Myrmikan Update

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Gold's Great Depression

Gold's decline back into the low-$1200s produced another very challenging month for gold shares. With gold above $1400 – more or less – junior miners generally increase their invested capital per share through cash flow or, in the case of exploration companies (since the costs of expanding a deposit are somewhat stable) a higher gold price generally means equity issuances are accretive.

Gold prices below $1250 imply decay of shareholder value at varying rates depending upon the company. The spread in value between holding an asset that is growing versus one that is shrinking is extreme, as gold investors have witnessed.

Fortunately, price movements can be extreme in both directions. The reason to hold these assets is less short-term operational performance than the option value they provide on the inevitable negative consequences of the fractional reserve banking system enhanced by a feral central bank: the values of the shares can flip higher as fast or faster than they collapsed. Appended to this monthly commentary is analysis by Gene Arensberg on the unusual positioning in the gold futures market, which is now more bullish than it was at the bottom in 2008, suggesting gold is at or very near a bottom.

To provide some background on Arensberg's points, the commercial category should never be long gold on the futures market. Gold mines either sell their gold as it is produced or, if they wish to engage in tactical or strategic hedging, sell short to lock in the price of their future production. Similarly, the bullion banks have natural long exposure to gold because of their loans to miners, which they hedge by going short in the futures market. The players in the commercial category should always be short.

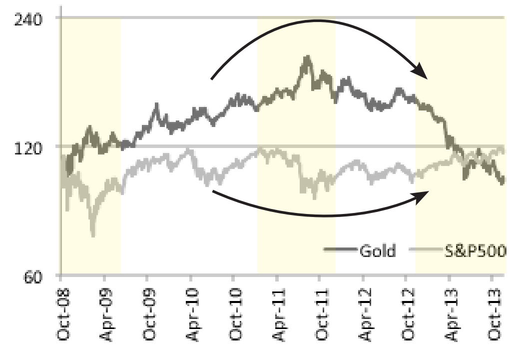
As speculated in the Myrmikan Update of August 19, 2013, the only reason a bullion bank should go long futures is if it has sold physical gold belonging to clients to Asian buyers to capture the premium on physical, covering the physical short exposure with a paper long. According to John Brimelow's Gold Jottings service, physical premiums in India (including import duties) persist at 25% of spot. In other words, with gold at $1260 on the COMEX, Indians are willing to pay $1575 per ounce. Although official Indian gold imports have fallen because of the high duties, imports and premiums in neighboring countries have spiked as smuggling expands. Meanwhile, China continues to import record setting amounts of gold at high premiums, suggesting this Western trade of swapping physical for paper continues.

Because these physical flows to the East continue apace, absorbing the gold being dishoarded by various Western depositories such as GLD, there will be that much less gold to speculate on when the next rally occurs. Moreover, assuming it is correct that the bullion banks are now short physical, they will have to stand for delivery on their long futures contracts to replenish their vaults. It is interesting to note that the JP Morgan House account has scooped up 95.6% of December COMEX deliveries so far. The funds that are short gold cannot deliver physical – to cover their position they must buy gold futures: who will they buy them from?

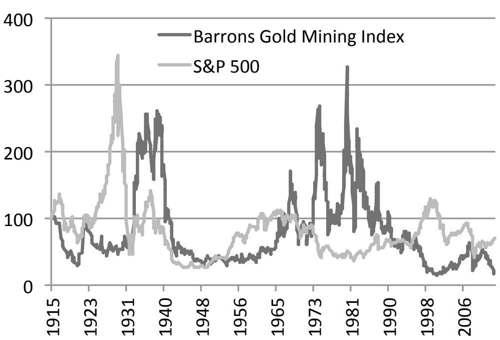
Investors intuitively know that the stock market generally goes up slowly and down suddenly. This is because the market is almost all longs, with many longs levered with margin debt. Futures markets are different: they are zero sum games. For every long there is a short, and leverage is available in equal amounts on both sides. This symmetry means that futures can melt up with the same force that they crash down.

