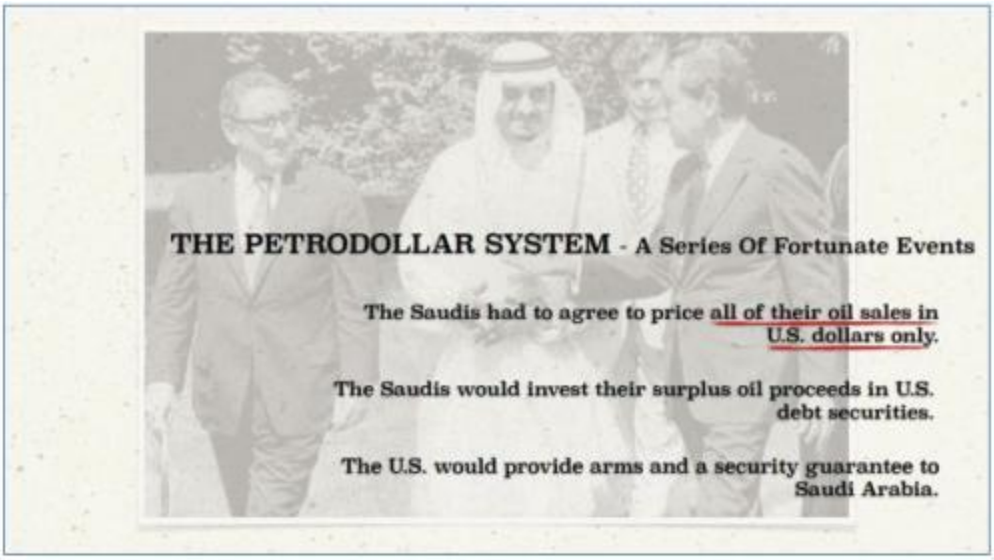
RUSSIAN GOLD

By Caitlin Long – Lew Rockwell

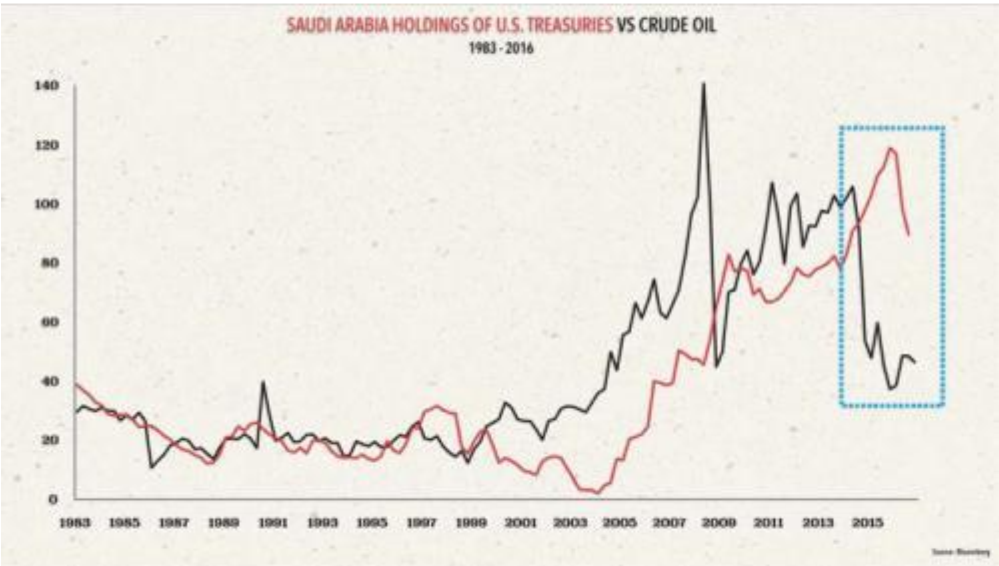
Grant Williams pieced together some of the same things I did in my Russia piece which you ran last April, about why the Russians are buying gold (when economists are advising them to sell it) and why Russia's balance sheet is in great shape compared to those of Western nations. The ruble's recovery still confounds the mainstream! But Grant takes the analysis a step further to show that oil may be trading in gold terms again, tying its price action to the proposed Shanghai crude oil futures contract (which has been delayed) and the Shanghai gold market. When that oil futures contract goes live, basically the countries that have been cut out of the USD-based financial system by sanctions will be able to sell oil for gold in Shanghai. This will be a very big deal, and few mainstream economists will understand why! No one knows the timing, of course, but it's certainly worth watching because it's an important piece of the geopolitical and financial puzzle.



The story begins in the 1970s when Henry Kissinger and Richard Nixon struck a deal with the House of Saud — a deal which gave birth to the petrodollar system.

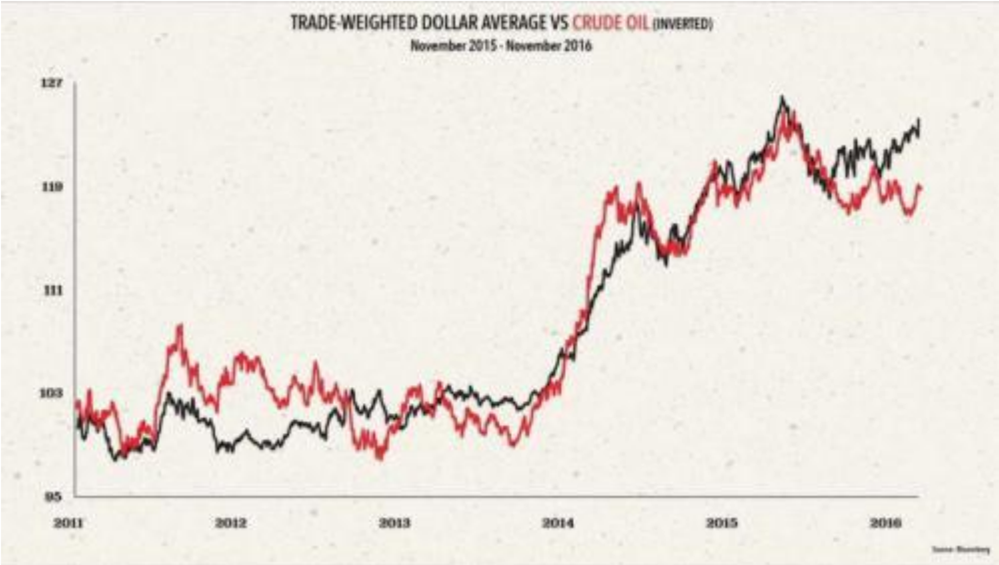
The terms were simple The Saudis agreed to ONLY accept U.S. Dollars in return for their oil and that they would reinvest their surplus dollars into U.S. treasuries.

In return, the U.S. would provide arms and a security guarantee to the Saudis who, it has to be said, were living in a pretty rough neighbourhood. As you can see, things went swimmingly (chart below)



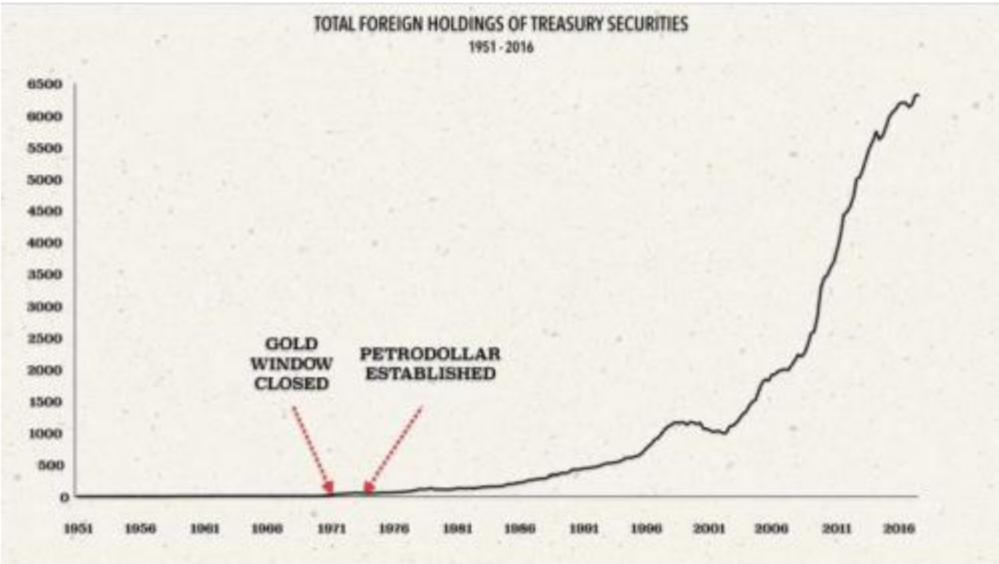
Saudi purchases of treasuries grew along with the oil price and everyone was happy. (We'll come back to that blue box on the right shortly)

The inverse correlation between the dollar and crude is just about as perfect as one could expect (until recently that is… but again, we'll be back to that).



