Flash Report Gold & JPM

January 21st, 2014

francescomaggioni.com
IT +39 393 70 40 234
UK +44 757 681 62 43

"Quantitative approach for asymmetric results"

Investing in gold like a real pro

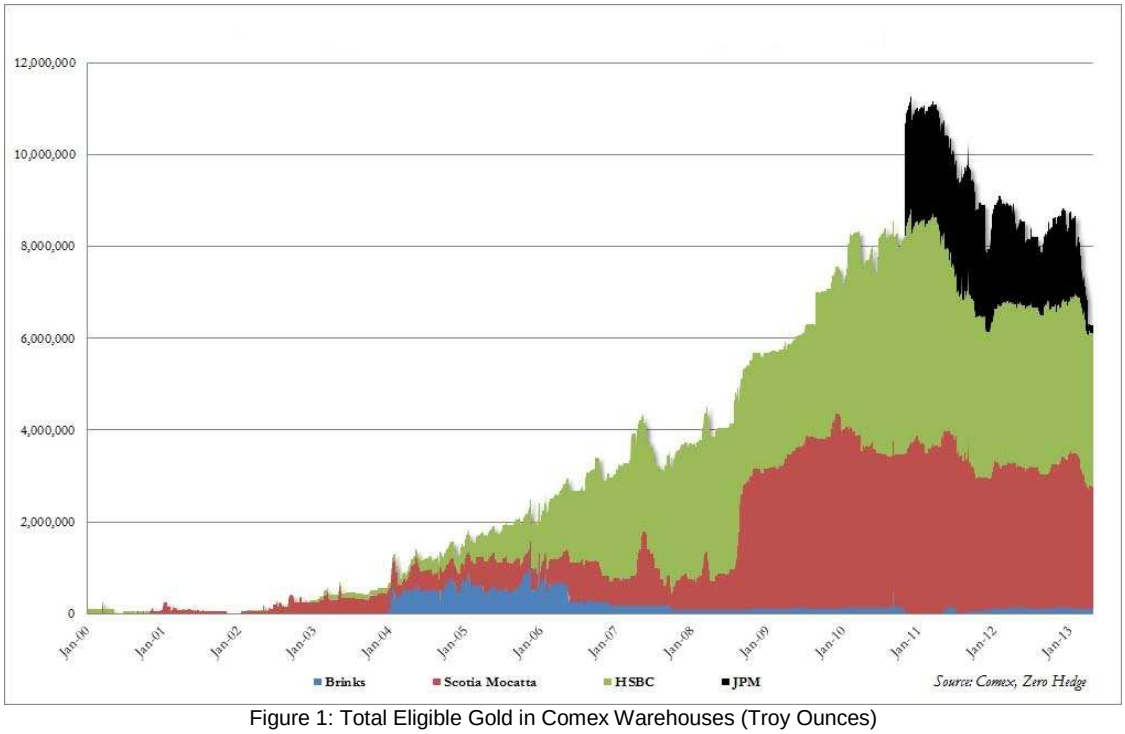


Figure 1: Total Eligible Gold in Comex Warehouses (Troy Ounces)

I don't know how many of you remember last year news concerning JP Morgan and their troubled situation with their Gold deposit. Around May last year the news was that JP Morgan vault was empty and that had to borrow Gold from third parties in order to proceed and delivery it for those who wanted the physical against their future contracts. The news was in May, but looking at the chart above and the following ones, it is clear that the bank was forced to constant and huge deliveries for the physical even weeks and months before. What exactly does it say about Gold? That there is a huge request for the physical despite all the reports claiming a bear market for the yellow metal.

Remember, Gold at that point was valued at a 6 months average (November 2012 to April 2013, just before the May event and biggest drop in price of the metal) at 1,580 usd circa and still demand was huge. Can you guess today with Gold at 1,238 usd how strong the demand is (the chart on Figure 6 will try to anser this question)?

