Jeffrey Snider: Since 2008 major turning points in Gold have been punctuated by Eurodollar anomalies

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Erik: Joining me next on the program is [Alhambra Investments] Chief Investment Officer, Jeffrey Snider. Our regular listeners, I'm sure, recognize Jeff's name. Because of course he's been the star of Eurodollar University, which is still available at [macrovoices.com/edu] (edu is for Eurodollar University). That is a very in-depth examination of the Eurodollar system.

We're going to take a look today, though, at gold – coming from a different perspective. Jeff's experience and knowledge of the Eurodollar system uniquely qualify him to understand a bit deeper picture than you hear and read about on the internet when it comes to gold.

Jeff has provided an outstanding slide deck to accompany this interview. You're definitely going to want to download it. You can find the download link in your Research Roundup email. If you're not yet registered just go to macrovoices.com and look for the [download instructions] next to Jeff's picture on our home page.

Jeff, why don't we go ahead and dive right into your slide deck here? As you talk about the history of paper gold, starting on Slide 4 you talk about the "gold swap." And I think that's a really important concept. A lot of people know that central banks engage in these gold swaps, but, frankly, a lot of us don't understand the backstory of why they do this, how it affects the system, and what the mechanics are.

So, what are gold swaps? Why do central banks engage in them? And how did this all come about?

Jeff: Thank you, Erik. I think the first gold swap, or at least the first recorded instance of a gold swap, is a good place to start. There were some gold swaps that happened earlier in the 19th century. But at least the for one in 1925 there is some recorded history with it and some information about it.

I think that your listeners, at least those who are interested in gold, are going to recognize the year 1925 for its significance. Which was that the United Kingdom in that year went back to the gold standard after being off of it since the beginning of World War I. Winston Churchill had insisted that, if the UK were to go back on the gold standard, that it do so at the pre-war parity. Which meant that there was significant strain in the financial markets and in the economy for doing so.

The US central bank, the Federal Reserve, stood ready to aid the Bank of England in trying to defend the pre-war parity, despite all of those of difficulties. And one of the ways in which it did was this first gold swap in 1925.

Essentially, what happened was the Federal Reserve Bank of New York on behalf of the Federal Reserve system made $200 million of gold bullion available to the Bank of England for its disposal in whatever transactions it might take in defending sterling at that pre-war parity price.

What's important about that is that it aids both sides of the equation. Because the way a gold swap works is that, essentially, the central bank agent that is providing the gold exchanges it for what's called a gold receivable.

If you look at Slide 5, for example, I've sketched out roughly what this gold swap meant. $200 million in gold was made available to the Bank of England, which it would then sell in the market for sterling at the price that it wished to defend. They put the sterling currency into an account in London on behalf of the Federal Reserve Bank of New York.

So what really happened was gold disappeared from New York and ended up as cash in the UK denomination in London. But, for accounting purposes, the Federal Reserve Bank of New York showed a gold receivable where gold used to be.

You've heard the expression "as good as gold." In this case it's literally taken to be that. A collateralized account on behalf of a counterparty central bank was, in the thinking of people in New York and London, as good as having gold.

Because if (for whatever reason) the Federal Reserve Bank of New York needed its gold back, there was sterling in an account where it could theoretically buy it back. So the gold receivable was taken as equivalent to actually having bullion on hand in a vault in New York City.

So both parties were satisfied. The Federal Reserve Bank of New York got to continue reporting the same amount in its possession, while the Bank of England was supplied additional metal in order to help defend the sterling at pre-war parity.

Erik: So, basically, England goes back on the gold standard, and says that our pound sterling is worth just as much as it used to be in gold. The open market says, no way. If that's true, we'll take the gold.

That means they don't have enough gold. They borrow some, effectively, through this gold swap from the US central bank. But the way that the accounting works is they're basically pretending they didn't give that gold away, which really got sold to people in England who recognized that the pound sterling wasn't worth what the government said it was worth.

What's happening is the gold is coming off of the reality of the balance sheet, but it's not being taken out of the accounting. Is that still the way that things work today? And what is Slide 6 telling us?

Jeff: Yes, that's exactly the convention as it stands now. Again, there are legitimate reasons for it. You could make the case that a gold receivable is as good as gold, because you're not likely to default from a counterparty central bank. In other words, if the Federal Reserve Bank of New York asked for its gold back, the Bank of England is not going to refuse. It's going to happen.

In the modern conventions, that's still the case. What Slide 6 shows us is that in the conventions of the International Monetary Fund – when this question was raised in 1999, the ruling, the convention, was that on official reports to the International Monetary Fund central banks and other government official agencies are not required to disclose how much gold they have, as distinct from gold swaps or gold receivables.

So those two things are combined. Because in the conventions of how these things work internationally, those two things are taken as equivalent. Even though, essentially, they're not.

You were right to point out the fact that the metal kind of disappears into the market with the promise that some other central bank at some other time will buy it back at some future point, if it's ever desired to be converted into actual bullion.

That is an important point here in terms of actually analyzing what a gold swap is. It dislodges stored physical supply into the marketplace in a way that it's hidden. And it's often confusing.

Erik: So we're taking gold out of a vault and selling it on the open market. But, because the party that did the selling was a central bank, their credit is considered to be bullet-proof. And so, for accounting purposes, we're going to pretend the gold is still in the vault.

Am I exaggerating to say that that's the way this works?

