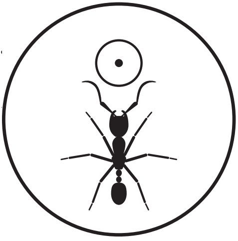

Myrmikan Update

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January 16, 2013

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Gold mining shares had another challenging year in 2012. The chart at right shows that the large-cap HUI gold mining index formed a choppy top in 2011 and then plunged lower in 2012, slipping 30% from its 2011 high. The smaller stocks fared worse, with the GDXJ mid-cap gold stock ETF ending 2012 down over 50% from its 2011 high. Some of the junior names have fallen 90% or more.

Even more frustrating for gold equity investors, the metal itself has materially outperformed the stocks, which are supposed to be levered to the gold price. The next chart shows the ratio of HUI to gold is sitting on its rising trendline, having peaked nine years ago.

The disconnect between gold and gold equities over the past five years is puzzling since, as the lower chart shows, the ratio of gold to industrial commodities has been rising sharply since the crash in 2008. In other words, the value of gold has risen materially in terms of the raw costs of mining it.

As inferred from Austrian economics, this trend of an increasing real value of gold, regardless of nominal price, should continue until the global debt bubble has been liquefied, either through cascading defaults, as in the 1930s, or though massive inflation. As macro conditions for gold mining continue to improve, gold stocks should find support in terms of both their nominal price and gold, especially from these low levels.

As bad as the market is for junior gold stocks, the market for junior base metal stocks is even worse. One result is that the demand for exploration and mining services has slackened, sending prices tumbling. For example, drilling companies have extra capacity for the first time in recent memory. In another example, The Wall Street Journal reported in November that failing coal operations are releasing secondhand heavy equipment into the auction

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market, sending prices plunging. Caterpillar, Inc. has been forced to offer incredible vendor financing on new equipment as it struggles to maintain sales. These lower prices are only now feeding into the operations of gold miners.

Under Austrian Economic Business Cycle theory, artificially lowered interest rates (enhanced by money printing) encourage debt-financed malinvestments in long-term projects, which increase demand for base commodities. In its second quarter earnings report, Caterpillar demonstrated it had become aware of this relationship:

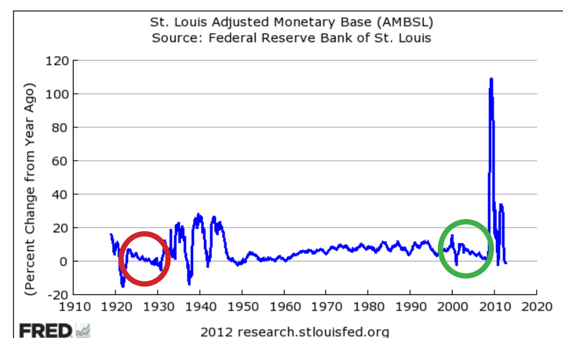
> The U.S. Federal Reserve's balance sheet expansion in the first half of 2010 benefited the economy, but those gains seem to be slowing. Banks are expanding credit at a moderate rate, but money growth is slowing. We have not detected much benefit to economic growth from the central bank's policy of lengthening the maturity of its securities. Eventually, we expect the U.S. Federal Reserve will resume expanding its balance sheet, but not soon enough to benefit growth in 2012.

This statement is extraordinary because it reveals the complete financialization of the economy – real economic actors, not just financial speculators, must now anticipate Fed action to remain competitive. It also reveals the bind in which the Federal Reserve now finds itself. To benefit the real economy, it must continually print more, stoking inflation. If it should stop printing, then artificially stimulated portions of the economy, like housing and capital investment, will slump revealing massive overcapacity.

Either outcome benefits gold miners, but only one outcome is likely. Bernanke prints money because he remains terrified of deflation. He understands that the cascading debt defaults of 1931 drove the economy deep into the Great Depression. He cannot wait for prices to start falling because "curing" a deflationary debt collapse requires far greater effort than preventing it, the reason he embarked on QE3 and QE4 even as most prices are actually rising.

