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Zoltan Pozsar: Gold To Soar, Crush Western Banks When Putin Unveils Petrogold

BY TYLER DURDEN

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Let's start with something tangential. One week ago, we quoted Curvature's repo guru Scott Skyrm who pointed out that the recent "upward rate pressure on large settlement days and month-end seems to be starting again", which means just one thing: reserve scarcity - the catalyst that ultimately culminated in the repo market breaking in Sept 2019, sending repo rates soaring to double digits and forcing the Fed to launch "NOT QE" - is slowly but surely coming back.

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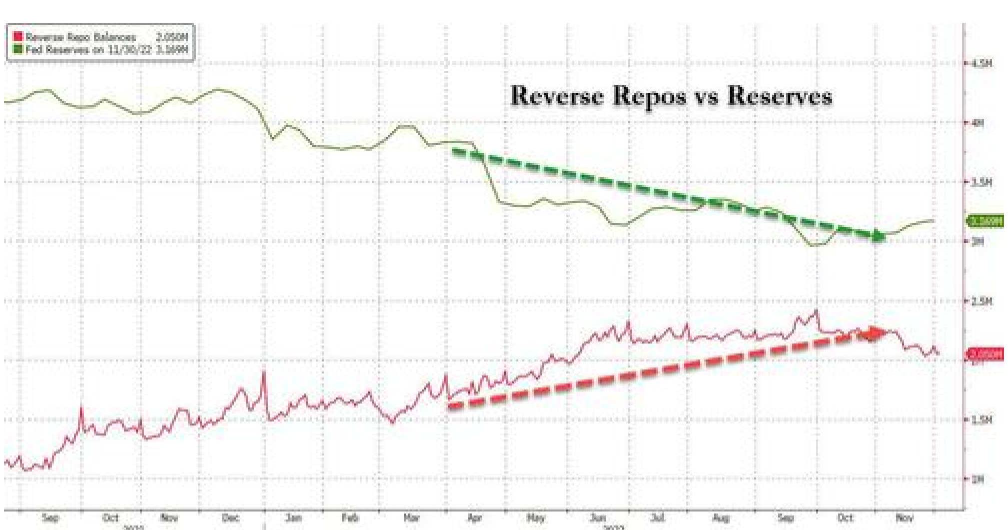
reserve scarcity is baaaaaack:

"Upward rate pressure on large settlement days and month-end seems to be starting again."

2:17 PM · Nov 29, 2022

Or maybe not: according to that *other* repo guru, former NY Fed staffer and current Credit Suisse strategist, Zoltan Pozsar, who correctly called the acute reserve scarcity in 2019 and also the monetary debacle in March 2020, the last thing investors should be worried about today is the level of Fed reserves as he explains in his latest *must-read* note published overnight titled "**Oil, Gold, and LCLo(SP)R**" (and available to pro subs) after several months of silence. The reason: **there is $2 trillion in inert funds in the reverse repo facility which can be used to plug any reserve gap.** While we think this is an oversimplification - and if that was the case, there would be no drain of reserves as all the liquidity since the start of QT would have come from the O/N RRP facility which has clearly not happened...



... we'll ignore that for now as Zoltan merely brings up the distinction between Reverse Repo and Reserves to frame a tangential point that is critical further on in his analysis. Below we excerpt from Zoltan's note in which the Hungarian funding guru explains why he is "stunned" every time a client asks him if he is worried about the current level of reserves:

> The market's search for the level of reserves at which the system "breaks" implies that the market is worried about a repeat of the 2019 repo blowup. Such fears are misplaced. To be clear, there are risks lurking in funding markets, but they have nothing to do with the draining of reserves via QT (watching paint dry). **Rather, they have to do with the draining of reserves via geopolitics (Russia responding to price caps).**
>
> The fundamental difference between QT during 2018-2019 and QT today is that **the first episode of QT happened while balances in the o/n RRP facility were zero.** The U.S. financial system didn't have a penny of excess reserves, except forwhat banks had over and above their ***lowest comfortable level of reserves (LCLoR).*** The bid for repo funding was immense and the marginal repo lenders were banks with excess reserves to lend... until they ran out of reserves to lend.