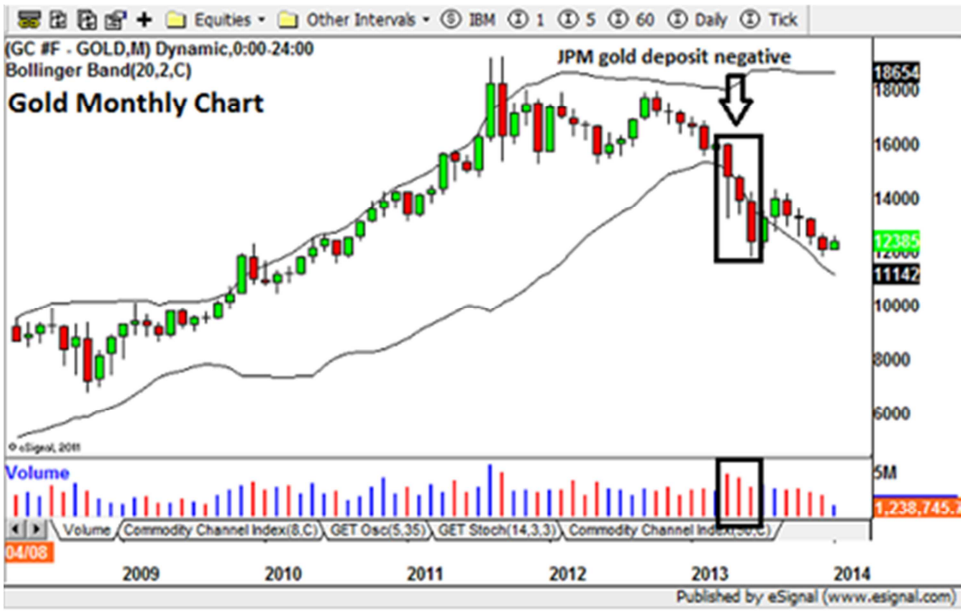


Figure 2: Gold (Bloomberg ticker: GC) monthly chart with highlighted the worst drawdown

The JPM vault - the *largest private gold* vault in the world - is located at 1 Chase Manhattan Plaza, and is literally adjacent to the vault of the New York Fed 80 feet, and 5 sublevels, below street level. It is known that for a long time the vault held around 2.5 million ounces of eligible (*commercial*) gold, a number which declined only gradually until end of 2011. What many may not know, is that while registered Comex gold has been flat, the amount of eligible gold in Comex warehouses in the past several weeks has plunged from nearly 9 million ounces, to just 6.1 million ounces as April 2013 - the lowest since mid-2009.

CME Group

COMMODITY EXCHANGE, INC.

METAL DEPOSITORY STATISTICS

GOLD — **Report Date: 4/26/2013**
Troy Ounce — **Activity Date: 4/25/2013**

DEPOSITORY	PREV TOTAL	RECEIVED	WITHDRAWN	NET CHANGE	ADJUSTMENT	TOTAL TODAY
BRINK'S, INC.						
Registered	494,576.350	0.000	1,300.030	-1,300.030	0.000	493,276.320
Eligible	130,311.285	0.000	0.000	0.000	0.000	130,311.285
Total	624,887.635	0.000	1,300.030	-1,300.030	0.000	623,587.605
HSBC BANK, USA						
Registered	378,053.279	76,315.116	0.000	76,315.116	0.000	454,368.395
Eligible	3,108,179.422	76,315.116	0.000	76,315.116	0.000	3,184,494.538
Total	3,486,232.701	152,630.232	0.000	152,630.232	0.000	3,638,862.933
JP MORGAN CHASE BANK NA						
Registered	780,334.469	0.000	0.000	0.000	-17,468.876	762,865.593
Eligible	141,581.496	0.000	0.000	0.000	17,468.876	159,050.372
Total	921,915.965	0.000	0.000	0.000	0.000	921,915.965
MANFRA, TORDELLA & BROOKES, INC.						
Registered	19,971.075	0.000	0.000	0.000	0.000	19,971.075
Eligible	6,974.886	0.000	0.000	0.000	0.000	6,974.886
Total	26,945.961	0.000	0.000	0.000	0.000	26,945.961
SCOTIA MOCATTA						
Registered	501,154.696	0.000	0.000	0.000	499.520	501,654.216
Eligible	2,429,661.996	1,118.742	0.000	1,118.742	-499.520	2,430,281.218
Total	2,930,816.692	1,118.742	0.000	1,118.742	0.000	2,931,935.434
TOTAL REGISTERED	2,174,089.869	76,315.116	1,300.030	75,015.086	-16,969.356	2,232,135.599
TOTAL ELIGIBLE	5,816,709.085	77,433.858	0.000	77,433.858	16,969.356	5,911,112.299
COMBINED TOTAL	7,990,798.954	153,748.974	1,300.030	152,448.944	0.000	8,143,247.898

For questions regarding this report please email Registrar@cmegroup.com or call (312) 341-3370.

