Gold's Permanence Anchors Comex Futures Delivery

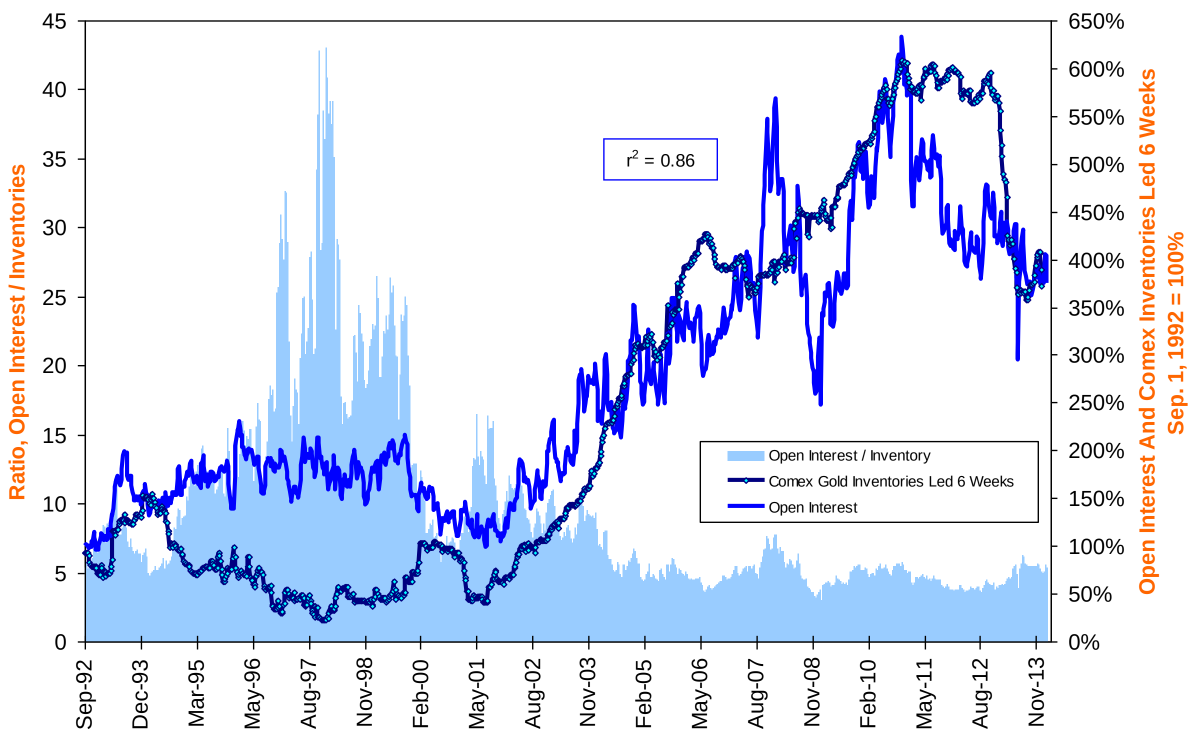
The second-to-last person on Earth will be able to exchange gold for value to the last person on Earth. Gold's rareness, durability and the simple fact it cannot be created at the stroke of a pen or by a printing press makes it a recognized store of value. This is why virtually all of the yellow metal ever mined remains in visible supply; you can cast and re-cast gold repeatedly, recycle it out of electronics and convert it from one financial delivery point to another in a well-known arbitrage. For example, you can take delivery of 100 ounces on the Comex in dollars per ounce, have it recast into kilogram bars for delivery to Mumbai's National Commodity & Derivatives Exchange in rupees per ten grams.

Elastic Supply

This ability for gold to change its physical form and ownership quickly and at a relatively low cost makes its actual physical location relatively unimportant. Many central banks moved their own physical gold into storage at the Federal Reserve Bank of New York during and after World War II. More recently, gold depositories in Switzerland, Canada, Dubai and Singapore, inter alia, have seen bullion inflows and outflows reflective of changing sentiment as to which location provides the best custodial services. Gold-backed exchange-traded funds (ETFs) use their own storage facilities, often at commercial banks such as the Hong Kong & Shanghai Bank in London.