In fact, the Fed must ensure that prices keep rising. Nominal prices have gone up consistently since 1933, so borrowers assume that a certain amount of their debt will be inflated away each year. Therefore, they are willing either to borrow at a higher interest rate or, if rates are fixed by the Fed, to borrow commensurately more. If prices increase less than borrowers' expectations, their assumptions are frustrated, and their real debt burdens increase beyond what was planned or is sustainable. The scramble for dollars to sustain these debts to defend collateral against seizure causes a spike in the value of the currency and the deflationary crash.

Though Bernanke likely will be remembered as the mad-money-printer, the second coming of Rudolf Havenstein, it is an interesting and unpublicized fact that he began his tenure by slowing the rate of printing to its lowest level since the 1960s. The blue line on the chart at right shows that the annual percentage increase in the monetary base began a downtrend in 2002, similar to the downtrend that occurred prior to the crash of 1929. In fact, the parallels are striking.



The Fed prints money by buying bonds, pushing bond prices up and interest rates down. When printing slows, interest rates rise. At first, the rising interest rates stimulate asset prices: rising rates increase the opportunity cost of holding cash, demand for cash declines, and asset

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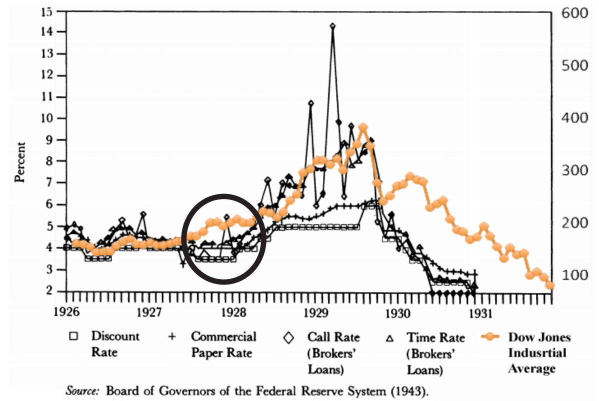
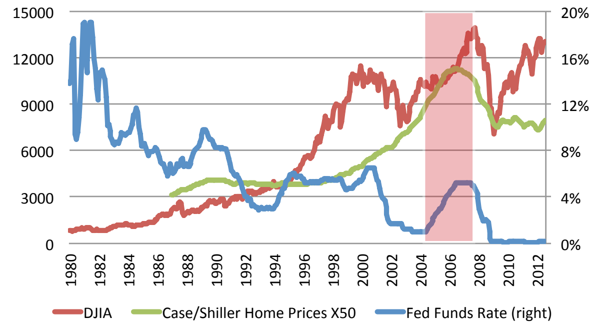
prices increase. Later, borrowers cannot make the cash payments on their debt at the higher rates resulting in widespread debt failure, which is precisely what happened in the late 1920s.

In 1926, the country was facing a mild recession and Europe was being destabilized by capital flowing to the safety of the United States. To solve both problems, the Fed lowered rates, which bottomed at 3.5% in early 1928. As the circle in the chart at right shows, the lower interest rates caused the stock market to shoot higher as market participants took on more debt at the lower rates to buy assets. A panicked Fed backtracked, raising rates to 5% less than a year later. Instead of halting the bull market, as intended, the higher rates increased the opportunity cost of holding cash accelerating speculation into the final bubble. Eventually, however, cash flows could not support the excessive debt at the higher interest rates, and the economy and market collapsed together.



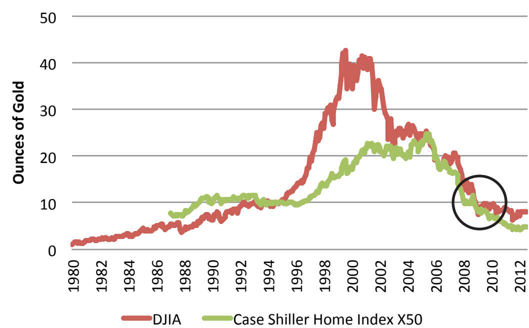
Source: Board of Governors of the Federal Reserve System (1943).