And, as you can see here, beginning when Nixon slammed the gold window shut on French fingers and picking up speed once the petrodollar system was ensconced, foreign buyers of U.S. debt grew exponentially.

Having the world's most vital commodity exclusively priced in U.S. dollars meant everybody needed to hold large dollar reserves to pay for it and that meant a yuuuge bid for treasuries. It's good to be the king.



By 2015, as the chart on the next page shows quite clearly, there were treasuries to the value of around 6 years of total global oil supply in the hands of foreigners (if we assume a constant 97 million bpd supply which I think is a pretty reasonable estimate).

Now… with that brief background on the petrodollar system, here's where I need you to stick with me. I promise you it'll be worth the mental effort

Ready? Here we go.

Now, back in 2010, then-World Bank President Robert Zoellick caused something of a commotion when he suggested that an entirely new global monetary system maybe wasn't such a bad idea.

The system he had in mind involved a freely-convertible Yuan and, controversially was constructed around gold as its central reference point:

(Robert Zoellick, November 8, 2010): …the G20 should complement this growth recovery programme with a plan to build a co-operative monetary system that reflects emerging economic conditions. This new system is likely to need to involve the dollar, the euro, the yen, the pound and a renminbi that moves towards internationalisation and then an open capital account.

The system should also consider employing gold as an international reference point of market expectations about inflation, deflation and future currency values. Although textbooks may view gold as the old money, markets are using gold as an alternative monetary asset today.

In seemingly unrelated news, two years later, Iran began accepting Yuan in payment for its oil amid US sanctions. The transactions were conducted through Russian banks:

(Financial Times, May 2012): Iran is accepting renminbi for

some of the crude oil it supplies to China…

…Tehran is spending the currency, which is not freely convertible, on goods and services imported from China…

The trade is worth as much as $20bn-$30bn annually according to industry estimates…

The renminbi purchases began some months ago…much of the money is transferred to Tehran through Russian banks, which take large commissions on the transactions…

Beijing has been trying to get its trading partners to use the renminbi, in effect transferring the exchange rate risk to its counterparties, since the price of crude is set in US dollars. It also frees Beijing of the need to hold as many dollars in its reserves.

The crucial part of this deal was that, by diversifying their purchases in this way, the Chinese had found a path towards not only needing to hold fewer U.S. dollar reserves, but to circumventing the petrodollar system altogether.

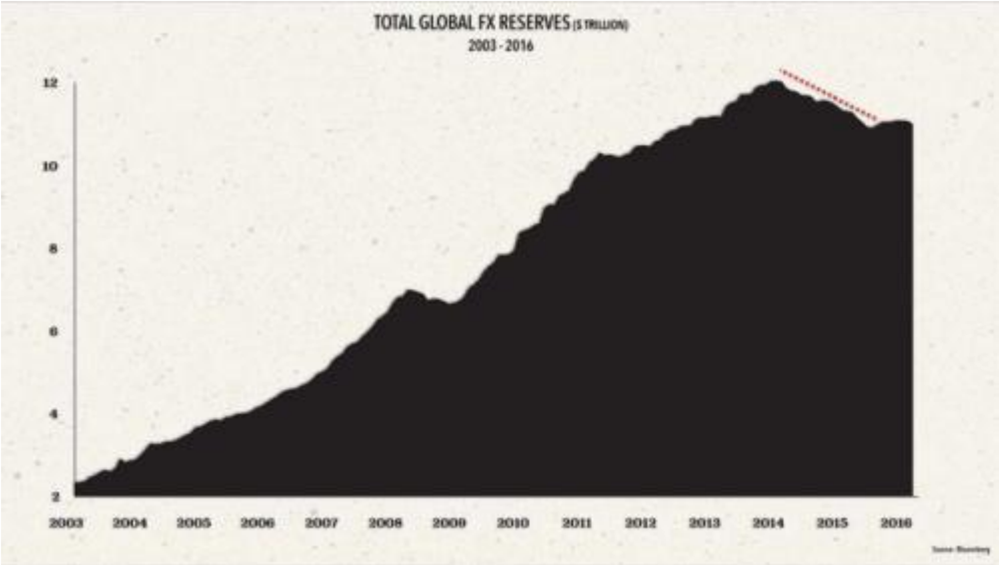
By 2013, the penny had clearly dropped at the PBoC who declared an end to the era of their accumulation of U.S. treasuries:

(Bloomberg, November 2013): The People's Bank of China said the country does not benefit any more from increases in its foreign-currency holdings, adding to signs policy makers will rein in dollar purchases that limit the yuan's appreciation.

"It's no longer in China's favor to accumulate foreign-exchange reserves," Yi Gang, a deputy governor at the central bank, said in a speech organized by China Economists 50 Forum at Tsinghua University yesterday. The monetary authority will "basically" end normal intervention in the currency market and broaden the yuan's daily trading range

Yes, it was, apparently "no longer in China's interest" to accumulate foreign exchange reserves.

Sure enough, in 2014, global FX reserves began to decline at the fastest rate in 80 years as you can see from this chart:



That same year, another piece of the puzzle was laid in place when Xu Luode, the Chairman of the newly-founded Shanghai Gold Exchange, explained that gold would be priced and sold in Yuan as a step towards what he called the “internationalization of the renminbi” (for those of you confused by Yuan and Renminbi, just think of them as the Chinese equivalent of ‘Pound’ and ‘Sterling’):

(Xu Luode, Speech to LBMA, May 2014): Foreign investors can directly use offshore yuan to trade gold on the SGE international board, which is promoting the internationalization of the renminbi…

Shanghai Gold will change the current gold market “consumption in the East priced in the West” situation.

When China will have a right to speak in the international gold market, pricing will get revealed…

Interestingly, Luode acknowledged what he accurately described as the “consumption in the East, priced in the West” situation and assured the world that the ‘real’ price of gold would become apparent once China took its rightful place at the centre of the gold market.

We can but hope he is correct. When that day comes, the change on the world’s gold markets will be unprecedented.

In 2015, another announcement slipped by the world when it was revealed that Russia’s Gazprom would also begin selling oil to the Chinese in exchange for yuan and that they were negotiating further agreements to use rubles and yuan to settle natural gas trading directly, without the need for dollars:

(Moscow Times, June 2015): "Two state energy companies, gas producer Gazprom and its oil arm Gazprom Neft, said they would use more Chinese currency in trade, while Russia's largest bank, Sberbank, has also promoted the use of the yuan…

Gazprom Neft announced that it began settling shipments of oil to China in yuan. And previously, the head of Gazprom, Alexey Miller, said in a TV interview that the company was negotiating with China to use yuan and rubles for gas deliveries via a planned pipeline in Western Siberia.

OK… hands up if you're still with me… great!

Oh… you're reading this so I can't see you but hopefully you're following the dots…

For those of you who aren't, here's a little recap of where we are so far to help you get things into the right order before we push on to the end:

Get it? Got it? Good.

So… here we are, in 2016 and, as it turned out, April was a hell of a month if you were paying attention.

Firstly, the Saudis threatened to sell almost a trillion dollars of U.S. assets—including over $300 billion of treasury bonds—should a bill be passed by the congress allowing the Saudis to be held responsible for the 9/11 attacks:

NY Times, April 16, 2016): Saudi Arabia has told the Obama administration and members of Congress that it will sell off hundreds of billions of dollars' worth of American assets held by the kingdom if Congress passes a bill that would allow the Saudi government to be held responsible in American courts for any role in the 9/11 attacks.

Adel al-Jubeir, the Saudi foreign minister, delivered the kingdom's message personally last month during a trip to Washington, telling lawmakers that Saudi would be forced to sell up to $750B in treasury securities & other assets in the US before they could be in danger of being frozen by American courts.

In a rare show of bipartisanship, the bill was subsequently passed before being vetoed by President Obama who then had to watch in ignominy as he suffered the first veto override of his presidency.

