"Positive Carry"

We first heard about John Devaney because of his yacht, 143 ft long jobby, furnished with a Sikorski helicopter and staffed by a crew that included "an expert in spear fishing" so that guests could "shoot their own meal." Devaney made his pile by borrowing money at low rates and ploughing the proceeds into high-yielding dreck – asset-backed securities, mortgage CDO's, what have you. The name of the game was "performance", something the 35-year old hedge fund manager apparently had a weakness for. The name of his yacht? "Positive Carry."

Like its not-so-distant cousin, 'compounding interest', "positive carry" does have, at least from a distance, certain magical qualities, worth exploring, especially given recent developments in the gold market. The concept refers to the term structure of a product's forward market. If a product for immediate delivery trades at a premium to the same product to be delivered on some future date, the forward curve is said to be negatively-sloped (or in backwardation); if the converse is true, the forward curve is said to be positively-sloped (or in contango.) If one is long a negatively-sloped term structure, wherein the price rises as a distant contract approaches the present, one effectively gets paid for holding the position, all else being equal. Hence the elixir of "positive carry."

The forward markets of almost all monetary instruments exhibit a negatively-sloped forward curve and it is easy to see why. The person who takes delivery of a bond tomorrow gets interest payments that the person deferring delivery does not. The positive carry associated with such a forward rate is generally related to the yield of the instrument. If one funds a position by borrowing, the carry amounts to the difference between the interest paid and the interest received. One can see how borrowing yen at 1% to buy high-yield receivables secured by flat screen TVs inspired Devaney to name his yacht as he did.

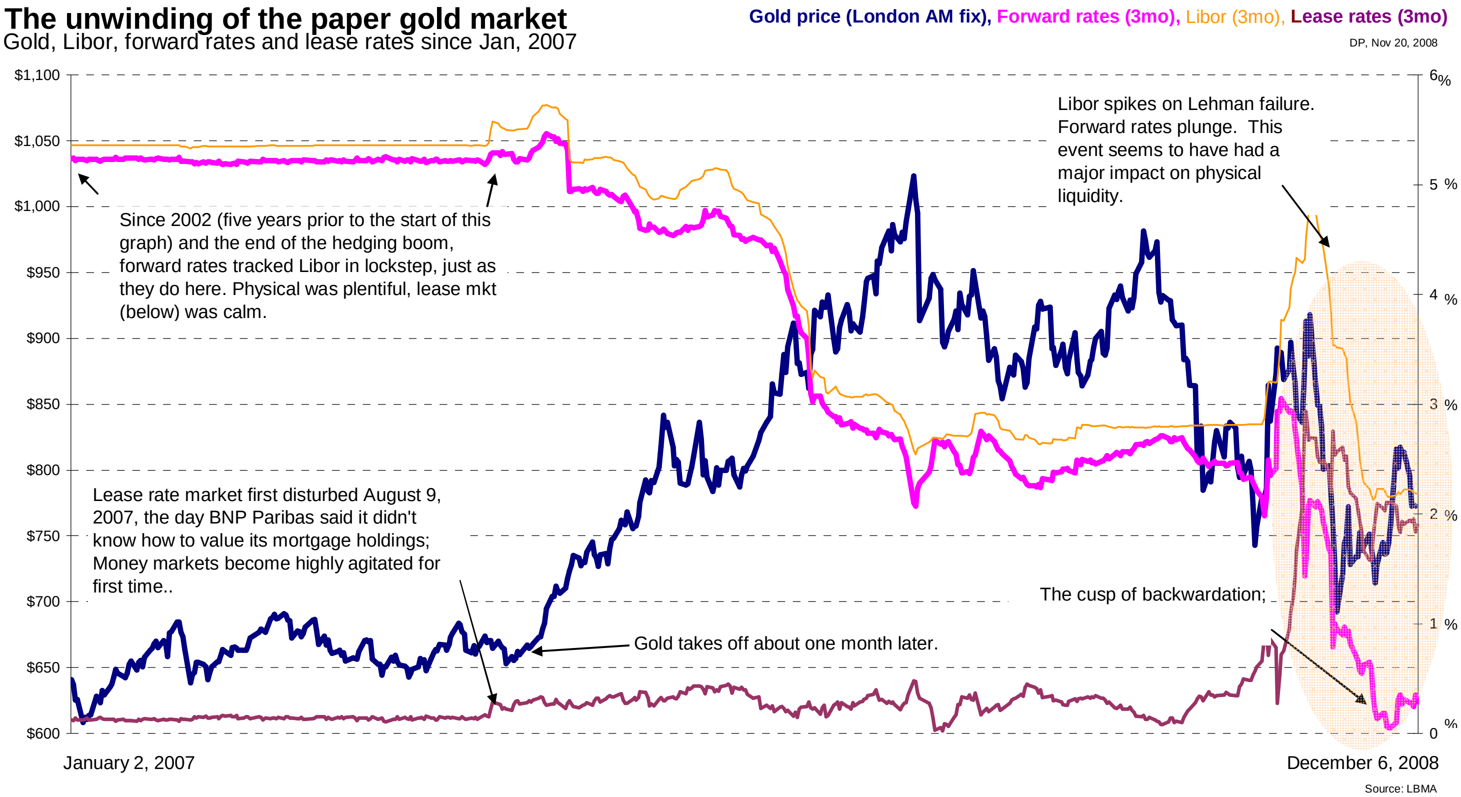
The forces that determine the term structure of the gold market are no different than the forces that determine the term structures of instruments favoured by our yachtsman friend. Unlike cotton and crude and copper, the forward market in gold is strictly a function of money market rates; in particular, the forward rate in gold is the difference between Libor and gold lease rates (that is, the interest rate charged by lenders of gold.) In the past, with lease rates remaining at a fraction of one percent and Libor anywhere from 3-7%, the forward rate has, with rare exceptions, been positively-sloped to the tune of, well, 3-7%. Positively-sloped forward curves, if you're long, means *negative carry*. Put differently, holding gold has almost always *cost* you money, all else being equal. This may now be changing.

