!

Yet, surprise, surprise, it has now happened, although not in industrial but in monetary relations. Holders of physical gold, now on fully-fledged strike, are offered a strike-pay by the futures market, and the offer is left on the bargaining table, but the strikers still won't budge. There it is: the gold basis went negative, gold has been in backwardation for over a week, and physical gold is still not coming out of hiding.

In spite of all the propaganda aimed at discrediting me and my theory of gold backwardation, what we are hearing is the shrill sound of the fire-alarm indicating that the house of the international monetary system is on fire. For many a year I have been warning all those who cared to listen that such a fire-alarm was coming sooner or later, and the consequences of ignoring it would be disastrous. Well, it is sounding loud and clear now, and guess what. Fire-fighters brazenly ignore it. Yet you can ignore it at your own peril.

What does it all mean? Not only does it mean that the market is willing to pay all your carrying charges involved in holding physical gold, but *it is also willing to pay you (allegedly) risk-free profits for the privilege of relieving you from carrying the burden!* "Let me take over your yoke just for a few days; I shall pay you handsomely for the honor" – so the clearing members of Comex plead.

It is as if the bank was paying all your utility bills without charging it to your account. Nay, the bank is actually offering you a bonus for you allowing it to do you the favor. Suppose, for the sake of argument, that all the banks in the world offered all their account holders to take over responsibility for paying their utility bills. Would it not evoke some searching questions about the hidden agenda of the banks? Wouldn't people become extremely suspicious of the preposterous offer? Yet here we go, the futures market in gold, the world's residual source of cash gold, is making the same preposterous offer, and nobody is asking questions. *Timeo Danaos et dona ferentes* (I fear my enemies most when they bring me gifts, *Virgil*, Aeneid, II. 49.)

I warn the world again that the futures market would not go to backwardation in gold if the house of paper money were not on fire. There is just no *prima facie* reason for a shortage in physical gold. A very large part of all the gold produced throughout history still exists in monetary form, sitting in vaults doing nothing. (Under the gold standard it used to be doing heavy-duty work in financing production and world trade.) Unlike all other commodities with the exception of silver, for gold the stocks-to-flows ratio is a high multiple (by contrast, the stocks-to-flows ratio of copper is a small fraction). And, on the top of privately held gold, there is central bank gold amounting to one quarter of all the gold ever produced since the dawn of history. Why are central banks unwilling to take advantage of risk-free profits by releasing gold? Could it be that, in possession of inside information, they have reason to be afraid that the regime of irredeemable currency may soon collapse and, with their gold gone, they don't want to be left holding the bag? Could it be that the Babeldom of the debt tower is already crumbling, but the fact is being covered up?

There is simply no explanation for the backwardation in gold, absent monetary science. And since monetary science has been exiled from the world's universities for the past fifty years (this is what I call "Lysenkoism -- American style", see References below), people are dumbfounded. They don't understand the phenomenon of holders of gold passing up the opportunity to earn risk-free profits.

Monetary science gives a clear and unambiguous explanation. Here it is, and please remember that you have heard it here first. We are facing a pathology of the international monetary system based, as it is, on irredeemable promises to pay. People are enjoined through 'legal tender' legislation to use these irredeemable promises as if they were the ultimate means of payment, even though they are not, and the world would rather use gold and silver as the natural and ultimate extinguisher of debt. But gold and silver have been coercively eliminated from monetary circulation for the competition they offered to synthetic debt-liquidating devices. Mainstream economics pretends that the issue has been settled for once and all. It asserts that liquidation of debt through the coercively maintained payments system has no threat to the national and world economy. Yet what is happening is that the government keeps kicking the toxic garbage upstairs which keeps accumulating unobtrusively in the attic, only to come crashing down in its own good time to cause untold amount of social damage.

In the real world it is natural law, rather than man-made coercive laws, that prevail. The pathology of the regime of irredeemable currency has not been attended to, and day of reckoning has dawned. Our pathological monetary system has allowed the burgeoning of debt beyond all rhyme and reason. *It has no mechanism to extinguish debt. It pretends that transferring debt to the banks, and ultimately to the government, is tantamount to extinguishing it. However, the truth of the matter is that only gold circulation is able to extinguish debt. When it is stopped in its tracks, as it is under conditions of backwardation, debt explodes.*

The debt tower is toppling. Central banks work overtime printing money to plug the holes in the leaky foundation, but their traction that they could once take for granted is gone. The money they print goes into either gold hoarding or into government bonds. The monetary system has short-circuited and is in the process of burning out. Practically no money is going into the production of goods and services. The bloated economy is contracting fast. Great Depression II is upon us. The monetary system is past the point of repair. This is the story that the backwardation of gold is trying to tell those of us who have ears for hearing and brains for comprehending.

