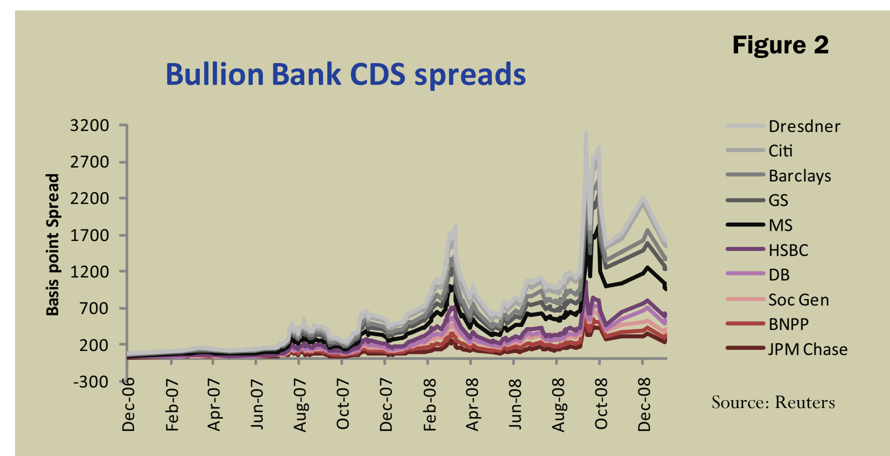
Gold Lease Rates

A Rapidly Changing Market

By Raymond Key, Deutsche Bank

It is startling how rapidly markets have changed over the last 15 months in the face of the worst financial turmoil since the Great Depression. The gold market has experienced this first hand and there have been ramifications for the gold lease rate market. It is the purpose of this article to review how the market has changed since my speech at the LBMA conference in November 2007, and to consider outlook for gold lease rates in 2009 and beyond.



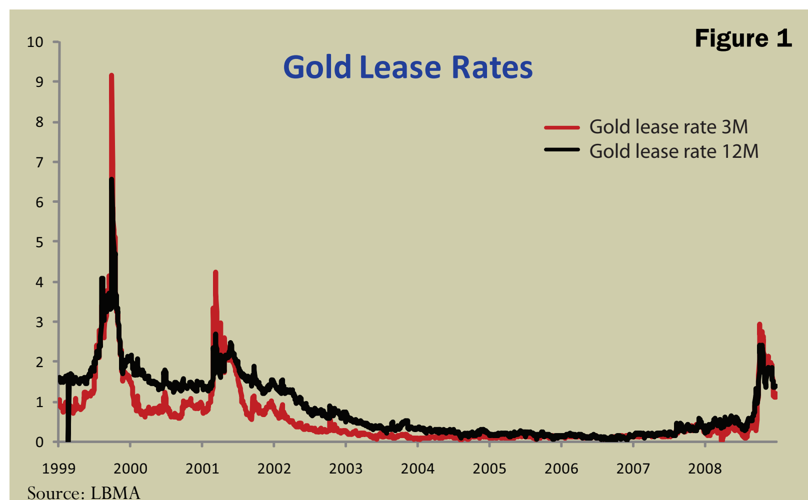
Source: Reuters

2008 saw significant volatility in lease rates and the highest rates observed since May 2001. The trading range for the three and twelve month tenors were 0.03 to 2.93% and 0.22 to 2.42% respectively (see Figure 1).

What were the driving factors behind these moves and will we see more of this volatility in 2009?

Firstly, let us examine some of the major developments within 2008. In my paper in 2007, I went through the major drivers of supply and demand for gold rates. These areas were central bank supply, the direction and magnitude of private gold investment and finally producer (de)hedging.

