The long & short of gold.

The Gold Pyramid.

Think about this great business idea for a minute. Let's borrow some surplus stuff and sell it for whatever we can get. We'll buy a futures contract to get it back at some certain future date, so we're covered. Meanwhile, we'll earn an interest spread plus commissions. While we're at it, let's sell puts and calls against the stuff even if we don't have it on hand. Our mathematical models will guarantee that our position is always neutral, and we'll clean up on commissions, interest and other fees on the options too.

The foregoing, approximates the rationale of the present day, little-known gold derivatives pyramid. John Exter, a famous gold analyst almost two generations ago, was the first to suggest that gold related to paper assets in the form of a pyramid. He described the relationship of gold to paper assets as an inverse pyramid balanced on trust. Currency at one time was a gold derivative. Government issue was backed by physical gold held by central banks. Because currency was a claim on gold, it was in effect a short position against a physical asset that was relatively easy to calculate. Governments hated the idea because they could never seem to stop issuing new paper. Even the pretense of a link has been long abandoned. Since currencies no longer have gold backing, and the world still appears to function, nouveau central bankers assert that

gold is superfluous.

The old currency/gold pyramid has been replaced by a little understood labyrinth of paper claims against gold. Responsible senior officials of mining companies, central banks, and bullion banks cannot begin to understand the internal mechanics in order to make appropriate judgments of risk. There are few published figures, no reserve requirements, no supervision or regulation, and no accountability. It is the private domain of bullion dealers, central banks, and mining companies. The credit worthiness of the old currency/gold pyramid was quantifiable. The credit worthiness of the new pyramid can only be an educated guess. Our guess is that it is bankrupt.

The gold derivatives pyramid is a vigorous free market creature. It cannot be put down with a simple declaration that the paper is no longer redeemable in gold, as governments did with currency. It is a short selling scheme that has become a trap from which few short sellers will escape. Paper claims in the form of derivatives far exceed the underlying physical metal on which they are based. The trust, which balances this new pyramid, is based on false assumptions and lack of information. Paper gold claims have proliferated at a pace rivaling any government printing press. A surfeit of paper gold has driven down the price of the physical on which it is based.

The structure can survive as long as bullion dealers, the mining community and the financial media subscribe to the bearish case. But the position of short sellers is precarious. This is true whether gold stays at current levels, or drops below $1500/oz. The point is, they will be unable to realize their paper profits, and stand to lose money on their positions in the aggregate. The compound miscalculations on which the gold market is based rank with the blowup of the yen carry trade in 1998. The yen carry disaster illustrates how over-investment and near unanimity of market opinion can lead to a vicious squeeze. Compared to the yen, gold's liquidity is microscopic. The coming squeeze will lead to a several thousand dollar rally and a permanent change in attitudes towards gold. $3,000.00 per ounce gold is closer than you think. Short sellers have been shorting gold for the last 10+ years. While they continue to average up the price per ounce it will cost them to cover, the market only needs a small crisis to push gold over $1900.00, like we saw last year.

The difference now, is short sellers won't be able to continue to borrow the gold they are short and that will cause gold to skyrocket in a short squeeze, that could push prices as high as $5,000.00 per ounce or higher. As the world continues to buy physical gold, the short sellers continue to short gold and its gotten to the point where there isn't enough physical gold in the world to cover the paper shortage that exists. This is just another example of a pyramid getting ready to collapse and when it does, the world as we knew it will never be the same. Everyone should be long gold for the next 5 to 10 years and buy on dips. The dips are caused by shorting to push the price down in an effort to cover. The new price floor is where the short seller needs to cover his average short. Its somewhere around $1500.00 per ounce. There are more gold buyers at the $1500.00 level than there is gold currently being produced. There will always be short sellers selling more gold than there exists, but one worldwide crisis and the shorts will all be wiped out along with the gold derivatives pyramid.