The Macro-Metal News

Gold Slams in the Time of COVID-19

March 31, 2020

METAL

Gold prices were washed away just as the virus wave hit hard. Why?

- Gold prices suffered two savage declines of $110 and $180 dollars between February 24 and March 16 despite the exponential advancement of the virus, escalating socioeconomic uncertainty and rapid, deep drops in stock markets.
- Nevertheless, the "gold slams" were not surprising. Over the past dozen years, these sudden $100-dollar declines coincided with a shortage in capital market collateral. Heading into 2020 this scarcity was anticipated.
- Since 2011, a persistent or rapid redemption of US Treasury securities, held in custody by the Federal Reserve, but owned by foreign central banks, has signaled a collateral shortage and coincided with gold slams. The latest data shows the largest redemption in series history.
- The failure to deliver and receive US Treasury collateral in the repurchase agreement market by Primary Dealers reached $407 and $566 billion dollars the weeks of March 11 and 18. These results were in the 95th and 99th percentiles of experience since January 2018.
- Primary Dealers are obliged to bid on US Treasuries, but it is their discretion whether to retain or distribute this pristine collateral. For the four weeks ending March 18 Dealers felt it the better part of valor to hoard $58 billion for themselves, a 99th percentile result since 1991.
- The price of gold appreciated into the shock, correctly anticipating unrestrained volatility and collateral shortages. Once the panic was in progress, the golden insurance policy was cashed in and found willing buyers. Once again, gold did what it was supposed to.

Through the week of Friday, February 21 the severe acute respiratory syndrome coronavirus 2 (SARS-CoV-2) was considered an issue limited to China. That was the collective opinion of consumer sentiment polls, purchasing manager surveys, financial markets, monetary technocrats and politicians outside of East Asia.[a] Indeed, as late as Wednesday of that week, America's stock markets, which had been leading global equity markets since January 2018, were recording all-time highs.[b]

Everything changed that weekend.

First there were the lurid rumors about the situation in Iran. Yet without credible press confirmation it was fair to wonder if it was merely opposition propaganda. How then to explain away that weekend's border closings by Turkey, Afghanistan, Pakistan and Armenia?[1] Each was walling off the Islamic Republic.

Then there was news from Italy that Venice's famed Carnival celebrations were ended early.[2] Furthermore, roadblocks were being put up around towns in Lombardy. Even the armed forces were to be given authority to enforce them.[3] Perhaps Italy's reaction was overwrought? But then word came of Austria's Sunday night closing of the Brenner Pass to Italian rail traffic.[4]

Also, in Moscow the mayor confirmed that, "officials ordered police raids of hotels, dormitories, apartment buildings and businesses to track down," Chinese nationals.[5] Unsettling.

Lastly, in South Korea, the government raised its infectious disease alert system to its highest level.[6]

That Sunday an Australian virologist requested Professor Sandman and Dr. Jody Lanard comment on these and other developments. The husband and wife team had served as members of the World Health Organization's SARS Scientific Research Advisory Committee. They responded to confirm, "Yes, it is past time to say 'pandemic'."[7]

Sandman and Lanard were not the only concerned professionals. On Twitter your blogger identified a pathologist, toxicologist, chief medical officer, infectious disease epidemiologist and virologist whose statements are too long to recount here but are faithfully summarized by a quote from the 2011 American movie *Margin Call* by English actor Jeremy Irons: "This is it. I'm telling you; this is it!"[8]

One would assume that on Monday, February 24th the world woke up to learn a plague had been loosed on the world and – after already having been treated to a month's worth of videos out of China that were a mix of George Orwell's book *1984* and Steven Soderbergh's movie *Contagion* – promptly bought gold and silver. Apparently not. Indeed, precisely the opposite.

As the graph on the next page shows, gold prices fell from the close on Monday, February 24 through March 2 (plus or minus a day depending on which market serves as the reference point). Perhaps it was just a random fluctuation?

Initially that was a strong possibility as gold rebounded all the way back in the next few trading sessions. Over the coming days the remaining 'there's-nothing-to-worry-about' holdouts were overwhelmed by the severity of either the disease itself or the proposed response to it (i.e. the quarantines). Stock markets seemed to be in a competition as to which index could drop the farthest, the fastest or both. For gold investors, the scene was as if out of central casting; it was precisely the setting imagined that would launch gold into the thousands.

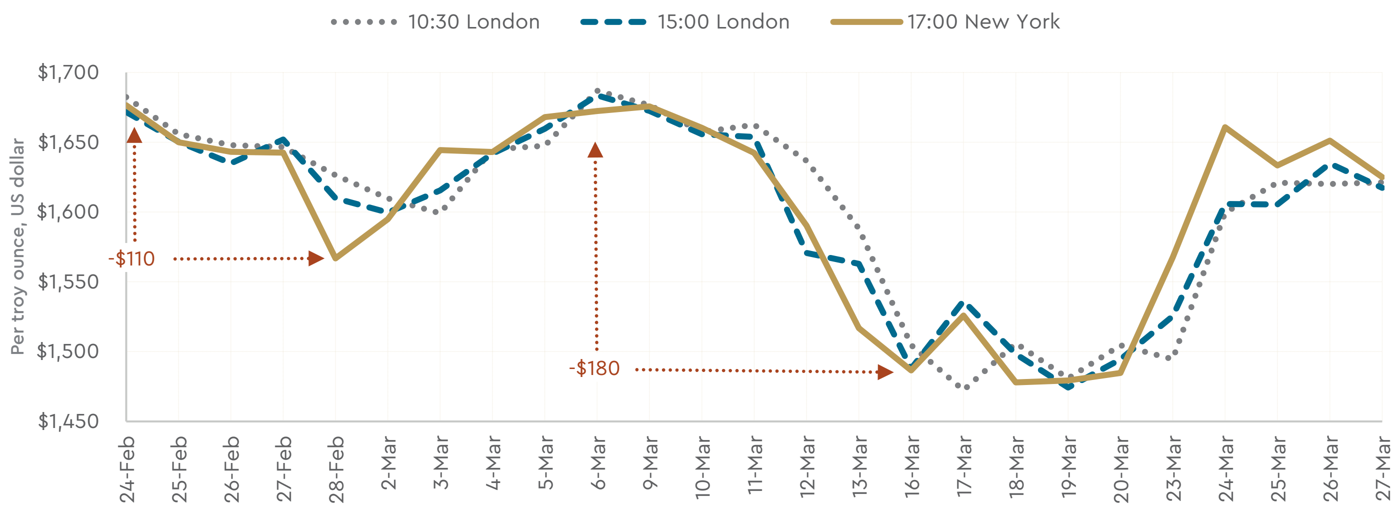
Yet despite the steady surge of bad news, gold, instead of standing up to the tide like an immovable granite mountain, was washed away with prices tumbling head-over-heals from March 6 to March 18 (plus or minus a day). Maybe Jason Zweig, columnist for *The Wall Street Journal*, was right after all when in 2015 he authored a piece entitled, "Let's Be Honest About Gold: It's a Pet Rock".[9]