Figure 3: CME April 26th report showing movement in the CME deposits

What nobody knows, is why virtually the entire move in warehoused eligible gold is driven exclusively by one firm: JPMorgan, whose eligible gold has collapse from just under 2 million ounces as of the end of 2012 to a nearly record low 402,374 ounces as of April 2013**,** a drop of 20% in one day, though slightly higher compared to the recent record low hit on April 5 when JPM warehoused commercial gold touched a post-vault reopening low of just over 4 tons, or 142,700 ounces. This happened just days ahead of the biggest ever one-day gold slam down in history.

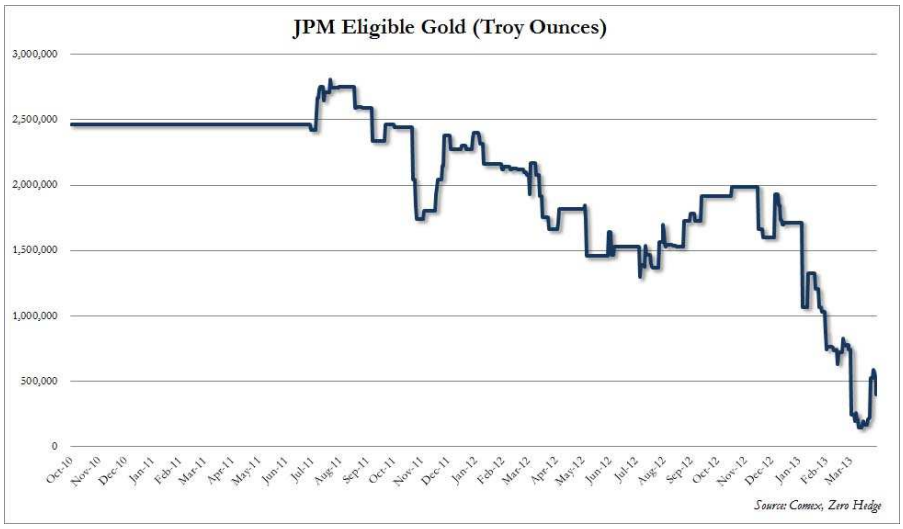


Figure 4: JP Morgan Eligible Gold (Troy Ounces)

The following table shows how still in August 2013 JP Morgan's eligible gold was just little above the lowest level registered during the previous April one and brings evidence to the fact that the bank was borrowing the yellow metal from other institutions, Scotia bank in this case.

GOLD — **Report Date: 8/23/2013**
Troy Ounce — **Activity Date: 8/22/2013**

DEPOSITORY	PREV TOTAL	RECEIVED	WITHDRAWN	NET CHANGE	ADJUSTMENT	TOTAL TODAY
BRINK'S, INC.						
Registered	129,282.490	0.000	0.000	0.000	397.420	129,679.910
Eligible	118,480.915	0.000	0.000	0.000	-397.420	118,083.495
Total	247,763.405	0.000	0.000	0.000	0.000	247,763.405
HSBC BANK, USA						
Registered	154,455.153	0.000	0.000	0.000	100.520	154,555.673
Eligible	3,132,474.000	0.000	0.000	0.000	-100.520	3,132,373.480
Total	3,286,929.153	0.000	0.000	0.000	0.000	3,286,929.153
JP MORGAN CHASE BANK NA						
Registered	286,485.185	0.000	0.000	0.000	0.000	286,485.185
Eligible	148,786.664	**28,809.155**	0.000	28,809.155	0.000	177,595.819
Total	435,271.849	28,809.155	0.000	28,809.155	0.000	464,081.004
MANFRA, TORDELLA & BROOKES, INC.						
Registered	13,002.306	0.000	0.000	0.000	0.000	13,002.306
Eligible	6,715.933	0.000	0.000	0.000	0.000	6,715.933
Total	19,718.239	0.000	0.000	0.000	0.000	19,718.239
SCOTIA MOCATTA						
Registered	207,712.634	0.000	**28,809.155**	-28,809.155	4,605.515	183,508.994
Eligible	2,815,860.361	0.000	0.000	0.000	-4,605.515	2,811,254.846
Total	3,023,572.995	0.000	28,809.155	-28,809.155	0.000	2,994,763.840
TOTAL REGISTERED	790,937.768	0.000	28,809.155	-28,809.155	5,103.455	767,232.068
TOTAL ELIGIBLE	6,222,317.873	28,809.155	0.000	28,809.155	-5,103.455	6,246,023.573
COMBINED TOTAL	7,013,255.641	28,809.155	28,809.155	0.000	0.000	7,013,255.641

Figure 5: CME August 23rd showing movements of eligible gold among banks.