Of course, as readers will recall from our extended coverage of the repo train crash three years ago, when the reserves ran out, overnight repo rates spiked and the music stopped until the Fed started to print reserves anew (who can possibly forget the hilariously mistitled "NOT QE" episode in Sept 2019) and broadcast them using a new o/n repo facility (the SRF). However, according to Zoltan, "**the chances of the same happening today are low**" and as he adds, "worrying about how close banks are to their lowest comfortable level of reserves is pointless for three reasons." He explains why below:

1. **First, demand for repo funding is weak today,** in sharp contrast to demand during 2018-2019 when demand was breaking new highs every single day. Similarly, demand for dollar funding in the FX swap market is weak too, as FX-hedged buyers of Treasuries are now scaling back their positions and economic uncertainty and higher nominal rates are driving a wave of deleveraging.
2. **Second, balances in the New York Fed's o/n RRP facility represent reserves that the financial system did not bid for during the day.** In other words, the balances in the o/n RRP facility represent cash the system does not need. Today, that amount is over $2 trillion. **That's $2 trillion that large U.S. banks sweep off their balance sheets at the end of every day and that foreign banks and dealers don't bid for to fund their loan books, inventories, or market making.** *[ZH: it's also $2 trillion that banks are willing to hand over to **the Fed which has no counterparty risk,** and not to some other institution, say Credit Suisse... but this is a discussion for another time].* That's $2 trillion of reserves coming out of the market's ears. In plain English, **the $2 trillion in the o/n RRP facility is the system's "cash under the mattress".**
3. Third, if we still end up in a situation of LCLoR miscalibration *[ZH. i.e., if Scott Skyrm is right and reserve scarcity has reappeared]* , the system has two pools of liquidity to tap: the $2 trillion under the mattress (see above) or the SRF. The raison d'être of funding markets is to mobilize excess cash;today, $2 trillion iswaiting to be mobilized through funding markets **so don't sweat a repeat of 2019.**

Here we must sadly disagree (to an extent) with the man who first charted the US shadow banking system back in 2010, but since that particular argument is not the crux of Zotlan's analysis, we will let it go and proceed right to the next section in which the repo expert claims that discussions today about the lowest comfortable level of reserves are a red herring *(here Zoltan recaps again that "back in Sept 2019, when JPMorgan ran out of excess reserves to lend, the interbank market froze up because other banks did not have any excess reserves to lend either. Today, if banks run out of excess reserves to lend, they have two alternatives to tap (the o/n RRP facility and the SRF), so the system is backstopped very well: both at the bottom (lots of cash to mop up) and also the top (lots of cash to call on")* – and as such, "don't sweat the LCLoR from a QT perspective."

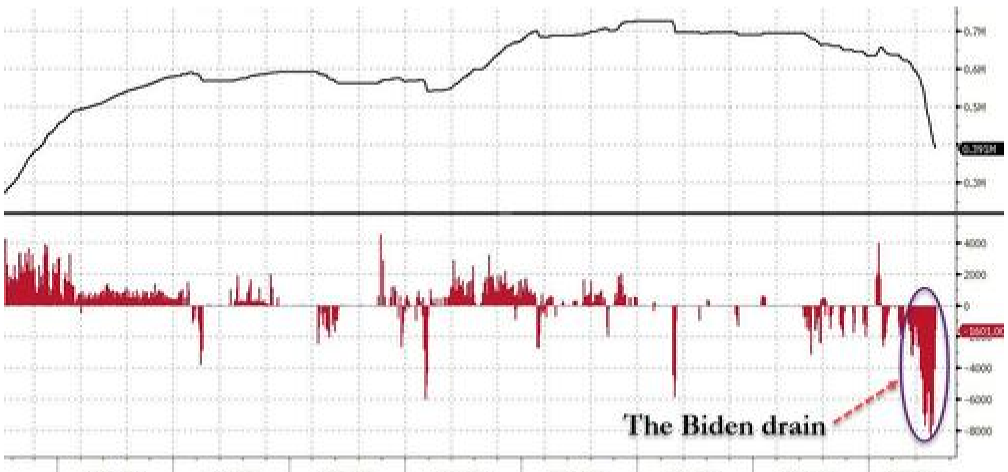
But that doesn't mean there is nothing to sweat, because as Zoltan then adds... "**worry about it from a… …geopolitical perspective."**

And here we get to the crux of today's note, which begins whimsically enough, by comparing the level of Fed reserves, parked either at the IOER or Overnight Repo facility, to that "other" critical reserve - the ***Strategic Oil Reserve,*** or as Zoltan puts it, *"within commodities, there are reasons to be concerned about oil and gold. Instead of worrying about the LCLoR,* ***we should worry about the "LCLoSPR"...***