Is that right? Is gold bullion just an unwieldly trading card? A shiner tulip? A less digital Altcoin? No. Gold did exactly what it was supposed to, as it has for millennia. Here's what happened.

[a] That is not to say there was an absence of credible, public voices warning that a worldwide pandemic was the most probable outcome. There were at least two that your blogger is aware of. The first, was Chris Martenson, a pathologist who specializes in toxicology. He began making daily, public statements on January 24, one day after the city of Wuhan was put into quarantine. The second, was Erik Townsend, the macroeconomics podcast host who on February 8 explained that it was crystal clear by February 1 the most likely scenario was a pandemic.

[b] The S&P 500, NASDAQ Composite and Wilshire 5000 Total Market indices each reached their respective highs on February 19th. America's other main index, the Dow Jones Industrial Average, put in a closing high one week earlier, on February 12. This raises the question, and not for the first time in the past dozen years, whether stock markets remain reliable forward-looking economic indicators as was, or perhaps still is, widely believed. This article is not the place for that discussion, but your blogger would suggest that they are not reflections of general economic conditions.

NOT SINCE THE SAVAGE GOLD PRICE SLAMS OF 2008 HAS THE MARKET SEEN ANYTHING LIKE THIS
(LONDON FIXING AND NEW YORK FUTURES CLOSE, DAILY)



COLLATERAL OF LAST RESORT

First of all, this was to be expected. The preconditions for $100-dollar gold price slams were in place and probable. Why? As I wrote earlier this year for the Singapore Bullion Market Association:

> Gold has over the past 13 years developed a relatively consistent pattern. As the preconditions for the next financial denouement proliferate across the horizon, investors begin to batten down the hatches by placing a higher value on collateral, be it US Treasury securities, German bunds or gold. These safe harbors appreciate in value either absolutely or relatively; the change in valuation a consequence of the rising anxiety levels felt by financial institutions. They fear being caught out, of being short funding, of lacking collateral to post...
>
> Gold hasn't been a cross-cultural monetary standard for millennia just because it is pretty to look at. It has a job – one that it is exceedingly qualified for – and that is to be accepted as money when other financial instruments that were thought to be money are revealed to be credit. **That is when gold is sold.**[10]

The global monetary system malfunctioned in August 2007 and though it still operates, it does not produce enough capital market collateral for the orderly expansion of credit to fund global economic advancement. As a result, the monetary system is susceptible to violent fits of volatility when this collateral shortage is made self-evident (again). Already, since the initial 2007-09 shock, the world has experienced three such paroxysms: the 2011-12 European Sovereign Debt Crisis, the 2014-16 Emerging Markets Currency Crisis, and present day. And while SARS-CoV-2 gave the world a good, sharp shove sending it headlong into another financial palpitation, the conditions for the convulsion had appeared much earlier, all the way back in the fourth quarter of 2017. Throughout 2018, disorder spread quietly through money, currency and commodity markets. By the last quarter of the year the economy had clearly been affected. And despite a year-long campaign by central banks to loosen monetary conditions, the probability of a violent spasm continued to escalate. By the time the virus arrived markets were already standing (dancing?) on a banana peel.

The use of leverage is endemic in financial markets but as a consequence of 2007-09 that leverage must now be collateralized (whereas previously interbank trading – where the great majority of credit is created – was unsecured, if the reader can believe it). As volatility rises the value of the collateral backing the borrowed funds falls.

Think of price volatility as the cost of liquidity. A liquid market is one where an asset can be sold in size without upsetting the market much, if at all. As price volatility rises it signals that liquidity is becoming dearer, less certain and that the orderly sale of assets less probable. Naturally the lenders that extended their balance sheets to financial market participants become anxious in this circumstance. They worry that if markets move rapidly against the borrowers the collateral may not cover the loan and result in a loss for them.

And that is what happened recently. Price volatility spiked across a number of assets. That made many speculations, trades and investments uninvestable. Lenders quickly issued margin calls demanding cash, or additional collateral. If the borrower was unable to provide any, the lender seized the collateral or closed out the borrower's speculation.

This created a self-reinforcing spiral of uncertain collateral value, frequent margin calls – an increasing number of which were not met, closed positions, fire sales, further volatility, further falling collateral values and more margin calls.

