PEAK GOLD!

A Primer on *True* Hedging, Part Three

Antal E. Fekete
Gold Standard University
aefekete@hotmail.com

Double standard in gold hedging?

This is in answer to Mike Mish Shedlock's rejoinder *Double Standard in Gold Hedging?* http://globaleconomicanalysis.blogspot.com (September 11, 2007) to my *Peak Gold! - Part Two* www.gold-eagle.com (September 10, 2007). Mr. Shedlock challenges my claim that unilateral hedging by a gold mine, in particular, the practice of selling forward longer than one year, or quantities in excess of one year's mine output is, in effect, a naked short sale, involving unlimited risk. I have suggested that unilateral hedging and forward sale of several years' output are imprudent, fraudulent, and should not be allowed by the exchanges ? as they certainly are not in case of agricultural producers.

At this point I would like to remind my readers that the series *Peak Gold!* has not been concluded as I have not yet fully discussed what *true* (or bilateral) hedging as opposed to *fraudulent* (or unilateral) hedging is. But before I do that I feel it is necessary to answer the points raised by Mr. Shedlock, which I now do point by point in the same order he raised them.

Unlimited risk is for real

- There is fraud involved in the practice of unlimited forward selling of gold beyond one year precisely because it may not be possible to deliver the gold as contracted. One year is the logical production cycle for gold. There is a difference between selling forward gold already in the pipelines moving towards the market, and selling forward gold still locked up in ore bodies. It is safe to assume that gold already in the pipelines will make it to the market. By contrast, gold locked up in ore bodies may not. The oft-quoted dictum that "there's many a slip between cup and lip" applies. Ore has to be extracted, pulverized, processed, and refined. The company may not be there to do it if it goes bankrupt in the meantime ? for example, as a result of its foolish unilateral hedging policies.

- The idea of 'unlimited risk' involved in naked forward sales is real. The miner does not have the gold in hand. He has only a bird in the bush. In addition to the risk to potential profits there is the risk that the company will be foreclosed on its naked forward sales and go into receivership. Mr. Shedlock simply ignores the dynamics of the gold market. He ignores, for example, that forward sales as practiced by Barrick rely on gold lease rates remaining stable ? a fact admitted arrogantly in its last Annual Report. Perhaps Mr. Shedlock doesn't realize lease rates are nothing more thaín the fulcrum upon which the dollar-rate of interest and the future price of gold teeter in balance. But what if no more gold were available for leasing, as will surely happen when the central banks finally empty their cupboards? Lease rates would explode as one piece of gold in hand would be worth severalin the bush. I am grateful to Tom Szabo of www.silveraxis.com for pointing out to me that this could and would happen if the demand for gold becomes greater than the lease supply. *There is no way to hedge against this risk.* The fact is that gold could go into backwardation so fast as not to allow time for the company to take defensive action. It will matter little then that Barrick claims a great deal of flexibility in its gold contracts since the very thing it has egreed to receive in exchange for gold ? U.S. dollars ? will have lost all of its value. Does Barrick have enough capital to deliver the "hedged" gold for nothing, and will it be given much time to do so? This is where Barrick would fing that backwardation poses a serious obstacle to its survival as the value of future gold production, and thus that of a gold mine, is but a fraction of the same amount of gold when held in the hand.

Bullion bankers are, no doubt, a nice bunch of people when they coax the gold miner into the trap of unlimited risk. They will not be nearly so nice when they get ready to make their margin call and take their pound of flesh, as any Shylock worth the name would.

- Sure, profit risk runs in both directions. This is exactly why *true* hedging must be bilateral involving forward purchases to complement forward sales. This is exactly why unilateral hedging is *false* hedging. It fails to be symmetric. Bullish sentiment is nipped in the bud, while the bearish variety is cheered on. It pretends to market a product at the best price available, but all it does is *ruining its own market* by inviting *competitive short sales* from other gold mines and speculators. Profit risk running in both directions is the whole point of my series on *Peak Gold!*, a primer on true hedging, if you just have the patience to hear me out. I wonder if Mr. Shedlock has read the section in *Part Two* on bilateral hedging, namely, how a downstream short leg (forward sale) of a hedge ought to be complemented by an upstream long leg (forward purchase) representing down payment on gold bearing properties that the gold mine is in the process of acquiring. Bilateral hedging works with four-legged straddles, a short and a long leg downstream, plus a long and a short leg upstream. Unilateral hedging tries to get by with one-legged straddles: the only leg being the short one downstream. I ask you: which is going to win the race?

