Myrmikan Research Update

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

Credit Onslaught

Most investors have no idea what money is, which is odd since it is money they seek. Americans use dollars, Europeans use euros, Indians used wampum. Indeed, Niall Ferguson wrote in *The Ascent of Money*: "[Money] is trust inscribed . . . Anything can serve as money . . . And now, it seems, in this electronic age, nothing can serve as money too." So what makes the difference?

A more enlightened age knew the answer to this question. In 1932, Garet Garrett described in precise terms why for thousands of years the free market has chosen gold over everything else to serve as money:

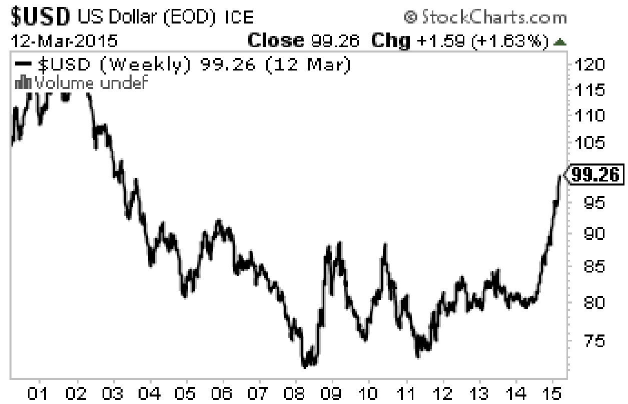
> The value of gold is arbitrary; so is the length of a yardstick. But just as it is necessary to sell cloth by the yard or coal by the ton, so it is necessary to have some arbitrary unit of value in which to price the yard of cloth and the ton of coal. It would be ideal to have something of absolutely invariable value in which to price them. But there is no absolutely invariable thing in the world. The relative constancy of the gold supply, the durability of the metal, the fact that over the centuries the amount of human exertion necessary to get it out of the rocks changes very slowly—for these and other reasons gold is the least unstable thing man has found for purposes of money, hence his preference for it.

We are told gold isn't money because groceries may not be purchased with gold coin. In fact, retail transactions were never transacted in physical gold. Gold is so valuable that it would be highly inefficient to trade in such small size. Retail transactions were transacted in silver or copper until the advent of the fully backed bank note, which is what made small transactions in gold feasible and demonetized silver.

Bank notes remain good money only to the extent they remain backed by gold. The data is clear: since President Nixon abandoned the gold standard in July of 1971, oil has increased 26 times in terms of dollars, or 8% per year. Oil in terms of gold hasn't changed. Using gold as a reference of value makes prices much more stable than using dollars.

Pricing oil in gold also makes it less volatile than in dollars. The annual change of oil priced in gold (considered monthly) has had a standard deviation of 40% since mid-1971. Over the same period, the annual standard deviation of oil priced in dollars has been 63%. Those who deal in oil, whether as traders, prospectors, developers, investors, consumers, etc., will be surprised in the market to a lesser extent if they keep their books in gold as opposed to dollars or anything else—they will prosper compared to others.

This philosophical position is small comfort to gold investors who decidedly have not prospered as against their peers, having seen the value of their physical holdings decline and of their mining stocks collapse, in one of the deepest and longest retreats ever.



One reason for this outcome is that the dollar index (the value of the dollar as measured against currencies in proportion with which the U.S. trades), has spiked higher in the past six months, as the chart above shows.

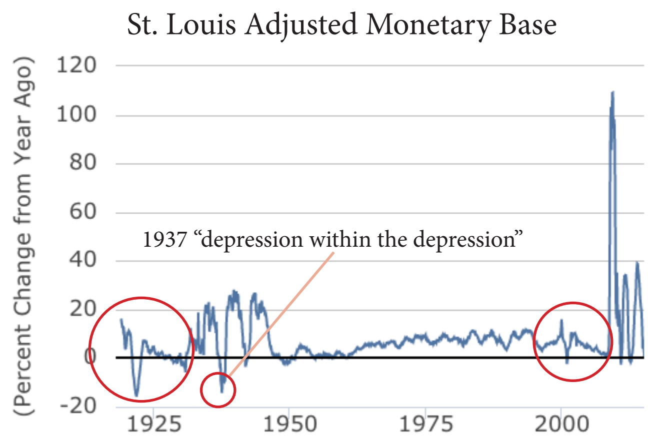
The bull market in gold, running roughly from $250 in 2001 to $1900 in 2011 corresponded with a huge decline in the dollar. Perhaps it is not surprising then that a spiking dollar would result in a declining gold price.

