Myrmikan Update

Toute Nation a le Gouvernement qu'elle Mérite[1]

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Daniel Oliver
Myrmikan Capital, LLC
doliver@myrmikan.com
(646) 797-3134

Obama's 2008 victory could be blamed on Bush-fatigue, the market crash, and a terribly flawed Republican candidate impotent against an unknown, idealized media construction. After a first term disastrous on any metric and a snarky campaign, Obama's 2012 victory presents a much darker reflection of America: Romney was right; 47% of Americans now depend on the government for a substantial portion of their incomes and will never vote to cut their benefits. Combined with various interest groups dependent on government policy for their own rent seeking, the principles of limited government can no longer succeed at the national level absent a realigning crisis. Republican control of the House of Representatives rests on the successful but tenuous gerrymandering of various ethnic groups into concentrated districts. The domination of Progressive policies at the national level will continue.

As examined in detail in the Myrmikan Research Report, *Something Wicked This Way Comes*, Progressive policies create a process that must lead to an expanding state that continually tightens its control of capital requiring the abrogation of individual liberty. History, both ancient and modern, is very clear on the end result of a government's bribing its own citizens with bread and circuses. The more citizens on the dole, the less tax revenue there is for the state. The state must increase taxes on the remaining producers, diminishing economic growth and creating more dependents in an accelerating positive feedback loop. Eventually the economic and political systems collapse.

Post-election chatter has focused on how Washington will prevent the fiscal cliff. Most commentators opine that a deal will be reached since Obama does not want to start his second term with a recession, and chastened Republicans are reluctant to be solely obstructionist.

This view is flawed. Obama has shown through his writings and his actions that he is of the hard Left, and now he's out for "revenge." If no deal is made, Obamacare is implemented, taxes rise, military spending shrinks, and bureaucrats controlled by the executive branch continue to regulate: more than six thousand regulations have been proposed in the past 90 days alone. In short, the Progressive program is accomplished. Washington is on autopilot toward absolute statism. The ascending Left does not need any votes to implement its goals. The Republican House of Representatives has no negotiating power. Nor is there the threat of immediate economic calamity: the Federal Reserve will support the economy through indefinite money printing regardless of what policy actions Congress may or may not take.

The Democrats are discovering this logic. Patty Murphy, Democrat co-chair of the deficit supercommittee, commented in a recent interview: "If the Republicans will not agree with [higher taxes on the rich,] we will reach a point at the end of the year where all the tax cuts expire and we'll start over next year. And whatever we do will be a tax cut for whatever package we put together [*sic*]." In other words, Democrats perversely will run in the mid-term elections on the "Obama tax cuts."

1 "Every nation gets the government it deserves," Count Joseph de Maistre, 1811

Any deal will reflect the negotiating power of the participants, and weak Republicans are already surrendering. Bill Kristol, editor of the Weekly Standard, commented: "I really don't understand why Republicans don't take Obama's offer to freeze taxes for everyone below $250,000. . . . Don't scream and yell if one person says 'You know what? It won't kill the country if we raise taxes a little bit on millionaires.'"

Increasing income taxes on the rich will not produce additional revenue. The rich are adept at postponing or hiding income and in extremis can do without income for long periods of time, living off of capital instead. Therefore, Obama's definition of rich as income above $250,000 per couple is more likely to ensnare tenuously employed young professionals impoverished by student loans than the millionaires and billionaires whose wealth he covets.

And, so, a counter idea emanates from malfunctioning conservatives. Rick Santelli, whose 2009 on-air rant was a catalyst for the Tea Party movement, has argued for a wealth tax, as in France, to distinguish between the billionaires and young professionals. His idea has unlikely support from Conrad Black, who wrote last week: "I favour a wealth tax to be administered, under supervision as charities are, by the taxpayers and devoted to the reduction of poverty."

The problem is that the rich, whether taxed on their incomes or wealth, do not have enough money to finance the promises the Progressives have made to their constituents. In fact, most rich are so because they own financial assets, which are valued on the fundamental assumption of free market capitalism. Like Tantalus reaching for fruit, government reaches for revenue by undermining the conditions that created and sustain capital and the yields from it.

Deficits will increase no matter what deals are struck in Washington. If tax rates are held constant for the middle class, where most revenue is generated, then revenues will be insufficient to fund entitlements. If taxes are raised on capital, then capital will flee or hide, revenue will be constant, and more entitlement spending will be required for the newly unemployed, precisely the dynamic facing Greece and Spain. Either way, the Fed will be called upon to fill the gap in revenue by printing dollars, undermining the integrity of the dollar and dollar denominated bonds.

Faced with this logic, foreigners will be reluctant to continue to finance U.S. deficits. It is true that, from one perspective, foreigners have no choice. To continue their export models, developing countries like China remain competitive by buying dollars to weaken their currencies. The side-effect is they import the inflation that has so far been absent in the United States. This state of affairs has been constant since Bretton Woods, the reason Nixon's Treasury Secretary John Connally famously told European finance ministers in 1971 that the dollar is "our currency but your problem."

Ironically, Connally delivered the line at the moment the dollar was to become an American problem. As explained by Guggenheim CIO Scott Minerd, European countries, having recovered from World War II:

> began to consider that the price of dollar-denominated inputs such as oil would fall dramatically if their currencies were revalued upward. By abandoning Bretton Woods, they could reduce their domestic inflation by reasserting control over their domestic money supply.