In the current cycle, interest rates haven fallen for thirty years, as shown by the blue line at right, powering debt levels and asset prices higher. In 2004, just as in 1928, the Fed became concerned about rising home prices and raised rates. Instead of ending the boom, the increase in rates induced the spectacular final bubble, shown in the shaded area of the chart. But, as in 1929, the higher rates forced borrowers to spend more cash to meet their debt obligations – cash they did not have – and eventually defaulting borrowers caused the economy and asset prices to tumble.



The Fed's response to the crashes of 1929 and 2008 was the same: print money to drive interest rates to zero to bail out the borrowers. What differed was the scale. In the 1930s, the proximity of the gold coin standard and European hyperinflations limited Fed action, and the stock market fell 90% from 1929 to 1933. The Bernanke Fed was under no such constraints. Its models show that if only the Fed had printed more in the 1930s, the Great Depression would have been averted. The chart on the previous page shows the dramatically larger scale of Fed action this time. The chart just above shows that it has so far been successful in maintaining asset prices.

But, even if the Fed can influence prices, no bureaucrat, no matter how powerful, can control values, which are solely the domain of individual human action. The exploding price of gold reveals the post-crash rally to be an illusion. The chart at right is the same data as the previous chart, except the figures are discounted by the price of gold. There is no bounce after 2008. Despite Bernanke's extraordinary actions, asset values have



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continued to decline in real terms, the reason why conditions still feel depressed even while prices are near record highs and climbing.

Not only has the Fed failed to maintain asset values, it has not resolved the debt bubble either: debt levels continue to rise. At the beginning of 2008, the U.S. economy had $50 trillion of debt outstanding. That figure has risen to $56.2 trillion currently. Raw dollars available to service that debt, the monetary base, have increased in number from $0.85 trillion to $2.6 trillion during the same time, but velocity has plunged with interest rates: there is still a shortage of dollars. More currency must be printed to prevent the cascading debt defaults until inflation rises fast enough to diminish the debt burden. As the outgoing Governor of the Bank of England Mervyn King remarked on October 9:

> It would be sensible to recognize that there may be circumstances in which it <u>is</u> justified to aim off the inflation target for a while to moderate the risk of financial crises. [underline in original]

King's appointed successor Mark Carney recently echoed: "To achieve a better path for the economy over time, a central bank may need to commit credibly to maintaining highly accommodative policy even after the economy and, potentially, inflation picks up." Central bankers will continue to scheme about new methods to justify faster printing through novel and unorthodox methods.

Central bank action has focused on sovereign debt, the traditional area of market intervention, and housing debt, the most important kind of consumer debt. But, the interventions have grown so large as to impair the functioning of those markets. As former Federal Reserve Governor Kevin Warsh commented earlier this year: "Now that I am out of government, I can tell you what I really believe. Central banks are now so heavily influencing asset prices that investors are unable to ascertain market values. This influence is especially evident, with the Fed's purchase of government bonds, which has made it impossible for investors to use bond prices to learn anything about markets."

Future QE must focus on markets other than saturated Treasury and real estate bond markets. The Federal Reserve's newest member, Harvard Economist Jeremy C. Stein, anticipated the next step in an October speech at the Brookings Institute:

> In this case, all bonds—including Treasury securities, corporate bonds, and MBS—can be thought of as close substitutes for one another, and an LSAP [large-scale asset purchases], by reducing the total quantity of duration in private hands, lowers the price of duration risk and so reduces the yields on all long-term bonds by an amount proportional to their duration.

By subtly sandwiching corporate bonds between the two markets the Fed currently manipulates and proclaiming their equivalence, Stein launches an intellectual trial balloon for the next target of Fed intervention. Later in the speech, Stein suggests there is no difference between a Treasury and a corporate bond protected by a derivative, implying the combo is appropriate for monetization.

The dollar was originally backed by gold, historically the main asset on the Fed's balance sheet. Soon the dollar will be backed by OTC derivatives with private counterparties protecting contracts held by the Fed of other private counterparties denominated in those very same dollars issued by the central bank. The dollar, thus recursively – and absurdly – defined, will become ever more brittle.