The previous Myrmikan update queried what would happen in a market crash scenario, which looks increasingly likely. Would gold fall as all sell assets to raise dollars? Or would investors anticipate a new, more powerful intervention by the central bank and bid gold up?

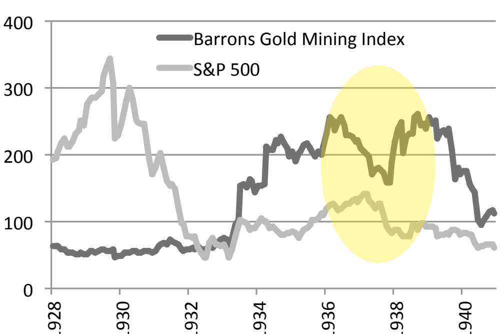
The top chart at right shows the relative performance of gold versus the S&P 500 since October of 2008 (adjusted lower by 11% per year to adjust for inflation and make the graph flat). On a micro scale, gold and the S&P 500 are often anti-correlated, as shown by the yellow shaded areas, though sometimes not. On a macro scale, as the arrows show, the two are quite anti-correlated, once adjusted for the upwards bias.



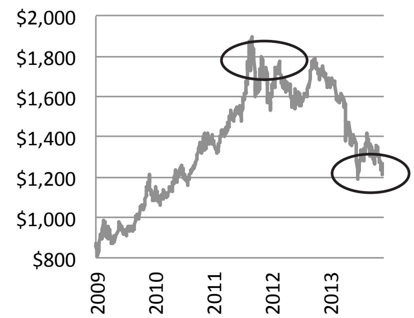
The lower chart shows the relationship between gold and stocks since 1915 using gold mining stocks (since gold wasn't freely tradable until 1971) and adjusted for currency in circulation to make the graph flat and legible on a reasonable scale. Again, for most long periods, gold instruments and mainstream stocks trade against each other.



Other features that stand out in this chart is the violence of the miners' performance in the 1970s. And, zooming on the one period when the two lines do look somewhat correlated, the deflationary 1930s, reveals that the general stock market recovery in 1937 was met with gold share weakness, and the subsequent slump with gold share strength.



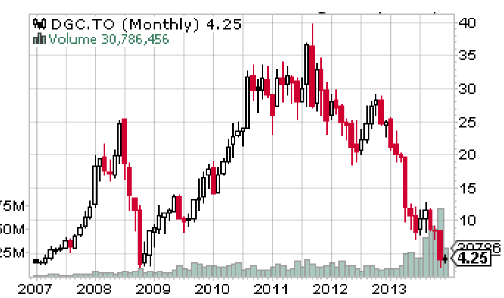
This anti-correlation makes sense from a macro perspective: the very reason why gold makes good money is that its value is anti-correlated to the business cycle. From a trading perspective, one ponders which speculators, at present, short or long, must cover when money becomes suddenly scarce. The import of Arensberg's analysis is that those currently long gold are not levered: commercial users utilize the futures markets to hedge their physical exposure. It is the speculative shorts who are massively levered for further declines in the gold price and vulnerable to tightening financial conditions. If the market crashes down, gold is likely to crash up.



In fact, this may already be happening. Except for one brief foray, Gold stalled at $1800 back in 2011, despite constant macro news favorable to gold. Conversely, the gold bears have been trying to force gold below $1200 to meet bank sell side targets below $1100. Aside from a temporarily breach back in June, the $1200 support has held, despite serious macro headwinds for gold, including a shrinking budget deficit and taper talk. And, in the last few trading days, gold has risen strongly even in the face of rising yields, which have been in recent past very negative for gold prices.

Perhaps most interestingly, Tuesday saw 3,000 gold futures trade in within a second sending the gold price up $10 and triggering a 10 second circuit breaker. Those who follow the gold market closely will recall that a series of such down moves, testing the liquidity of the market, preceded the April smash in gold. It appears someone using the same methodology is testing the liquidity and fortitude of the shorts. If they are found wanting, prices could move much higher violently.

It is hard to imagine such a move not boosting gold shares, whatever is happening in the general market. Although gold shares have fallen so low it may seem impossible to claw back the losses, the drawdown has presented opportunities to buy world class assets at distressed pricing.