We can then make some assumptions based on the facts above:

1. Demand for physical gold never declined, actually between 2012 and 2013 there has been an incontrollable spike in physical delivery requests that JP Morgan was not able to control.

2. During the same period of time JP Morgan decided not to buy gold in the open market in order to fullfil their obligations, letting its gold deposit go even negative. With hindsight another safe assumption is that someone at JP Morgan was correctly forecasting that a strong downward movement in the price of the metal was just around the corner, suggesting the executives to wait and buy it at a better prices.

3. Since then we (those who took the bother of looking at this matter) have been witnessing a divergency between reports released by investment banks and the actual physical gold behaviour. Most of the reports in fact have been declaring a new bear market in gold, while behind the (media) scenes the opposite was actually happening.

To bring some confirmation about point 1. in particular, at the following chart you can see Comex gold stocks (= read quantity of gold requested, not gold listed companies) that are eligible for delivery versus open interest has risen to a historic extreme of 112:1. This means that the gold owners will demand higher prices to put their gold up for delivery and is bullish for gold prices.

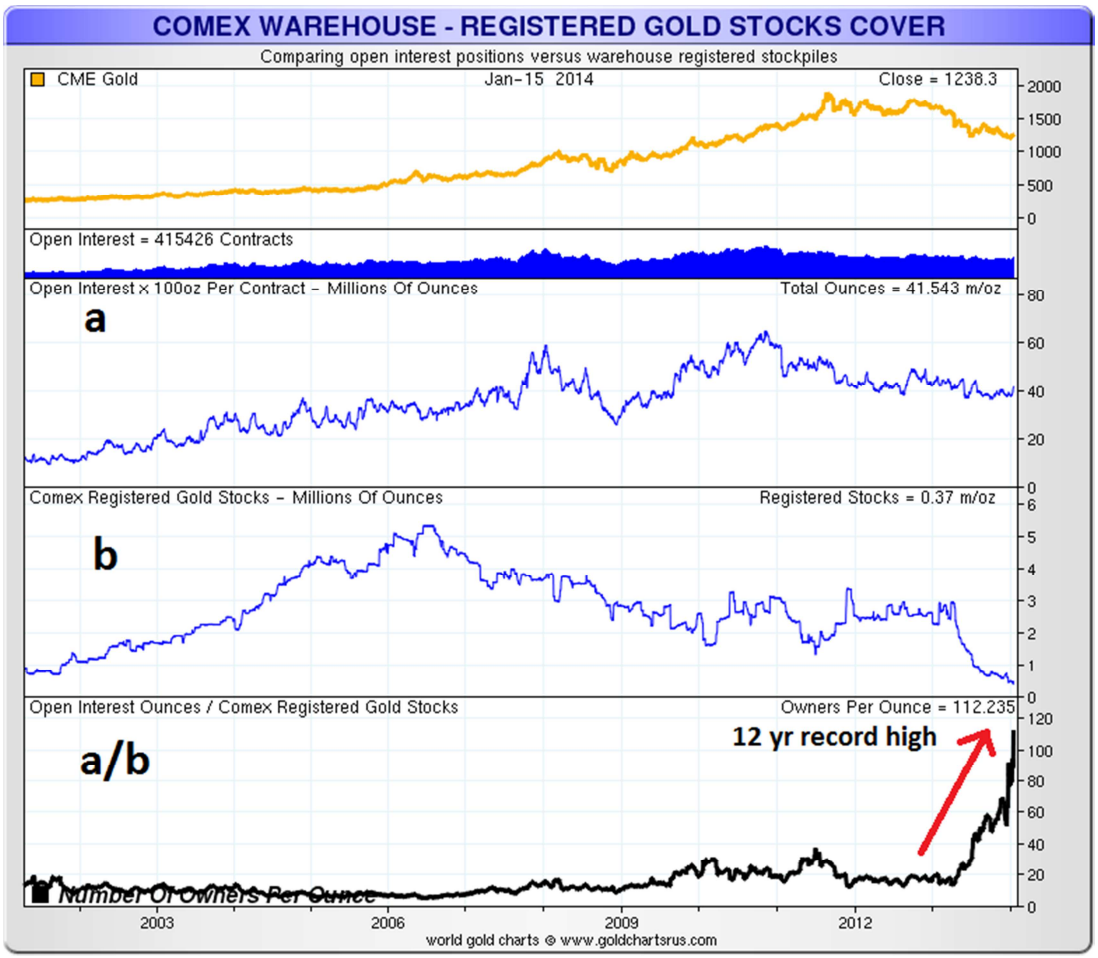


Figure 6: Gold: price, open Interest, eligible amount, and open Interest/eligible amount

What can be derived that could be put in our investment strategy so far, even without going any further?

That the current gold price range between 1170 and 1280 usd can be safely labelled as a good accumulation range, and that to me it will be very surprisingly if such low will be broken.