As a result of the financial turmoil, credit conditions have tightened to extreme levels and risk appetite has in most cases shrunk. Whilst some market commentators believe that central banks may have added more liquidity into the gold lease rate markets (as they did in the currency markets), all of our evidence counters this argument. In fact, in my mind 2008 was the year that central banks became more co-ordinated in their belief that they should not lend gold at such low rates and also more effectively differentiate bank credit risk. During the years 2003 to 2008, bullion banks observed some central banks pulling gold lending when rates were below 1%, whilst other central banks continued to lend down to 1 basis point. This behaviour is changing. Whilst is if difficult to accurately estimate the amount of lending by central banks, Virtual Metals believe that lending decreased from 2,912 tonnes in 2007 to 2,330 tonnes in 2008. Our own insight would suggest that it has fallen more dramatically. In addition, the amount of lending should continue to drop rapidly if risk reward is at all a factor in central banks behaviour. Lease rates are not high enough to justify un-collateralised lending. Unless the lending is considered necessary for the smooth functioning of the gold market (which is not the current case), then the credit conditions do not justify lending below one percent. Figure 2 shows the current credit default swaps (CDS's) for a basket of some of the top bullion banks. Note sixty percent of these bullion banks have CDS's above 100 basis points (bps), and the average spread is 160 bps. This is substantially higher than the 47 basis point average CDS at the end of 2007. Central banks should be reluctant to lend gold to bullion banks on an un-collateralised basis.



Source: LBMA

Turning to collateralised deposits, I noted in 2007 that under certain situations bullion banks would convert collateral for long dated gold borrowing away from government bonds to gold itself. Given the costs of borrowing government bonds have risen from approximately 10 basis points pre August 2007 to 50-200 basis points over the last 15 months, a number of bullion banks have wisely developed facilities to allow them to convert to gold collateral when gold leases are low enough to justify it. This will be a continuing feature of 2009.

Another factor in gold lease rate trading last year was bullion banks strategically holding lower levels of gold inventories in an attempt to reduce their balance sheet usage or

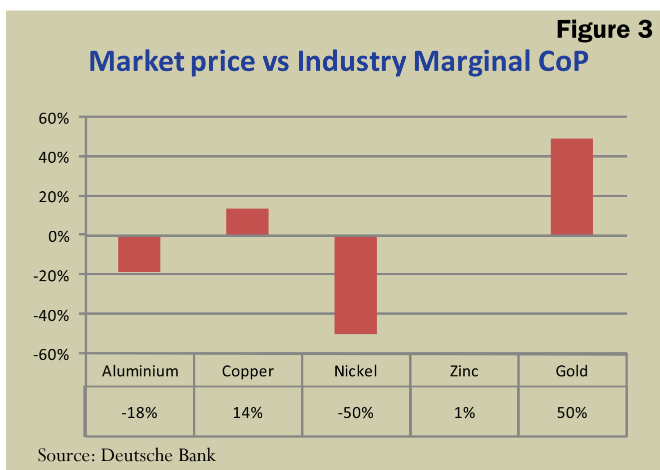
they used the inventory to raise USD through the gold swap market. This inadvertently facilitated the spike in lease rates as this reduced their ability to lend into the rising lease rate market.

I believe the above issues have been the main driver of lease rates throughout 2008. I also believe that none of these issues have been resolved so we are likely to experience further spikes in 2009 and I would expect rates to remain at elevated levels when compared to the previous six years.

Another issue that I believe will have wider attention this year is producer hedging. Traditionally, producer hedging provided the primary demand for gold borrowing. At its peak the demand was approximately 110 million ounces in 1999, however as at the end of 3Q08 it only accounted for 16.9 million ounces (Fortis-Virtual Metals report).

A few comments on the topic: it is interesting that the reduction from 2Q08 to 3Q08 was the lowest in two years. Are we at the end of de-hedging and about to enter into a new era? Does it make sense to spend scarce cash flow or debt on buying back hedges in the current environment? The lesson in base metals markets is that super normal profit margins have been destroyed in a matter of months and a large number of producers will not survive if industrial metals remain at current prices. Certainly the gold producers are in an enviable position where gold acts as a safe haven asset and remained solid in the face of widespread liquidation and demand destruction. However, what happens when markets stabilise later in 2009? Costs are unlikely to increase for the next two years given the global economic outlook. Is this not an opportunistic time for them to lock in margins on a two to three year basis opportunistically? Have they not been given the second chance that most of their industrial metal peers did not get?