One example is Detour Gold, which reached a high of $40 per share in 2011, but traded as low as $2.88 last month, a decline of 92%. The project is a huge, open pit, low grade deposit in Canada that has already cost $2.3 billion to develop, is currently ramping up production, and is hated by investors (see chart).

The mine has 15.6 million ounces of reserves and will produce 650,000 ounces per year for 22 years with a projected cash cost of below $800 per ounce. This mine life does not include 12 million additional resource ounces nor the exploration potential in the large prospective land package. Under a gold standard, Detour Gold would be a utility, steadily churning out money for decades. As discussed in the most recent Myrmikan presentation, gold mines with long lives can go nearly forever, if conservatively managed to survive the business cycle, because gold continually increases against the costs of mining it, turning surrounding waste to ore.

One constant in mining, however, is that starting a mine is fraught with peril. It will take nearly 18 months from the start of production last June for Detour to reach full production. Until that time, pre-stripping and other development activities will cause costs to run ahead of revenues, especially given the slide in gold prices.

In the most recent quarter, Detour's reported costs were higher than expected, and it raised its cash costs and continued Capex for estimate for 2014 to a range of $1150 to $1250 per ounce. With gold below $1250, the market was unhappy. Days later, the founding CEO unceremoniously resigned, causing the stock to plunge as the market anticipated further bad news (though it now appears the departure was a function of personality and share price performance).

But, all is not lost. As of September 30, 2013, Detour reported working capital of $121 million, and it has possibility of squeezing an extra $55 million from its CAT equipment leases. As long as gold remains, generally, above $1200 during 2014, Detour should not require any external capital. Capex requirements begin to trail off after 2014, meaning Detour can withstand lower gold prices starting in 2015.

It is not unlikely that the company may seek to raise additional capital soon to augment its liquidity reserves for 2014 and guard against lower gold prices. Given various existing debt arrangements, such a raise would most likely be done through equity, another reason that the stock has plunged. However, with a fully diluted market capitalization of $560 million, while such a raise would be unpleasant, it would not be devastating to the capital structure, especially since the company is 80% held by institutions, including 15% by Paulson & Co, implying sponsorship.

To be sure, Detour is very operationally levered: it cannot survive sub-$1000 gold, so any investment is at risk of total loss. On the other hand, *if gold were to return to $1900 per ounce, Detour's annual cash flow would well exceed its current fully diluted market capitalization at $4 per share.* In that case, given the near infinite mine life, it is difficult to project a return less than 10X. 20X would be appropriate, even assuming some mild dilution, driven by a 50% increase in the price of gold. And, in the next wave, gold is likely to go a lot higher than $1900.

Professional commodity investors are of the opinion that gold must wallow sub-$1200 for a couple of years in order to bankrupt the high-cost producers such as Detour. The analysis would be correct for all other commodity markets: if temporary demand conditions allow the construction of high-cost supply, and demand reverts to normal, then there will be oversupply and falling prices until the high-cost producers close. Worse, since mines continue in production until price falls below the marginal cost of production, as opposed to full cost (including capital), commodity prices can sink well below equilibrium for a period of time. In other words, Detour would keep operating long after the equity were wiped out and the debt holders became the owners, lowering the financial breakeven costs because of the absense of interest.

The flaw in this analysis with regards to gold is that unlike all other commodity markets (with the exception of silver), global production is only 1.5% of above-ground supply. Mine supply has only faint influence on the price of gold, which is determined by monetary conditions.

This attribute of the gold market cuts both ways. If monetary conditions so demand, gold can fall below the cost of any production – analysts who claim that there is floor on gold at $1200 because that is the marginal cost of production are analyzing the wrong commodity. Conversely, gold can rise far beyond the price that brings in the marginal suppliers, and this is the reason why gold markets are so violent. Fortunately for current gold investors, monetary conditions demand far, far higher prices that no amount of available supply can diminish.