Backwardation in gold is the sweet siren song that is trying to tempt Odysseus to his doom. But Odysseus was smart enough to have himself tied, fist and foot, to the mast and had the ears of his oarsmen be plugged with wax. His ship is sailing through the dangerous waters without unloading gold.

Backwardation also gives a signal to those who are not so fortunate as to have some of the precious yellow in hand. It tells them to be prepared for a thunderous collapse of the international payments system, worse than the collapse of the twin towers of the World Trade Center. Backwardation means the inevitable contraction of the world economy, the beginning of an era of diminishing enterprise and employment, an era of snowballing business failures and poverty. Printing more irredeemable promises to pay will make this condition worse, not better.

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It can be seen that the $80 rise in the spot price from $740 to $820 during the week that just ended *has not been able to compel holders of spot gold to exchange their holdings for a promise to deliver gold a mere 18 days later, the bait of 'risk-free' profit notwithstanding,* in spite of the unprecedented discount on gold futures. To tell the truth, the promised profits are not risk free. The risk is that the gold will never be returned and those who have listened to the siren song will be left holding the bag.

Events of last week show the heroic resistance of the bulls: they have so far refused to listen to the sweet siren song of the clearing members. They unearthed the golden hatchet and have not let themselves be led astray from the warpath. On Thursday, December 11, 12,588 contracts in the December futures month (an increase of 139 contracts from the previous day) stood in line waiting for delivery. This is equivalent to 43% of registered gold in the warehouses! As is known, the clearing members have till December 31 to deliver; otherwise they have to declare "liquidation only", effectively closing the gold window. If that happens, it would be a *historical first, likely to cause a much bigger stir than the appearance of backwardation on December 2, which caused a yawn.* The world would be shaken out of its lethargy. This backwardation would break the grip of the regime of irredeemable currency on the world.

The clearing members have used the carrot to no avail. Will they now use the stick, increasing margins on long positions to exceed the value of the underlying contract? We don't know, but obviously they are hesitant to make a rash decision. Such a move could easily backfire. It would betray their desperation, which could provoke even more notices demanding delivery of physical gold.

Who is going to blink, the good guys or the bad? It is too early to say. At any rate, even if the good guys blink, they will be back in force in February for a showdown to face a much-weakened opponent.

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Mike (Mish) Shedlock published a rejoinder to my *There Is No Fever Like Gold Fever* (see References below). According to him I have stated that "gold is not for sale at any price", here and now. What I have said was that if Comex declared "liquidation only", in effect closing the gold window, and backwardation became a permanent fixture of gold futures trading, then it would be tantamount to "gold is not for sale at any price". Mish also puts words into my mouth suggesting that I considered this an equivalent of the gold price shooting up to infinity, a kind of initial salvo to mark the beginning of hyperinflation in the United States.

I have been very careful to avoid any prognostication that backwardation in gold would trigger backwardation or price rises in other commodities. I am not even talking about a price rise of gold itself. The truth is that my own position on deflation in the United States is, and has been, very close to that of Mish. Backwardation in gold has nothing to do with the opening salvo for hyperinflation. "Gold is not for sale at any price" is not the same thing as a runaway gold price. Rather, it is an indication that it has dawned on people how foolish it is to accept irredeemable promises to pay in exchange for gold, the ultimate means of payment.

What Mish seems to be missing is that *it is not unthinkable that gold futures trading stops altogether for want of deliverable material, while the price of oil, grains, and other highly marketable commodities keep falling along with the rate of interest* -- *symptoms of deflation.* This is precisely the problem that need to be researched, but no university or government think-tank is doing it.

Mish says that the United States is not Zimbabwe. Who said it was? However, the United States dollar and the Zimbabwe dollar are no different in principle, if not yet in practice. They are both an irredeemable currency. Managers of the U.S. dollar are just making the first tentative steps to join the managers of the Zimbabwe dollar in Dante's *Inferno*. The eighth of the nine circles in Hell is reserved for perpetrators of fraud and false pretenses, among others, the managers of irredeemable currencies. As Dante describes it, their punishment is to be kept submerged in a cesspit full of excrement. Honestly, they don't deserve to be washed clean by Mish or anybody else.