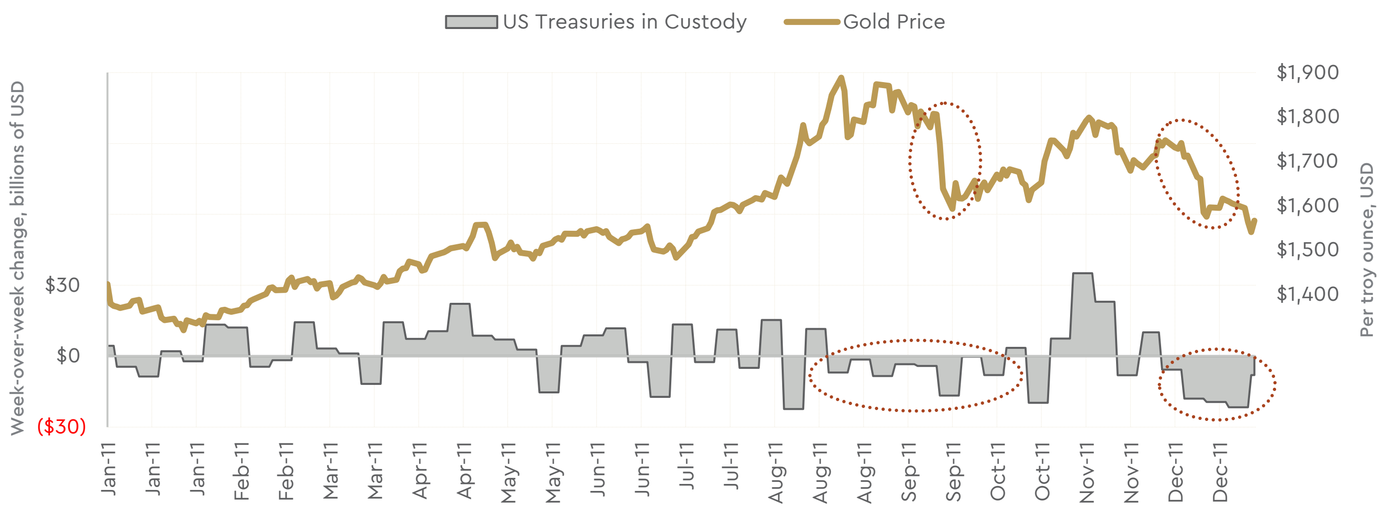
This is where gold comes into the picture. It is an asset that is accepted by everyone, anywhere and anytime. It also has had the habit over the past 12 years of appreciating in value right into the teeth of these volatility fits. Traders, seeing an asset that was already profitable, will 'sacrifice' it to raise funds to cover a levered position that they prefer to retain or perhaps not realize losses on, and thus 'be pulled underwater.'[a]

That is why I was issuing a warning well

[a] Not that your blogger is suggesting gold is the only, or even primary, such fail-safe asset. Short-term sovereign debt issued by the United States, Germany, Japan, and Britain perform the same role and more often than gold. At least, for now they do. This blogger is not the first, nor only commentator to wonder what the half-life is for free-floating currencies tied to wanton fiscal mania.

GOLD SLAMS CORRESPOND WITH CENTRAL BANK COLLATERAL SCRAMBLES: 2011

(US TREASURIES, FACE VALUE, CUSTODY HOLDINGS BY FEDERAL RESERVE, FOREIGN OFFICIAL AND INTL. ACCTS, WED. LEVEL)



before I even knew how to spell SARS-CoV-2:

> Keep an eye on the collateral markets, not the stock markets. Are central banks comfortable holding their US Treasury securities in custody with the Federal Reserve? Or are they pulling them to subsidize the local banking network that may be experiencing difficulties in securing Treasuries on the open market? Are primary dealers freely distributing Treasuries? Or are they hoarding them for their own use? Are banks returning collateral as part of their overnight operations? Or has a disorder convinced them to fail to deliver, even at penalty rates? Are overnight rates in the repurchase agreement market narrowing? Or are they spreading outwards from the unsecured funding offered by the Federal Reserve?[11]

So then, how did the prognostication do? Was there any visible disorder in collateral markets that coincided with gold's rapid descents in price?