Just days later, the Saudis were the cause of a seemingly surprise failure by OPEC to agree a production cut as the oil price languished in the low-$30s:

(Wall Street Journal, April 17, 2016): DOHA, Qatar—Oil producers that supply almost half the world's crude failed Sunday to negotiate a production freeze intended to strengthen prices.

The talks collapsed after Saudi Arabia surprised the group by reasserting a demand that Iran also agree to cap its oil production.

Oil prices had rallied in recent weeks on speculation that Saudi Arabia might successfully lead an initiative between members of the Organization of the Petroleum Exporting Countries and Russia, which joined the talks.

A deal would have marked a new level of cooperation between non-OPEC countries and OPEC members that producers hoped would keep prices above January lows of $26 a barrel.

Just 48 hours after that surprise, the Chinese finally launched their twice daily gold fixing, setting the price at 256.92 yuan per gram:

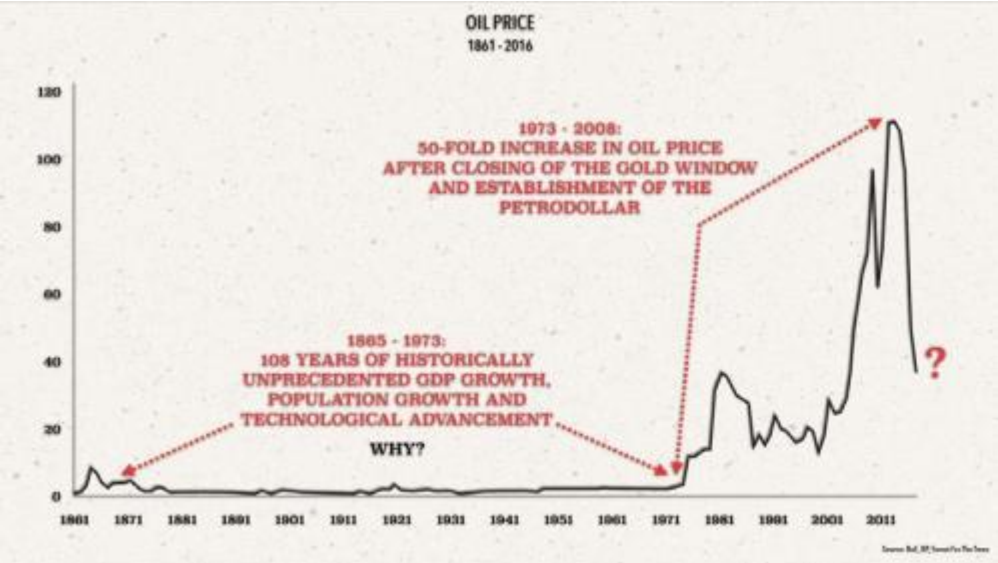
(Bloomberg, April 19, 2016): China, the world's biggest producer and consumer of gold, started a twice-daily price fixing on Tuesday in an attempt to establish a regional benchmark and bolster its influence in the global market.

The Shanghai Gold Exchange set the price at 256.92 yuan a gram ($1,233.85 an ounce) at the 10:30 a.m. session after members of the exchange submitted buy and sell orders for metal of 99.99 percent purity.

"This is a very important development and will obviously be very

closely watched," said Robin Bhar, an analyst at Societe Generale SA in London. "But as long as it exists inside a closed monetary system it will have limited global repercussions. It could be a very important development if the new benchmark is a precursor to greater use of gold in the Chinese monetary system, Kenneth Hoffman…said by e-mail on Monday. It may also boost interest in the Shanghai free-trade zone, he said.

As Soc Gen's Robin Bhar correctly identified, if the ability to trade gold for yuan exists within a closed monetary system, its importance will be limited BUT, as Bloomberg's Ken Hoffman also correctly pointed out, if this was the thin end of the wedge, things could get very interesting indeed. Now, this chart shows the oil price going back to before the U.S. Civil War:



Between 1865 and 1973, the price of oil was incredibly stable against a backdrop of perhaps the greatest simultaneous economic, demographic and technological expansion in human history.

How was that possible?

Well simply put, because oil was effectively priced in gold.

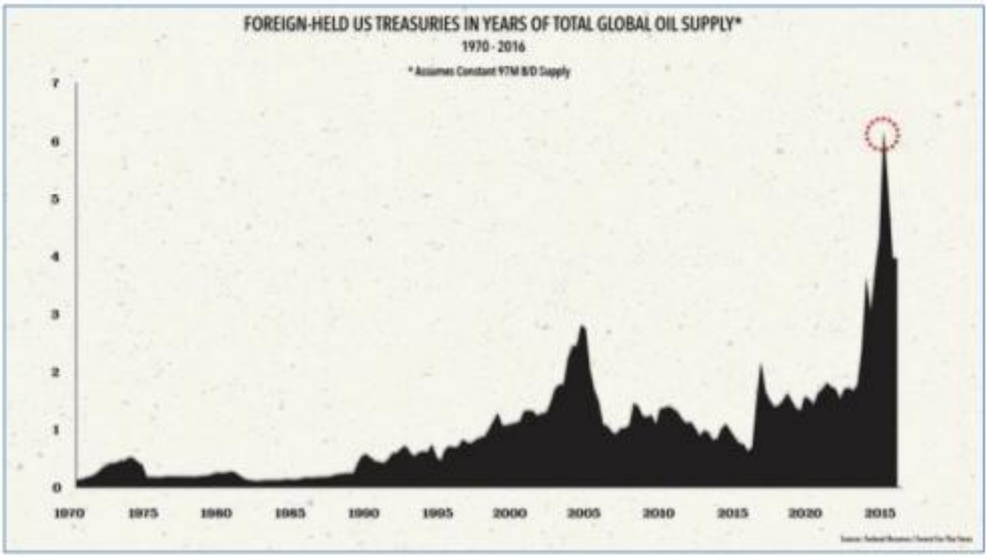
However…

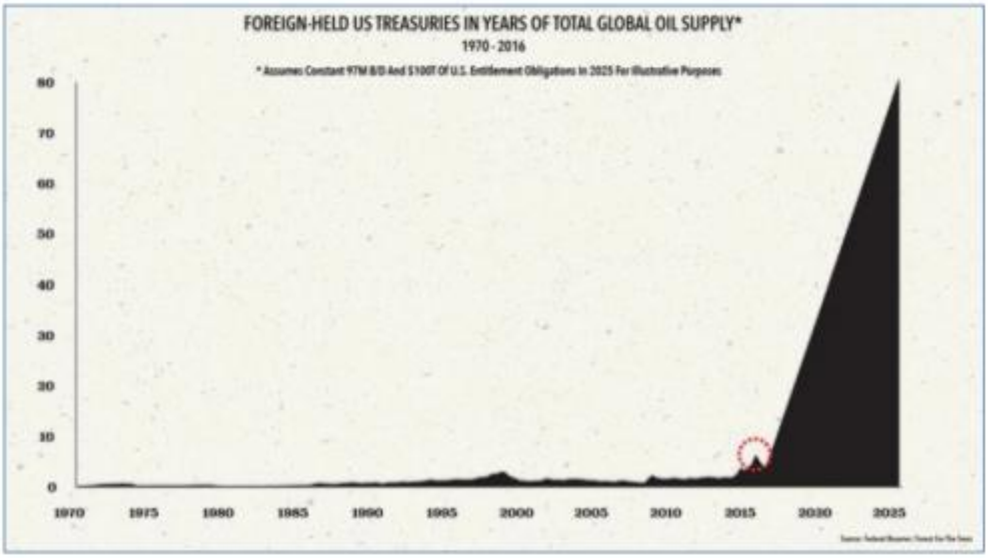
Once the gold window closed and the petrodollar system was implemented, the price of oil soared 50-fold in just 35 years.

The move on the right? With the question mark against it? We're getting there, I promise.

Now, you remember this next chart and the yuuuuuge supply of treasuries which exists compared to oil now? Well, when we add in the roughly $100 trillion in boomer entitlements that will need to be paid for by issuing—you guessed it, more treasuries—the chart changes somewhat:

That red circle down at the bottom of the second chart is the spike you see on the first chart.