Rumors that there may be a failure of delivery in the December contract turned out to be surprisingly accurate. Mish is premature in doubting that such a failure is in the cards. Backwardation-deniers must not jump the gun. A titanic struggle is taking place right now, out of earshot and out of sight: *the bull fight at Comex.* In this bull ring it is not always the toreador who kills the bull. Sometimes the bull kills the toreador. The fight takes place on weekdays from 8.15 a.m. to 3 p.m. EST. While it is not carried on TV, it is carried by the wire services. The last fight is scheduled on December 31 -- unless the toreador resigns beforehand and the bulls win by default.

Mish says that actually he hopes that there will be a failure of delivery in December gold. Be careful what you wish for, you may just get it! Especially if you have not made a study of what backwardation of a monetary commodity means, because you don't know what you are wishing for. It is no picnic. It is more like a monetary earthquake measuring ten on the Greenspan scale. Hyperinflation is not the only hell on earth! Hyper-deflation ushered in by backwardation in gold could well be worse.

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I have received the following letter from a reader.

Mr Fekete:

I always read your articles as part of an effort to educate myself about the gold market. Thanks for sharing your expertise and I look forward to your future articles.

In your most recent articles you harp on Mr Sprott for no longer supporting your University.

I don't know Mr. Sprott personally but I have to say he has every right to support or not support whatever endeavours he choses.

Your constant negative referral to him diminishes your credibility, imo.

Give it a break!

Kevin Southwest

I have sent this answer:

Dear Mr. Southwest:

Thank you for your kind words. I am delighted that you have found my writings of some value.

You are right in saying that Mr. Sprott can do with his money as he pleases. What you don't know is that I have not approached Mr. Sprott asking for money; he has approached me offering it. Under these circumstances I thought I could expect the courtesy of an advance notice of his decision to terminate the arrangement. Instead, he just cut me off and ignored my repeated inquiries. When I insisted on an answer, he sent me a letter with the insulting remark that "results do not justify the expense". For your information, the grand total of his "expense" was $22,500 Canadian.

I am sorry that you find my repeated reference to this humiliating incident annoying. Please allow me to be the judge whether my procedure diminishes my credibility or not. After all, nobody is forcing you to read someone with impaired credibility.

Yours, etc.

Here is another letter:

Hi Antal,

This letter is to thank you for and congratulate you on your priceless contributions to the education of your fellow men.
I have said this to you before, but now I repeat it: ***Your lasting legacy to history will be your work on the 'basis'.*** *I am sure that a hundred years from now you will be quoted favourably by authors of financial articles and books.* ***You have become a truly great financial intellectual power.***

Constructive criticism: I do understand your disappointment at the cancelling of financial support for Gold Standard University Live by Eric Sprott. I am sure this was a business decision. If so, it was a bad one. Time will prove this.

But you are much too big and important of a person to let it drag you down. Get over it! Let it go! Move on! We all have great respect for you. Your written sideways slaps at Eric's bad decision do not hurt him but rather diminish you.

Give him credit for the assistance he did provide. Rise above the hurt feeling slipping into your writings.

I do hope you understand that this is sent to you by a friend who intends only the best for you.

Regards,
Frank

I have answered this letter as follows:

Dear Frank,

Thank you for your kind words and encouragement. I can assure you that Eric's decision in no way drags me down. Nor have I ever had any intention of hurting him.

Every week my readership is increasing by hundreds of newcomers seeking knowledge which they could not get from any other source. I have the right to inform them about the reasons why Gold Standard University Live had to fold tent.

I have never doubted that you have but the best intentions towards me.

Your friend, Antal

References

Tainted Research: Lysenkoism -- American Style, June 4, 2003

Monetary *versus* Non-monetary Commodities, April 25, 2006

The Last Contango in Washington, June 30, 2006

Red Alert: Gold Backwardation!!! December 4, 2008

Has the Curtain Fallen on the Last Contango in Washington? December 8, 2008

There Is No Fever Like Gold Fever, December 10, 2008

These and other articles of the author can be accessed at the website www.professorfekete.com

The Nonsense about Gold Backwardation, etc., by Mike (Mish) Shedlock, December 7, 2008, www.globaleconomicanalysis.blogspot.com

No Fever Like Gold Fever: Response, by Mike (Mish) Shedlock (*ibid.)*

Acknowledgement

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Calendar of events

Szombathely, Martineum Academy, Hungary, March 28-29, 2009
Encore Session of Gold Standard University Live.

Topics: *When Will the Gold Standard Be Released from Quarantine?*
The Vaporization of the Derivatives Tower
Labor and the Unfolding Great Depression
Is There Life after Backwardation?

San Francisco School of Economics, June-August, 2009
Money and Banking, a ten-week course based on the work of Professor Fekete. The Syllabus of this course is can be seen on the website: www.professorfekete.com

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