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Rock-paper-scissors

Award for Most Arresting PowerPoint Slide at the *Grant's* conference goes to John Hathaway, co-portfolio manager of the Tocqueville Gold Fund. We display it nearby. Depicted is the ratio between the number of ounces of gold represented by the open interest in Comex gold futures trading (the numerator) vs. the number of ounces of gold available for delivery on the Comex (the denominator). The plot resembles the flight path of a 1999-era Internet stock.

What do the data say? That, as of Oct. 23, open interest totaled 467,868 contracts, each contract a claim on 100 ounces of gold, for a grand total of 46,786,800 theoretical ounces. On the same date, gold available for delivery on the Comex totaled only 202,333 physical ounces, thus producing a ratio of paper gold (open interest) to God's own metal (deliverable ounces) of 231.2:1. It's a reading some 10 times higher than the average one can observe from the year 2000.

The data illustrate that Comex trading is settled almost entirely in cash. And they underscore that bullion is moving East, chiefly to China, where the Shanghai Gold Exchange may soon displace the Comex as the world's No. 1 gold-trading hub, and to India.

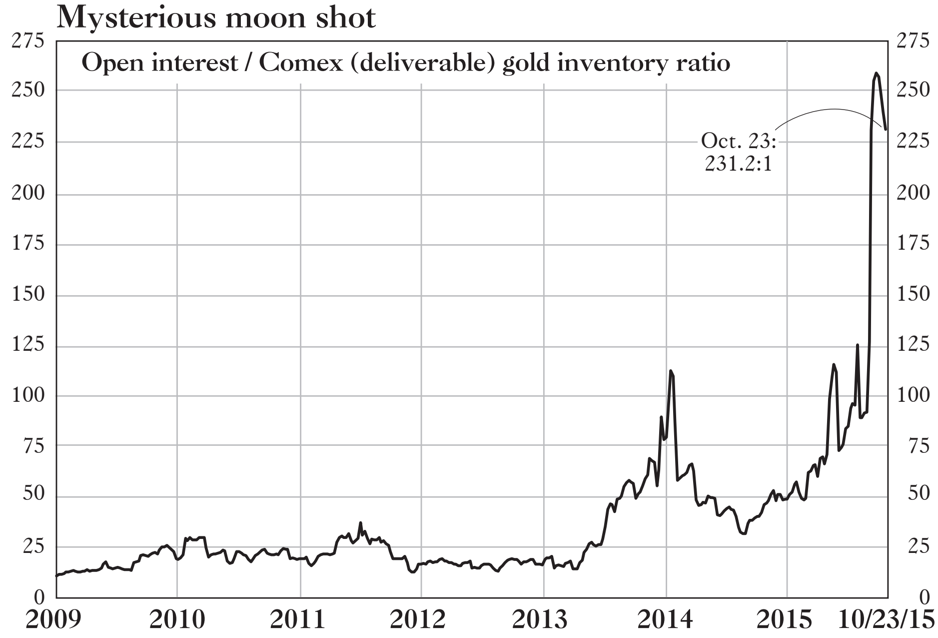
Beyond those observations, even knowledgeable people guess. "The part that we never know is the counterparty," a lifelong gold-mining and -investment practitioner tells colleague David Peligal. "Banks might buy GLD [the gold exchange-traded fund] and then short it. What you don't know is the trade they do on the private side. They may have already sold to the client the same amount of gold. Or they may have repurchased it in a different form from clients by devising instruments that you don't know anything about. The banks are not crazy. They are not going to go naked [short] on 1,000 tons of gold when they know there is no physical gold."

Leave it to Wall Street to turn a guiltless component of the Periodic Table into a kind of neo- subprime mortgage-backed security. Certainly, gold-related financial engineering is mysterious. What we don't understand is why the ratio of paper gold to metallic ounces has suddenly taken to zooming.

Peligal called Hathaway after the conference to ask if the spike in the paper-to-physical ratio might be evidence of the growth in some giant carry trade—for instance, selling gold for dollars and investing the proceeds in Treasurys. "I'm not sure it's a carry trade," Hathaway replied. "There probably is some of that. A lot of it is high-frequency day trading. I think it's more of a pair trade. It's like being long the DXY [dollar index] and short gold. Or you can be short [gold] in options. It can take many forms. But the thought process is largely 'strong dollar because other currencies are weak.' And how do you hedge that? You short gold. I think there is a lot of that going on."

One wonders if the Fed is on board with the strong-dollar trade. Members of the Federal Open Market Committee mentioned the dollar 11 times last month, minutes of the September meeting reveal. Not once did the speakers sound happy about the greenback's

Mysterious moon shot



relative strength. The Federal Reserve Bank of Atlanta, compiler of real-time national-income data, is currently predicting growth in third-quarter GDP at the annual rate of just 0.8%. The CFO of Fastenal Co., a leading distributer of nuts and bolts and myriad other industrial supplies, issued its own GDP status report on the Oct. 13 earnings call. "The industrial environment is in a recession," Daniel L. Florness, the chief financial officer, told dialers-in. "I don't care what anyone says because no one knows that market as we do. . . . We touch 250,000 active customers a month." Nor is economic weakness isolated in the 50 states. Caterpillar, Inc.'s complaints echo those of Electrolux AB; those of A.P. Moller-Maersk, the world's largest sea borne transportation group, comport with those of the Japanese air-cargo shippers. And if the Fed is not on board with the strong-dollar trade, might it discreetly cheer a weak-dollar alternative?

Hathaway—we return now to the Plaza Hotel—closed his talk with a pitch for NovaGold Resources (NG on the Mkt wing of the Big Board). It's an idea that he—and we—have pitched before (e.g., *Grant's*, Jan. 10, 2014), and at least one conference-goer got up and left the hall rather than subject himself to the temptation to buy more of what, to put it charitably, has not worked lately.

"To me," said Hathaway, launching into NG, "it is the perfect example of why you would own a gold stock. It has optionality to the gold price. We called Morgan Stanley and asked what would it cost us to get an option on 100,000 ounces of gold 10 years out. I don't think they took it seriously, but they quoted a premium of roughly $400 for a strike price of $1,340. Your all-in cost, should you exercise the option, would be $1,700, and you would be losing the use of that money for 10 years.

"If you look at NovaGold and you take the market cap, you are buying assets in the ground at $70. That's your option cost. The rest of it—Capex, operating costs, all that—you don't spend that until gold prices are in the clear and it is a discretionary choice by management. You have that gold. The gold is defined, it is permitted and NovaGold is well-financed, and they have more than $100 million. The burn rate is low. It is the best potential new mine in the world, and it is located in Alaska, so it is a great jurisdiction.

"To me, this is why you think about a gold stock: You have dynamic exposure to the upside. Believe me. First of all, you probably couldn't trade the option, you would probably have to exercise it. You can trade a security. Its response to higher gold prices is going to be much different than what you would have with the option I just described. That's NovaGold."

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