BULL IN BEAR'S SKIN?

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Dear Mr. Northwest:

Thank you for asking the provocative question whether the current bull market in gold is stage-produced by the powers-that-be in order to divert attention from the deliberate devaluation of all currencies. Your letter has given me an opportunity to sort out my own thoughts on the subject. Here is the result.

Supply and demand

My analysis of the gold and silver market is very different from the conventional. I am a monetary scientist. Supply and demand equilibrium analysis means nothing to me. For a monetary metal both supply and demand are undefinable. There is no way to quantify speculative supply, still less demand. Yet without it the gold market is like *Hamlet* without the prince, to borrow a phrase from Samuelson.

Speculators can jump back and forth between the long and the short side of the market at a moment's notice, and in case of monetary disturbances they do. If you insist on using these concepts, the most you can say is that both the supply of and the demand for the monetary metal or its paper substitutes are infinite. Therefore the price can approach any conceivable figure, including infinity for the metal, zero for the paper substitutes. Of course, the banks and the government want to maintain the myth that futures markets provide a reliable link between the two. The fact remains, however, that this link is tenuous and illusory.

It follows that any scientific analysis of the gold market must sidestep concepts such as supply, demand, equilibrium price and replace them with concepts such as asked price, bid price, spread, basis, contango, backwardation.

Corner and short squeeze

The literature on corners is scanty. Yet it is the possibility of corners and short squeezes that must be analyzed if we want to understand the present situation. The facts are as follows. While short squeezes are common, true corners are exceedingly rare. So much so that some authors flatly deny that successful corners are possible save under siege or blockade. By a corner I mean the attempt of longs in a commodity exchange to prevent the shorts from making good on their contractual obligations by forestalling supply. However, the shorts are going to move heaven and earth to get supplies to the market in time for delivery. The higher the longs have bid the price, the greater the incentive for the shorts to deliver. If we examine the historical corners in the Chicago wheat pit we shall see that every one of them was a short squeeze that fell short of being a successful corner.

The shorts used every available means of conveyance from dinghies to triremes, from barrows to lorries to move supplies from distant places to the appointed elevators in time.

Contrary to popular beliefs, the shorts are not stupid. Nor are they suicidal. They are responsible businessmen well able to calculate, including calculation of the cost of transportation by the fastest conveyances available such as supersonic aircraft if need be to carry supplies half-way around the globe. Whenever they sell short, they are not acting on impulse. They act on cold facts. They know full well that the futures markets fail to be symmetric. They know that there is a built-in bias favoring the longs at the expense of the bears: the risk shouldered by the former is *limited* (as the price cannot fall below zero) while that shouldered by the latter is *unlimited* (as the price can theoretically go to infinity). Whereas an individual short seller might miscalculate, it is virtually impossible that the shorts collectively would.

Are the shorts really naked?

It is a fatal mistake to underestimate your opponents, in this case the short sellers in precious metals, arguably the smartest lot on earth. They know how to do what Aristotle and latter-day economists have said was impossible: to make gold beget gold. I don't for a moment give credence to the fable that the commercials are selling short naked. Most of their short position is hedged most of the time, if not directly by metal in their possession, then certainly indirectly by metal in the possession of the principals, i.e., for whom they act as a man of straw. The commercials are agents. They act on behalf of their customers, be they wealthy individuals who want to sell call options or futures on their gold hoard anonymously, or banks and governments that do not want you to find out what they are up to. The fact is that selling covered calls and puts is a more efficient way for a bull to husband his resources than buying gold and sitting on it.

Consider the hypothetical scenario that the government of Israel wants unobtrusively accumulate gold. Or, to furnish an example of a more populous country, let's assume that the government of China wants unobtrusively to accumulate silver in any conceivable amounts. The task is cut out for both countries. They have respectable hoards to begin with. Gold is the most portable form of wealth and the most frequently mentioned word in the Bible after God. China has been on a silver standard since time immemorial and did not participate in the silver-demonetization farce of the 19th century. The best course of action for a government wanting to accumulate gold or silver is to mislead the market by fomenting the bearish case. The net short position in gold represents its stake that it is willing to risk in an effort to get more gold and silver through market manipulation. In other words, the net short position is only apparent, a red herring to throw gold bugs off the scent. It is the tip of the iceberg that you can see and touch. What you don't see and can't touch is the bulk of the iceberg submerged: the huge physical gold and silver hoards that the owner wants to increase further by hook or crook. It can be done by hiring agents in the commodity pits. The commercials sell the metals short in excess of visible supplies, acting on behalf of their faceless principals. They sell more gold than the future output of the mines going out five years. They sell more silver than the total inventory held in exchange warehouses. The longs take the bait eagerly. They buy and hold in the hope that the shorts are overextended and will not be able to deliver. The point is that this is exactly what the shorts want them to believe.

It is easy to predict what will happen in such a situation. The longs are sitting ducks and the shorts keep preying on them. They raid them periodically so that, after the shake-out, they can pick up gold and silver dropped by weak hands. Not only do they buy back what they have sold short as bait; they pick up a lot more. It is a wolf in sheep's skin or, if you like, a bull in bear's skin. The name of the game is to mislead the public and induce it to give up monetary metals for a pottage of lentils. I am not putting this forth as a thesis. It can never be proved or disproved. It is merely a hypothesis more plausible than the one suggesting that the shorts are as stupid as they are suicidal.