Below, Zoltan explains why - unlike monetary reserves - "the oil market is tight", or in other words, why physical reserves are much more problematic:

> Demand for oil exceeds supply coming from oil fields. Were it not for the release of oil reserves from the SPR and OECD inventories and lockdowns in China all year, **oil prices would have traded higher this year.** Excess reserves in large banks' HQLA portfolios (reserves > LCLoR) are like excess production capacity for large oil producers. **Similar to how JPMorgan ran out of excess reserves in 2019, Saudi Arabia is low on spare capacity today.**

It's clear where Pozsar is going with this: according to Hungarian, the Strategic Petroleum Facility - with its inventory warehousing capacity, "*is like the overnight RRP facility. It can be tapped when oil levels are tight."* But unlike the RRP facility, the SPR is finite, and recent releases have brough reserves down to levels we haven't been at since the 1980s.



According to Zoltan, the 400 million barrels left in the reserve isn't much:

> it could help police prices for a year if we released 1 million barrels per day (mbpd), half a year if we released 2 mbpd, and about four months if we released 3 mbpd. Think of these releases in the context of OPEC+'s recent decision to cut production by 2 mbpd and also that according to some estimates, the re-routing of Russian crude oil from Europe to Asia has so far led to a loss of 0.5 mbpd of lost output and risks are that that production losses will grow to 1.5 mbpd once the price cap on seaborne Russian crude goes into effect today. Now that SPR releases are over, production cuts by OPEC+, re-routing, and price caps (not to mention the risk of China re-opening due to protests), **the question for the U.S. becomes what to do with the SPR? Release more? Refill?**

The Credit Suisse strategist continues (and here his lack of a detailed commodity/oil/SPR background becomes apparent), writing that releasing more has its limits: **supply lasts only about four months at 3 mbpd,** but given the lack of "spot" spare capacity in Saudi Arabia and the UAE, declining shale production in the U.S., headline production cuts by OPEC+, a loss of production due to a re-routing of Russian oil shipments, and the risk of more demand in China, future SPR releases will have to be big to have an impact."

Thus, according to Zoltan's calculations, "**in the worst case, the SPR is empty by spring (next April), at which point the oil market is in the same spot as the repo market in 2019: zero balance in the o/n RRP facility to tap.**" Here Zoltan is alas wrong: as we explained one month ago, while there are various additional volume considerations, the most binding one is the very geology of the salt caverns that make up the US SPR, and here according to a 2016 long-term strategic review of the US SPR by the DOE under the Secretary of Energy Ernest Monitz, *due to specific issues, including cavern integrity issues,* ***the salt caverns would require a minimum volume held of about 160 mn bbls, or approximately 22% of the SRP capacity.***

In other words, from today's level **there is at most about 200 million** more barrels that can be safely drained from the SPR before the very integrity of the SPR is put into question. Which actually makes Pozsar's point evven more acute: instead of April, even a base-case continued drain of 2mbpd would lead to an effectively empty SPR in roughly 3 months.

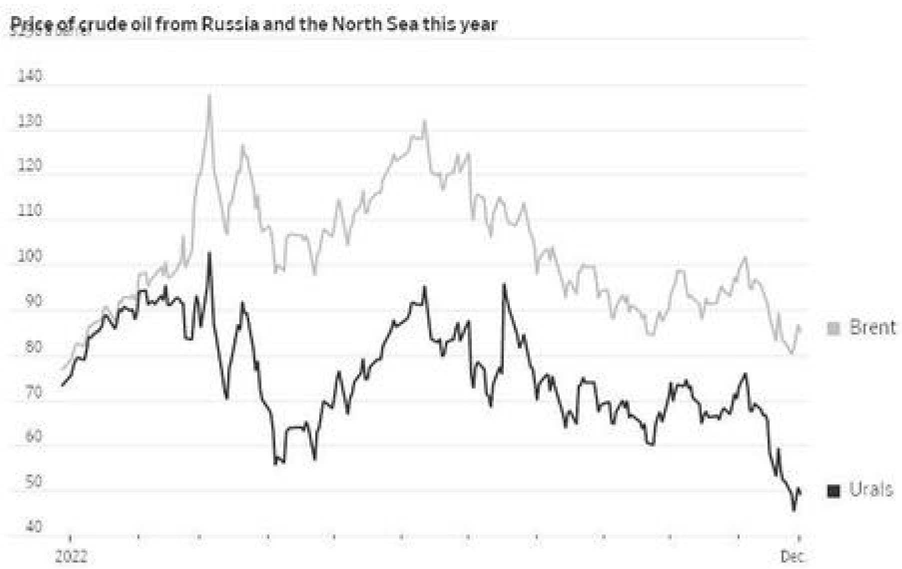
But while Zoltan may have a little more to learn about the nuances of SPR drainage, where he is spot on is that unlike reserves, which the Fed can easily print, "**you can't print oil to heat, or wheat to eat**" a phrase which we popularized some time in 2010. And while one can frack new wells, "that takes time and until new production comes online, oil prices will spike**.**"