Jeff: That's the way this works. And of course it opens the door to all sorts of conspiracy theories. Because, obviously, people have argued, and do argue still, that if there's more receivables than gold, then there's no gold left. And how would anybody know the difference?

And the point of fact is we don't know the difference. We don't know how much gold has ever been swapped out. And how much gold remains. Because nobody has ever been required to make a distinction there.

Our interest here is defining why that would be. Why are central banks interested in doing this kind of transaction? Other than the fact that they are intentionally trying to mislead the public, which I don't think is the case.

Again, there are legitimate reasons for all of these things to happen. You may not agree with why they're being done, or the times of when they're being done, but there are legitimate reasons for this.

And one of the things that I think it's important to understand is, taking that to the next step, gold swaps tend to be between central banks, from one central bank to another. Like the 1925 example between the Federal Reserve and the Band of England.

But starting in the '60s and '70s, and really the 1980s forward, we started to see a lot of gold lending and gold leasing. Which was between central banks as one counterparty owning gold and gold producers, miners, those kind of firms that go out there into the world and actually dig up the stuff from the ground.

The gold lending and leasing, again, there's nothing nefarious about it. It's two different counterparties coming together for a mutually beneficial transaction. On the one side, the central bank side, the reason you want to engage in the gold lender, gold lease, is because gold doesn't pay interest.

Now that's not a big deal for somebody like the Federal Reserve. But for smaller central banks who used to own a huge percentage of their foreign reserves in gold, that was a big issue. Because a central bank is still a bank in that it has to earn some money for something. It has to at least cover its own expenses. In a lot of places there are needs and requirements that central banks actually earn money on their assets.

So a central bank is interested in turning what is a non-interest-bearing asset into an interest-bearing asset.

On the other side of that, a gold miner faced with something like falling prices of gold is going to be interested in hedging. They want to lock in the price where it is before it falls further. Let's not forget the process of mining gold – there's a time lag involved. You dig it up out of the ground, but it still needs to be assayed, it needs to be measured, it needs to be purified and refined. So between the time that you actually get it out of the ground and know how much you have in your possession, and the time it actually is marketable, is considerable.

When we get to Slide 9, we have this "gold forward" where the gold producer is selling forward physical metal. It's metal that they don't have. The only way you can sell physical metal that you don't have is by borrowing it from somebody who does. And who holds the most amount of gold – or who used to hold the most amount of gold – was central banks.

So a gold forward was nothing more than a miner or producer that wished to hedge against falling prices forward borrowing gold, held on behalf of whatever country or whatever central bank counterparty, and paying an interest rate to do it. That's the GOFO rate, or the gold forward rate.

So all parties are satisfied here. The producer is hedged because they've sold forward gold that they don't have. Which is then easily replaced by their actual production. So it's not like they're really short metal that they can never get back.

While at the same time the central bank is happy because it's turned out, it has mobilized its stockpile of physical metal, receiving an interest rate for it, while at the same time not reporting that it actually lent gold into the marketplace, I should say. Because, under the convention that we discussed earlier, a gold receivable is the same thing as bullion on hand.

So the central bank gets interest, nobody knows that the gold is gone, the miner gets hedged, and the whole thing works really well.

Erik: Jeff, I want to pick up on something you said a few minutes ago. You mentioned that this leads to lots of conspiracy theories. There are plenty of people in the gold bug community who think that there is a secret conspiracy of central bankers who are intentionally working with one another, conspiring to suppress the gold price.

And a lot of people, myself included, have been skeptical of those views, saying, I really don't think that central banks are engaged in that.

But the gold bugs make a really good point. Which is they say, if that's not what's happening, explain why the heck it is that, for some strange reason, right around 8 o'clock in the morning, it is very common to see what some people call gold pukes. All of a sudden, somebody sells hundreds or thousands of contracts all at once in the futures market.

Now, any competent futures trader knows that that transaction happening all at once rather than gradually is going to dramatically affect the price. So the critics or skeptics in the gold bug community say, look, how is it possible that these massive sudden sales that for some reason seem to happen at 8 o'clock in the morning could possibly be occurring? If it's not somebody with really big heels, like a central bank, intentionally dumping gold for the express purpose of manipulating the price lower.

How would you answer that?

Jeff: The basis of the question is correct. Who is it that's in the marketplace who doesn't care about the price? Right? If you're dumping gold all at once and you're driving the price down, obviously you don't care about the price.

But are there other explanations other than a central bank trying to manipulate the price lower? I think the answer is yes. And I think that there is an alternate explanation that fills all of those requirements. It gets back to the setup with gold lending and gold leasing and the dislodgement of previously stored gold into the marketplace. Often all at once.

And I think we have to start asking ourselves, why would that be? Why would this happen all at once? What are those periods in time where somebody who doesn't care about the price of gold is just slamming it on the market?

And I think 2008 is a very good place to start to try to piece together what might be happening that isn't central bank manipulation. Going back to the arrangement between gold lending and leasing between a central bank and a mining company, there's no risk for a central bank in price.

And there's no legitimate reason for them to actually take an interest in price, because the gold leasing arrangement is, by its very nature, negative in price. For reasons that have nothing to do with monetary policy of any central bank around the world. Because it's dislodging previously off-market stored gold onto the marketplace. That's a key point to remember moving forward.

When this stuff happens, when there's an uptick in lending and leasing for whatever reason, it is price negative. It has nothing to do with manipulation. It's just the natural supply and demand mechanics of the way these things are set up.