Ted Butler believes that mountains of surplus silver, remnants of silver demonetization six score years and fifteen ago, that were still around in 1945, have long since been dissipated and "consumed". Of course, the shorts welcome such beliefs and help foster them by all means. Aided by this myth they accumulate still more silver by fleecing the naive and overconfident longs who are cocksure that they are facing naked shorts in the pit. Meanwhile the watchdog agencies know that physical silver exists and can be delivered if necessary. One should not be so sardonic as to think that he was the only one to discover that silver was dirt cheap at $3. The "wolf pack" has also discovered it and started accumulating, albeit very, very quietly. Theirs is quite different from Butler's "buy and sit" strategy. They are not waiting for the miracle of silver in four digits to happen. They do something in order to start drawing benefits from their investment immediately. From their vantage point the longer the price rise is stretched out, the better. Why? Because they know something that Butler apparently doesn't: how to make silver yield an income provided that you can hide it under a bushel.

There is no need to cry "foul play". It will do nicely if you credit the shorts with more wits than you assign to the longs.

Short covering and profit taking

Granted that the shorts are bluffing to tease, taunt, and bait the bulls, it is clear that at one point short selling must become counter-productive. Large bait tickles small fish. When it does, the shorts pull in their nets. They cover. But the fact stands out that it is they, the shorts who call the shots even though their paper losses appear to be staggering, not the longs. Unknown to the public, these losses are far surpassed by gains on physical gold that the shorts have been amassing clandestinely at the expense of the longs for half a century. When the shorts pull the plug and cover their position, the longs are jubilant amidst cries of "cornered rats". Yet all the longs can show for their effort is paper gold, while the shorts control an increasing slice of physical pie. The price of paper gold is destined to go to zero; that of physical to infinity. Who is fooling whom?

The shorts realize that in any bull market there is bound to be periodic profit-taking. They don't have to induce one. It will happen on its own accord. It is spontaneous and unpredictable. While it scares the daylight out of the longs; it is picnic for the shorts. It provides a reliable steady income for them, one that the longs sorely miss. Moreover, the shorts tend to sell into strength and buy into weakness. This is their strength. The longs typically buy into strength and sell into weakness. This is their weakness.

Backwardation and basis

Instead of the COT reports Butler should concentrate on such direct indicators as backwardation and basis. Backwardation is the market phenomenon whereby nearby futures are selling at a premium over the more distant. The normal condition for monetary metals is the opposite, contango, indicating that supply is plentiful. Backwardation in monetary metals is a foolproof indicator that supplies are getting tight. Basis is the name for the spread between the nearby futures price and the spot price. Its shrinking reveals that short selling is becoming counter-productive so that the shorts may be getting ready to cover. Conversely, the widening of the basis tells you that shortages may soon end the shorts are likely to start selling once more. Butler will write a hundred pages about the COT reports while writing half a sentence about backwardation. As far as I can tell, he has never written even a quarter of a sentence about the basis, in spite of a challenge I issued to him privately two years ago. Perhaps he has never got around to take a refresher course, so busy he was poring over reams of COT reports. Be that as it may, the basis is a most sensitive market indicator. When negative, it is a red-hot alarm indicating that offers to sell gold are drying up fast, and may be withdrawn at any time. Please don't take me wrong. I am not against studying COT reports. All information is useful if you know how to interpret it intelligently. But it is not a very intelligent construction to put on the COT reports to assume that the bulk of the short position of the big commercials is naked.

Having said this, I must credit Butler for advocating the ownership of metal fully paid for as against futures positions or ownership of unallocated metal in public warehouses. He also admits the possibility that the "wolf-pack" may engineer another sell-off even after having suffered horrendous paper losses during the latest run-up of the price.

Can depression be averted?

Where does all this leave us? The short-covering and profit-taking charade will continue, possibly for several years to come. There will be no disorderly cut-and-run by the shorts and no meteoric rise in the price. Spectacular rises, yes. But they will be followed by equally spectacular and sometimes protracted corrections testing the stamina, staying power, and intestinal fortitude of the longs. Volatility will increase faster than the moving averages. Exchange rules may be changed unilaterally favoring the shorts, prejudicial to the longs.

Obituaries of the dollar are a bit premature. We cannot rule out the possibility that policy-makers favor a controlled devaluation of the dollar in terms of gold. By now they must realize that bilateral devaluations against selected currencies will never work. They would provoke trade wars and competitive currency devaluations. By contrast, a 1979-80 style devaluation of all currencies against gold should be acceptable to all governments, even though the outcome would be the same. The dollar would be devalued against other currencies at various rates, higher for the yen, less for the euro, and least for the renminbi. The trading partners of the U.S. would tolerate that without retaliating with discriminating tariffs and quotas.

You see, my position is close to your own. Yes, as you say, there is an iceberg of gold and silver which is unseen that never enters the market. Yes, the watchdog agencies know this (as well as the identity of the principals of the short sellers who fool the market in posing and parading naked while in full armor, in a reversal of Andersen's amusing tale) but they are sworn to secrecy. And yes, it is not impossible that this bull market in gold is stage-produced in order to devalue all currencies deliberately without the policy-makers making a scape-goat of themselves. The purpose of the exercise? Why, it is to get rid of the debt-incubus short of deflation, defaults, and depression. Come to think of it, a measured devaluation of all currencies against gold is the only hope to avoid an enormously destructive and protracted depression of the world economy that would be triggered by the sudden toppling of the Debt Tower of Babel. A planned melt-down, well-entombed inside of a golden sarcophagus, is the preferred way to go.

What if I am wrong and policy-makers are getting more band-aid out of the medicine cabinet to patch up the disintegrating international monetary system? In that case may God help us survive the coming Armageddon.

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