As as a result, the strategist concludes that **"refilling the SPR could lead to different dynamics."** Next, he explains what these are:

> *President Biden noted that he plans to refill the SPR when oil prices get down to $75 per barrel. That plan is hard to reconcile with OPEC+'s price target near $100 per barrel. Yes, we are headed toward a recession, but* ***unlike in 2008 or during Paul Volcker's reign, oil prices aren't collapsing as production capacity hasn't grown recently*** *(shale is fantastic, but production is not growing; shale was a sugar high and we are coming off the high, slowing on the margin)* ***and so getting to $75 per barrel will be hard.***

So how will the U.S. refill the SPR, Zoltan asks rhetorically, and answers: "**Could a price on Russian oil be a part of the strategy? Consider the following...**"

- **First, Russian crude already sells at a steep $30 discount relative to Brent.** It is widely known that the big purchasers of Russian crude are China and India. Both countries have both state-owned and privately owned tanker fleets that the state can insure. In the case of India, it is widely understood that Indian refiners are turning some of the imported oil into diesel for re-export. Buying Russian crude at $60 per barrel (pb) and selling diesel at $140 pb makes for a nice crack spread, the petroleum market's equivalent of 100 bps of spread in the land of OIS-OIS cross-currency bases. **India and China thus serve as matched-book commodity traders (instead of Glencore or Trafigura), the former dealing in oil and the latter in LNG, keeping commodities in circulation.**



Note: Urals price is for crude leaving Primorsk, and doesn't include insurance or freight costs.
Source: Argus Media

- **Second, the risk of sanctions for buying Russian oil has certainly changed a lot for some countries:** "*the United States is happy for India to continue buying as much Russian oil as it wants, including at prices above a G7-imposed price cap mechanism, if it steers clear of Western insurance, finance, and maritime sen/ices bound by the cap"* Treasury Secretary Janet Yellen said last week (see here). Gone are the days when the U.S. Deputy National Security Advisor warned India and other countries of sanctions if they bought Russian crude oil. **The change in tune could be one backdoor mechanism to refill the SPR, and given the $30 dollar discount to Brent that India is paying for Russian oil, this would be below President Biden's $75 target.** In a related news item - Indian refiners becoming wary of buying Russian oil as EU sanctions loom - it seems like crack spread harvesting (import oil, export diesel) will soon end, but then if we are "happy" for India to import, exports will serve a different goal.
- **Third, we now know that the price cap is set at $60 pb, the same price at which Russia sells oil to India and China.** But there is a difference between a tough bargain and an administered price. Europe needs oil at capped prices, **but President Putin is not interested in selling at capped prices out of principle. He said in the past he wouldn't.**

But while Putin will hardly look to sell oil to non-friendly countries on *someone else's terms,* and indeed earlier today we learned that Russia is already planning an oil-price floor - on the other hand, the US needs to re-fill the SPR at some point, Zoltan stipulates, **"because if it doesn't, it might not be able to control domestic oil prices in case oil gets caught up in geopolitics."** That said, if Russian oil is re-exported from, *say,* India to refill the US SPR, Putin probably won't like that out of principle either. "And while Russian oil shall not age in giant, underground salt caverns along the U.S. Gulf Coast, or, if it were to, then payments will be accepted only in gold, not dollars or rupees", the Hungarian repo guru argues, going straight to the heart of the argument: **step aside petrodollar - here comes petrogold!**

"This is nonsense you say", Zoltan rhetorically preempts the reaction by the incredulous reader, and counters with "*No it is not*"

> *Look at the tit-for-tat measures so far: you invade Ukraine, I freeze your FX reserves; you freeze my FX reserves, I make you pay for gas in rubles; the West boycotts my Urals, I'll ship it east...* ***the West caps the price of Urals, let them, but I'll make them pay in gold. And if some countries re-export Urals to the West, I'll make them pay in gold too.***

Here Zoltan also quotes Pippa Malmgren saying that "*World War III already started, it's just that it is a hot war in cold places (in space, cyberspace, underwater, and Svalbard) and a cold war in hot places (militarizing islands in the Pacific and mines in Africa).*"

> Hot wars in cold places also involve corridors of power that determine who gets to use cutting-edge technologies (the U.S.'s technology blockade of China), who gets paid how much for commodities (the G7's price cap on Russian oil), and how commodity trades get settled (Moscow's demand to get paid in gold as an analogue to Moscow's demand this year to get paid in rubles for gas). War is not about gentlemanly conduct...