FOREIGN-HELD US TREASURIES IN YEARS OF TOTAL GLOBAL OIL SUPPLY*
1970 - 2016
* Assumes Constant 97M B/D Supply
0
1
2
3
4
5
6
7
1970
1975
1980
1985
1990
1995
2000
2005
2010
2015
2020


FOREIGN-HELD US TREASURIES IN YEARS OF TOTAL GLOBAL OIL SUPPLY*
1970 - 2016
* Assumes Constant 97M B/D And $100T Of U.S. Entitlement Obligations In 2025 For Illustrative Purposes
0
10
20
30
40
50
60
70
80
1970
1975
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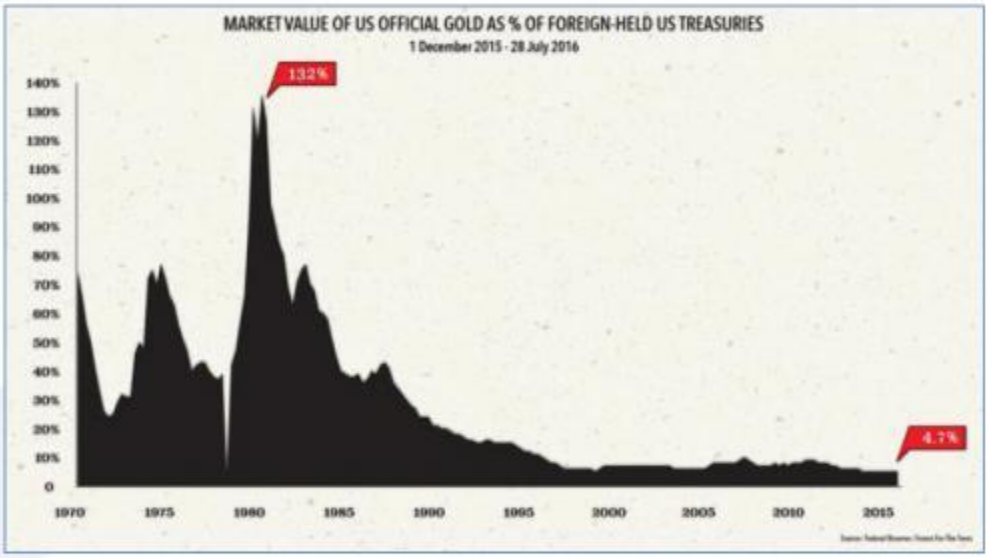
2005
2010
2015
2020
2025


MARKET VALUE OF US OFFICIAL GOLD AS % OF FOREIGN-HELD US TREASURIES
1 December 2015 - 28 July 2016
132%
4.7%
0
10%
20%
30%
40%
50%
60%
70%
80%
90%
100%
110%
120%
130%
140%
1970
1975
1980
1985
1990
1995
2000
2005
2010
2015

Ruh-roh!

It's safe to say that, relative to even oil, and without any infrastructure spending by Donald Trump, treasuries are going to be…. abundant in the coming years.

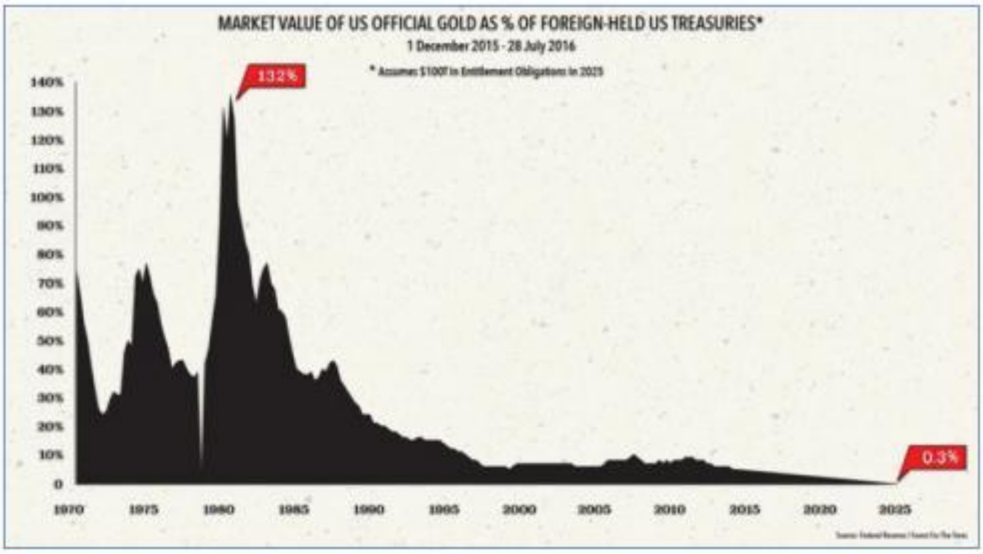
Conversely, if we look at the value of gold relative to foreign-held treasuries, we see an altogether different story unfold.

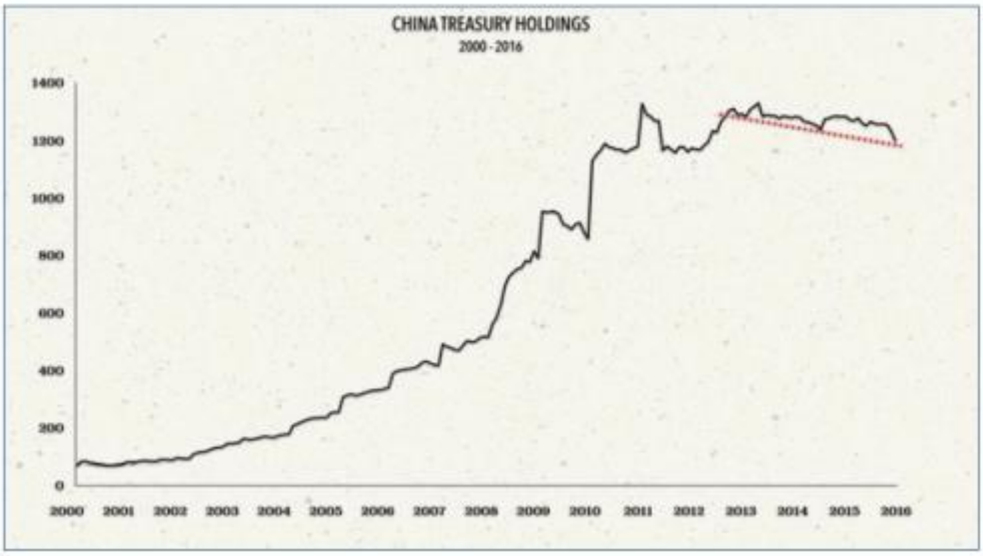
During Reagan's presidency, US treasuries were backed 132% by the market value of the country's gold reserves.

Today, that number has fallen to just 4.7%

If we do the same thing and account for the $100 trillion in entitlement promises, as you can see from the chart on the next page, the number falls to 0.3% in 2025.

So the second chart (below, right) should come as no surprise to anybody.





Yes, the Chinese have started to do what they promised to start doing, when they promised to start doing it.

Now, this next part of the presentation was a rattle through a whole bunch of charts showing the recent activity in the U.S. treasury, corporate bond, agency bond and securities markets so you'll have to brace yourself.

The charts will appear on the next page.

Chinese sales of US treasuries (1) have been consistent for the last three years…

…as have their sales of US securities (2) since 2015 after plateauing in 2013 when treasury divestiture began Concurrently, Chinese sales of corporate bonds (3) have accelerated over the same period…

…though agency sales (4)—despite a few periods of consistent selling—have yet to follow suit.