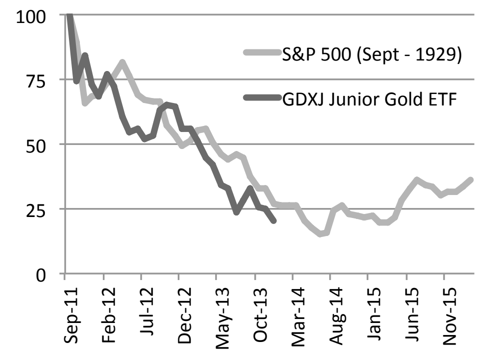
I have been asked if I foresaw the depression in gold prices. The short answer is of course not. Gold is down 35% from the peak, senior gold stocks are down over 70%, and junior gold stocks are down even more. Anyone foreseeing such moves would have been very short.

The more nuanced answer is that, yes, I have written extensively about volatility, and how historical gold markets increased in volatility – in terms of percentages – as prices went higher. In fact, the Myrmikan Update of May 2011 warned of ominous signals suggesting that gold might face a large correction.

But, aware that it is gold's volatility that prevents most from preserving their wealth during a currency collapse, secure that holding gold shares unlevered eliminates the risk of margin calls, and having identified companies that had the liquidity to enable them to withstand a couple of years of falling gold prices with limited capital structure damage, the calculation was that it was better to bob up and down the waves of liquidity than try to time the chaotic steps leading up to hyperinflation.

From this perspective, the magnitude of the drawdown was not unexpected. However, the length of time gold has stayed low is surprising. Normally, as currencies near the drain the spiral accelerates. More than likely, because the Fed has provided false stability, the subterranean forces will be that much stronger when they burst into view.

The graph at right gives some sense of just how painful this market has been: small-cap junior gold shares have fallen at faster rate and nearly as long as the general stock market during the Great Depression, with the nano-cap sector that Myrmikan focuses on falling even more.



As painful as these losses have been, investors should consider what it would be like if their sum total wealth were to perform similarly, for this is the outcome against which the gold miners protect.

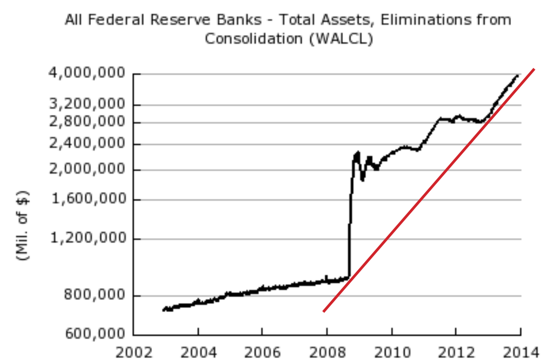
Following the panic in 2008, Bernanke made several revealing statements: "The international policy response averted the collapse of the global financial system"; "I was not going to be the Federal Reserve chairman who presided over the second Great Depression"; and "How much would you pay to avoid a second Depression?" Clearly, not just Austrian economists, but mainstream policy makers were aware of the dangers of total debt liquidation.

Yes, Bernanke saved the system, but he did so by piling up even more debt. Financial conditions around the world are now more imbalanced than they were in 2007, so the depression, when it comes, will be that much worse. Gold shares have already had their depression and will likely respond vigorously at the first signs of financial collapse.

To Taper or not To Taper

Readers of these pages are well aware that Austrian economic theory backed by hard historical lessons shows that once an economy becomes supported by money printing, the printing of money must accelerate to prevent an economic collapse. The logical space of outcomes, therefore, is an economic collapse if the printing ends at some point, or hyperinflation otherwise (which also causes economic collapse).

The graph at right shows the size of the Fed's balance sheet on a logarithmic scale. Log scales are useful for revealing rates of change: a straight line represents a constant growth rate, with the slope of the line being the rate of growth. The red line shows the average rate of printing from the beginning of the program to the start of QE∞. That the black line is now steeper reveals that current rate of printing is faster: the Fed is, indeed, accelerating the printing, as it must.



In fact, the reality is worse than the graph shows. In our modern times, the Fed is not (yet) dropping paper money from helicopters, but monetizing bonds of various durations. The longer the duration of the bond being monetized, the greater the effective amount of new money. As the QEs have progressed, the Fed has been lengthening its duration profile, meaning the printing is accelerating not just in nominal terms, but in terms of duration as well.