Which brings us to...

Petrogold

Extending his petrogold analogy, Zoltan writes that **the cap of $60 per barrel for Russian oil equals the price of a gram of gold (at current market prices):** "Let's imagine this set up as a peg. The G7, led by the US, effectively pegs the US dollar to Urals at $60 per barrel. *In turn, Russia* *pegs Urals to gold at the same price (a gram of gold for a barrel of Urals)."*

This is how the fund flow dynamics in this new monetary world order look like according to Pozsar:

> The U.S. dollar effectively gets "revalued" versus Russian oil: “a barrel for less", but at the cost of losing the global petrodollar status. The Western side is looking for a bargain, effectively forcing a price on the “+’ in OPEC+. **But if the West is looking for a bargain, Russia can give one the West can't refuse: "a gram for more."**

And if Russia countered the price peg of $60 with offering two barrels of oil at the peg for a gram of gold, gold prices double, or alternatively the dollar is devalued relative to the world's most important commodity overnight.

What does Russia get out of this? Well, it won’t produce more oil, **but would ensure that there is enough demand that production doesn't get shut.** And it would also ensure that more oil goes to Europe than to the U.S. through India. And most important, **gold going from $1,800 to close to $3,600 would increase the value of Russia's gold reserves and its gold output at home and in a range of countries in Africa.**

Or as Zoltan summarizes, *"Crazy? Yes. Improbable? No. This was a year of unthinkable macro scenarios and the return of statecraft as the dominant force driving monetary and fiscal decisions."*

* * *

This brings us to Zoltan's amazing punchline, in which he starts off by informing us that he is often asked about the next LDI blowup. He counters that *"Those questions are missing the point. The lesson about the mini-budget and the gilt sell-off that followed is that states sometimes do irresponsible things, or things that seem responsible but may backfire."*

> ***Russia’s decision to link gold to oil could bring gold back as a settlement medium and increase its intrinsic value sharply.***"

And here is arguably the most cluth part of Zoltan's argument: a world in which Russian oil is pegged to gold would lead to an immediate overnight banking crisis due to the synthetic gold short held by most:

> *Banks active in the paper gold market would face a liquidity shortfall,* ***as all banks active in commodities tend to be long OTC derivative receivables hedged with futures (an asymmetric liquidity position).*** *That’s a risk we don’t think enough about and a risk that could complicate the coming year-end turn,* ***as a sharp move in gold prices could force an unexpected mobilization of reserves (from the o/n RRP facility to banks) and expansions in balance sheets (SLR) and risk-weighted assets. That’s the last thing we need around year-end.***

The conclusion is, once again, only something Zoltan could envision.

> Basel III was designed to keep banks from doing things that could hurt them, but as the mini-budget has shown and Russia's response to the cap might show, Basel III won’t protect from states doing things that could end up hurting banks.
>
> Just as the German industrialist who built a successful business over a lifetime and outsourced only one thing to the German government - energy security - **banks have been managing their paper gold books with one assumption, which is that states would ensure gold wouldn't come back as a settlement medium.**

And now, Putin has the power and the ability to flip the gold-suppression script on its head, and the reserve status of the petrodollar, and replace its with petrogold, an eventuality for which both Russia...

... and China (which as we noted recently has [secretly been buying up hundreds of tons of physical gold]), are already prepared.

What's the engame? We hinted at it just a few weeks ago:

> ... back in March [we pointed out] that according to JPMorgan, "*while the world is short on commodities,* ***China is not given they have started stockpiling commodities since 2019 and currently hold 80% of global copper inventories, 70% of corn, 51% of wheat, 46% of soybeans, 70% of crude oil, and over 20% of global aluminum inventories.***" And now, China is aggressively stockpiling every ounce of physical gold it can get its hands on.
>
> Almost as if China is actively preparing for war.

The full ***must-read*** *report available to professional subs.*