Erik: Jeff, you said 2008 was a good place to start in terms of understanding this. Why don't we move on, starting at Slide 12. You talk about what happened in the 2008 crisis and how gold fared through that. Walk us through this next series of slides.

Jeff: One of the striking things about gold in 2008 was that, for a while there, it didn't perform very well. Most people hold gold as a hedge against end-of-the-world type stuff. And the closest we've come to experiencing something like that was in 2008.

As you can see clearly from the chart on Slide 13, fundamentally gold was in an uptrend up until March of 2008. And I think that's what most people expected. Not only did you have the weak dollar trend, and commodity prices, and inflation and all of that, but you also had an increasing interest in gold as a safety hedge given that everything was going wrong at that particular moment in time.

And all of a sudden out of nowhere, we got, in the middle of March 2008, one of the first real big gold pukes. Where it didn't make sense. Fundamentally, gold was positive. But, yet, for the next eight or nine months, gold was really negative. It didn't seem to hold as good of a hedge against all that was going wrong in 2008 as it should have.

To explain that, I think we need to realize what it is that gold can be at specific points in time. Why are people dumping gold all at once? Not caring about the price. What is the most striking thing about 2008? The fact that it was a liquidity panic. A monetary panic.

In other words, there was a shortage of money. There was a shortage of liabilities. And, among other things, manifested within that overall trend, was a shortage of collateral. One of the most prominent parts of the 2008 panic was the fact of mortgage bonds and other kinds of instruments being repudiated in the repo market.

If we go from Slide 13 to Slide 14, what you see pretty clearly is that these gold pukes line up pretty well with repo market fails. And repo market fails are nothing more than an indication of collateral problems inside the dollar system.

If we think about gold as it pertains to this lending and leasing arrangement, it's actually sort of like a collateralized loan where somebody can borrow a financial asset – in this case, gold, a physical metal sitting idle at a central bank – and use it to help alleviate a collateral shortage system wide.

When you do that, of course – if you're going to be lending cash against gold – you have no interest in holding it. Because holding gold requires storage and it requires costs. So if you're lending cash against gold, because you intend to use gold for something else, you've over-collateralized your lend and lease.

Say you're doing $100 worth of gold lending and leasing where you put on a 10% haircut for example, you don't care if you dump it all at once in the morning. Because you're over-collateralized. Your only obligation in that lending and leasing arrangement is at some future date you have to put back physical metal. What you're betting on is that, essentially, you can be able to do that at a lower price. So you don't care what the price is today. You're just moving on from the gold.

The reason the person is putting gold towards you on the opposite side is, frankly, because they have no other choice. A commercial bank or some other institution that is running into collateral issues in the repo market might appeal to their store of gold, or whomever else's store of gold they can find, as a kind of last resort collateralized method to borrow your dollars.

That, I think, answers the question of who it is at these specific moments in time where, especially, funding conditions in all markets are not robust, and in some cases are very bad – why gold prices tend to go down at those times.

If you look at the chart on Slide 14, that first gold puke corresponds exactly with the Bear Stearns failure of 2008, which triggered a whole bunch of dollar problems, repo market fails. It looks on that chart to be smaller, but only in comparison to later in 2008.

We're talking about more than $2 trillion in fails in the later weeks of March 2008. I mean, that was just a massive problem, a massive seizure of the repo financing market in US dollars at that time. What ultimately ended that particular downturn in gold was in May 2008 the Federal Reserve removed some collateral restrictions on its TSLF auctions.

If you look at Slide 15, for example, the press release from the Federal Reserve at that time, they allowed primary dealers to pledge AAA-rated asset-backed securities in addition to everything else that the Fed would take. In other words, the Fed knew that it had a collateral problem on its hands.

And when it would loosen the eligibility restrictions for collateral in these auctions, all of a sudden gold stopped going down. Because at that moment these financial counterparties on the other side of the gold lending/leasing arrangement weren't so stressed as to use gold as a last resort. In other words, they were able to use other paper that had been previously restricted from the repo market such that they didn't have to get rid of their gold or mobilize their gold stores.

Erik: Okay, just to clarify my understanding of this, when we're talking about repo failures, we're not talking about the gold itself being the asset that is in a repurchase agreement, but rather these big banks are using repurchase agreements to finance massive, massive transactions. Many of those are in over-the-counter derivatives that are very dependent on counterparties.

And, as you start having fears of counterparties failing, something that's never supposed to happen starts to happen. Which is delivery failures in the repo system create an absolute crisis situation for a bank where they urgently need cash, no matter what.

What do you do if you're in that situation? You sell your gold because you don't have any other choice. Is that essentially what we're talking about here in terms of what happened and why these big gold pukes started when the tri-party repo system was starting to fail?

Jeff: That's how it works out. I mean, that's how it looks. It's not exactly where you're selling your gold. Remember, we're talking about a gold lending arrangement. But that's exactly how it works out in terms of the price. The more the repo market system is stressed in terms of a collateral shortage, the more people have to appeal to last resort kinds of alternatives including gold. Which means the amount of gold lending goes up.

Remember what I said before. The more that there is of gold lending, the worse it is for the gold price. Because it's dislodging previously stored-up and off-market supply of metal – both paper as well as physical.

So it's an increase in supply all at once on the market, which ends up being price-negative. So it's a connection between funding market illiquidity and collateral issues, and why the gold price ultimately goes down in relation to it. It works out – kind of like what you said – where it looks like banks are just selling anything and everything all at once. That's not exactly how it works in the transaction, but that's what happens in the price.