- A gold mine can never be smart enough to outsmart speculators who make it their business to forestall other market participants. It is outright stupid to pursue a market strategy of long-term forward selling, given the fact that in the futures markets nimble speculators make split-second decisions to turn from a buyer into a seller. By the time the gold mine, a dinosaur in comparison, has made its longtrumpeted forward sale, the speculators have run away with the best of the pick. Unilateral long-term forward selling of gold could work, but *only if* governments or central banks have underwritten the losses that are almost certain to accrue.

- It is not a question of liking or not liking hedged mines. The demonstrable fact is that the leading hedger takes unfair advantage of all the other mines, hedged or unhedged, by forcing them to sell ahead of schedule at lower prices. Unilateral long-term forward selling is a *predatory practice* which enables the big fish to gobble up the small. No fair play is possible as long as the practice is allowed. For this reason the suggestion that if you don't like hedged mines you should short them is puerile. Shorting a predator may be suicidal.

- It is true that every production process has its production cycle. As Mr. Shedlock remarks, for agricultural commodities it is typically from harvest to harvest, or one year. Although for gold it is not so sharply delineated, it is reasonable to make the fiscal year to play that role. Once a year shareholders meet, elect new directors and there may be changes in management. Important decisions are made about acquiring new gold-bearing properties, prospecting, exploration, mine development. In this sense, yes, you plant in the first quarter to reap in the fourth, typically the busiest season for the gold mining concern.

- It is true that, as far as its fundamentals are concerned, gold production is far more stable than the production of agricultural commodities or, for that matter, the production of any other good. This is what makes gold such a superb monetary metal. It is foolish to suggest that gold, as a result of its 'demonetization', has ceased to have stable value ? fluctuating gold price notwithstanding. What the fluctuating gold price shows is not the lack of stability in the value of gold; it is the lack of stability in the value of paper currencies, issued by devaluation-happy governments, in which the price of gold is quoted. It is certainly not indicative of a mysterious disappearance of stability in the value of gold.

- The fluctuating price of gold, as well as fluctuating forex and interest rates, are not nature- given as are the fluctuating prices of agricultural products. They are *man-made*. They have deliberately been inflicted upon the people by governments in betrayal of their sacred mission to protect them. The fluctuating gold price and gyrating bond prices are the instrument of the most vicious exploitation the world has seen since chattel slavery. The government in regulating futures trading has approved "double standards" in an effort to create a practically infinite supply of

> *ersatz* gold, including paper gold (such as gold futures that can be sold greatly in excess of physical gold in existence), and unmined gold locked in ore bodies below ground (which can then be sold forward), in the hope of keeping the price of cash gold in perpetual check. This is not a myth. This is a well-established fact admitted, at one time or another, by many a government in its more sober moments.

Niagara-on-Potomac

The world-wide regime of irredeemable currency would have come to a sorry end decades ago if it weren't for gambling casinos foisted upon the world by governments hell-bent to keep the game of musical chairs going non-stop. Governments, in the best tradition of casino owners, want people to gamble in gold, bond, and forex futures. The futures markets in gold, bonds and forex serve a purpose, and one purpose only: to provide an outlet for the Niagara-on-Potomac, money supply gushing forth from the Federal Reserve that could drown the entire world in a hyperinflationary deluge. If it hasn't, that's because excess money has been soaked up by the gambling casinos. So far. People scramble for the excess because they could use them as chips at the gaming tables. But as growth in the derivatives markets (the size of which doubles every other year and by now exceeds half a *quadrillion dollars* or $500,000,000,000,000) shows, this is not a stable process secured with proper checks and balances. This is a runaway train on which the brakes (i.e., natural limitation on gold production) have been deliberately disabled. Fraudulent hedging of gold mines, and double standards in regulating futures trading are part of the sabotage. This is a world disaster waiting to happen.

Hedge fund masqerading as a gold mine

Mr. Shedlock has missed my point. We may honestly disagree on the question whether long-term unilateral hedges are prudent or fraudulent. But there is no ambiguity about the fraudulent nature of a hedge fund masquerading as a gold mine. If it is the world's biggest gold mining concern, then the masquerade assumes cosmic proportions.

I repeat the verdict: the gold carry trade is criminally fraudulent. In more details: to lease gold, to sell it for cash, to invest the proceeds like a hedge fund, and to report the income from these investments as profit to shareholders, as if they were profit from gold mining operations, constitutes fraud. Paper profit is no profit. It is encumbered with a contingent liability, the extent of which cannot be ascertained until the hedge is lifted and the hedgebook closed. The trouble is that by that time management will have spent the 'profit' taken out of the corporate treasury fraudulently.