In addition to all the above we can safely assume that we will be witnessing the return of an upward trend in the price of gold only when the banks' deposits will show significant increase in the amount of eligible gold held, which to date it is not yet happening.

Now let's move on and try to give additional information which can be used to predict future gold price movements.

Investing in gold has two main goals: protection against inflation, and protection against possible implosion of the financial system.

We can debate that concerning a possible implosion of the financial system, either politicians and central bankers did a good job in making us to believe we avoided it for good, or it has been just postponed, while for **what concerns inflation there is no question that sooner or later we will be dealing with it. It is just math, and math does not lie.**

However what I have been wrong on gold is that before getting to the upcoming (hyper) inflation new era there would have been an intermediate period of low inflation and anemic growth in most of the western countries due to real problems in the real economies: that therefore did not immediately translate into outright inflation.

The question is then, am I still right in forecasting **at least** a double top in Gold in the near future?

In the next charts you will see how gold prices are quite correlated to the Fed's balance sheet expansion, and surprisingly since when that correlation has been temporarily put off. Similarly there has been a correlation between the US Debt (being possible thanks to the Fed?) and Gold prices too.

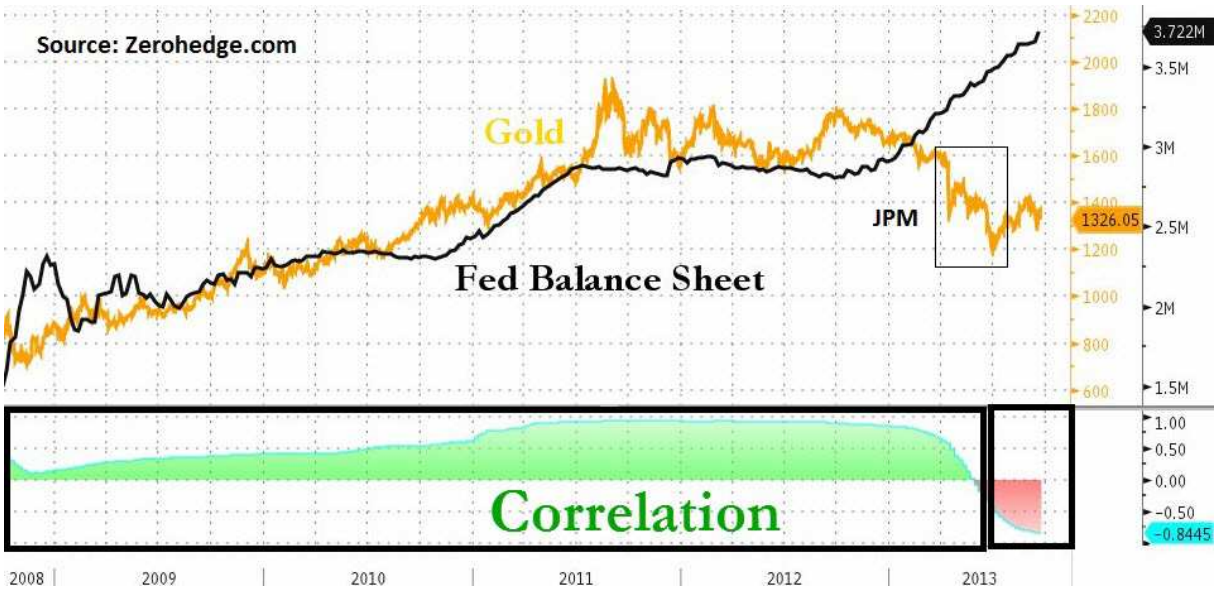


Figure 7: Correlation between Fed Balance Sheet and Gold price

For the “stable and long lasting” relationship between central bank balance sheets and gold to recouple, Gold would need to be back to around $1800 an ounce as of late 2013.