Erik: Okay, so 2008 hits. A lot of people think on a fundamental level that ought to be positive for gold. But what actually happens is, because they need cash so badly, or they need liquidity so badly, it has an adverse effect, a negative effect, on the price of gold for the rest of 2008.

But then things turn around at the end of 2008. A lot of people have said, okay, look, the reason is because they announced quantitative easing. And that was perceived by a lot of people as just outright money printing that's going to debase the currency, should be wildly positive for gold.

But I can't help but notice that gold really started to recover in price, not after QE was announced in March of 2009, but really at the very end of 2008. So what turned it around? Was it quantitative easing? Or was it just that these other factors were finally starting to come under control?

Jeff: It's a little bit of both. Remember there's two sides of the gold coin. We're describing the downside. The upside of it is what we talked about before: that demand for safety as a hedge against central bank errors or just general currency risk.

One of the things that turned it around in 2008 was the fact that the demand for safety overwhelmed any negative factors from – whether it be leasing or dollar illiquidity. Because, quite frankly, by the end of 2008 there was no more denying that the world had a very, very serious problem. And that continued all the way through 2008–2009 into 2010–2011.

And in 2010–2011, of course, we had the European problems, which many were expecting that it would potentially break up the Euro. So there was a massive Euro currency risk that became embedded in the gold price too.

But even though that was happening on the upside, there were still these collateral irregularities taking place quite regularly. In fact, way too regularly. We should not see these kinds of things happen if the monetary system is recovering.

As the gold price was going up in 2010–2011, there were all sorts of anomalies in the gold market that were consistent with what we had seen in 2008. Even though they didn't necessarily work out in price. Because the upside – or the demand for safety – was stronger at that point, the bid for gold was stronger at that point, than the negative factors from collateral.

And it stayed that way until September of 2011, simply because the balance was far more toward people expecting currency safety. Until the dollar problem in 2011 became far too big to ignore.

Erik: Jeff, you mentioned what happened in 2010–2011. I think that takes us to Slide 17 in the deck. Talk us through what Slide 17 and 18 are telling us.

Jeff: There are a couple of anomalies – or aberrations, whatever you want to call them – in the gold market that popped up in especially 2010. Remember, 2010 is supposed to be a year of recovery. Not just in the economy, but in the financial markets. We had ZIRP (zero interest rate policy) in the US, we had ZIRP in Europe. We had QE in the US. We had all of these positive monetary factors.

And yet, in the middle of 2017, it came to light that the Bank For International Settlement, which is the central bankers' central bank, had swapped 346 tons of gold with ten European banks in December of 2009 and January of 2010. And people couldn't figure out why that was.

Because, again, things are supposed to be recovering. Why the hell are they taking gold out of the hands of European banks?

And the reason was, of course, continued funding anomalies in dollar markets. What was reported along the way, as these things became more and more investigated, was: What had happened during the bull market in the 2000s was that people – European customers in particular – who were interested in buying gold because gold was in a bull market, may not have intentionally been buying gold for gold property. They had been buying gold – physical metal – and depositing it with their local bank for custody.

When they were doing that, the bank gave them a choice about what type of custody they would choose. And one of the options was unallocated gold accounts. The reason most people chose that was because it was a much lower price point. In other words, the bank charged you a hell of a lot less for an unallocated account than for an allocated account.

But an unallocated account was a very big difference in terms of legalities and who actually owns the metal. An unallocated account means that you're just depositing the gold with the bank. The gold then becomes a liability with the bank. And what they give you back in return is essentially a warehouse receipt. Not actual title to the metal.

All the bank is saying is that if you ever ask for your metal, we'll give you metal back. Not necessarily the specific bars or the specific whatever that you deposited.

And what that allowed was, in times of stress and strain, because that metal became a liability at the bank and not a separate constructive bailment as an allocated account would be, these European banks, including Swiss banks, found that they had a deep pool of unallocated gold that was their own liability that they couldn't realize.

Again, their only liability was that they would have to put the same kind of metal or the same amount of metal back if their customers ever asked for it back.

What happened in 2010, as the European crisis wore on and got worse, was that these European banks started to appeal to those stores of unallocated gold. They started to motivate them into the lending and leasing arrangements, which tended to be negative in price the more that happened.

Where that really broke out was in later 2011 as the dollar crisis worsened that year. September 6, 2011, the Swiss National Bank shocked the markets by pegging the franc to the Euro, essentially trying to get away from the dollar balance. Which triggered all sorts of responses across US dollar funding markets.

And you could see, once again, another big, massive gold puke. That actually represented the exact top in the gold price. It has never been back to that point.

And if we look at that in terms of the bigger picture, the Eurodollar picture we went over in Eurodollar University, it coincides exactly with the final systemic break in the Eurodollar system. In other words, up until 2007 the Eurodollar system rapidly expanded, exponential growth everywhere. And every kind of offshore assets, any kind of offshore money-dealing capacity you might ever think of.

From 2007 to 2009, obviously, we had the panic. We had a setback and whatever. 2009–2010 and early 2011 there was a partial recovery that goes alongside the higher price of gold from 2009 forward, 2008 forward.

So the Eurodollar system was partially rebuilt up until this moment in 2011 when all hell just broke loose again. So gold was used and deployed as collateral in what was another dollar problem. Another dollar crisis, essentially. Which marks for many of the banks involved in it a complete systemic break. They realized that, no matter what the central banks did, no matter what the Federal Reserve did, or ECB, or whomever else, they were not able to fix the Eurodollar system.

