

The paper market swindle

We are led to believe that price reflects supply and demand. What if the relationship between paper and physical is just a delusion?



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The origin of today's paper markets

In the mid-eighties, a regulatory event occurred in London which was termed Big-Bang. Banks moved into securities markets buying brokers and jobbers: brokers advised investors and managed their portfolios, while jobbers are known today as market makers. The reason that London was the epicentre of this change and not New York is that US banks were still constrained by the Glass Stegall Act which separated commercial from investment banking. This restricted investment banking and stock market trading activities in New York, but the big US commercial banks were free to do so in London.

Futures and options activities boomed both in regulated exchanges and unregulated over the counter markets. This did two things: it introduced limitless capital into securities trading and also bank credit creation provided the necessary capital. The very thing that Glass Stegall banned in the 1930s, which was the expansion of credit for securities trading putting depositors' funds at risk, returned in London and gradually gained ground in New York until Glass Stegall was finally repealed.

It radically changed the way securities markets operated. Instead of expanding bank credit out of thin air to lend to businesses, bank credit was created for securities trading. And it brought a paper culture into trading which was fundamentally different from the physical securities and commodity markets which operated before.

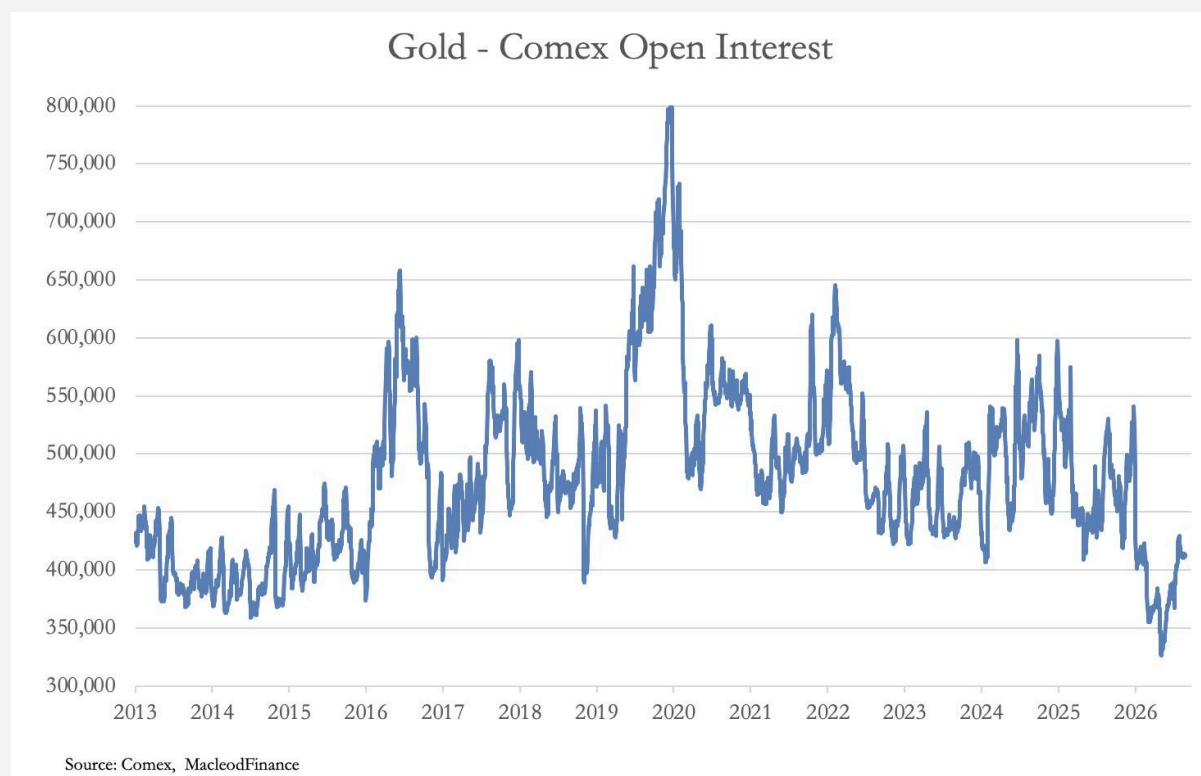
It was embraced by the US authorities who saw it as the means to suppress commodity prices through paper expansion. That would reduce producer and consumer price inflation while the dollar bedded in as gold's replacement. And with respect to gold, the expansion of paper supply would ensure that the horrors of the 1970s — for the dollar that is — would not be repeated and gold would be relegated to non-monetary roles.