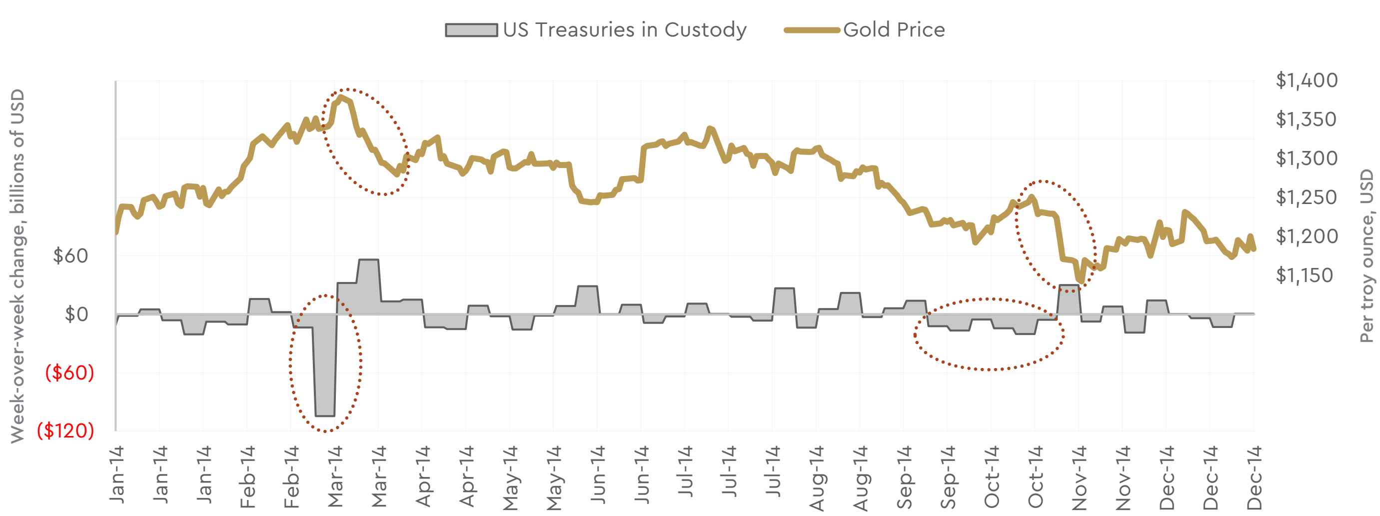
FOREIGN OFFICIAL INSITUTIONS

The Federal Reserve Bank of New York (FRBNY) holds various assets in custody for "foreign official institutions and international accounts". Your blogger will use the short-hand 'other central banks' going forward but actually the clunky term covers several entities.[a] The assets belong to the 'other central banks' but as New York is a global money center these entities find it more efficient to leave them in the city so as to meet the mission of that institution, whatever it may be. Since 2011, the rise and fall of these holdings corresponds well with global monetary conditions.

Specifically, when the environment becomes uncomfortable, when a collateral shortage is more acute, these 'other central banks' pull US Treasury securities out of custody. Why Treasuries? Because they are the keystone in the arch holding up the modern financial edifice. The 'risk-free' rate – such as you will – is derived from them. They

GOLD SLAMS CORRESPOND WITH CENTRAL BANK COLLATERAL SCRAMBLES: 2014

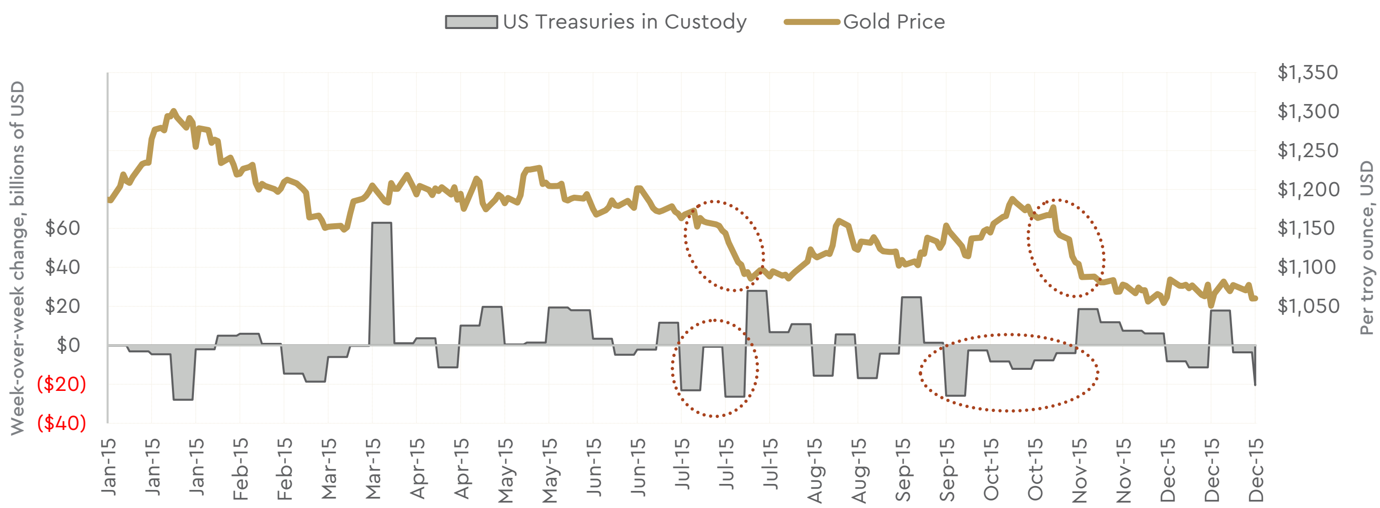
(US TREASURIES, FACE VALUE, CUSTODY HOLDINGS BY FEDERAL RESERVE, FOREIGN OFFICIAL AND INTL. ACCTS, WED. LEVEL)



[a] As a September 2004 note from the US Treasury explained, "'Foreign official and international accounts' are defined to include those of foreign governments and central banks, as well as a small number of international organizations and government investment funds which have accounts at the FRBNY, including the [International Monetary Fund] and the [Bank for International Settlements]."

GOLD SLAMS CORRESPOND WITH CENTRAL BANK COLLATERAL SCRAMBLES: 2015

(US TREASURIES, FACE VALUE, CUSTODY HOLDINGS BY FEDERAL RESERVE, FOREIGN OFFICIAL AND INTL. ACCTS, WED. LEVEL)



are the system's preferred collateral asset.

It is likely that the securities are being pledged as collateral to raise cash, or being lent to the local banking system at favorable (i.e. subsidized) rates to relieve the pressure those local institutions are confronting.

Since the monetary order is global, a disorder somewhere in money markets can spread to regions that have nothing to do with the problem. If it gets bad enough, financial actors 'everywhere' turn for help to their monetary technocrats pleading, demanding, threatening, or all of the above simultaneously. These 'other central banks' have quality collateral on hand locally, but if the panic persists, they turn to the FRBNY and draw on that storehouse.