Market participants of all stripe are atwitter about when the Fed will taper: next week or in March, the mode of guesses. The predictions, of course, are based on Fed communications not data, since this decision is driven strictly by policy. Perhaps it is instructive, then, to consider the recent minutes of Fed meetings to gauge the sentiment of the actual voters [all emphasis added]:

January 2013:

> A number of participants stated that an ongoing evaluation of the efficacy, costs, and **risks of asset purchases might well lead the Committee to taper or end its purchases before it judged that a substantial improvement in the outlook for the labor market had occurred**. Several others argued that the potential costs of reducing or ending asset purchases too soon were also significant, or that asset purchases should continue until a substantial improvement in the labor market outlook had occurred. . . . a number of participants discussed the possibility of providing monetary accommodation **by holding securities for a longer period than envisioned in the Committee's exit principles, either as a supplement to, or a replacement for, asset purchases.**

March 2013:

> Many participants, including some of those who were focused on the increasing risks, expressed the view that continued solid improvement in the outlook for the labor market **could prompt the Committee to slow the pace of purchases beginning at some point over the next several meetings**, while a few participants suggested that economic conditions would likely justify continuing the program at its current pace at least until late in the year.

May 2013:

> **A number of participants expressed willingness to adjust the flow of purchases downward as early as the June meeting** if the economic information received by that time showed evidence of sufficiently strong and sustained growth; however, **views differed about what evidence would be necessary** and the likelihood of that outcome. One participant preferred to begin decreasing the rate of purchases immediately, while another participant preferred to add more monetary accommodation.

June 2013:

> **However, several members judged that a reduction in asset purchases would likely soon be warranted**, in light of the cumulative decline in unemployment since the September meeting and ongoing increases in private payrolls, which had increased their confidence in the outlook for sustained improvement in labor market conditions. Two of these members also indicated that the Committee should begin curtailing its purchases relatively soon in order to prevent the potential negative consequences of the program from exceeding its anticipated benefits. Another member pointed out that if the program were ended because of concerns about such consequences, the **Committee would need to explore other options for providing appropriate monetary accommodation.**

July 2013:

> A few members emphasized the importance of being patient and evaluating additional information on the economy before deciding on any changes to the pace of asset purchases. At the same time, **a few others pointed to the contingent plan that had been articulated on behalf of the Committee the previous month, and suggested that it might soon be time to slow somewhat the pace of purchases as outlined in that plan.**

September 2013:

> However, all members but one judged that it would be appropriate for the Committee to await more evidence that progress would be sustained before adjusting the pace of asset purchases. . . . For several members, the various considerations made **the decision to maintain an unchanged pace of asset purchases at this meeting a relatively close call**.

October 2013:

> Many members stressed the data-dependent nature of the current asset purchase program, and some pointed out that, if economic conditions warranted, **the Committee could decide to slow the pace of purchases at one of its next few meetings**. A couple of members also commented that it would be important to continue laying the groundwork for **such a reduction in pace through public statements and speeches**, while emphasizing that the overall stance of monetary policy would remain highly accommodative as needed to meet the Committee's objectives.

At nearly every meeting, the FOMC has threatened to plan to make contingent efforts to taper the printing at some point in the near future, yet QE continues. In October, the members explicitly admitted that the PR surrounding such statements is not about policy, but is part of policy itself (and since the minutes are now part of PR, one wonders if there are secret minutes in which the FOMC discusses what the public minutes should say).

The only times the members of the FOMC are, perhaps, serious about tapering the printing, they plan other devious methods to keep rates low, which is the explicit goal of printing, and, therefore, is merely printing in another guise: the communication essentially tells the private market to behave as if there were printing, for the Fed will ensure that no losses accrue to financial actors who so act.

The Fed may well try a little tapering soon, if only to find out exactly how small is the box that they are in. A $10 billion/month taper combined with language about keeping rates low forever and reiteration that QE is data dependent and therefore can be dialed up would be the perfect experiment to see how markets react and allow rhetorical retreat when they tank, for retreat they must in order to maintain stability.