The current market

Paper markets are just another form of credit. After all, the definition of a bank is that it is a dealer in credit. The last thing a banker wants is to encumber his balance sheet with a physical commodity because it is an inefficient use of his balance sheet.

Consequently, banks run neutral positions by matching paper longs with paper shorts, typically between the LBMA and Comex futures.

When speculator demand enters the paper markets, it is normally crushed by the simple expedient of expanding credit until it runs out of steam, as illustrated by fluctuations in open interest in the Comex futures gold contract:



Normally, letting the speculators run up their long positions to between 600,000–650,000 contracts has been enough to neutralise any bullishness. Because the banks control the market, they are assured of substantial profits irrespective of the gold price.

The speculators live in hope that one day they will break the banks. But it will not be them that do so. Gold is the antithesis of dollar credit, and the paper game will only stop when either there's a wider banking crisis or the dollar's value as a fiat currency disintegrates. We must therefore assess outside events to determine the prospects for paper markets rather than factors specific to capital markets.

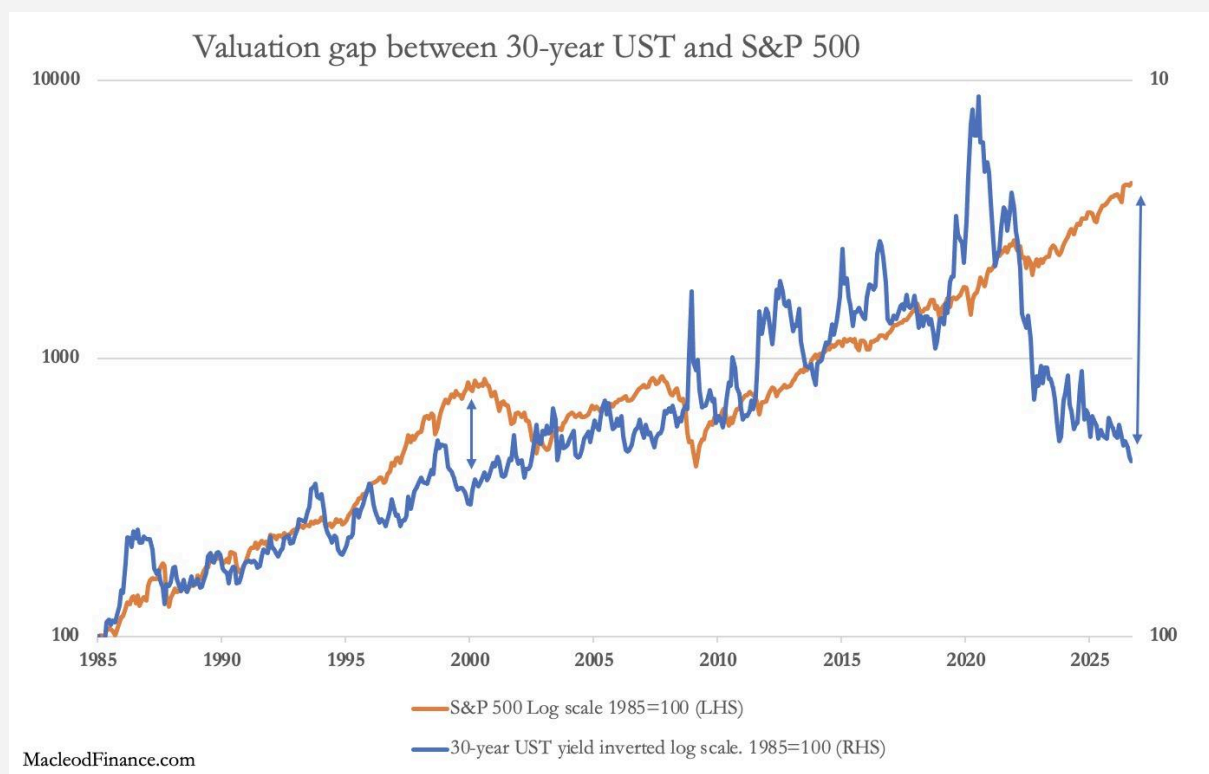
It's the economy, stupid!

The political catchphrase of the Clinton era seems appropriate to our topic. It has been demonstrated above that to assume the trillions of paper obligations in over the counter and regulated markets will be the system's undoing is not what we should be looking at. Instead, we should focus on the consequences of fiat currencies running out of road.