But what is causing the dollar to rise? It seems especially bizarre in the wake of the Fed's printing more than three trillion of them since 2008, quintupling the monetary base. One theory is confidence: the American economy is doing so well that global investors want to buy dollars. This makes no sense. If it were just economic performance investors wanted, they would hedge their currency exposure, and there would be no pressure for the dollar to rise.

There is a better explanation: there currently exist roughly $4 trillion of base money outstanding against $57 trillion of credit market debt. The size of private debt and the shadow banking system is unknown, but estimated to be another $20 trillion. This does not include foreign debt denominated in U.S. dollars. The roughly $100 trillion of dollar debt demands constant interest payments. Those who fail to have enough dollars to service their debts lose their assets. This is the incentive to hold dollars.

But where are the dollars to come from just to pay the interest, never mind retire this debt pyramid? The Federal Reserve must supply continually the raw dollars qua tokens needed to allow interest to be serviced to keep the debt system from collapse. When they fail to print enough money, there is a short squeeze, and then cascading defaults as the banking system and the entire economy implodes.

The first time this happened under the Fed's watch was in the 1920s. The fractional reserve banking system created huge amounts of debt-based money, powering asset markets higher. A nervous Fed slowed the pace of printing to reign



in the markets—as the first circle on the chart shows—reaching negative 3.7% annual growth in September 1930. Prices didn't cool, they collapsed as borrowers scrambled to get dollars to maintain their debts. As prices fell, it became ever harder to get dollars—debtors started defaulting, which meant their creditors couldn't pay their respective debts. It wasn't the stock market crash of 1929 that ushered in the Great Depression, but cascading defaults in the bond market in 1931.

The most notable of the initial defaults was not in America but Europe: the Austrian bank Creditanstalt. The Austrian banking sector had made large loans to Eastern Europe during the credit bubble of the 1920s. When these debts started to go bad, Austria forced strong banks to absorb and support weaker banks. To further stabilize the system, the Austrian central bank guaranteed Creditanstalt's liabilities.

Creditanstalt failed in 1931, triggering the guarantees. The market soon realized that the Austrian central bank was itself now insolvent and could not longer lend aid. Austrian banks were interconnected with German banks, and the panic quickly spread. Within months the pound was forced off the gold standard. Interest rates on private debt in the U.S. spiked as Europeans demanded cash, which ushered in a wave of loan defaults and bank closures in America. The Federal Reserve printed huge numbers of dollars to flood the system with liquidity, but it was too little and too late to prevent the malinvestments of the 1920s from liquidating.

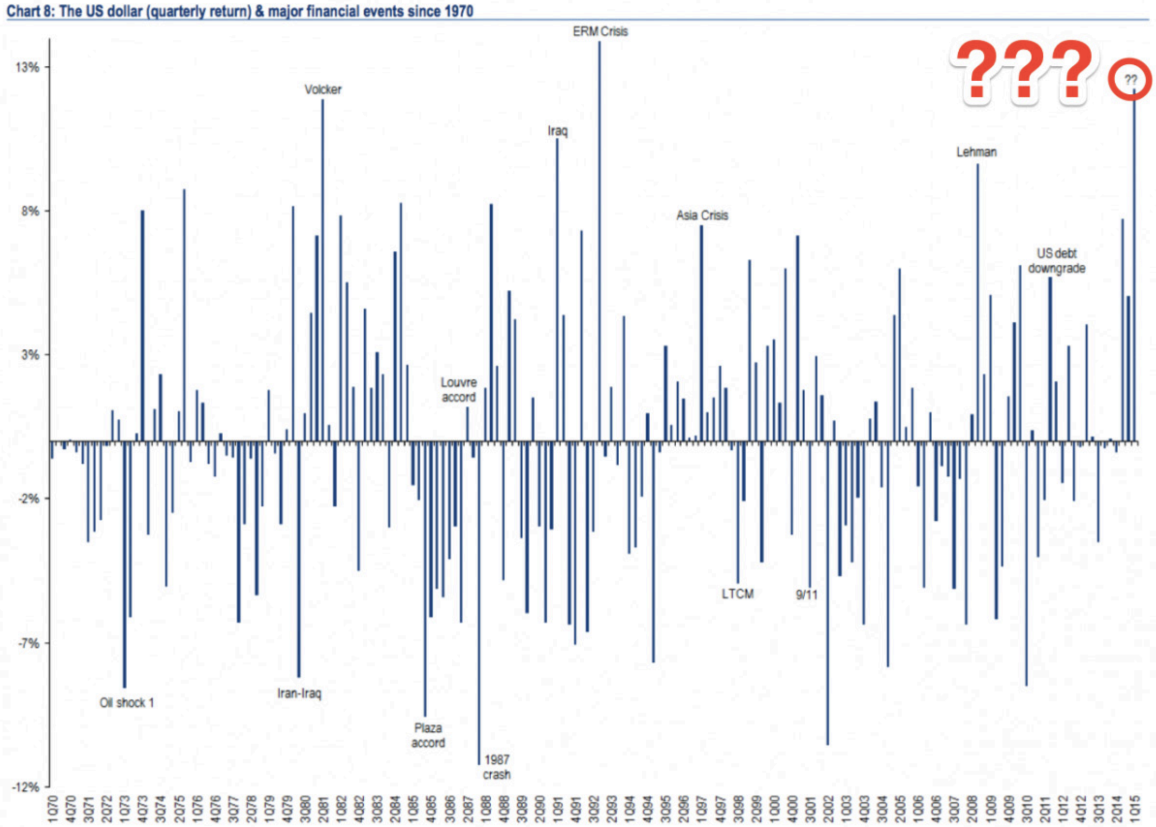
There is only one other time on the chart above that looks like the 1920s: the mid-2000s. Former Fed Chairman Ben Bernanke began his tenure by slowing the rate of printing to reign in the speculative excesses caused by Greenspan in the same way as had his predecessors in the 1920s. The results were the same. An over-levered economy lacked the dollar tokens needed to maintain its debts, and the banking system imploded, starting with the weakest credit and moving towards the center.