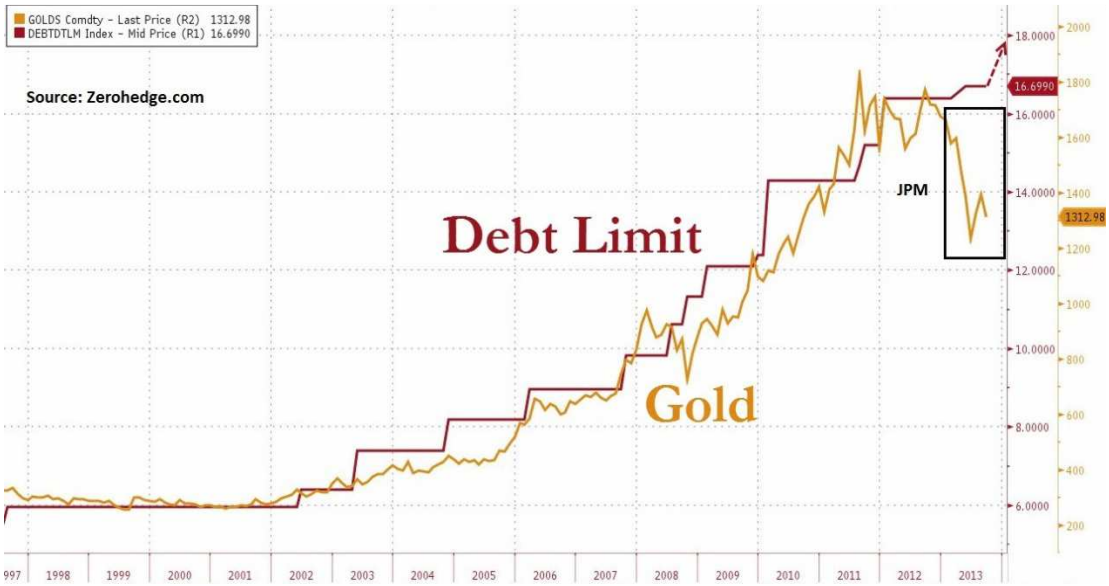


Figure 8: Correlation between US Debt and Gold price

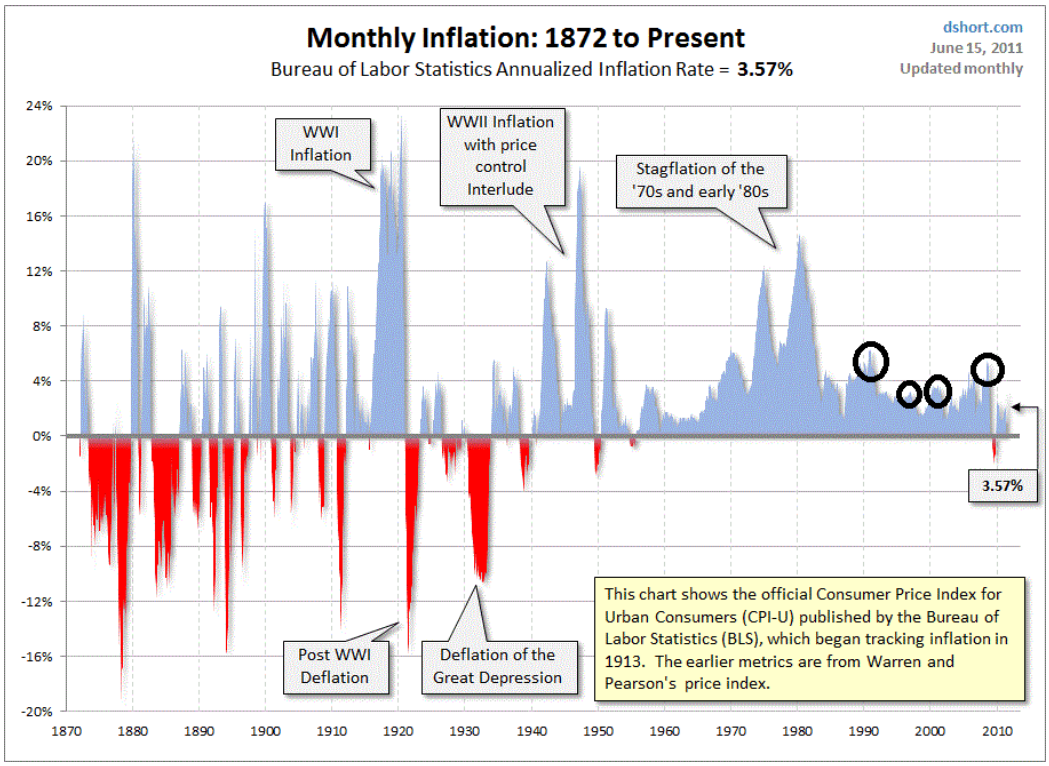


Figure 9: Monthly chart showing historical inflation level in the US

The above chart shows the historical inflation level in the US up to 2010. It does not contain very recent data but very little has changed since 2010 apart from a massive QE injected in the financial system. What it is interesting to note though is to see when in the last few years there have been spikes in inflation, and namely there were in: 1990, 1998, 2002, 2007.

To which events those years have a connection to?

Each of those years are subsequent to a financial crisis and namely the 1987, 1998, 2001 and we have yet to see the consequences to the 2009 one.