In early-August 2011 America's central bank was having internal discussions about stepping into something called the repurchase agreement market to bring it under control. The market serves banks as a source for overnight, collateralized loans. Here is an excerpt from the August 9 transcript of the Federal Open Market Committee meeting (emphasis added):

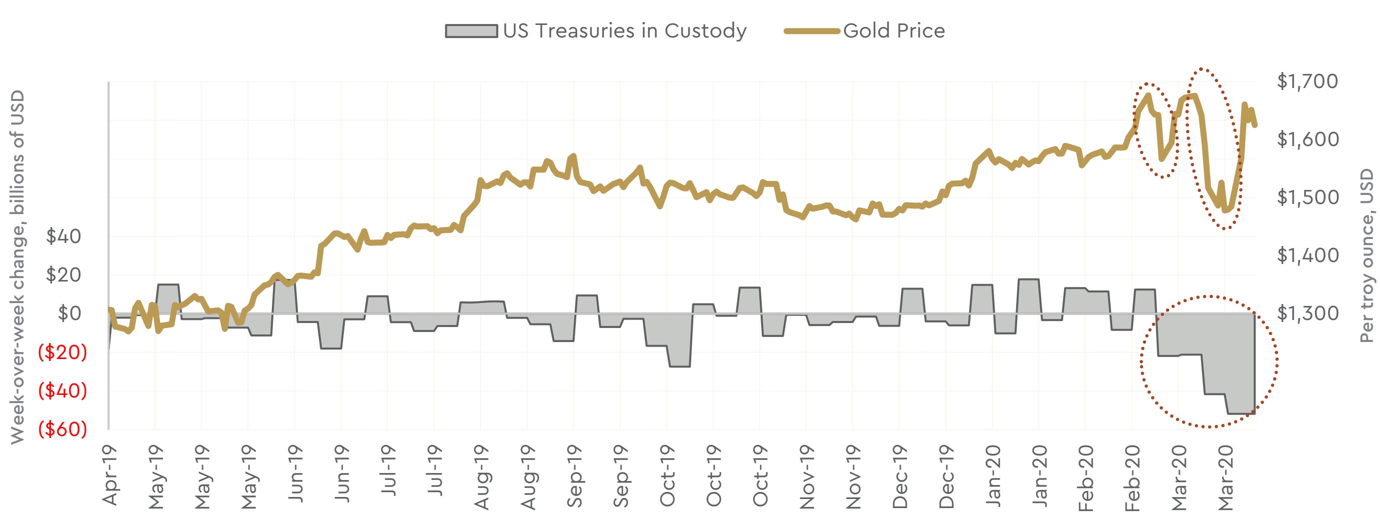
> As I noted on the videoconference, the spike in short-term funding rates left the Desk on alert to the possibility of having to conduct repurchase agreements to keep the federal funds rate within the FOMC's target range. **This was an extraordinary outcome**, given that the financial system has about $1.6 trillion in excess reserves. In the end, we did not conduct any such operations, as the federal funds rate remained within the FOMC's target range.[12]

Though the intervention didn't take place (at least, not till September 2019) it is clear that collateral markets were malfunctioning at the time. Later that month, gold experienced a dramatic and swift fall in price traveling $135 dollars from $1889 on August 22 to $1754 in just two days, a 7% decline. A collateral scramble was in progress. This is now known thanks to the five-years delayed transcript. But it could be surmised at the time too, based on how 'other central banks' were behaving.

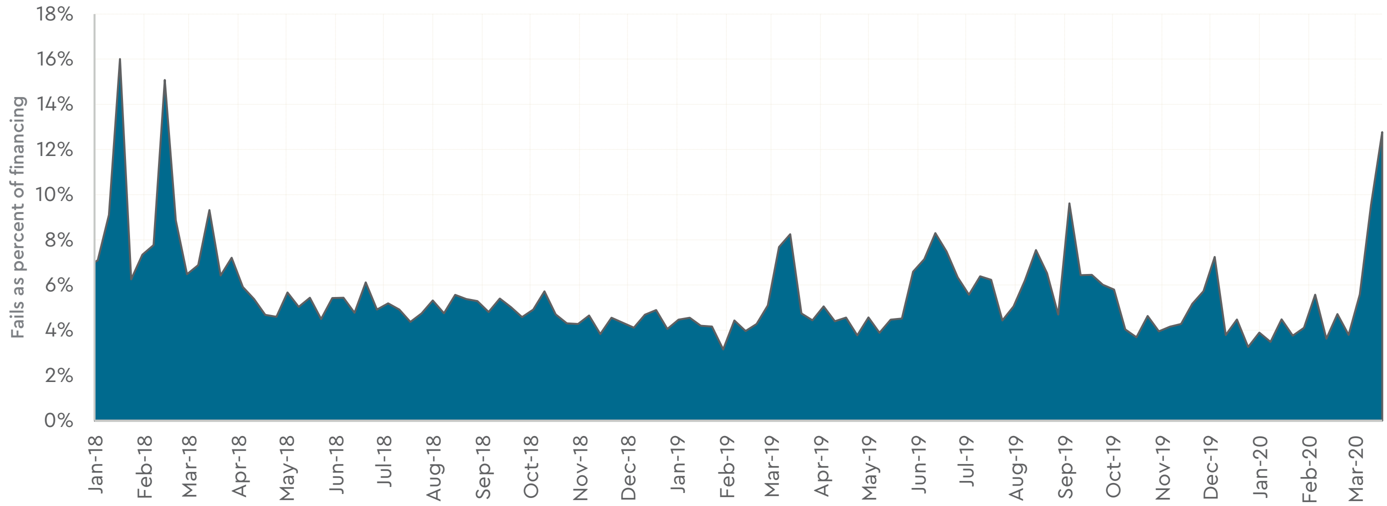
On August 17 the face value of US Treasury securities owned by 'other central banks' held in custody by the FRBNY was reported at $2.665 trillion. But for the next eight weeks 'other central banks' drew down their holdings every week. That's highly unusual. The last time anything like it had happened was a six-week stretch that began August 8,

GOLD SLAMS CORRESPOND WITH CENTRAL BANK COLLATERAL SCRAMBLES: 2020

(US TREASURIES, FACE VALUE, CUSTODY HOLDINGS BY FEDERAL RESERVE, FOREIGN OFFICIAL AND INTL. ACCTS, WED. LEVEL)



RECENT DISORDER IN REPO IS ANOTHER CONFIRMATION OF A BROAD COLLATERAL SHORTAGE
(FAILS VS. FINANCING, PRIMARY DEALERS, TREASURIES EX-TIPS, FAILURE TO DELIVER + RECEIVE, SECURITIES IN + OUT)



2007. That was the week when the Great Financial Crisis (worst name ever) began. As Adam Applegarth, the chief executive of Northern Rock, explained, "The world stopped on August 9. It's been astonishing; gobsmacking. Look across the full range of financial products, across the full geography of the world, the entire system has frozen." [13a]

Another collateral free-for-all occurred in 2011 as well. On November 30 the FRBNY held $2.667 trillion in US Treasury securities in custody for 'other central banks'. Over the next six consecutive weeks this silo of collateral was reduced every week, lowering holdings by $77 billion, equal to a 3% reduction. Gold prices swooned dramatically right on cue. From a closing high of $1741 on December 7 gold dropped $166, or 10%, to $1575 by December 15.