Bernanke's response was proportional to the problem and then some. He was bold where the 1930s Fed had been timid. He printed enough money to halt the cascading liquidations in their tracks, historically unprecedented.

Now the mantle has shifted to Janet Yellen. The Fed has been tightening for over a year. The latest reading of monetary base growth was negative 2.3% on March 4. She is charting a course analogous to the 1937 "depression within a depression." But there is a major difference: unlike in 1937, the malinvestments from the previous cycle have not yet been forced to liquidate. They trundle on, devouring real resources. When they fail, all society will be upturned, as it was in the 1930s.

The lack of fresh dollars is already causing an epic short squeeze. As the following chart from Bank of America shows, every time the dollar has been subject to such a squeeze a wheel has popped out.

Chart 8: The US dollar (quarterly return) & major financial events since 1970



The first pip may have already squeaked. First the background: Hypo Alpe-Adria-Bank, owned by the Austrian province of Carinthia, rolled the dice in the 1990s by aggressively expanding into the Balkans. In 2007, a bank owned by the German state of Bavaria named Bayerische Landesbank purchased a majority interest. During the 2008 panic, Germany and Bavaria had to bail out Bayerische with €10 billion, some of which went straight to Hypo.

In 2009, Austria nationalized Hypo and placed the non-performing assets in a "bad bank" called Heta Asset Resolution. Austria guaranteed €1 billion of Heta debt, and Carinthia guaranteed another €10.7 billion. This story by now should be sounding familiar. Last month, Austrian Chancellor Werner Faymann defended the actions saying: "The crash of Creditanstalt in 1931 caused economic meltdown. There was a consensus in 2009 to act where necessary, to avoid the mistakes of the 1930s, to avoid a collapse by nationalizing and by installing protection measures at the European level."

In February, a report surfaced suggesting that Heta was impaired by €5 billion, which the Austrian Finance Ministry promptly dismissed as "pure speculation." The speculation paid off: two weeks ago, auditors disclosed a €7.6 billion hole in Heta's balance sheet. The loss had been exacerbated because many mortgagees in the Balkans took out loans denominated in Swiss francs to benefit from lower interest rates. When the Swiss franc broke the peg and soared in value, these debts became impossible to pay and property values imploded. Regulators immediately imposed a moratorium on debt repayments affecting €9.8 billion of Heta's liabilities, including €1.8 billion owed to Bayerische, effective until May 2016.

Heta creditors face three problems: first, under the European Union's Capital Requirements Regulation, the state guarantee of Heta meant its liabilities were considered sovereign and therefore banks holding the debt were allowed to apply a 0% risk weighting. In other words, banks could and did use this debt as tier 1 capital. Second, the guarantees were written such that they only kick in once other remedies have been exhausted. In other words, they won't see any money until mid-2016 at the earliest. Third, Carinthia's budgeted revenue for 2015 is €2.4 billion, which makes a €10 billion guarantee dubious in the extreme. In fact, according to Barclays, Austrian regions currently guarantee in total over €50 billion, which exceeds annual income in six of the nine regions.