Of course that's obviously true, because no central bank actually acknowledges the Eurodollar system exists. It became a situation where 2011 forward, the system was irreparably broken. There wasn't even the possibility of a small recovery in it. And that's how it started, how it snowballed in terms of the gold price.

It was – if you look on Slide 18 – another big collateral issue in September of 2011 that coincides with another big gold puke that triggered the next stage lower in gold.

Erik: And I think it's very clear here that all of these Eurodollar problem spikes very much – not just in 2011 but the prior ones – coincide with changes in the direction of the gold price. And it's certainly a narrative that you don't hear in most of what you read about gold.

Moving on to Slide 20, Jeff, I think that central bank gold holdings are a topic, generally, that leads to a lot of confusion. So please give us the big picture in this next series of slides.

Why are central banks holding gold? And, particularly, why is it changing? Because post-2008 some banks were divesting their gold holdings for some reason, while, at the same time, other central banks around the world were increasing their gold holdings. So what drives all of this?

Jeff: Again, we've got to start from the perspective that we don't really know exactly what's going on in the central banks. Because – going back to what we talked about with the first gold swap – a gold receivable is treated as the same thing as physical bullion in terms of the central bank accounting system.

So when we talk about – I am presenting here the Bank of England's reported gold holdings. And this is something that they're reported in their Annual Report for a long time, but only recently broken out by month. What they're doing in their custody of gold holdings is they have gold on behalf of not just the BOE itself, but also other central banks, also commercial banks and other commercial interests.

So I think it's important to distinguish between what central banks might be doing as a matter of monetary policy as it pertains to gold, and what commercial banks are being forced to do as a matter of funding and dollar liquidity issues.

If you look at the chart on Slide 20, there is a striking relationship between the amount of gold held on custody at the Bank of England on behalf of other central banks and commercial banks, and the price of gold from 2011 forward, we have to ask ourselves immediately, where did that gold go? And whose gold was it that disappeared out of the Bank of England's custody?

I think if we go back and think about that in terms of what happened in 2008 and 2011, it seems pretty clear, though, it's not obviously defined specifically that way in the data that whose gold disappeared was commercial banks'. Because of this lending/leasing relationship.

If we go to Slide 21, for example, we see the one-month forward rate for gold. Remember the forward rate for gold is the interest rate paid to lend out physical metal. What we find is that there is relationship between the gold forward rate and the tendency of gold to disappear in the manner that we described in 2008, 2010, and 2011.

Usually, when we talk about gold leasing it's tied to LIBOR. Because if you're a cash owner you have an alternative that you can select between lending cash against gold collateral and interest rates, and just lending cash into a specific unsecured interbank market, which is what LIBOR actually denotes.

If you go to Slide 22, you see the relationship pretty well. Where the forward rate was high in 2011 and 2012, and then became very low in preparation for what we see in the Bank of England data where the amount of gold in custody just disappeared.

Normally, LIBOR is supposed to determine which way it goes, which direction leasing takes. But in this case, it's not LIBOR that we're really interested in, it's the zero rate. The zero boundary. Because if you think about it from the perspective of the cash owner, why would you lend cash at a negative rate? Especially in a gold leasing arrangement. What is it about gold that would essentially force you to pay somebody else to borrow cash from you with gold as collateral?

The reason is obviously because the gold that you're getting back in return is more valuable than the cash you're lending out. And the only reason that would be the case is if systemically there is a collateral problem whereby you expect to profit from the collateral shortage.

If we further analyze these negative forward rates, this disappearing gold in Bank of England custody – not just the Bank of England custody – throughout 2013–2014 gold disappeared in a lot of different pockets – what we find is that the gold forward rate was often negative during those periods. Which, from our perspective of the Eurodollar system and the dollar system in general, is telling us isn't necessarily about gold. It's the gold market telling us something about dollars.

Whenever I see the forward rate go negative, and we see gold disappear from official stores, that tells us that there is a funding problem, a collateral problem, in these global Eurodollar markets. One that we wouldn't be able to see, or might not be able to easily see otherwise. That's how we need to analyze the gold market in terms of how it relates to the dollar market.

Unfortunately for us – if we go to Slide 24, for example – you can see at certain points that the forward rate was negative not just at the short-term maturities, but was negative out to three months and sometimes six months. Which, again, was an indication of the strength of the severity of the problem in how much demand was there for gold as collateral. It got to be at certain points a big, big, big problem.

And unfortunately for us, the LBMA decided in late 2014, just as this was really starting to become a very big issue, especially outside of the United States in these offshore Eurodollar markets, they decided they were going to discontinue publishing the forward rate. As of – I believe it was January 30 of 2015 – they were no longer going to publish any information whatsoever about the gold forward rate. Which deprives us of our ability to really get a good sense of how bad the problems were in these particular parts of the funding markets.

It gets back to what we were talking about earlier, conspiracy theories. Conspiracy theorists would say, why are they discontinuing it then? Because they're obviously hiding something. And I don't really know what the answer is. They've never provided an answer. If you look on their website for why they discontinued GOFO, they really don't provide any rationalization whatsoever. They don't give us any reason.

And what that does is it makes it harder for us to lodge legitimate criticism against these kinds of things, legitimate criticism against the dollar market, because it opens the door to the idea that there's some vast conspiracy here. And I don't think there is.