Let me remind you that each and every market top from 1990 to today has been achieved mainly (but not solely) by a prolonged environment of low interest rates. The deviation to the normal set of actions to exit from a financial crisis happened only in 2009, when together to the usual lowering of interest rates the Fed had to also directly inject liquidity just to achieve the same result as before.

Is it therefore safe to assume that a period of higher inflation is just in front of us? The answer is yes, and it is also a very conservative answer.

Below you can find a final chart which shows the historical movements of the Dow Jones index / Gold ratio.

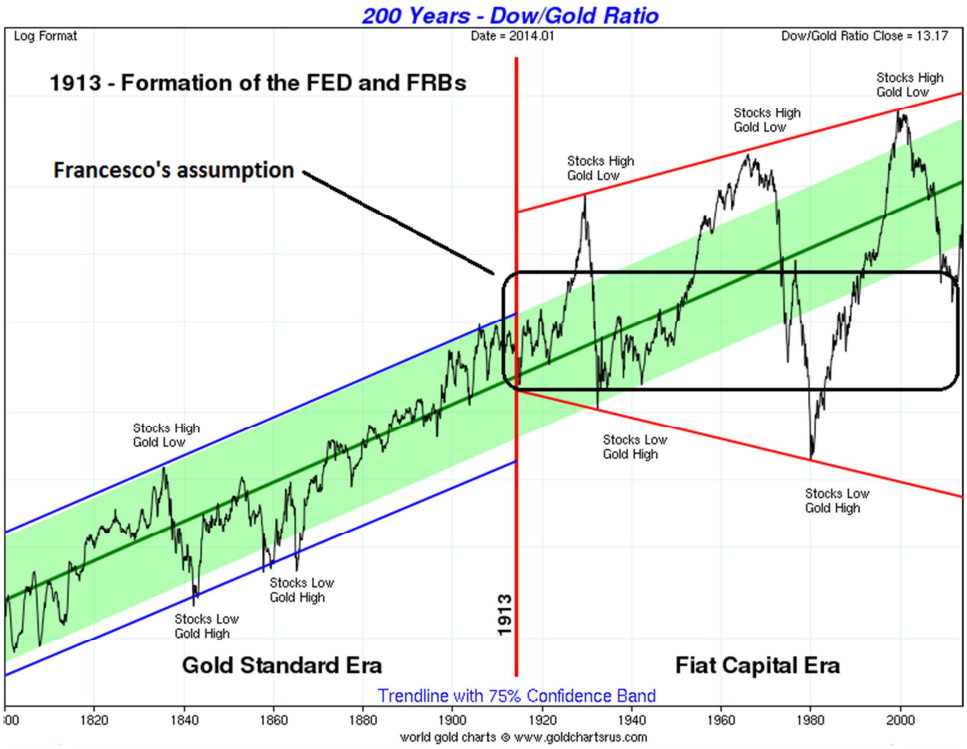


Figure 10: Historical chart of the Dow/Gold ratio

The first interesting information you can derive from the chart (source: solarcycles.net) is the effective intrusion that the creation of the Fed has generated since its creation in 1913.

