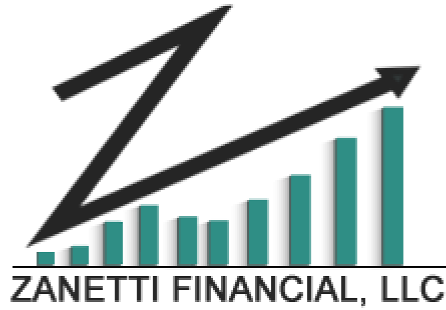
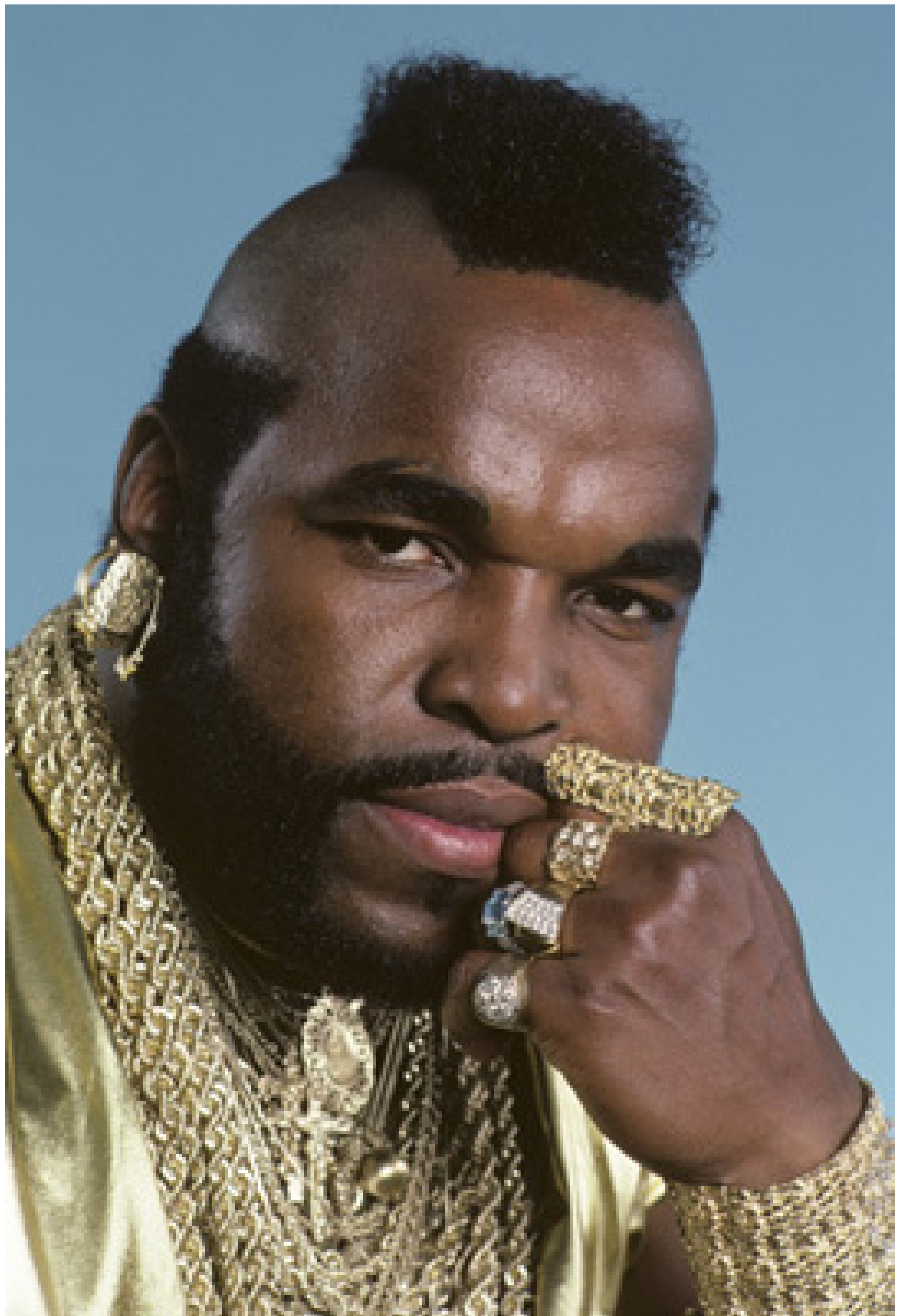


Zanetti Monday Missive 2023.01.16
Paper Vs. Real Gold

"Gold was a gift to Jesus. If it's good enough for Jesus, it's good enough for me!"
~ Mr. T



Hello Everyone,

I don’t usually quote Mr. T. But it made me laugh. **“But, Mr. T,”** I ask, **“At what price?”**

It’s always about price so let’s tackle a question many of you have asked over the years.

“Greg, why is the “paper” gold market is so disconnected from the “real” gold market?”

“The spot price of gold on my computer screen says $1860/ounce. But, if I go to dealer to buy a coin, they want over $2050/ounce. I know the dealer has to make some money, but that mark-up is way too much. What gives?”

Good questions.

Which is the real price? The paper price or physical price?

Here is the short answer.

The “paper” gold price is the “real” paper-gold price. And the real physical gold is the “real” physical price.

That isn’t a very satisfactory answer is it?

So, let’s unwind this.

Oh, and once you understand what follows, you will be so happy you have either Sprott Physical Gold in your accounts….or gold “in hand” at your home or office! :>)

So, let’s get to it.