There really isn't a conspiracy. It's more about the fact that the Eurodollar system, especially past 2011, never really healed, it never really restored, it never really recovered. And after 2011, especially in 2013 and 2014, it was getting a lot worse. That's what these forward rates are telling us. That's what this disappearing gold was.

It was telling us that the dollar system, before the dollar actually started rising in exchange value against other currencies – long before – that there were irregularities in these funding markets that were so severe they were distorting gold markets to a massive, massive amount. It was a tremendous distortion in gold markets, which warned us that the dollar system was getting worse heading into what eventually became the rising dollar.

Erik: Moving on to Slide 25, I see on this price chart on the left side some things that I want to ask you about. First of all, I see, obviously, the 2011 peak. So that was the top. And the questions that that begs is, why did the top happen when it did? And I think you may have already answered that with the spikes of problems in the Eurodollar system. But I don't know if that's the full extent of the answer.

If I look ahead, it seems to me that, from the 2011 peak right to the end of 2012, that looks to me like what could have been a consolidation pattern. There was plenty of room to think, maybe, that the market was going to head towards new higher highs after that.

But, holy cow, look at the beginning of 2013. It's like somebody flipped a switch and all of a sudden the gold market is headed straight downhill from there.

So why the peak exactly when it was in 2011? Why did things appear to stay in a consolidation pattern through the end of 2012? And why did everything suddenly change at the beginning of 2013 that was so bearish for gold?

Jeff: The 2011 peak is, I think, explained by the fact that that was the last straw for the Eurodollar system. Again, between 2009 and 2010 and 2011, it partially recovered. Bank capacity partially came back. Some banks were expanding again. Some banks were taking risk. And these are global Eurodollar banks. They were doing some of the things that they had done before, but they were doing it more measured and more cautious.

And then this 2011 crisis showed up. By September of 2011 it had become clear that it was another global crisis, especially in these offshore currency markets. That was something that the central banks – not only could they not follow it, they didn't even know it was there, they had no idea what was going on.

If you're a global Eurodollar bank in that position, now having to face the prospect of a second global crisis, you're going to say that's it, I'm done. This Eurodollar system just doesn't work for anybody.

So from that point forward, the Eurodollar system has never been the same. There was no possibility of recovery. And I think that's why gold had peaked at that particular time. Because it coincides exactly with what was the final top in the Eurodollar system.

To your point about what happened in 2013, distinct from 2012, I think we have to consider the fact that in 2012 there was a whole bunch of central bank activity. Mario Draghi in July 2012 made his infamous promise. The Federal Reserve in September of that year came out with QE3, and then in December QE4.

For a lot of people, especially in these offshore markets, QE3 and QE4 were not comforting. They were, again, more evidence that these central banks were, at best, behind the curve. They didn't know what the hell they were doing. And they couldn't solve the issue.

And so the dollar system tightened, effectively. Not loosened. And, of course, that runs against mainstream interpretation of what quantitative easing is. But here we have dramatic evidence in early 2013, long before the word "taper" was ever uttered, where this tremendous gold slam, especially in April of 2013, that indicated that the dollar system was getting worse. Especially in the global offshore spaces.

But that is not how it was interpreted at the time. If you go back into that period, a lot of the central bankers, a lot of economists, a lot of the more optimistic people, a lot of optimistic commentators, took the drop in the gold price at that moment as if the recovery had become real. That the recovery had actually cemented itself. And that the gold market was telling them that the fear and the negative impacts of 2008 had finally passed.

When in fact what we see going forward was that the drop in the gold price in 2013 was a tremendous warning about what was to come, even though it was a year and a half later in 2014.

It was the idea that these internal hidden parts of the Eurodollar system were not only dysfunctional but they had gotten worse again. So it was a way to observe in real time, if you could understand what the markets were telling you from the perspective of Eurodollars and dollars, that the gold system was saying things are getting worse, not better.

Even though it looks like, superficially, it was consistent with the idea of reflation and recovery, it was, to put it in general terms, deflation. Not inflation.

Erik: Jeff, let's move on to Slide 27 and talk about how dollar index futures fit into this story. Obviously, gold is priced in dollars, so it has an inverse relationship with the strength of the currency.

Jeff: It's something we talked about at the end of the year with this dollar squeeze, or this dollar shortage.

If you go back to 2013 as the price of gold is getting killed, and you don't recognize all of this stuff – the lending and leasing and what that means in terms of collateral, and what that means in terms of dollar markets – it definitely does look like gold is saying, hey, things are getting better. People are dumping gold because they're more confident and optimistic about the markets and the economy. And even the dollar index got better. You know, the weak dollar is consistent with reflation.

Or the pre-crisis period, you know, the dollar fell between 2001–2002 and 2008. In fact the bottom in the dollar was the day Bear Stearns failed.

So it did look like, on the surface, the price of gold was consistent with reflation and recovery. However, if we start to factor in the negative forward rates, if we start to factor in the disappearing gold in terms of dislodging previously stored supply, it told us that something beneath the surface was not right.

If you look at it in terms of DXY, or the dollar index, up until the middle of 2014 you had all of this stuff going wrong in the gold market. Yet it hadn't broken out in any major way in terms of the rising dollar, or dollar squeezing as we call it.

If you turn to Slide 28, that's exactly what you see. Unsurprisingly. Those warnings in the gold market proved to be right on the money (so to speak) in 2014. We were warned by the gold market as early as late 2012 that these things were getting worse. And eventually they were solved. They were going to break out into another global dollar crisis. Which is what happened.