On a pure technical analysis point of view the formation that resulted since 1913 is called an "opening wedge" or a "fan" and it would imply that the instrument which is inside such formation should touch on both sides of the wedge's extremes. Indeed is what some are waiting. However please note that the chart is up to 2009 and therefore it does not show the latest price actions. Most probably the current level of the ratio should be in near the upper side of the wedge.

That forecast makes perfect sense with the inflation expectation that we can derived from the current situation and the chart on Figure 6.

However I tend to make a more conservative forecast for the chart on Figure 10 and you can see it in the black box I added. It is a safer bet to expect the ratio to come back where it has been most of the 20th century rather than shoot for the extremes, but let us not forget that it is quite a wide box.

The higher side of the box still implies around 1,000 points for the SP500 or 10,000 points for the Dow, with no movements for Gold. Such level of the ratio will be more probably achieved via a combination of both effects, meaning a decrease of the Dow and an increase of Gold price at the same time.

Let's sum up the facts from all the above:

1. JP Morgan starts entering into the Comex deposit and start selling most of its gold in January 2011 up to most of 2012.

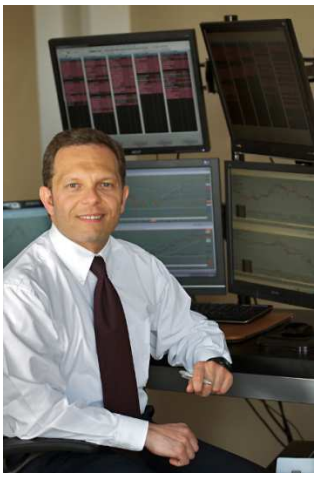
2. From late 2012 to April 2013 JP Morgan does not have any more gold and needs to borrow it from third parties in order to fulfill its requirements to delivery physical gold against futures contracts.

3. In April 2013 Gold has its worst drawdown in more than ten years: it is safe to call it a sort of "flash crash" for the breadth of the range achieved in so little time.

What are the safe conclusions to this?

1. Sooner or later the positive correlation between Gold and Fed Balance Sheet will resume;
2. Expect news of sudden shortage of gold in Comex deposits which will make price spikes violently;
3. (Current) Shortage of gold will be covered until it won't be possible anymore;
4. **Such cover up will be lifted in possible moment of crisis, when gold will be sought after the most;**
5. Keep an eye on the news concerning JP Morgan and Gold;
6. Keep an eye on movements of banks' gold deposits;
7. 2013 Fed Balance Sheet would translate into a 1,800 usd. Gold price target;
8. With QEs still in place, Fed Balance Sheet and therefore Gold price target should be both revised up.

With this study I am in no way saying explicitly or implicitly that JP Morgan did any wrongdoing with their gold deposit nor I am assuming that gold price is or has been manipulated (by someone or some institution), of which I do not believe even to be possible. My intention is only to show how professional investors are behaving with their gold strategy and how their behavior can be read it to predict possible future prices.



Mr. Maggioni has been working in the financial markets for the last 13 years covering different roles and working in tier 1 consulting companies and banks worldwide.

In recent years his studies have been focused on the psycho-emotional aspects of trading and how those aspects have an impact on traders' behavior.
Before starting this venture, he was head of a hedge fund desk at HSBC Private Bank in Monaco and before that he was employed at Credit Suisse Asset Management (CSAM) in Zurich covering the in-house single manager hedge funds.

Most of his experience in hedge funds was gained while working in a Swiss family office where he was in charge of the research and analysis as well as due diligence for US and European hedge funds. He also performed quantitative analysis and portfolio construction for several funds advised by the family office.

Prior to that he worked as an external consultant for KPMG Financial Services in the Milan office. In 2002 he has been hired by Ernst & Young LLP, San Francisco as auditor for hedge funds, auditing large single funds and fund of funds. In 2000 he joined Ernst & Young in Milan as an auditor for mid-sized companies.

Mr. Maggioni holds an MBA from IUM and a Portfolio Management degree from the University of Chicago GSB.

Useful Links:

European Central Bank:	www.ecb.int
Bank for International Settlements:	www.bis.org
International Monetary Fund:	www.imf.org
Federal Reserve:	www.federalreserve.gov
US CFTC	www.cftc.gov