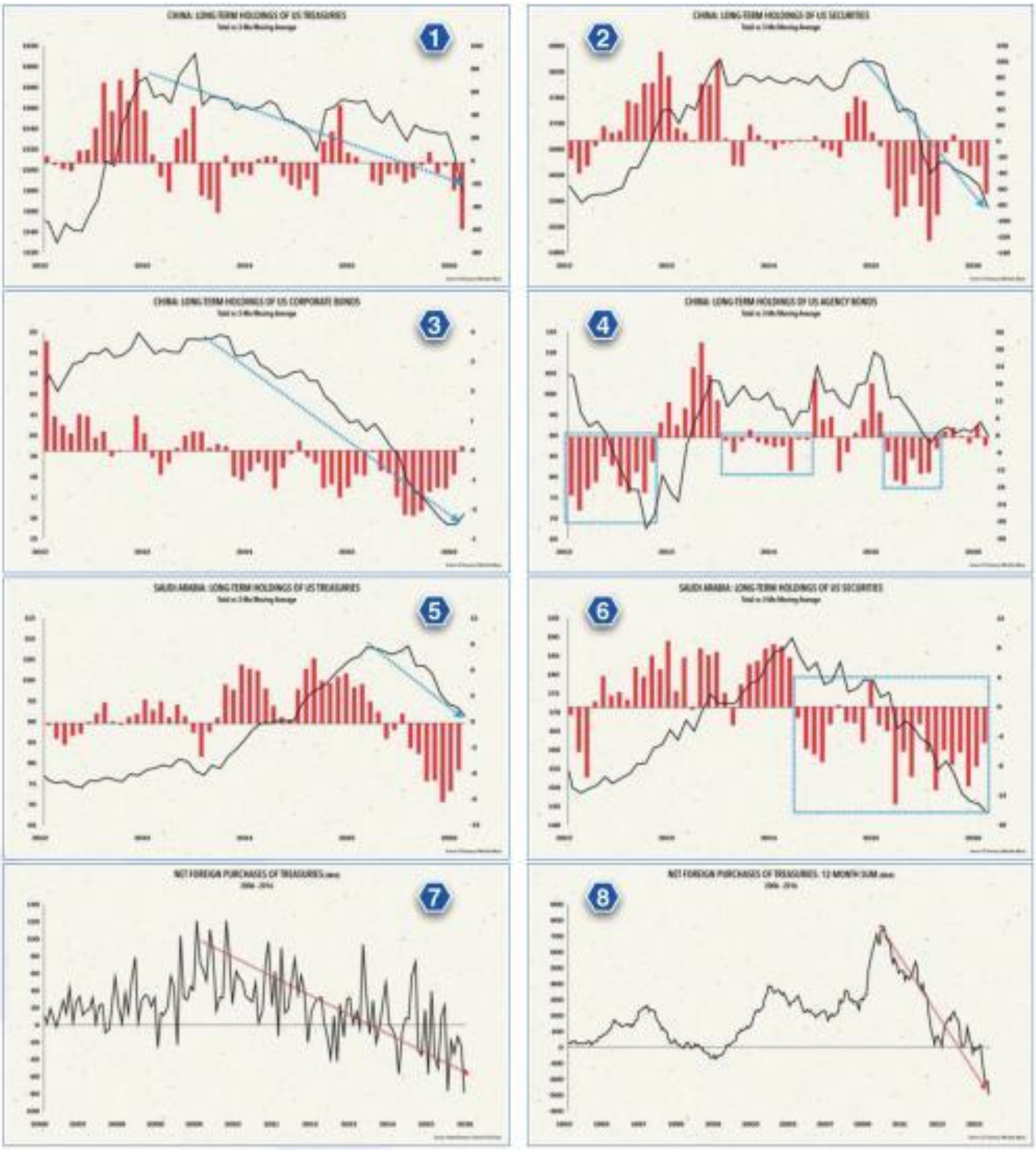
But now, as tensions rise and the cross-currents get harder to discern, guess who else has showed up as a seller?

That's right, the Saudis are now steady sellers of US treasuries (5)…

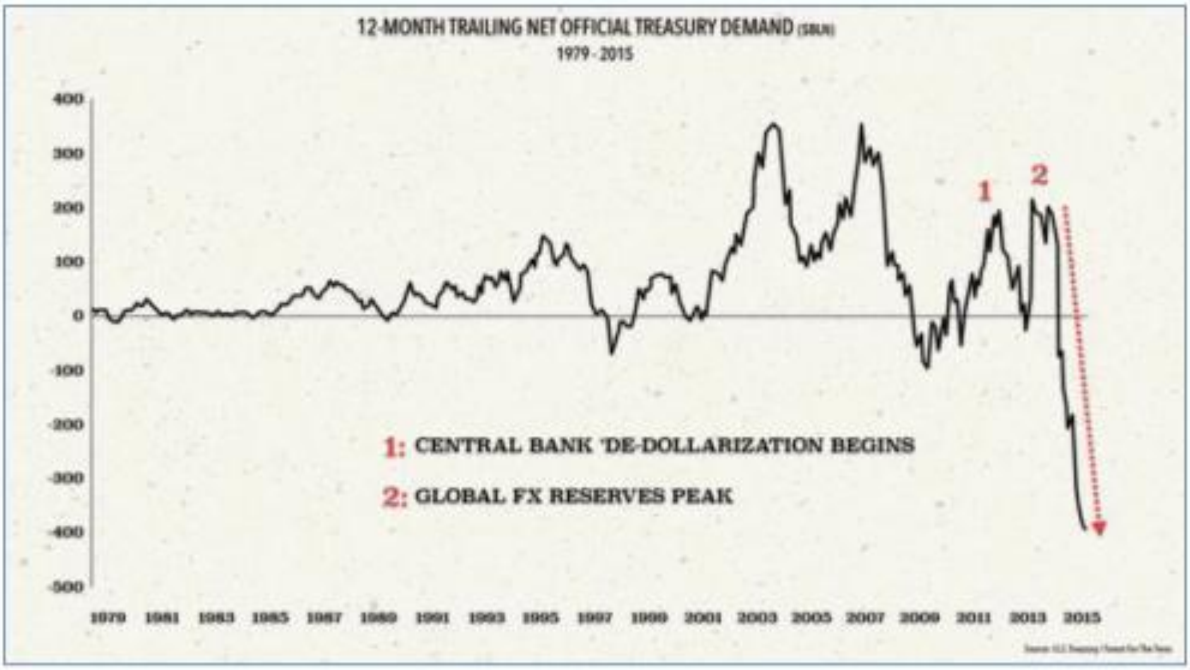
…and even more aggressive sellers of U.S. securities (6)…

Meanwhile, taking a broader view, net foreign purchases of treasuries, according to the TIC data, have been in a clear downtrend since 2009 (7) and have been largely outflows for the last three years.

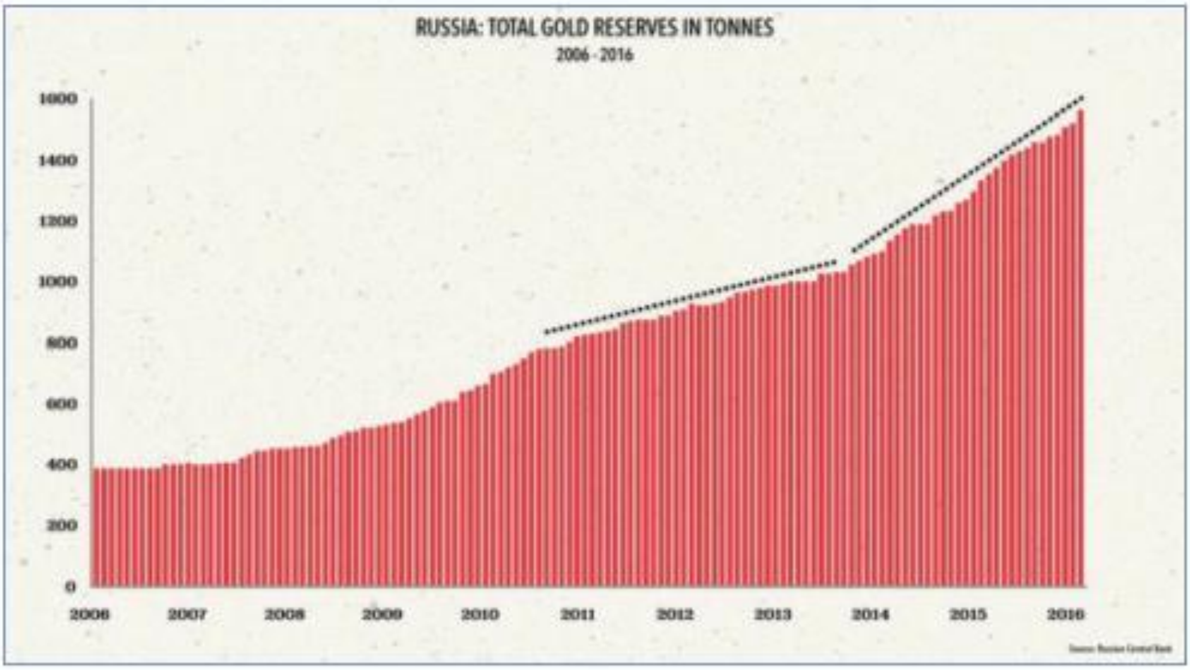
If we look at the 12-month sum of sales (8), we see an even sharper decline…