The turned-tide can be traced back to August 9, 2007, the day

BNP Paribas announced that it was suspending withdrawals from one of its hedge funds because it was at a loss as to how to value the portfolio, a portfolio comprised of "high performance" instruments with no doubt attractive term structures. Money markets coughed hard, Libor shot up and lease rates, after years of somnolence, tellingly showed a heartbeat. (Just as tellingly, other commodity markets remained unaffected.) Gold forward markets remained unsettled for the remainder of 2007 and the first half of 2008. Then Lehman filed and money markets seized up altogether.

The reaction of the gold markets was again telling: lease rates soared and forward rates – a rough measure of the availability of physical gold – plunged. Clearly, the lending markets for gold, the source of physical liquidity for decades, had stopped functioning just as lending markets for Dollars and Euros and Yen had stopped functioning. The last time the gold term structure was so agitated was in 1999, when two producers got caught with too many short positions and not enough liquidity. The price then popped briefly, but conditions soon returned to normal. This time around, there was again evidence of short squeeze (gold rose $80 in a day), but unlike in 1999, unsettled conditions in the forward markets have persisted. Briefly, in late November, the gold forward curve in London tipped into backwardation.

The positive carry was, of course, very, very thin gruel, a tiny fraction of 1%. But the implications of a more favourable forward curve in gold signalled something more profound than merely the prospect of a good roll on the December contract. Gold bugs have often griped that the metal has been depressed because its monetary nature has not been fully appreciated. This misses it: gold prices have been depressed precisely *because* the metal's monetary nature has been appreciated (and exploited) all too well. It's not that gold wasn't treated as money – surely it was, and there is no better evidence of this than the manner in which the metal's term structure was disturbed in lockstep with the chaos in the money markets – but rather, it has been treated as *unattractive money*. In a word,



there has simply been no appetite in the last thirty years, witness to a bender to end all benders, for money that didn't pay (bribe?) you to own it, the more the better, counterparty risk be damned. In such an environment, how could gold compete?

Alas, the worm seems to be turning. Gold is no longer the portfolio drag it used to be, and the competition, as it were, is no longer so competitive. Yesterday's auction of three month treasuries sold at "yields" of 0.005%, the lowest since 1929. "It's all about capital preservation," commented a fixed income manager out of Princeton, whose job title is quickly becoming a misnomer. This all points to a change in market tastes. To everything/There is a season/And a time for every purpose. Turn turn turn indeed.

The shortage of gold coins and small bars has been well-publicized, but usually with the rejoinder that the wholesale market – the big bars, 400 ozs per – is well sated. Forward rates belie this. Even as we did not see a squeeze on the December Comex contract (it appeared touch and go for awhile, with Dec-Feb spreads trading as low as 40c), it remains that demand remains robust – Q3-08 made headlines for physical off take – and gold lending markets show no signs of thawing anytime soon; indeed, lenders are likely more concerned about getting back the gold they've already lent, now stuffed into people's teeth and iPod circuit boards (how's that for counterparty risk?) In these conditions, it is difficult to see how the gold forward curve returns to "normal" anytime soon. And in the past (eg. 1999, 2003), price has followed spreads. If the kettle is to run dry, and supply-demand imbalances suggest it one day must, you will smell it coming here, in the spreads, first.

Even if we don't see severe backwardation (i.e. a squeeze), we're not sure it really matters. The "price" of gold, at least as modern finance would have it, has now, for all intents and purposes, converged to the price of paper. One bears the risk of a printing press run amok, the other you can take home in your pocket. Take your pick. And if you don't, we feel others certainly will.

Amidst all this, we mustn't forget Mr. Devaney. In mid-2007, he closed his hedge fund under a cloud of massive losses. Soon thereafter, he was forced to sell his beloved yacht and disband his crew. We are not sure what happened to Devaney's "expert in spear fishing," but if any of you can pinpoint the gentleman's whereabouts, please do advise. Such talents should prove useful in the days and years to come.

Douglas Pollitt, December 9, 2008.