And that's, I think, the key point – going back to the peak in 2011 – was that the market was saying that these things are not going to be solved. And, because of their constant irregularity, and their constant problems, and all of these vital funding markets, that eventually things are just going to break. As they did, starting in the middle of 2014.

The dollar squeeze at that point was on. And it had, in many places, catastrophic consequences. You go to places like China and Brazil – Brazil in particular. Brazil's economy was utterly decimated by the rising dollar period. And it has never recovered from it, even though that was two years in the rear-view already.

The Brazil economy has never recovered from the rising dollar. The Chinese economy has never recovered from the rising dollar, nor has its financial system.

So this was another dollar liquidity crisis which was, in many ways, described ahead of time by the irregularity in gold, once you understand the mechanics of leasing and understand what that means in terms of collateral. It tells us something very important about the state of the system in a way that no central bank is going to be able to fix or solve.

And, unfortunately, for whatever reason, the LBMA has decided in its infinite wisdom that it will no longer publish the forward rate. Which means we have to struggle a little bit more with even less information going forward.

Erik: Moving on to Slide 29, we're looking at the gold price more recently, in the last year or so. It feels like the mood has changed. There was definitely a downtrend there. It seems like maybe the bottom is in. There's been an uptrend in gold.

Definitely the action in gold prices has felt different in recent months. So what's going on? What's behind the mood change in gold that we've seen since the beginning of 2017?

Jeff: Both gold and the dollar, going back to 2016, are behaving just like they did in 2010–2011. It's the reflation and recovery scenario. Which makes sense, because we went through the rising dollar downturn, which was a severe liquidity shock across the world.

So it stands to reason that there would be some retracement in it, some abatement in the liquidity pressure, and some abatement in the monetary pressure in that reflation trend.

What we see, especially recently in the last six months, is we find these gold pukes. And not only do we find them, we find that they correspond, again, with repo market irregularities. These collateral fails that indicate that there is a collateral shortage, as there has always been a collateral shortage.

But there are periods where these shortages become acute enough that they become problematic. If they are so problematic that they cause the gold market to decline substantially, especially all at once in these gold slams or pukes or whatever you want to call them, then obviously, there are still problems in the Eurodollar system.

And that's what the gold market is telling us. Even though there is reflation, there is positive sentiment, there is even inflation expectation, we still think like –

Go back to 2013. The irregularity in the gold market is telling us that maybe we should pay attention. That, even though the dollar has been falling for a year and two months now, that it might not necessarily continue to do so. Because the liquidity squeeze, or the dollar squeeze, the next episode in it might be just around the corner.

If you go back to any of the dollar episodes of the falling dollar previously, especially the one in 2011, up until April of 2011 it looked very much like the dollar was going back to the pre-crisis falling dollar period. Then it abruptly stopped, out of nowhere. And the reason was because the dollar squeeze had abated in 2010 and 2011 to some degree. The irregularities in funding markets continued, as noted in these aberrations and anomalies in the gold market.

And I think that's the important point here. Even though the gold price is higher – again, we have to recognize the two different parts of the gold market. There's always going to be inflation and safety bid driving the price higher. But against that there is these times where collateral problems, illiquidity, dollar squeeze, however you want to characterize it, are going to force it into downside risks.

Eventually, if these things become serious enough, as they had in 2011, as they had in 2013, they can become quite severe price negative for gold. And not just gold.

What that would mean for the rest of the world, what that would mean for the rest of the financial market – and I think we've already seen some of that at the end of last month. The stock market crashed. It didn't crash, but it was liquidated at the end of January and the early part of February – not just here but across the rest of the world too – as an indication that these warnings in the gold market are telling us that the dollar system as much as reflation appears to be the dominant sentiment.

Underneath all of that, there are still the same problems that are unresolved.

Erik: Jeff, where does which leave us in terms of your outlook? I think, if I've understood your view previously, it was that there's probably still more downside for gold here. Because the dollar squeeze effect that we've talked about means that you expect that the dollar will move higher.

When we discussed this at yearend, you and I definitely sounded like the smartest guys in the room talking the dollar bull story. But the chart's kind of proven the other guys right. So (one) do you still see it that way? And (two) what if the other guys are right, and the dollar continues to slide to the downside? Does that mean that gold takes off to the upside from here? Or how do you see this playing out?

Jeff: Taking your second question first, I think that's true. If we're wrong about the dollar squeeze and the dollar system is fine and there's nothing really wrong, then it should continue to fall and the gold price will continue to rise.

I sincerely doubt that's the case, however. And I'm not surprised that the dollar has fallen as far as it has or for as long as it has, simply because sentiment has changed and it takes time for these things to be processed inside the system.

Again, go back to what we were talking about. The gold price dropped precipitously in the early part of 2013. And yet it wasn't until the middle of 2014, more than a year later, that it finally broke out into a major worldwide problem.

In other words, the dollar didn't reverse higher for more than a year, while these gold irregularities were happening.

The same happened in 2010 and 2011. Between the middle of 2010 and April of 2011, the dollar was falling precipitously. The same as it has been now. In fact, it fell further back then than it did now. While all of this stuff was going on in the gold market. Not just the gold market, but the repo market and funding markets and European markets and all sorts of other things.

It wasn't until whatever triggered the ultimate breakout in 2011 that reversed the dollar higher. And I guess my overall point here in analyzing the gold market and what's behind the gold market, especially in these collateral spaces, is that we're still seeing these same kind of irregularities. Even in later 2017.