…and if we take the trailing net official demand chart for treasuries back to 1979, the scale and extent of the change is evident—as are the catalysts for the acceleration (and we're back on this page once again):



12-MONTH TRAILING NET OFFICIAL TREASURY DEMAND
1979 - 2015
1: CENTRAL BANK 'DE-DOLLARIZATION BEGINS
2: GLOBAL FX RESERVES PEAK



RUSSIA: TOTAL GOLD RESERVES IN TONNES
2006 - 2016

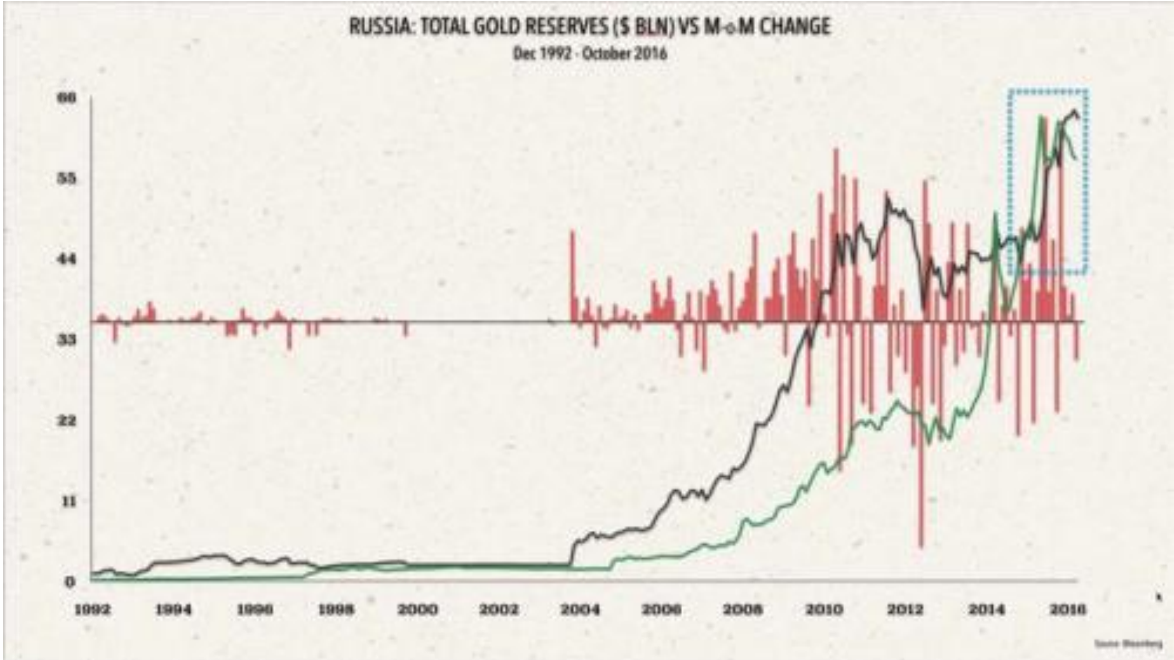
RUSSIA GOLD RESERVES: M-o-M CHANGE IN TONNES
2006 - 2016

Take a long, hard look at that last chart folks—particularly within the context of the bond bull market and the 'bid' for treasuries we've seen throughout 2015 and 2016…

Meanwhile, the Russians—who, as we've seen are now selling oil for yuan to the Chinese, remember?— have been picking up the pace of their accumulation of gold reserves yet again, with the most recent monthly data setting yet another record…

…and the pick up in pace is evident when we look at average monthly purchases prior to 2013 and post the agreements put in place around that time between the various parties. Now, the next chart (top of the following page) is crucial to understand because a look at the market value of Russia's gold reserves shows just how crucial their ongoing accumulation of bullion has been for the country's finances over the last two years…

…and that increase in value has cushioned the effects of, amongst other things, the bailing out of the ruble.



As you can see from the green line, Russia's gold reserves in Ruble terms have soared as the country's currency has weakened—something which confounded all the doommongers who called Game Over for Russia amidst sharply declining oil revenues:

(Bloomberg, April3, 2015): Here's why Governor Elvira Nabiullina is in no haste to resume foreign-currency purchases

after an eight-month pause: gold's biggest quarterly surge since 1986 has all but erased losses the Bank of Russia suffered by mounting a rescue of the ruble more than a year ago.

While the ruble's 9 percent rally this year has raised the prospects that the central bank will start buying currency again, policy makers have instead used 13 months of gold purchases to take reserves over $380 billion for the first time since January 2015.

Hmmm…

Now, crucially, being given the ability to sell oil to the Chinese for yuan and buy gold with that same yuan directly through the Shanghai Exchange has completely changed the game for the Russians and those changes are being reflected where they matter most—in the energy markets, the supply/ demand dynamics of which are quietly morphing in plain sight.

By Augu of this year, Russia had overtaken Saudi Arabia as the largest exporter of oil into China…:

(Al Awsat, August 3, 2016): During the first seven months of this year, China imported about 30.5 million metric tons of Saudi oil, a 0.4% decrease than that of last year. Whereas, China imported about 29.5 million metric tons of Russian oil with 27% increase than last year.

…and that wasn't something the Saudis could take lying down:

Amid this fierce competition, it is important for Saudi Arabia to fortify its oil position in China with more political and strategic support

On the contrary, they rededicated their efforts to increase what they call "political and strategic support" for China.

Now, I hope you're all still with me because here's where we get to the final piece of this glorious puzzle—the piece that ties all these seemingly unrelated threads together: China's own crude oil futures contract, to be priced in Yuan and traded at the Shanghai

International Energy Exchange—a yuan contract which will be made fully convertible:

(**Bloomberg, November 5, 2015): By the end of 2015, China, the world's No. 1 oil importer as of April, may start its own crude futures contract.**

The idea is to establish a Chinese rival to the world's two most traded oil contracts: West Texas Intermediate, housed on the New York Mercantile Exchange, and Brent Crude Futures, owned by ICE Futures Europe in London.

The yuan-based contract will trade on the Shanghai International Energy Exchange and will be among the first Chinese commodity contracts available to foreign investors as China promotes global use of its currency…

Participation will be open to all foreign investors and the yuan will be fully convertible under the contract, according to Song Anping, the chairman of the Shanghai Futures Exchange.

As you can see from the date of the article, this contract has been postponed several times— ostensibly for reasons such as stock market volatility in China, but perhaps there is more going on behind the scenes that is causing the delay because, once this contract is in place, things change.

Dramatically.

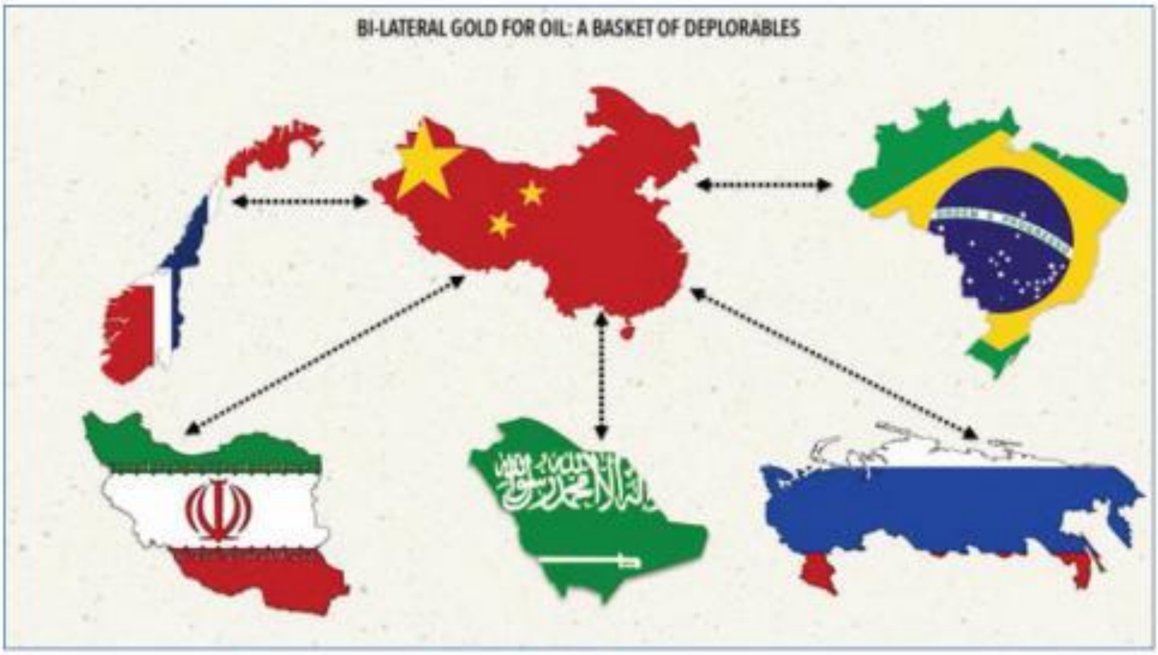
In the interim, China has supplanted the U.S to become the world's biggest importer of oil, which serves to increase both its importance in the oil markets and the likelihood of it launching its own yuan-denominated contract at some point in time:

(Bloomberg, October 13, 2016): China is now the world's biggest oil importer, unseating the U.S. The country's crude imports climbed to a record 8.08 million barrels a day in September, a year-on-year increase of 18 percent, customs data released Thursday showed.