But, the bold step of buying corporate bonds and derivatives may not be immediately necessary if tinkering in the MBS and Treasury markets proves sufficient to reignite inflation.

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If so, Bernanke has already told us how he will respond: "the main thing we need to do when it's time to tighten monetary policy is to raise interest rates. That's what we always do." And, the market will do what it always does: shoot up initially as the opportunity cost for holding cash increases, and then collapse when the even larger stock of debt cannot be serviced at the higher rates by existing cash flow. The next great crash will require QE in corporate bonds, derivatives, and perhaps in equities as well. Unless...

Unless, in the next inflationary wave, the inflation rate reaches escape velocity so that there is no great crash in prices, but instead a great crash of the currency. When interest rates next rise, the value of the Fed's assets will collapse due to duration risk (the long-term bonds the Fed is monetizing are especially sensitive to higher rates) and due to credit risk, since the United States government cannot possibly afford to sustain a $16 trillion dollar debt, increasing at over $1 trillion per year, at higher interest rates. With no assets to sell to protect the currency, the Fed will not be able to prevent the dollar from plunging in value. In this case, as the dollar falls, it would become easier to repay debt; as debt is repaid, the demand for dollars to sustain debt would fall, boosting inflation and raising interest rates further; higher interest rates would further weaken the Fed's balance sheet and increase the penalty for holding dollars, sending their value lower still in a positive feedback loop. Hyperinflation would arrive in an instant.

Once into the Daliesque world of hyperinflation, there will be different precedents to examine, some of which may seem all too familiar. Consider a recent quarterly report of the Reserve Bank of Zimbabwe:

> . . . in December 2003, the Zimbabwean banking sector was characterized by poor corporate governance and risk management systems, high levels of insider trading as evidenced by indecent loans to related parties, coupled with over indulgence in speculative non-core banking activities, inadequate capitalization, lax prudential supervision and regulatory forbearance. . . .

A more accurate description of the U.S. financial sector would be hard to pen. The report continues:

> As a result of the Reserve Bank's rigorous supervisory efforts, deep seated structural and operational deficiencies in numerous banks were exposed as liquidity and solvency challenges took their toll on these institutions. . . .
>
> In view of the problems that affected the banking sector, the Reserve Bank of Zimbabwe came up with various measures, including, the Troubled Bank Resolution Framework (TBRF). The TBRF was established in January 2005 to effectively deal with problem banks. . . . The Zimbabwe Allied Banking Group (ZABG) was created as a special purpose vehicle which facilitated the conversion of assets in the troubled banks into equity.

Did Ben Bernanke and Hank Paulson model the TARP bailout after Zimbabwe? Or was Bank of Zimbabwe Governor Dr. Gideon Gono reading the same academic papers from Harvard, Princeton, and Brookings? We may never know. But, we are sure to find out whether America's future will replicate what came next for Zimbabwe:

> Within this context [of deteriorating macroeconomic conditions], the Government of Zimbabwe failed to meet fiscal obligations from budgetary allocations which were severely eroded by rising inflation. As such, the financing of recurrent and capital expenditures presented serious challenges to [the] Government.

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> These negative developments threatened to bring the country's social service delivery system and the economy at large to a complete halt, thereby further impoverishing the Zimbabwean people.
>
> It is against this background that Government stepped in to save [*sic*] the situation through various interventions by the Reserve Bank of Zimbabwe.
>
> These interventions which were exactly in the mould of bail out packages and quantitative easing measures currently instituted in the US and the EU, were geared at evoking a positive supply response and arrest further economic decline. . . .
>
> Despite numerous intervention measures undertaken by Government through the Reserve Bank of Zimbabwe, economic activity continued to decline progressively with inflation peaking at 231 million percent by July 2008.

Replacing the word "despite" in the paragraph above with "because of" would yield a more accurate account of events, but Dr. Gono is correct that Dr. Bernanke is following the same script. America is larger and wealthier, but so are the imbalances and the intervention measures. The outcome will be similar.