The practice of window-dressing income statements using unrealized paper profits, especially as they are encumbered with unlimited liabilities, is a blatant fraud dealt with by the Criminal Code.

Are Barrick's officers masochistic or incompetent?

In *Peak Gold! Part One* I mentioned that Barrick President Greg Wilkins and Executive Vice President and CFO Jamie Sokalsky announced extremely optimistic predictions about the gold price for the next five to seven years in a conference call that has been widely publicized. These predictions are based on a study of gold fundamentals commissioned by Barrick. (Reuters, August 3, 2007.)

Here is my parting shot to Mr. Shedlock. He says that he disagrees with Citigroup analyst John Hill, who publicly called on Barrick to rid itself of the remaining 9.5 million ounces left on its 'project' hedge book. According to Shedlock Barrick *should not* cover those hedges now at $700. "If it did and the price of gold collapsed to $500, Barrick would be in a world of hurt… Barrick would be betting the farm that prices are heading north of $700 … and will stay there for quite some time… Is [this contingency] really worth betting the company on?"

I ask Mr. Shedlock what makes him think that Barrick's actual bet (namely, that the price of gold *will* collapse to $500) is a more worthwhile contingency to bet the company on? Who is Messrs. Wilkins and Sokalsky trying to fool in making prognostications potentially very damaging to the financial health of the company ? in view of its hedgebook deeply under water? Are they masochistic? Do they think that they have been hired by the shareholders to run the company aground? Why did they not lift all their so-called hedges, as John Hill suggested and Newmont has done, in good time, *before* releasing such a devastating report putting the company in jeopardy? This is what common sense would seem to dictate, to lift the hedge first, and make the announcement afterwards, is it not? If they did not have and could not raise the money to do it, at the very least they should have suppressed the optimistic prognostication on the gold price, in order to soften the blow to shareholders who are going to suffer one way or another the consequences of gold breaking above $700, due to Barrick's insane hedging policy.

It is understandable that Barrick's officers are reluctant to admit publicly that they have made the most colossal blunder in the history of mining, by committing their company to the policy of unilateral downstream hedging through unlimited forward sales of gold. Such an admission would be hard on the ego. They may hope against hope that their blunder will be quietly forgotten, and the shareholders will buy the desperate propaganda-line that a higher gold price is good for them, hedgebook or no hedgebook.

But you cannot keep kicking garbage upstairs to the attic forever, because it will keep rotting there until something gives and the accumulated garbage will come crashing down.

I have issued a public challenge to Barrick to explain why they ignored my warning ten years ago that unilateral downstream hedging is a dangerous trap they should avoid. I also pointed out to the top brass how their hedge plan could be made bilateral, a winning combination. Had they listened to my advice, they would have avoided having to carry the yoke of a millstone-size hedgebook around their neck. I take this opportunity to report that Barrick has so far ignored my challenge.

I am not sold on the conspiracy theory according to which Barrick is a front set up by governments to keep the gold price in perpetual check. Not yet anyhow. But then, the only conclusion is that the officers of Barrick are incompetent bunglers whose name will go down in ignominy in the annals of mining.

DISCLAIMER AND CONFLICTS

THE PUBLICATION OF THIS ARTICLE IS SOLELY FOR YOUR INFORMATION AND ENTERTAINMENT. THE AUTHOR IS NOT SOLICITING ANY ACTION BASED UPON IT, NOR IS HE SUGGESTING THAT IT REPRESENTS, UNDER ANY CIRCUMSTANCES, A RECOMMENDATION TO BUY OR SELL ANY SECURITY. HE HAS NO POSITION, LONG OR SHORT, IN BARRICK STOCK, NOR DOES HE INTEND TO ACQUIRE ONE. THE CONTENT OF THIS ARTICLE IS DERIVED FROM INFORMATION AND SOURCES BELIEVED TO BE RELIABLE, BUT THE AUTHOR MAKES NO REPRESENTATION THAT IT IS COMPLETE OR ERROR-FREE, AND IT SHOULD NOT BE RELIED UPON AS SUCH.

Gold Standard University Live

As announced earlier, Gold Standard University Live, Session Three, is planning an open-ended debate and panel discussion on *True versus False Hedging of Gold Mines,* scheduled to take place during the weekend February 8-10, 2008. Sprott Asset Management of Toronto, Canada, has agreed to sponsor the event. Representatives of gold mines, hedged and unhedged, will be invited to participate. For further information please contact GSLU@t-online.hu .

September 19, 2007