The “spot” price of something you see on the computer screen (spot oil, gas, lumber, copper, gold, etc.) is what we call the “futures” price. It is a misleading term. Most people think it predicts a future price. It doesn’t.

The futures markets do something far more important. Futures markets were originally formed to mitigate risk.

For example…

Let’s say you are the CEO of United Airlines. Energy is a pretty big cost for your operation. What if you could lock in the price of jet fuel today---- for fuel that will be delivered six months from now?   Wouldn’t that take away at least some of your operational risk?

Meanwhile, what if you are the energy producer? Let’s say, Shell Aviation. What if you could lock in the sales price of your jet fuel six months from now? Wouldn’t that take away some of your risk as well?

Now, all the consumer (Southwest Airlines) and producer (Shell Aviation) must do is agree on the future delivery price…preferably one that is beneficial to both.

This all makes perfect sense.

Historically, however, problems occurred when prices either spiked or dropped dramatically. When that happened, it was not uncommon for one side, or the other, to back out of the contract. Yup. Walk away. “Better luck next time.” Human nature.

To compensate for this default risk, futures markets/exchanges emerged. Here, professional traders (gamblers, really) could bet on the prices of the futures contracts and absorb the default risk previously carried by the producers and users.

Therefore, all the players (the producers, the users, and the gamblers) were all served. Oh, and the exchanges themselves (think of them as “the house”) got a cut along the way.

OK. So far, so good.

So, now let’s apply this concept to gold.

The difference between a futures market for jet fuel, oil, aluminum, copper, oranges, cotton, etc. and gold is this. Gold is not consumed!

Oil is. Aluminum is. Oranges, copper, pork bellies (bacon), cotton, etc. are all consumed.

Gold, however, is stored. Or, as Warren Buffett is fond of saying, **“[Gold] gets dug out of the ground in Africa, or someplace. Then we melt it down, dig another hole, bury**

it again and pay people to stand around guarding it. It has no utility. Anyone watching from Mars would be scratching their head.”

And, he is right.

Now, the fact that gold has “no utility” is what makes it valuable. But that paradox is the subject of another missive.

Moving on…

Since gold has no “use”----and since gold is not consumed---there really isn’t a need for a futures market to insulate anyone from risk. There isn’t the risk of a “supply” shock.

Almost all the gold that has ever been mined in the history of the world is still with us. It may change form. After all, gold is easily melted down and reshaped into coins, bars, earring, or necklaces.

Beyond that, gold isn’t discarded. It isn’t in landfills mixed in with the plastic bags. Even your local dentist removes a gold filling and flips it in the top drawer.

Thus, people may fear running out of oil, or gas, or copper, or lithium. But “running out of gold” isn’t an issue.

Gold sits quietly in vaults. Or, buried in peoples’ backyards. Or, in safety deposit boxes. Or, on someone’s finger. It even sits on the ocean floor in the hull of some wrecked ship just waiting for some intrepid diver to retrieve it.

The only supply shocks that occur with gold are when gold owners (think: super-rich people, miners, refiners, institutions, & banks) become reluctant to part with their gold at any price.

In short, gold “flow” may get sticky…but not supply.

If flow gums up, prices must rise to get gold flowing again. And if something big happens, (think wars, depressions, governmental collapses, etc.) gold flows don’t just get sticky, the come to a complete halt. And flow won’t restart until buyer and sellers agree on what figure the “real” price is.

And that price can go up very high and very fast.

This is why there is a disconnect between the paper and physical gold markets. Everyday commodities do not experience this, because there is a real world connection between the paper futures price of oil, cotton, iron ore, lumber, soybeans, and copper and prices in the real world.

If there were no connections, the futures markets would have failed long ago. After all, the survival of someone’s business depends on how prices move. And the futures markets serve as the valuable feedback mechanism to manage risk and ensure some semblance of honest price discovery.
This is why you don’t hear of corn markets being manipulated.
With gold, however, the spot (paper) price is not connected to any real supply-and-demand dynamic….but rather to flow.
Therefore, there is no supply-demand feedback mechanism in the physical gold market that is reflected in the paper gold market.

So, the bottom line. The spot gold price is not connected to any real world supply-demand dynamics. And this is why the paper gold market will eventually fail.

So, think of the spot price as entertainment. Yes, it gives you an idea of sentiment. But that sentiment is not grounded in reality as other commodity prices are. The gold future's market is a place where gold-price gamblers gamble against gamblers. They trade air and call it gold. An illusion really. And since the paper market is a shadow reality, trillions of dollars of gold derivatives (bets) are allowed to trade globally even though trillions of dollars of gold will never stand for delivery.

It's all based on confidence. And all confidence games are fragile. All it takes is for the illusion to slip.

And, yes, we are getting hints the illusion is slipping. Central banks are buying real physical gold at the highest rates in 55 years. Russia, China, India, and Saudi Arabia are openly talking about commodities-backed currencies, with gold at the core. Rival gold exchanges are gaining popularity in Shanghai and Moscow.

When the illusion fails. When they strike the set, sweep the stage, send everyone home, and shut off the lights, the real price of gold will be revealed. And it will be significantly higher.

Then, if "anyone from Mars" is watching, they will no longer be "scratching their head(s)" wondering why people valued gold.

Next week we will try to discern what that real gold price is. The answer may surprise you.

Signed, Your I-Am-Now-Officially-A-Conspiracy-Theorist-Whose-Personal-Pronouns-Are-I-Told-You-So Financial Advisor,

Greg

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