These gold slams and collateral stampedes occurred during the Emerging Markets Currency Crisis as well. The week of March 12, 2014 the FRBNY reported the largest single-week draw down in the data series history stretching back to 1989 at 3.5% of holdings. Gold began a vertigo-inducing drop lasting from March 14 to April Fools' Day of $100, just over 7%.

Later that year, another precipitous decline in gold prices from October 21 to November 6 amount to a $109 decline, or 8.7%. That coincided with a six-week block of consecutive redemptions at the FRBNY that had started September 24 and was part of a broader, unprecedented 27-week period of general withdrawal that lowered total holdings by $130 billion, or 4%.

The next year, from July 6 and for the next 12 trading days gold dropped like a (pet) rock from $1,173 to $1,091, or 7%. Again, heavy redemptions totaling $50 billion over that same period.

The futures price of gold in US dollar terms reached its eleven-year low of $1,051 on December 17, 2015. Right before that, from October 28 to November 6 gold tripped lower $90, or 8%. You, dear reader, won't be surprised to read that it coincided with another six-week string of redemptions totaling $61 billion and equal to 2% of holdings.

Fast forward to the first gold slam of the present situation. On February 26, $3.005 trillion in face value of US Treasuries were held in custody. Over the next three weeks custody holdings were drawn down each week totaling $85 billion. How extreme was each week relative to recent experience? Since January 2018 those three weeks delivered withdrawals that were in the 90th to 99th percentiles. And though gold prices have since recovered, the drawdown by foreign institutions didn't stop. In fact it accelerated to $52 billion as of March 18th, the latest available data at time of publication. For the four weeks combined, a total of $136 billion was drawn down. That is the most in the data series history. In relative terms, the drawdown was equal to approximately 5% of the face value a month ago. That reduction of 5% over the course of four weeks has only occurred on two previous occasions since 1989.

REPURCHASE AGREEMENT FAILS

A repurchase agreement is a process by which capital market securities (e.g. United States government bills[b], commercial paper[c]) or short-term bank obligations (e.g. bankers' acceptances[d], certificates of deposit[e]) are converted into cash. The innovation gained a foothold during the 1970s by converting future cash flows siloed on the balance sheets of businesses into immediate working-capital. The process works like an overnight, secured loan. The business would assign the securities to a bank who would in return credit the business cash. The next day, the cash was returned plus a tiny premium and the bank returned the collateral. This makes no sense as one-time transaction but if one rinses and repeats the cycle every day into a fine lather the business repurchase agreement account is cash liquid *every day*. And if it is cash-liquid then businesses can write checks against the accounts, which they did. Fast forward 40 years and the "repo market" is now dominated by banks who rely on it to fund themselves,

[a] The end of the six-week stretch was September 12. On September 14 the Bank of England announced it would extend a credit line to Northern Rock. The bank would be nationalized six months later.
[b] A short-term debt obligation backed by the US Treasury Department with a maturity of one year or less.
[c] An unsecured, short-term debt obligation backed by a corporation with a maturity rarely longer than 270 days.
[d] A short-term credit investment created by a non-financial corporation but also guaranteed by a commercial bank to make payment to a specific entity. However ownership is transferable prior to maturity to other entities.
[e] A savings certificate with a fixed maturity date, fixed interest rate and backed by a financial institution (like a bank, for example).

either for investment purposes or to meet regulatory requirements. The repo market is so vital that at least one monetary expert considers it, "the last line of liquidity defense in the offshore world."[14]

However, there are moments when the smooth function breaks down and a party refuses to return the collateral. Why would this happen? Either the collateral had been repledged by the collateral holder for their own funding purposes and is unavailable to be returned, or the collateral is more valuable than the cash and the reticent party will gladly pay a penalty to retain it.

The first possibility readers have likely heard of before and goes by the fancy term "rehypothecation", which means 'using something that isn't yours to lever up and goose your returns with the perfectly unreasonable expectation that nothing will go wrong.' It is the use of a single asset repledged multiple times for funding.

The second possibility is more awkward to grasp conceptually because in day-to-day life it seems that having cash is the ultimate financial certainty. But sometimes it is more valuable to have a credit card, with a large credit limit, even if the certainty is less. One monetary format is more certain, the other more high-powered. In the modern financial system collateral can act as that higher-powered monetary format.

Well, when these breakdowns occur, they are reported to the FRBNY as a failure to deliver or failure to receive. It means there is not as much collateral available as market participants anticipated there would be. The consequences of a collateral shortage then radiate out from repo into other markets.

The collateral this blogger is focused on is again the US Treasury security. (There are six different securities tracked by the FRBNY[a] but the lion's share – 62% as of March 18 – are nominal US Treasury securities.) The FRBNY reports every week what the cumulative dollar value was for fails by Primary Dealers.[b]

For the week ending Wednesday, February 26 total fails to receive and fails to deliver were reported to be $140.0 billion. Is that a lot? Well, as a percentage of financing[c] that was only 3.8%. To put some context around those numbers, since January 2018 that fails total in dollar terms only ranked in the 20th percentile; as a proportion of financing it was equivalent to just the 10th percentile. In other words, it was well below average for what a typical week looks like.