If you or I lose 3% of our money, we barely notice. If we lose all our money, our friends may lament, but the system moves on. Banks are different. Deutsche Bank, to pick an example, has a leverage ratio of just 3.2%. That means that if the bank loses just 3.3% on its assets, it is insolvent, the system implodes, especially if its insolvency were to detonate its $75 *trillion* derivative exposure.

Reliving Oedipus's fate, Austria's attempt to avoid another Creditanstalt has resulted in a much more virulent strain of the financial ebola. Who knows what conversations are being had at the boards of banks with Heta paper, though we can deduce the content of at least one: last night, Reuters reported:

> Germany's deposit protection fund is planning to take over the property lender Duesseldorfer Hypothekenbank AG (DuesselHyp), which has run into problems due to its exposure to Austrian lender Hypo Alpe Adria's "bad bank" Heta . . . "The deposit protection fund is granting a guarantee for the Heta bonds to eliminate the immediate risks. The goal is a complete takeover of Duesseldorfer Hypothekenbank," the BdB said in a statement on Sunday.

But history only rhymes. There was no ECB QE in the 1930s, and Keynesians and monetarists alike will boast that Europe can print its way out. Maybe so, but the Balkans are not Switzerland, and those that valued real estate as if they were created real losses that will lie somewhere—if not to creditors of private banks, than creditors of the central bank that bails them out, into which class holders of euros fall. This is why the euro is collapsing.

The failure of Creditanstalt in May 1931 barely merited a mention in the inside of the Wall Street Journal. By early June the situation was getting some press:

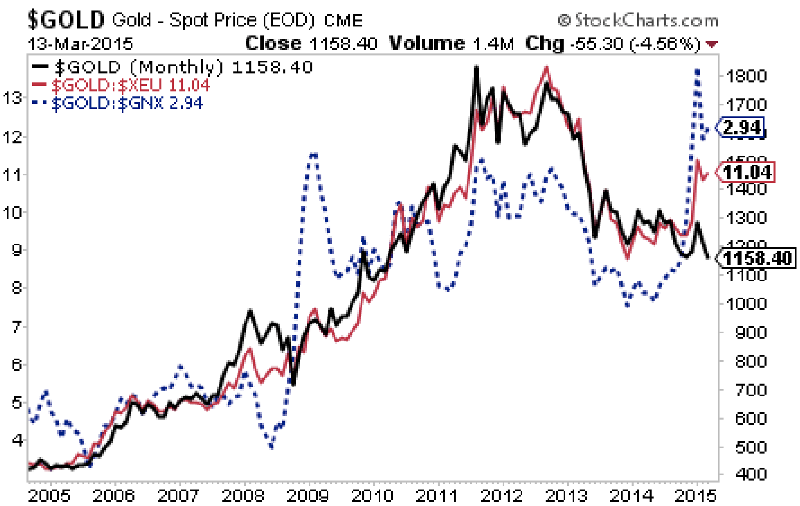
> Thanks to the prompt measures taken by central and private bankers to defend Austrian exchange and to extend credits to the Austrian Creditanstalt, there is every chance now that Europe will weather successfully the storm which was produced by what has been described in responsible banking quarters as the biggest bank failure in history. There was serious danger at one time of financial panic throughout central Europe.

By late August the tone had changed:

> In the two months ended July 31 credit withdrawals from the six leading German banks amounted to Rm. 2,228,000,000, or a reduction of 21.43% of the total on May 31 immediately following the collapse of the Austrian Creditanstalt.

On September 21, 1931, Britain abandoned the gold standard, the dollar was soaring in value, the market cracked lower, and bread lines appeared. Garrett described the scene:

> The faith is lost. All with one impulse people rush to seize the gold itself as the only reality left—not only people as individuals; banks, also, and the great banking systems and governments do it, in competition with people. This is the financial crisis.



Only professionals are currently following the travails of Heta Asset Resolution. But that may quickly change. And the market is reestablishing its taste for gold by stealth. This new appetite is hidden in the dollar price, which rests at resistance and threatens to break below $1150 as the short-squeeze in dollars accelerates. But viewed in terms of commodities (dotted blue) or in euro terms (red), gold is breaking out to the upside.

Euro QE was designed to soften the exit of Greece from the Eurozone. It will soon need to cover holes in the Austrian banking sector as well, and then perhaps the German. As the dollar goes vertical in comparison, we know how Janet Yellen will react: a flood of money printing proportional to Bernanke's as his was to the 1930s. Gold will also react proportionally. History will return. This will be the financial crisis.