

September 3, 2014 – Gold Loans Revisited

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This week, I had to finally admit to myself that what I once thought was impossible has recurred, namely, that gold lending has returned; not in the manner I had previously predicted would never return, but in a version fitting of the term. A widely cited article from Bloomberg described in no small detail the state of gold lending in China. If you haven't read it yet, I would suggest that you do so because it connects many of the developments in the gold market over the recent past. I haven't seen much commentary on the article, so I thought I would wade in on a topic I've been close to in the past. http://www.bloomberg.com/news/2014-09-01/china-banks-boost-precious-metals-hoard-amid-lease-demand.html#disqus_thread

In a nutshell, the article highlights how pervasive gold lending has become in China, primarily as an alternative financing source. The article only reported on the gold lending from four Chinese banks, but the numbers and growth in lending was notable, particularly, in terms of gold oz. As of the end of the second quarter, the four banks were said to hold the equivalent of 1445 tons (46.5 million oz) of gold loans, up 55% from year earlier levels. The article attributed much of China's demand for gold to the rise in gold lending, answering questions about the source of demand for metal into the country. It was also suggested that demand for these loans would determine future demand for gold from China.

Basically, the banks lend gold to borrowers who simultaneously sell it back to the bank and agree to ultimately pay off the loan in terms of the price of gold at loan's end, all for cash proceeds today. It was reported that this results in lower interest rates or no loan at all from competing loan sources. Don't feel bad if you can't quite grasp the whole concept, because to me the whole thing borders on lunacy; a lunacy that I thought was long dead and buried.

As I've previously explained, my introduction to public writing on the Internet was precipitated by my discovery that precious metals lending was the culprit in the dumping of tens of millions of gold ounces and hundreds of millions of silver ounces onto the market in the 1990's. I had been aware of the concentrated and coordinated short selling of COMEX contracts since 1985 and had petitioned the regulators since that time; but I couldn't figure out where the physical metal was coming from to satisfy the structural silver supply deficit at the prevailing artificially depressed prices. Since I was looking for a non-free market source of supply (thinking like a criminal), when I learned of precious metals leasing it dawned on me immediately that this leasing was the source. My very first Internet article, more than 17 years ago, was a letter I sent to then-Federal Reserve Chairman Greenspan and Treasury Secretary Rubin about the illegitimacy and fraud of gold and silver loans. <http://www.gold-eagle.com/article/letter-alan-greenspan>

Despite warning, as best as I could, about the inanity of precious metals loans and the certain bad ending to come, these loans actually grew for several years. In time, however, the market recognized (but never fully acknowledged) the folly of these loans, as the principle borrowers of metal, the big miners like Barrick and AngloGold, finally closed out the loans taking tens of billions of dollars in losses. Considering how expensive the lesson was to learn and the sheer idiocy of precious metal loans, I concluded the experience would not be repeated for generations to come. It would appear that the Chinese are destined to learn anew.

The reason precious metal loans are moronic is because the participants never look far enough ahead to consider the practical end results. In the case of the previous experience in which central banks loaned metal thru bullion banks to miners to be repaid from future production, it seemed like a win-win all around. Central banks got a (very small) interest rate on precious metals holdings that were theretofore fallow and miners got below market interest rates for financing operations and the bullion banks took a healthy slice of everything.

Very few noticed at the time that the origination of every loan caused physical metal to be indiscriminately dumped on the market which depressed current prices (hurting the miners). In essence, precious metals loans/forward sales were nothing more than short sales which had to be closed-out one day. More than anything else, the dumping of metal at the start of every precious metals loan combined with the requirement that these short sales be bought back one day explains fully why the gold price fell below \$300, only to rise above \$1900 when the loans were effectively closed out. That was then; what about now?

The Chinese gold loans are different than the previous gold loan experience. For one thing, it does not appear to be mining companies doing the borrowing and promising to repay metal from future production as it was in the past. This time, gold is being used as collateral to make loans for general financing purposes. (Also, these loans don't appear to involve silver, as was the case previously – which I think is to silver's advantage).

One similarity between the “old” gold loans and the modern Chinese version is that both sort of sound legitimate at first blush, until you sit down and analyze each with some thought. Originally, precious metals loans to miners sounded good – until it was too late. Ask yourself this – if the “old” precious metals loans/forward sales were such a good idea as was purported by the Wall Street rocket scientists who created them, then why have they fallen out of existence, especially since current prices would make them more attractive than the previous much lower prices? They fell out of existence because, at the core, they made no sense.

Now ask yourself this – if gold loans are such an attractive alternative source of general financing, then why is such lending largely confined to China? If loans collateralized by gold are that good, then why don't we see them in the West? Is the Chinese financial system that much more advanced than the rest of the world? I don't see any signs of that and instead must conclude that this whole concept of gold loans is a stunning miscalculation by bankers in China.