Even though the US dollar is falling in exchange value, there are still the same types of behavior that we saw previous to other dollar spikes in 2014 as well as 2011 and forward. Even going back to 2008 too. Irregularity in the gold market and then a dramatic reversal in the dollar, starting with Bear Stearns.

I think that's ultimately the point here is that the dollar is going to fall until it stops falling. It will keep going down until it doesn't. And we can't really predict what it will be or what it might be that reverses the dollar at that point, therefore negative for the gold price. Because you can never anticipate what it actually is.

And what the gold market is telling me, in conjunction with the repo market, is that these kinds of irregularities that we continue to see raise the probability that at some point, some undetermined future point, the dollar squeeze will be back on. The falling dollar will stop. The dollar will reverse.

It will probably be negative for the price of gold, as well as a whole bunch of other stuff. And when you put this all together, what's happened over the last six months tells me that these warnings in these various markets aren't just happening, they're escalating.

That's why I mentioned stock prices about a month ago. Because that was an escalation in the series of warnings we've been seeing inside the dollar markets over the last six months.

Erik: Jeff, one final question. I want to shift gears completely to another topic, because one of our generous donors who makes MacroVoices possible sent me this question which is just perfectly up your alley, even though it's off our topic today of gold.

Recently there was an announcement that interbank lending statistics were being discontinued and, of course, this leads the conspiracy theories of what are they hiding? What's going on here? Is there anything to this?

Jeff: There's a couple of clues here that it was nothing more than a data discontinuity. And I think the reason they discontinued the series was because they realized that it had produced a large discontinuity and a large negative discontinuity that people were interpreting incorrectly.

The short answer of what actually happened was the line item for interbank loans is not in a comprehensive line to begin with. The first clue of that was that it was only about $70 billion or so. That's not even close to the total interbank market. So that particular item was only capturing a small portion of what actually goes on in these kinds of places.

Because of that, it means it has specific definitions of what part of a bank call sheet it's tracking from. If there was a definition change on the call sheets or in the tracking system from turning call sheets into data, that just represented the change. The fact that, somewhere along the way, whatever the Federal Reserve is doing in its H.8 system, dropped one part of whatever it collated into that one line.

So it was nothing that actually happened in the interbank market. It was just a data discontinuity. So it's one of those things that got turned into a big deal even though it really wasn't.

Erik: Jeff, you've become something of a celebrity with our regular MacroVoices listeners. But, since we have lots and lots of new listeners, I just want to point out a few resources that are available.

You were so kind as to provide us a very thorough Eurodollar University. That is a four-part series that really goes deep on the history of the Eurodollar system and provides a lot of context and understanding of how important it has been in terms of fueling a lot of macroeconomic trends in the last 20 years or so.

I'd like to announce too – I think I've alluded to this on the show before – but that Eurodollar University really only took us up to just before the point in 2007 where the Eurodollar system kind of fell over and broke. We are planning Eurodollar University Season Two (yet to be produced) which will talk about the breakdown of the Eurodollar system that occurred in 2007, and everything that's happened since then. Of course, part of that is what we covered in today's story in the gold market.

The other resource I want to point out is our yearend special which included you, Luke Gromen, and Mark Yusko, talking about what the endgame dollar for the US dollar would look like. And, ironically, even though you and I have been bullish on the dollar relative to other currencies, it's not really bullish. It's more like a short squeeze.

You've explained very succinctly why you really do think the dollar's hegemony over the global financial system is ending. But it's just ending in a way that is likely to put more upside pressure on the value of the dollar relative to other currencies. That is the subject of our five-part yearend special at the end of 2017.

Both of those are available at macrovoices.com/edu (edu is for Eurodollar University). And they are highly recommended. They have been among some of our very most favorite content that's been most popular with listeners.

Before I let you go, though, Jeff, I know you've got a fantastic job there at Alhambra Investments. You get to do research and publish interviews like this as well as a whole bunch of written research that you do for your clients there. Alhambra is, of course, a retail investment advisor in Florida. You get to have all the fun, Jeff, doing Eurodollar research and looking at the gold market and so forth.

But your colleague Joe Calhoun has a whole team of professionals that are providing retail investors with investment advisory services. Please tell us a little bit more about what Joe's team does there in Florida and how people who are interested can contact Joe for more information.

Jeff: What Joe does, and what the investment team at Alhambra does, is they try to make sense of everything that we've been talking about. All the complexities, all the risks involved. And try to turn them into investable strategies with an eye toward making sure that we have a good idea of what the risks are with investing.

The most important part of managing money for other people is understanding exactly what the risks are to anything that you're trying to do or trying to accomplish. And Joe and his team have done a terrific job with turning what are very complex issues into investable strategies that are available to a wide range of potential customers.

Erik: For our listeners who may be interested in Alhambra's services, who would like to contact Joe, what is the best way to reach him? Maybe you can give us his email address and phone number.

Jeff: If you send Joe an email, he's going to respond. His email address is jyc3@alhambrapartners.com. And they can call us, if anybody still uses a telephone. Our office number is 561-686-6844.

Erik: Fantastic. Joe is a super guy. We really appreciate him making your time available for us. We're really looking forward, Jeff, to taping Season Two of Eurodollar University in the coming months.

That is going to have to be a wrap for today. Patrick Ceresna and I will be back as MacroVoices continues right here at macrovoices.com.