So, the world's largest exporter of oil is now dealing with the largest importer directly in yuan and it has the ability to convert those yuan proceeds into physical gold through the Shanghai exchange— which the data suggest it is doing as fast as possible.

Currently, the bilateral oil for gold trade is only available to what the U.S. would no doubt consider a ‘basket of deplorables’ in Iran and Russia…but just think what happens once that fully convertible oil contract is up and running…?

Suddenly, the availability to price oil in gold is available to everybody and, given rising Saudi/U.S. tensions and the Middle East nation’s recent rededication to providing “political and strategic support” to China it’s easy to see why this would be attractive to the Saudis, for example.



REUTERS

FINANCIALS

Shanghai signs Dubai as 1st foreign exchange to use its gold fix for futures products

Oct 28 The Shanghai Gold Exchange (SGE) has signed a deal to allow the Dubai Gold & Commodities Exchange (DGCE) to be the first foreign market platform to use its new yuan-based gold fix to develop derivative products, the Chinese exchange said on Friday.

The Dubai exchange will use the yuan-denominated gold price as a benchmark to launch a Shanghai gold futures contract, SGE said in a statement, the latest step in a broad push by top consumer China to increase its power and influence over bullion pricing in the global market.

Tokyo Commodity Exchange to launch Physical Gold Market

JULY 14, 2016 — BY VALENTINA KIRILOVA 0 COMMENTS

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The Tokyo Commodity Exchange Inc. **(TOCOM) has announced today that July 25th will be the start date of new Gold Physical Transaction**, pending regulatory approval. Gold is the most actively traded commodity at the Exchange with both futures and options contracts listed.

Simultaneously, TOCOM will introduce a delivery at settlement option for the Gold Rolling Spot contract. Originally a cash-settled contract, the change is expected to better serve investor needs.

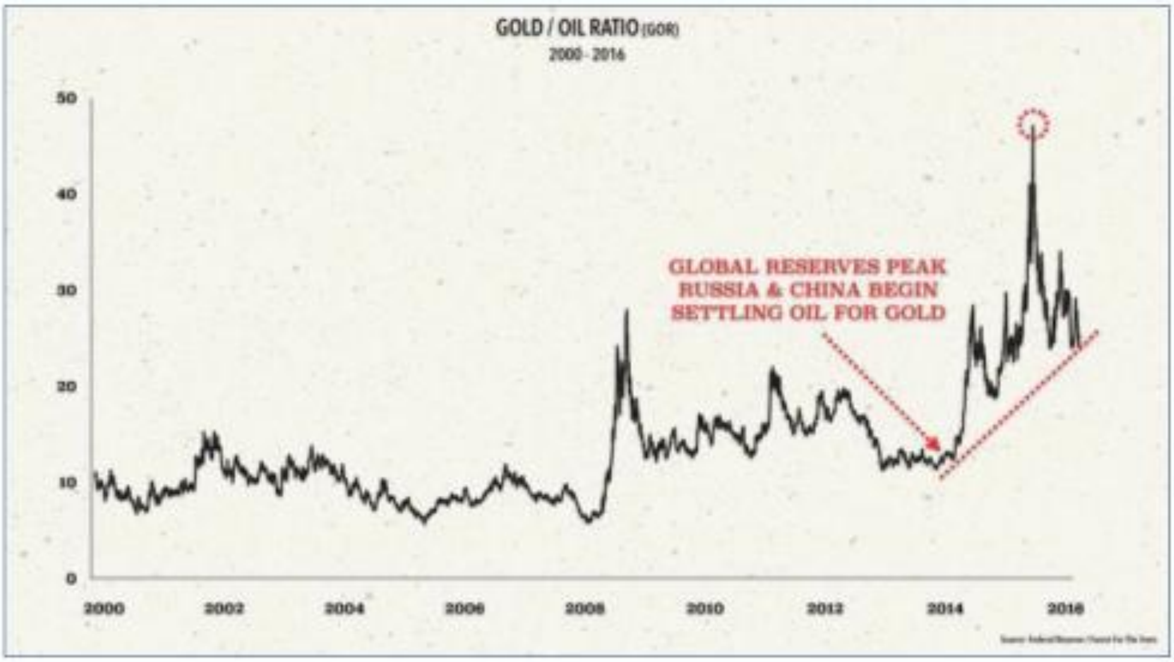
Whatever happens, opening that contract creates a market-wide arbitrage opportunity which affords anybody with oil to sell the ability to exchange said oil for gold and anybody wanting oil to acquire it cheaply by buying cheap gold in the West and shipping it to Shanghai or HK where it can be sold for yuan.

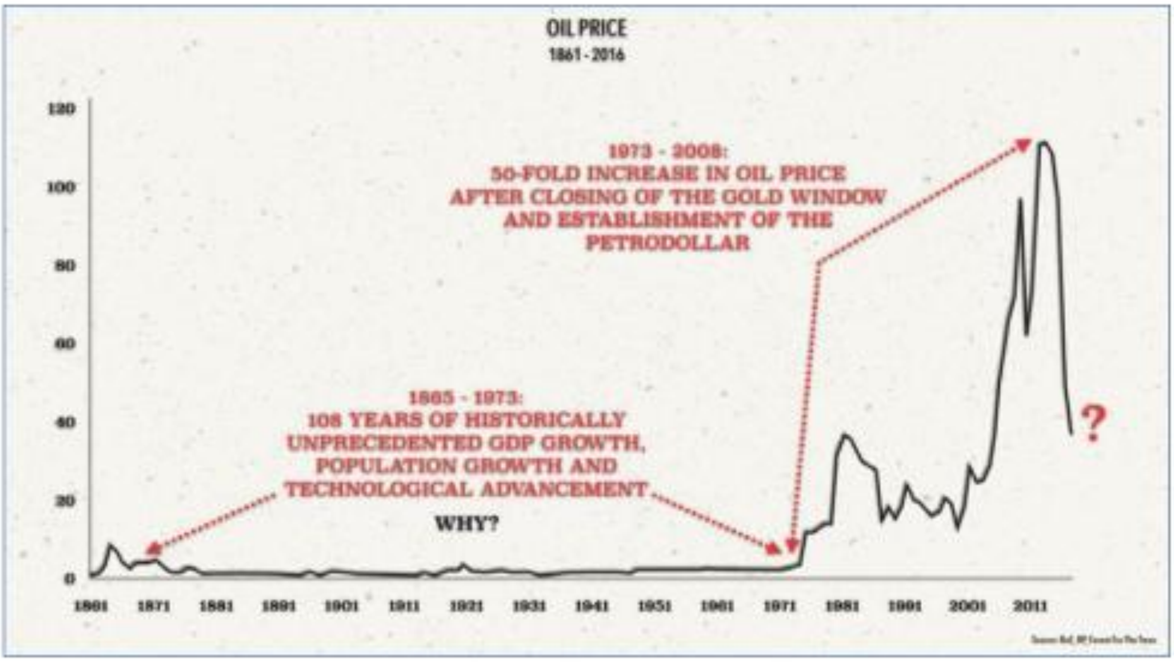
Already, places like Tokyo, Seoul and Dubai are opening physical gold markets and discussing linking their nascent markets for bullion to the Shanghai exchange which has rapidly become the largest physical delivery market in the world.