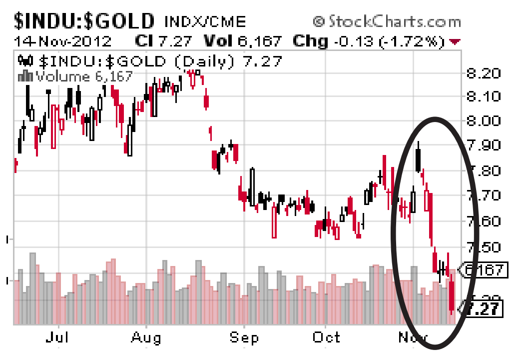
The dollar stabilized in the early 1980s when developing countries replaced recovering European economies as the primary importers of dollars to enable their own mercantilist policies. But, like the Europeans in the late 1960s, these countries are now much more advanced than they were thirty years ago. Minerd argues:

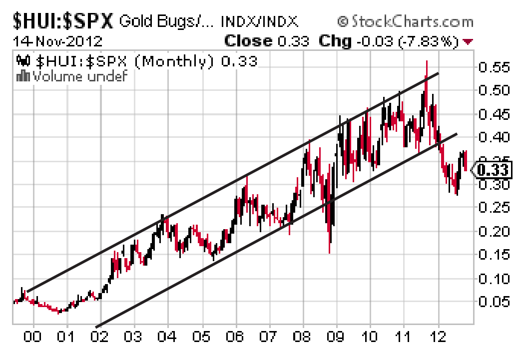
> Once global growth begins to accelerate and capacity utilization increases, economic bottlenecks will cause the price of inputs, such as energy, to rise. There will then be another inflection point when countries will realize that by allowing their currencies to appreciate, reduced import prices will spur productivity and domestic growth. This will happen when it becomes apparent that the savings resulting from lower input prices exceeds the export losses associated with a stronger currency.

This inflection point may not be distant. In the past year, China has reduced its holdings of U.S. Treasuries by 10% and on November 13 the Yuan hit the highest level against the dollar since 2005. As in the 1970s, once the exodus starts, it will gain speed rapidly.

Meanwhile, domestic capital seeks shelter from Obama's impending tax and regulatory onslaught. One destination, ironically, is the bond market. Low capacity utilization, declining asset prices, and absorption of dollars by foreigners are camouflaging domestic inflation making Treasuries seem a safe haven, perhaps as a waypoint to further, yet unknown destinations. For reasons described above, this strategy is likely to work well for a time, but is subject to sudden, catastrophic failure.

Another destination is gold. The chart below left shows that the DOW/Gold ratio has lurched lower since the election. The chart below right shows that the ratio of the HUI gold mining index to the S&P500, which fell out of its 10-year ascending channel at the beginning of 2012, has now reversed and is heading higher again.





The predators in the gold sector have also decided prices have reached bottom. There have been three merger announcements in the junior gold sector in the past month, all three involving cash flowing companies buying development companies at significant premiums. Over the past eighteen months, investors had gravitated toward the safety of cash flow, reasoning that development companies offer only downside dilution risk. But, with valuations so cheap, the development companies can make up lost ground in a hurry.

Perhaps the most interesting takeover is Hochschild Mining's acquisition of Andina Minerals. Andina has an enormous low-grade deposit in Chile containing 6.6 million ounces of reserves at an average grade of just 0.73 g/t, plus another 4 million ounces of non-reserve resource. The market viewed the pre-feasibility study base case, requiring $547 million in initial capital expenditure for an 11.8% IRR, as unfinanceable, especially given the low grade nature of the deposit. But, the base case used $1025 gold. Using $1600 gold the IRR jumps to 32.7%, and projecting higher gold prices yields enormously high returns.

Every commodity cycle sees an inflection point when the lumbering giants are outpaced by the aggressive, risk-taking competitors. Oil had tried to stay above $30 a barrel in 1985, then in 1990, again in 2001 and 2003. Responsible companies learned never to bet on projects requiring such high prices. By 2004, when oil finally broke above $30 and kept rising, only rank speculators would take on the marginal projects. But, for those speculators whose timing was correct, the gains were extraordinary.

The large, low grade gold deposits are especially unloved currently, yet offer the highest operational leverage on gold, assuming they can be properly financed. If gold runs up another $1000 per ounce, Hochschild's acquisition will be seen as brilliant.

Watching the United States rush headlong toward socialism/fascism/communism/statism – all terms to describe Progressive policies in other times and places – is depressing for those who know their economics and their history. It brings to mind an oft quoted passage from Charles Mackay's *Extraordinary Popular Delusions and the Madness of Crowds* published in 1841:

> In reading the history of nations, we find that, like individuals, they have their whims and their peculiarities; their seasons of excitement and recklessness, when they care not what they do. We find that whole communities suddenly fix their minds upon one object, and go mad in its pursuit; that millions of people become simultaneously impressed with one delusion, and run after it, till their attention is caught by some new folly more captivating than the first. We see one nation suddenly seized, from its highest to its lowest members, with a fierce desire of military glory; another as suddenly becoming crazed upon a religious scruple; and neither of them recovering its senses until it has shed rivers of blood and sowed a harvest of groans and tears, to be reaped by its posterity.

In our case, Americans have been seized with the expectation of wealth without toil provided by a powerful state led by a messiah. When this illusion melts, groans and tears are sure, most likely accompanied by rivers of blood as well.

Gold provides safe passage for capital through these interludes of popular madness and provides its holder the means to follow the advice of Baron Rothschild: "The time to buy is when there's blood in the streets."

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