The key is financial claims on gold, such as positions in Comex gold futures contracts, transfer easily and readily into physical gold moving into and out of Comex warehouses. This has been true for more than two decades. The weekly average aggregate open interest in gold futures leads the quantity of gold in Comex warehouses by six weeks on average. As open interest expands or contracts, so does the physical supply of gold that may be called upon to satisfy delivery demand. The r-squared, or percentage of variance explained, is a robust 0.86.

Comex Gold Inventories Follow Changes In Open Interest



Please note this history going back to September 1992 includes a period between 1996 and 1999 where the ratio of open interest to inventory surged to more than 40 on an ounce-to-ounce basis. Gold was still in its long-running bear market at this time and the notion a high level of futures open interest posed the danger of a squeeze on the supply of gold available for delivery would have been laughable. The open interest/inventory ratio has averaged 4.89:1 over the past ten years and stood at 5.36:1 at the end of January 2014.

As is the case with all futures contracts, whether they are settled financially or delivered physically, only a small percentage of gold futures ever go to physical delivery. The holder of a long futures position, the obligation to take delivery, typically offsets this contract by selling it outright without replacement or selling it and taking a long position in a later month's futures contract. The Comex' delivery procedures and margin requirements and the financial integrity of the CME Clearinghouse, the actual counterparty to all Comex gold futures contracts, have ensured default-free and "squeeze-free" delivery.

Movement West To East

As the World Gold Council has noted, global demand and ownership trends have continued a West-to-East shift with physical gold ownership increasingly in the hands of Chinese, Indian and Middle Eastern buyers. Gold traditionally has a very high income elasticity of demand in these markets; it is seen as a reliable store of wealth.

Much of this change-of-ownership trend since the end of 2012 reflects liquidation of gold held in inventory against ETFs and accumulation of gold held in jewelry form. ETF holdings of gold peaked in December 2012 at 84.6 million ounces and declined to 55.9 million ounces at the end of January 2014. The World Gold Council's provisional estimate of jewelry demand for the first three quarters of 2013 was 58.0 million ounces.

As gold prices peaked in dollar terms in September 2011 and have declined almost 34% since then, the changing geography of gold ownership reflects different geographic behavior as well. ETF investors began have been selling their holdings into lower prices while jewelry buyers have been scale-down buyers. Futures open interest has behaved far more like ETF ownership.

The Gold Lease Indicator

One major difference between large financial holders of gold such as central banks and small owners of gold is participation in the gold lease market. Just as custodial banks lend securities to earn a short-term interest rate, central banks lend gold to defray their costs of holding the metal. These lease rates are the difference between LIBOR and the gold forward offered rate. As more institutional holders make metal available in the gold loan market, lease rates relative to LIBOR decline. Conversely, a surge in small-holder ownership propels these normalized lease rates higher. These normalized lease rates jumped during the first half of 2013, something very consistent with the West-to-East transfer of ownership to small holders unlikely to participate in the gold-loan market, but have retreated since August 2013. These declining normalized lease rates are inconsistent with the idea gold supplies available for delivery against the Comex futures contracts are being squeezed.

A Normal Market

Nothing in the price behavior of gold or in its forward curve, the ultimate arbiters of supply/demand balances, indicates anything is out of the ordinary with the gold delivery mechanism. As Western ownership of gold has declined, Comex inventories have declined in response. It would have been irrational for these inventories to have increased against declining potential delivery demands. Similarly, as Eastern ownership has increased, supplies have shifted to where the demand is. Again, this is what we should have expected.

This has been the long history of gold. It changes hands and it changes form but its value and its cherished spot in wealth preservation remain constant. In any free market, there can be no shortage, only a price. The price action on the Comex, just like the price action in the cash market to which it is linked via arbitrage, is smooth and unremarkable and the downtrend in Comex inventories is nothing more than a part of that straightforward story.