Now, were this arbitrage to begin happening in any meaningful size, with the market for oil far bigger than that for gold, it would immediately be evident in the ratio between the two commodities…

…which, interestingly, is precisely what has happened since the peak of global reserves in 2014 and the Sino-Russian agreement to essentially transact oil for gold. With those conditions in place, the gold/oil ratio has broken out to its highest level in 80 years (chart, next page):

…which brings us right back to the question mark on the second chart which we left hanging like a matzah ball earlier in this presentation



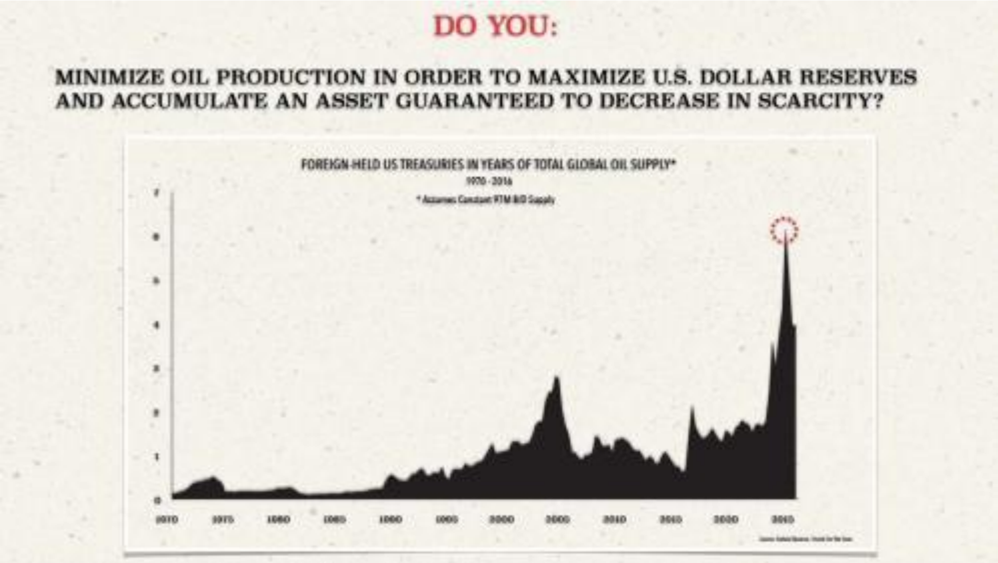


The recent move in the oil price looks to me suspiciously like a sign that a move has started to return to pricing oil in gold.

That move, if indeed it is happening beneath the surface, allied with the endless possibilities enabled by the potential full convertibility of the yuan under the Shanghai-based oil contract leaves oil producing nations with a rather obvious choice for the first time in almost half a century—a choice made perfectly clear by the two charts on the next page:

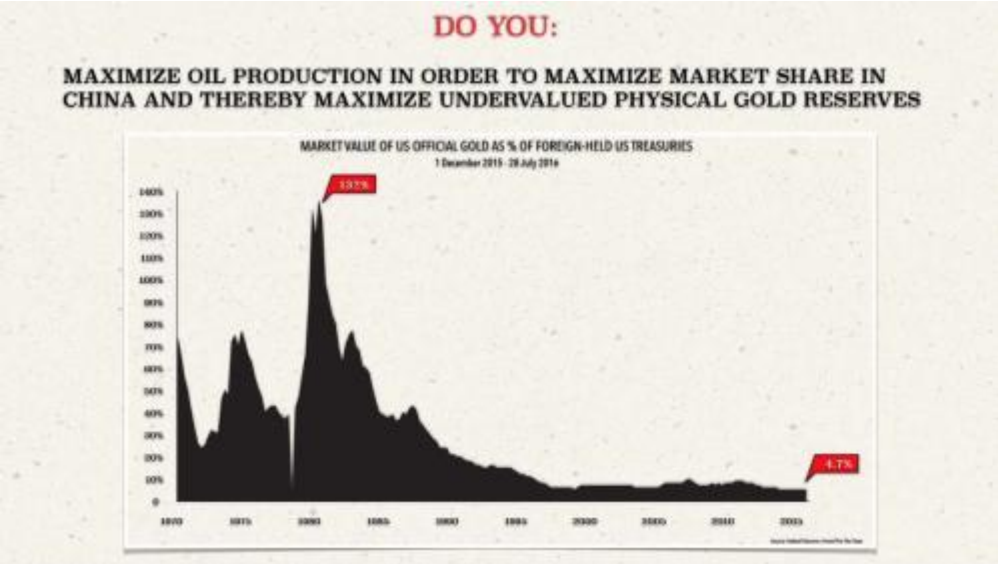
If you are an oil producing country, do you…:

MINIMIZE your production in order to MAXIMIZE your holdings of one of the most abundant and easily-produced commodities in the world—U.S. treasuries—as has been the case for the last 40 years… knowing full well that, with the level of entitlements due in the next decade, more will need to be printed like crazy?



Or……

Do you MAXIMIZE production in order to gain the largest possible market share in the biggest oil market in the world and, through the ability to buy gold for yuan, thereby maximize your reserves of a scarce, physical commodity which is impossible to produce from thin air and which happens to be not only the most undervalued asset on the planet, but is trading at its most undervalued relative to U.S. treasuries in living memory?



With an annual production of $170bn, gold is by far the largest metal market by value.

However, that figure is dwarfed by the oil market which is 10x the size of the gold market on an annual production basis.

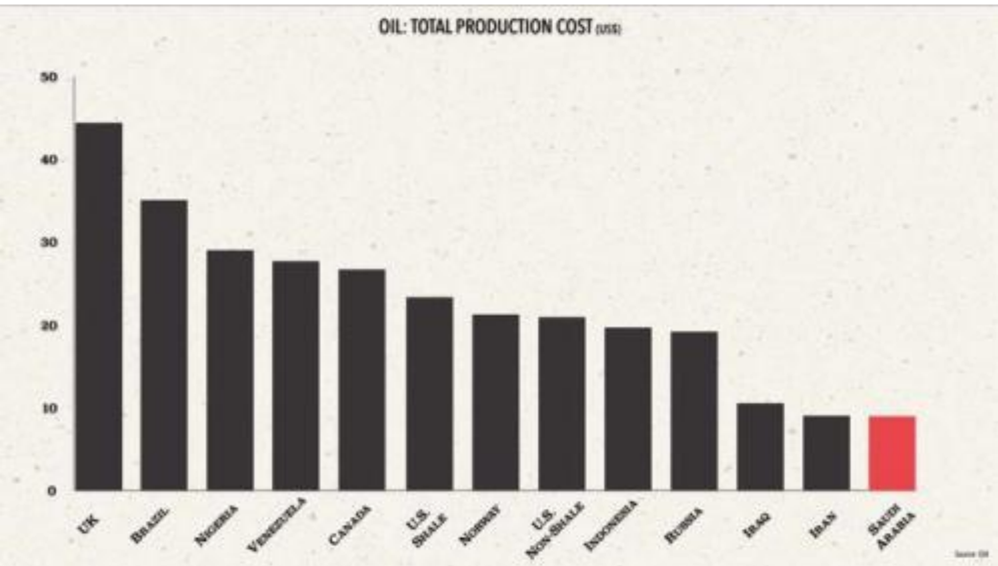
If we throw in the average annual foreign holdings of U.S. treasuries over the last 2 years, we see that the ‘other’ commodity is at a different magnitude altogether.

So, which one of these commodities has any scarcity value? Given the choice, which one would you seek to maximize your holdings of?

U.S. treasuries which can be conjured out of thin air by the U.S. government and which, are described thus by The Securities Industry and Financial Markets Association:

Because these debt obligations are backed by the "full faith and credit" of the government, and thus by its ability to raise tax revenues and print currency, U.S. Treasury securities – or "Treasuries" – are generally considered the safest of all investments. They are viewed in the market as having virtually no "credit risk," meaning that it is highly probable your interest and principal will be paid fully and on time.

Or how about oil? Which the Saudis, for example, can simply print pull out of the ground at will at a cost of a little under $10/barrel?



Or gold? A commodity which is limited in availability, trading at its all-time low relative to U.S. treasury supply and is not only getting harder and more expensive to produce, but which is also catching the eye not only of the central banks of the world's two largest producers, but of the largest importer and largest exporter of oil?