But then, by Wednesday, March 4 total fails had run ahead to $228.1 billion and were now equal to 5.6% of total financing. Those figures were now in the 80th and 65th percentiles.

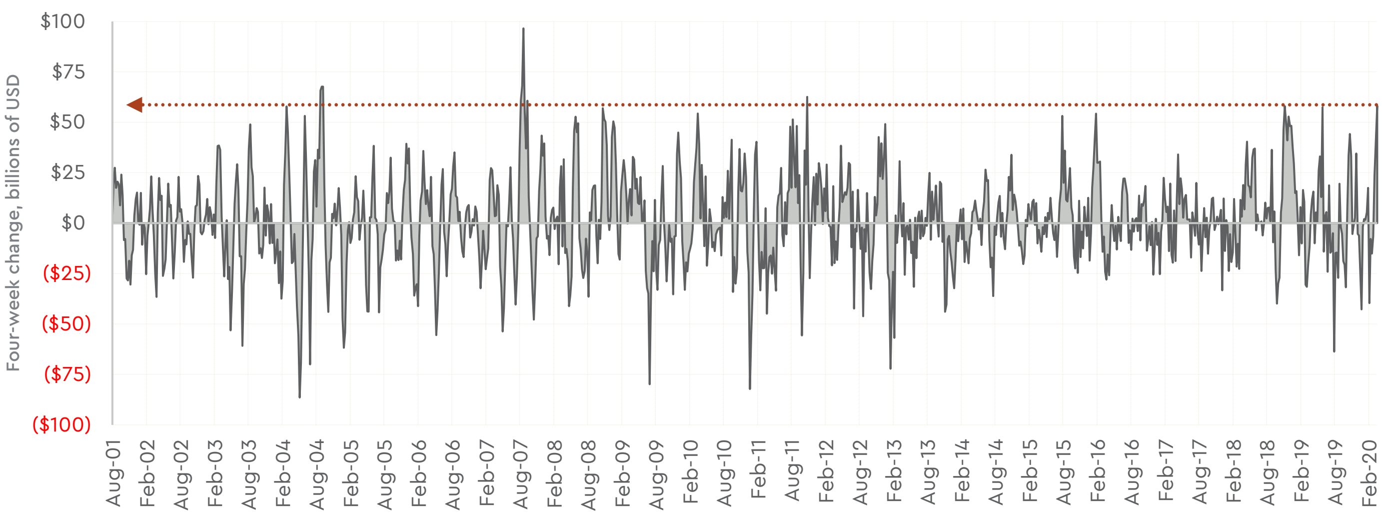
Over the following two reporting periods – March 11 and 18 – the fails to receive and deliver total accelerated to $407.0 billion and $566.2 billion, respectively! They were now equal to 9.5% and 12.8% of total financing, respectively! If the reader guessed that these two weeks found themselves between the 95th and 99th percentiles of the two-plus years since January 2018 then congratulations, that is correct.

PRIMARY DEALER HOARDING

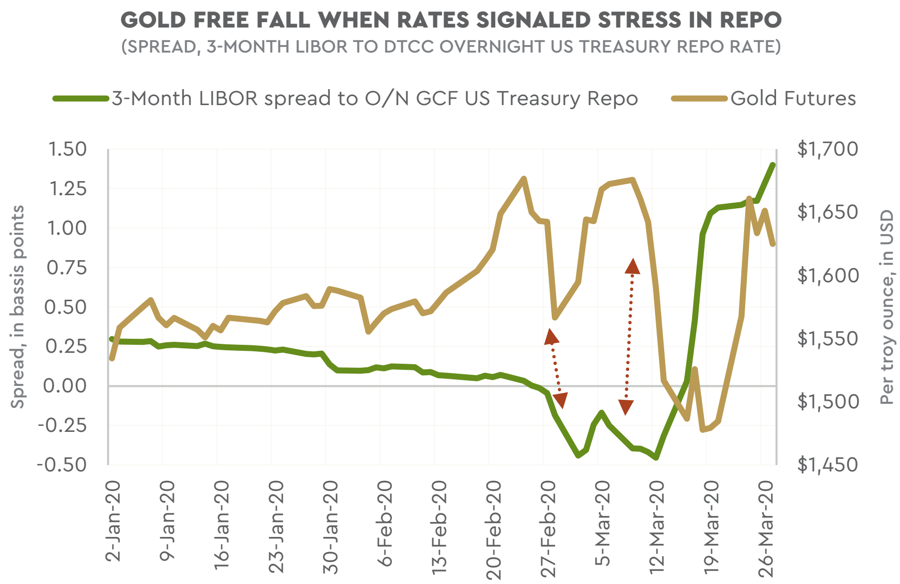
Another measure of collateral elasticity is the net position of Primary Dealers in Treasury securities. After all, they are on the front line of collateral acquisition and disbursement. Throughout the early 2000s the Primary Dealers were net short US Treasuries. And why shouldn't they be? It was the risk-free asset in a riskless world. What banker in their right mind would own any?