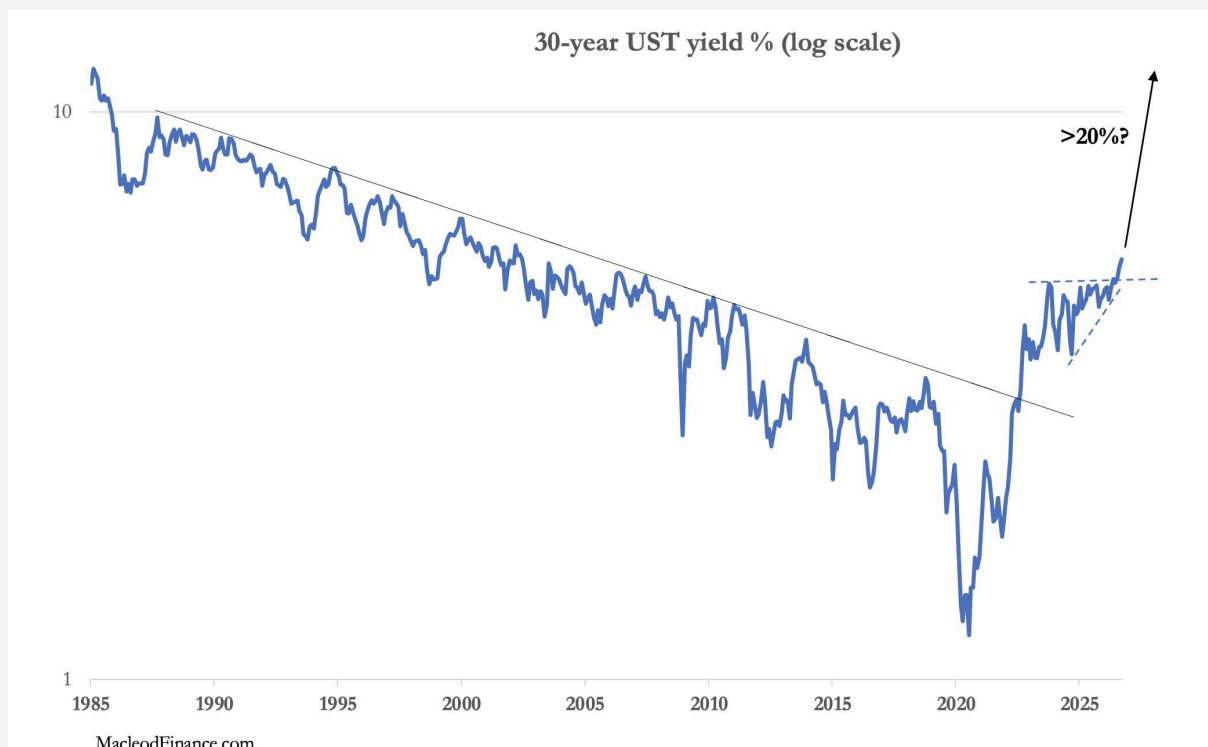
Fiat currency debasement is the medium governments use to both fund themselves in addition to tax revenues and to manage the private sector. The key to this policy has been to maintain control over expectations, which is the point behind targeting annual consumer price inflation at 2% — a figure achieved with the help of statistical manipulation. But there is always an end to monetary policies of this sort, as a gradual currency debasement is exposed as ultimately unmanageable.

Usually, it is foreign actors who become sceptical at first, demanding higher bond yields and interest rates to maintain their exposure, joined by savvier domestic investors. This is where the US government's finances and the dollar stand today. International investors are increasingly aware of the outlook for energy, food, and other commodity prices and how they will require higher interest rates and bond yields to maintain the fiat dollar's value.

This is where economics comes in. Higher bond yields will burst the equity bubble, which is floating on a sea of bank credit taking the S&P 500 index to its most overvalued relative to bonds since London's big-bang of the mid-eighties:



We've shown this chart before. Suffice to say that the double-headed arrow shows equity valuations three times more expensive relative to the long bond than during the dotcom bubble, also arrowed. As to the direction of bond yields, our next chart should cause investors acute alarm:



Taken together, these two charts graphically expose the Fed's policy problem — it has lost control and credibility with it. The consequence is that the current and further increases in bond yields will lead to a business slump and a collapse in equity markets. As the equity bubble bursts, foreign investors with over \$24 trillion invested will run for the exit and at the same time banks will be rapidly liquidating leveraged customer positions by selling collateral to protect their balance sheets. It will be a replay of the Wall Street Crash of 1929–1932.

This outcome is increasingly inevitable, as will be the joint efforts between the Fed and the US Treasury to stop the economy and state finances from imploding. Their very survival depends on it.

As much as possible, bad debts will be concealed by the expansion of central bank credit. Whether it will be sufficient to protect the entire banking system is an open question. But there can be little doubt that commercial bank credit will contract substantially as risks mount, and that will call time on the paper market swindle.