While the actions of the Federal Reserve and European Central Bank command the primary attention of the markets, it is Japan where modern financial infrastructure will be tested first. The government has abandoned all pretense of independent central banking. Now on QE 10, Japan's new prime minister Shinzo Abe has threatened: "We will forge a policy accord with the BOJ, and will set an inflation target to implement bold monetary easing." In Abe's view: "Most central banks in the world, except for that of Japan, set policy targets with the government or in response to requests from the government."

To the uninformed, this claim seems dubious. Central bank independence has been the corner stone of confidence in currency for decades. In fact, in 2010 Professor Bernanke himself lectured the Japanese in Tokyo on the importance of independent central banking to sound monetary policy. But, perhaps the Japanese were more impressed by Senator Schumer's lesson on how to get results: "you've used QE1 and QE2, but you still have other tools in the tool kit . . . so get to work, Mr. Chairman." No one should expect a Princeton professor to defy a pugnacious senator. Bernanke obeyed.

If Abe manages to reorient Japan from decades of asset deflation to inflation, interest rates will rise, the $14.6 trillion (230% of GPD) of government debt will quickly become unsustainable, and the world will witness the financial apocalypse awaiting Europe and the United States. Traders and speculators are quick learners. Regardless of which major currency falls first, the rest will follow closely.

With Canadian tax loss and American tax gain selling over, gold stocks gapped up on the first trading day of 2013. The minutes of the Fed's QE4 meeting were released on the second trading day revealing that several Fed members expect to end the printing in mid-2013, far sooner than the market anticipates. Gold and gold stocks tumbled, but constructively maintained some of their gains and have since crawled higher. The Fed has been discussing exit strategies since before it began Quantitative Easing, but the logic driving the money printing will only become more compelling.

Despite the recent launch of QE4, Narayana Kocherlakota, president of the Minneapolis Fed, opined last week: "This [economic] forecast suggests that, if anything, monetary policy is currently too tight, not too easy." He and Jeremy Stein are both listed as moderates, being neither hawkish or dovish, in a recent scorecard by Société Générale. Other than sniping by

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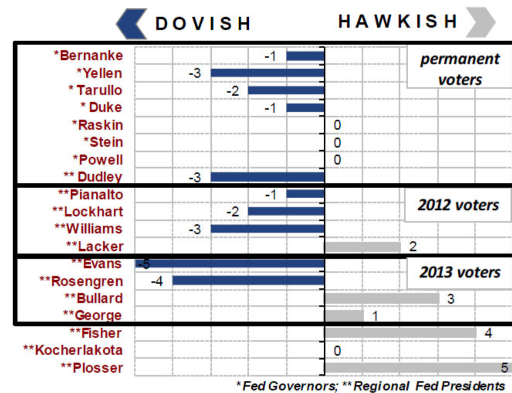
Bullard and other, non-voting members, there will be no consensus to halt the printing in 2013.



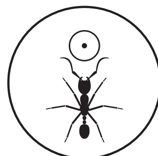
The chart above represents our subjective scoring based on recent speeches and voting record.

Source: Federal Reserve, SG Cross Asset Research/Economics

The next recovery will take the form of a crack-up boom as wealth holders shift out of currency. The real panic will begin when the Fed raises rates to defend the dollar and its balance sheet collapses. Gold investors should not expect vertical moves until this phase of the crisis arrives.

The new year begins with Fed engaged in open-ended printing and the Japanese determined to reduce the value of the yen. On January 14, Bank of Korea Governor Kim Choong Soo said the Japanese action could provoke an "active response to minimize any negative impacts on exports and investor confidence." The next day Eurogroup President Jean-Claude Juncker threatened "the euro foreign-exchange rate is dangerously high," prompting Russia to warn that the world is on the brink of a "currency war."

Recent performance has sorely tested the patience of gold mining investors. But, the trends pushing gold higher are poised to accelerate in 2013. A third year of movement against the primary trend seems unlikely. Most junior gold stocks could triple or more merely to return to where they were eighteen months ago. The crisis phase, when the Keynesian experience begins to unravel, should send them multiples higher again.



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