When you think about it, there's not much sense in a gold loan for general financing purposes. At least with the old version, it sounded like gold mining companies were in position to repay loans from future production; something not in place with Chinese gold lending. Further, where's the big attraction with basing general financing with gold as collateral? A bank ties up capital in securing gold and then turns around and lends that gold to a borrower who immediately sells the gold back to the bank for a cash loan at a preferential interest rate and then promises to eventually pay off the loan based on the future price of gold. Huh? There is just not any obvious benefit to such gold loans. Except one.

There is only one way in which these Chinese gold loans would appear to make sense. Unfortunately, there is nothing legitimate about that one way. Having each gold loan fully backed by specific collateral would virtually eliminate any chance of profit to the lending bank, given the costs associated with buying and storing the gold. But there would be potentially great profit if the same collateral could be used to make many loans. That, in essence, is what I believe these Chinese gold loans are all about – unsecured loans intended to evade local bank restrictions on lending by banks pretending they are collateralized.

I haven't reached this opinion in a vacuum. As the Bloomberg article concludes, there may be a connection between gold loans and other Chinese loans collateralized by copper and aluminum which are being investigated due to fears the same collateral was pledged for many loans. I would point out that gold and commodity loans in which the same collateral backs many loans seems to be unique to China at this time. After all, at least in the US, we've been there and done that more than 50 years ago in the great salad oil scandal run by Tino DeAngelis. I guess these are lessons that must be learned by direct experience and not from history.

http://en.wikipedia.org/wiki/Salad_Oil_Scandal

The existence and proliferation of gold loans in China would appear to answer the question behind the big gold demand from China and the great movement of metal from West to East. It's been hard, at least for me, to reconcile what has been driving Chinese gold demand. Was it based upon retail buying or perhaps official state buying? Now there is a plausible explanation behind the demand in that it may have provided (partial) backing for alternative financing, as reported by Bloomberg. Certainly, the quantities quoted would be in line with published import statistics.

Now comes the difficult part ^? trying to measure its past and future impact on price. The biggest difference between the old precious metals leasing among the central banks, the bullion banks and the miners and the new Chinese version is that it was easy to reconcile prices based upon the old way. As central banks originated loans, metal was dumped on the market and prices fell; as loans stopped being made and then paid off, that was clearly bullish for price (as history has demonstrated).

Price expectations are more difficult with the new version. If use as loan collateral has driven Chinese demand, then that demand should continue as loan demand grows. If such demand comes under scrutiny and falls off, as has commodity collateral lending in general, gold demand from China may suffer. And just because both the old and new versions of gold lending never made much sense to me, that doesn't mean they can't grow further as they did for years in the old version long after it became clear that the loans were nonsensical.

Most difficult of all is trying to judge what happens to gold prices as and when Chinese gold loans enter the repayment stage. With the old gold loans, it was easy to predict the closeouts of the loans would propel prices higher to a greater degree than the price weakness brought about when the loans were originated. I don't have a firm take on what will happen when the Chinese gold loans begin to be closed because I don't know who the borrowers are or the degree of over collateralization. Will the borrowers in China be forced to return gold as the miners in the West were so forced? I just don't know. Large publicly traded companies can't easily evade contractual loan obligations; I'm not sure that's the case in China.

Finally, it's not as if the large loan demand for gold from China actually resulted in higher gold prices, as most of the demand occurred on gold's historic decline since the beginning of 2013. I would readily agree that without demand from China, gold prices would have been driven even lower by the COMEX crooks than what occurred; but that's different than Chinese buying causing a great rally in gold because that didn't occur. As I indicated, the most common denominator between the old way of lending gold and the new Chinese way, is that both make little economic sense.

In developments since the weekly review, prices have taken the high probability downward course as suggested in the COTs and as evidenced in yesterday's high volume plunge. There is little question that yesterday's price plunge was as garden variety as it gets in that the technical funds were snookered into selling aggressively by the crooked and collusive COMEX commercials. It's a wonder how so many (not subscribers) still fail to see or acknowledge it, particularly since it is so repetitive.

There is more a question of whether yesterday's heavy technical fund selling/commercial buying will be accurately reflected in Friday's report, given that the biggest action was on the Tuesday cut-off and there have been past occasions when that occurred that the numbers haven't been up to date. Assuming there is no such inaccuracy in this week's report, there should be sizable reductions in the technical fund (managed money) net long positions and commercial net short positions in COMEX gold, silver and copper. This despite the technical fund buying in gold late last week when prices rallied above the 200 day moving average.

The biggest question is how much further down, in price and in number of contracts, the commercials will rig gold, silver and copper prices from here. It certainly appears we are past the mid-way mark in both COMEX silver and copper in terms of numbers of contracts and close to that in gold. With silver now well below the primary cost of mine production, it would appear that there is little reason to expect the commercials to be extra vicious to the downside, but like terrorists, criminals can't be depended on to act rationally. I do remain convinced that the coming bottom, whenever and whatever it turns out to be, should be treated as the final bottom in silver.

Yesterday's surprising near 2 million oz deposit into the SLV, still smacks of short covering, although that won't be reflected in next week's short report which covers positions thru last Friday.

Ted Butler

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Silver – \$19.20

Gold – \$1271

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