

HEDGING GOLD AND THE “NEWMONT” AFFAIR (the end of a declining trend ?)

Recent changes in the Gold mining industry have focused attention of analysts in the last weeks. This brings again to life a hot controversy among professional of the precious metal industry and trade. “Hedging or not hedging, that is he question!”.

NEWMONT, FRANCO-NEVADA and NORMANDY, three important mining companies, are about to merge under the leadership of NEWMONT. What is so important in this event ? Actually, this merger could have an important impact on the Gold market life. Let us remember at this point that the world of gold miners used to present itself, during a period spanning from 1982 to 1990, as divided into two fiercely opposed camps, about what would be the best theory of hedging. An outsider could well have seen this opposition as one more example of a sort of Lilliput divide, which made, one remembers , a group of people pretending that eggs should be eaten starting with the bigger extremity fighting those who declared that they should be opened trough the pointed end ! From a more professional point of view, however, the event may be analysed as nothing but a decisive turning point in the evolution of Gold markets, “actual”and “future”.

It is convenient to start the story in 1982. At this time, the price of the “actual” was relatively high : it even peaked at 500\$ per troy ounce. But there were fears of a long slide down of prices, which would have been detrimental to the prosperity of the mining industry. At the same time, there were some Central Banks, looking at their vaults filled with fat gold reserves. This was in a sense unfortunate as this asset brought them no return. To improve the situation, these Central Banks naturally started lending Gold to some gold traders, at a very low interest rate. Even this low rate was a better return than nothing ! Finally, the gold companies entering this new game saw in this situation an attractive opportunity. They would borrow this gold at a very favorable price, charged by the Central Banks. Could they not use it making a handsome profit, and so, compensating the risk of losses on the sliding bullion price ? . BARRICK, a canadian company took the lead of this new approach. They were soon followed by other big players, like South Africa’s ANGLO GOLD for ex. . Together they formed what could be dubbed the “hedgers” camp. On the opposite side were the “anti-hedge” camp members, with NEWMONT, GOLDFIELDS and HARMONY.

The situation on the Futures market opened attractive possibilities for the “hedgers”. On average, (roughly calculated) during 1982, the markets were at a “contango” (a weak ‘basis’) of about 13 percentage points, due to the fact that money market rate were much higher than the rate charged for gold leases by the Central Banks. This “contango” diminished year after year. But, over the period 1985 to 1994, when it went down from 10 points to 5 points, it still averaged something like 7,5 points. The hedging strategy was, then, relatively obvious. It was, for the Gold trader : first to take leased bullion from Central Banks, then to sell this metal on the Future market, and finally to deliver the actual at expiration hence receiving the return offered by the “strengthening” of the “basis”. In case the evolution of the prices was not completely agreeable, the possibility of rolling over the hedge was still open. At the end, it was easy to pay back the metal to the Central Bank, using its own gold production. The position was, in this manner, covered, and riskless. The result of the trick was brilliant. Instead of trying to painfully peddle the metal produced on the spot market, at unfavorable prices, this same metal could be sold, through the “Futures”, at a comfortable “contango”, which meant much higher prices. Not far from the famous “free lunch”!

It is no mystery that this same strategy came under the fire of a fierce criticism from the “non hedge” camp. The non hedgers had it easy to show that hedge positions could be more difficult to manage than expected. The huge losses shown by ASHANTI gold fields were a good opportunity to recall this possibility. A second snag was that a huge “short” future position made it impossible for a Company to respond to a rise of the price. And there were indeed intermediate rallies to give some credibility to these fears; in 1987, 88, and 89, for ex., when the price of the bullion, starting at the 300 \$ depressed level at the end of 1985, hit almost 500 again, just before returning to its decreasing trend in 1990. Funds, mainly hedge funds having part of their assets in gold were acerb enemies of these hedged positions. Finally, and possibly still more important, the action initiated by the Central banks could only increase the overall supply of Gold put on the market, then worsening the already bad long term perspectives of gold prices. For the “non hedgers” companies, “hedgers” were just destroying their own industry, focusing on short term transitory benefits.

The NEWMONT merger brings some new fuel the debate. It is true that these hedges have almost lost their interest today, as the monetary rate of interest have fallen to a large extent, since the times when the “hedgers” started borrowing and selling future. The “contango”, fluctuating since 1993 in a range roughly delimited by a floor at 1,5 points and a ceiling at 5 points, is no longer worth the trouble. But NEWMONT presents itself as a sort of “activist” non hedger, ready to take his revenge. It has already announced that, pending the merger, it would unwind all the hedge book of NORMANDY, in case of success of the announced restructuration. This would be for a quantity of 260 tonnes. And this action would take place either through deliveries of newly mined gold or through buying back some short positions outstanding, on dips.(Both solutions will probably be used.) If this happens, the supply of gold will shrink. And there already are some pundits of the gold market to predict that the long declining trend in gold price (they oscillate now between 250 and 300 \$ per troy ounce) is over. If they are right, guess who will be the main winners ? The “non hedgers” of course.

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