To put this in perspective see Figure 3. The chart attempts to illustrate the destruction of margin that gold's "poor cousins" are contending with. Whilst it is very difficult to calculate marginal cost of production accurately this chart attempts to indicate relative to current market prices the approximate margins across various metals. Gold stands out significantly.



Source: Deutsche Bank

In addition, what has happened to the vocal minority of shareholders of those base metals companies that demanded the pure play to the base metal price? Have they exited and abandoned these base metal companies, or are some still holders wishing that the companies had locked in super normal profit margins that were seen a little over six months ago? The debate around hedging will re-emerge in 2009. One certainly hopes that any gold hedging that occurs will be implemented when the profit margins are as healthy as they are now and not when it is a matter of survival.

If hedging does begin to become more acceptable, this could trigger a multi-year move higher in lease rates.

Investment demand is the other area that has an effect on gold lease rates. The purchasing of unallocated gold or futures provides liquidity to the market, whilst the global gold ETFs drain liquidity basis their holdings being backed by allocated gold. It is interesting to note relative to a year ago the global ETFs are 3.5 million ounces higher and the Comex speculative long positions are nearly 8 million ounces lower. These both net drain liquidity from the lease rate market and put pressure on rates to rise.

The caveat to higher lease rates in 2009 could come from two factors. Firstly, in the current environment, where global central banks will force interest rates close to zero to re-inflate the global economy, it is difficult for gold lease rates to remain high. It is also difficult to push the gold curve into backwardation - something that has rarely been seen in 20 years. The second caveat would be if central banks decide to put gold into the system to provide bullion banks with another form of liquidity. I doubt many central banks will consider this necessary yet.

In summary, I believe that gold lease rates will be floored close to 50 basis points for the foreseeable future and it is quite feasible that we will see the highs of 2008 retested.

A post script for those that look at lease rates more deeply: many market participants have asked during 2008, "what is the market gold lease rate?" Every bank now has a different lease rate curve when compared to Libor minus GOFO. 2008 has been the year where bullion banks' funding rates have never been so diverse. Three month rates across bullion banks have ranged from 50 basis points under, to 300 basis points over Libor. This has made it more challenging for central banks to assess bullion banks deposit rates relative to their credit quality and has also reduced liquidity in the inter-bank gold swap market. The outcome of these funding differentials has widened spreads and pushed the market towards the gold interest rate swaps market. Some bullion banks have taken advantage of long-term physical gold holdings to lend gold forwards, and borrow gold interest rate swaps to raise USD. Given that most bullion banks long term funding for USD is at least 150 basis points higher than Libor, there have been some great opportunities for banks that have either had, or have been able to raise long-term gold they can monetise. Based upon this fact alone it does surprise me to see the spread between gold forward and interest rate swaps is between 20 to 35 basis points (up from its lows of 8 basis points) and not substantially higher.

Certainly, the terrible events within the financial market have breathed life into the gold forward and lease rates markets and the future does not look dull. ■

Raymond Key *has 13 years experience in financial markets. He began his career with Bankers Trust in New Zealand, training as an interest rate derivatives trader before moving to trade currency options in 1997. When Deutsche Bank took over BT in 1999, Raymond joined the DB's metals business to trade precious metal options and forwards in Australia. In 2001 he was approached by Credit Suisse to be a Director, managing their global vanilla options and forwards books in London. When CS withdrew from the market late in 2001, Raymond then moved to Morgan Stanley to trade both precious and base metal derivatives. In June 2007 Raymond was approached by Deutsche Bank to become Managing Director, Global Head of Metals Trading.*