The careful reader will not be surprised to learn that bankers abruptly changed their philosophical position on the nature of risk in August 2007 and, at the same time, began to inexorably reduce their short position. They would eventually transition to being net long

THE MOST RECENT FOUR-WEEK INCREASE IS A 99TH PERCENTILE RESULT
(PRIMARY DEALERS, US TREASURY NET POSITION, COUPONS AND BILLS, EXCLUDING TIPS)



[a] US Treasury Securities, US Treasury Inflation-Protected Securities, Federal Agency and [Government Sponsored Enterprise] Securities, Federal Agency and GSE Mortgage-backed Securities, Other Mortgage-backed Securities and Corporate Securities.
[b] Primary Dealers are banks that been given the privilege and obligation of buying debt directly from the US government. These banks then resell these securities to the wider market or retain them for their own purposes. This privileged group of banks presently numbers 24 and includes non-American entities, which some readers may be surprised by: Amherst Pierpont Securities LLC, Bank of Nova Scotia, New York Agency, Barclays Capital Inc., BMO Capital Markets Corp., BNP Paribas Securities Corp., BofA Securities, Inc., Cantor Fitzgerald & Co., Citigroup Global Markets Inc., Credit Suisse AG, New York Branch, Daiwa Capital Markets America Inc., Deutsche Bank Securities Inc., Goldman Sachs & Co. LLC, HSBC Securities (USA) Inc., J.P. Morgan Securities LLC, Jefferies LLC, Mizuho Securities USA LLC, Morgan Stanley & Co. LLC, NatWest Markets Securities Inc., Nomura Securities International, Inc., RBC Capital Markets, LLC, Société Générale, New York Branch, TD Securities (USA) LLC, UBS Securities LLC., and Wells Fargo Securities, LLC.
[c] This data is also reported by the FRBNY and covers all "securities in" and "securities out" used by Primary Dealers, including reverse repurchase agreements, securities borrowed, repurchase agreements, securities lent and other financing activity.



having concluded they now inhabited a returnless world.

Over the past twelve years the position has fluctuated with the prevailing economic conditions. During an economic reflation – which is not the same thing as a recovery – the net-long position would shrink. And on three occasions, during the height of blithe optimism, the dealers became net short. These were fleeting periods. Today, they are longer Treasuries than they ever were short.

One could look at eight different types of securities tracked by the FRBNY and reported by Primary Dealers but this report will focus on nominal US Treasuries for simplicity's sake and because they're the best collateral format.

Unlike the custody holdings of 'foreign central banks' the Primary Dealer reaction does not seem to lead the gold price slam. Instead it roughly trails it.

The week ending Wednesday, February 26 gold prices had only been falling for two days. Was that enough to encourage Primary Dealers to add $21.3 billion week-over-week? Perhaps, perhaps not. They actually decreased their net position by $6.7 billion by March 4, the week of gold's first fall. Over the next week though they added an additional $43.2 billion. But then $0.4 the next week.

Despite the Primary Dealer collateral hoarding not moving in a 1-to-1 relationship with gold, one did observe a $21.3 billion increase (85th percentile since January 2018) and $43.2 billion (the biggest of the study period).

And the one-month period? On that measure holdings increased by $58.1 billion dollars during gold's fall. That's a 99th percentile result since 2001.

INTEREST RATE SPREADS

The problem with the measures recounted so far is that they are a week delayed in reporting. However, there is a real-time measure that can be looked at: interest rates.

The Depository Trust & Clearing Corporation publishes a rate every day for US Treasury collateral repo market trades. One can compare this rate to the London Interbank Offered Rate (LIBOR) which reflects what banks would lend to each other on an unsecured basis. As the reader can surmise, the collateralized loan rate should be lower than the uncollateralized LIBOR rate. And indeed that is what one observes generally.

Heading into February 24 the spread between the three-month LIBOR rate and the overnight repo rate was positive, but already declining.[a] By the 24th it was only at three basis points. The next day it hit zero. From there the collateralized overnight rate rose *above* the unsecured market until by March 2nd there was a 44-basis point spread!

The participants in the collateral market had put a premium on collateral, or they raised the credit risk of their counterparties. Whatever the reason, there was escalating disorder in the market.

Over the next two days when gold rallied the market 'calmed down' until the spread was 'only' a negative 17 to 24 basis points. Then, from March 6 to March 17 the spread widened up to 45. Since 2018, of the nearly 500 daily spreads the two 44-plus readings were in the top seven. Looking back to 2005, the two readings were in the 95th percentile.[b]

Now, while this most recent gold slam lines up almost day-for-day with the spread fluctuation this is not the case for previous gold slams identified in 2011, 2014 and 2015. Sometimes, they did and sometimes they did not. That is why it is necessary to look these rapid $100-dollar drawdowns through multiple lenses to get a proper sense of what's happening. As is usually the case with these complex systems, there is no silver bullet.

CONCLUSION

Your blogger remembers reading an academic analysis of gold prices during extreme economic and political events. The study concluded that gold did a poor job as an investment because prices did not vault higher in real terms. The authors found that gold only appreciated by a percent or so (in real terms).[15] (Of course, cash, bonds and equities were garroted during these same extreme events.) But that's the point. Gold retains its value and that's about it. In real terms it doesn't move up or down that much. In a world of constant change, this inertness and constancy is a true miracle. And it was observed again in present circumstances.

As the economy deteriorated the price of gold appreciated anticipating the escalating probability of unrestrained volatility. Then, once the panic was in progress, the golden insurance policy was cashed in. And as has been the case for millennia, the metal found willing buyers. That's what the metal is best suited for, an insurance policy. A form of wealth preservation that is turned in without worry that the 'insurance company' won't have the ability meet its liability. Once again, gold did it what it was supposed to.

[a] It seems a bit apples-to-mangos to compare a three-month rate to an overnight rate, however the 'gold standard' rate in LIBOR is the three-month rate. The same phenomenon described above occurs with overnight LIBOR, except that the spread was already negative heading into the gold slam. Both spreads were unusually high and signaled disorder in the collateral market relative to recent experience.

[b] Most interestingly, but not for the purposes of this report, the spread then performed a U-turn and exploded higher such that unsecured lending was now 40 to 90 basis points more than collateralized lending. What happened? Your blogger believes that the contagion spread out from 'just' the collateral markets directly onto the bank balance sheets. Unsecured lending now didn't want to lend to 'anyone', everyone was now suddenly a risk. Perhaps this is why gold prices rallied as the problem was no longer acutely collateral but everything in general.

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