Yet there are dangers to this plan that the Fed does not see. The economic intelligentsia believes in the efficient market hypothesis as exposed by Eugene Fama, recipient of the 2013 Noble Prize in Economics: “prices reflect all available information.” In an interview with the New York Times, Fama was asked:

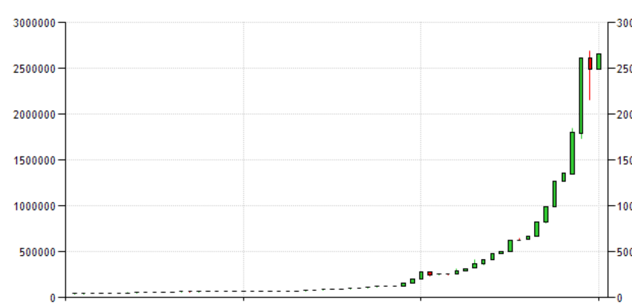
> NYT: But if I ask you what caused the financial crisis — was it an asset bubble, a real estate bubble — you’re going to tell me you don’t even know what a bubble is. Is that right?
>
> Fama: [He laughs] Yes! Absolutely right!

Bubbles are impossible because asset prices must always efficiently discount all information, and the definition of a bubble is asset prices that are “too high.” A corollary is, if there can be no bubbles, then there can be no market crashes either!

The Fed thinks that by broadcasting information it can thus perfectly control markets. This is why, when asked on 60 Minutes how confident he was that he could reign in inflation, Bernanke responded: “100%.” How confident is the Fed that it can reverse a market crash caused by taper? 100%.

Leaving Lewis Carol market theory aside, once a levered market begins accelerating to the downside, the margin clerk becomes more powerful than the Federal Reserve: rational expectations of Fed action are irrelevant to investors receiving margin calls; they must sell, and the selling begets more selling.

The Fed thinks its policies are like a thermostat – if markets are too cool, dial them back up. In reality, there are a series of tipping points beyond which the force required for influence grows exponentially. There is little doubt that the Fed could reverse a nominal market decline, but can it celebrate it to return to the “proper” level? Perhaps, like the Venezuela stock market shown at right, it may overshoot a bit. And does it have enough knowledge and power to set relative prices properly? If the Soviet Politburo couldn’t do it, with vastly more powers on hand, it seems unlikely the Fed can pull it off.



December could bring the policy error that forces the Fed to abandon QE in favor of dumping currency on the sidewalk. Perhaps this is why the bears are having trouble shoving gold below $1200. Wouldn't it be ironic if the taper announcement sent gold vertically up.

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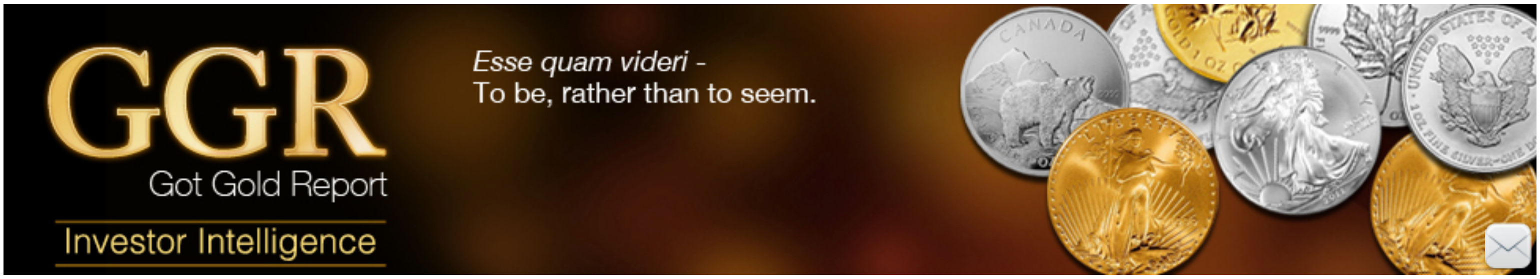

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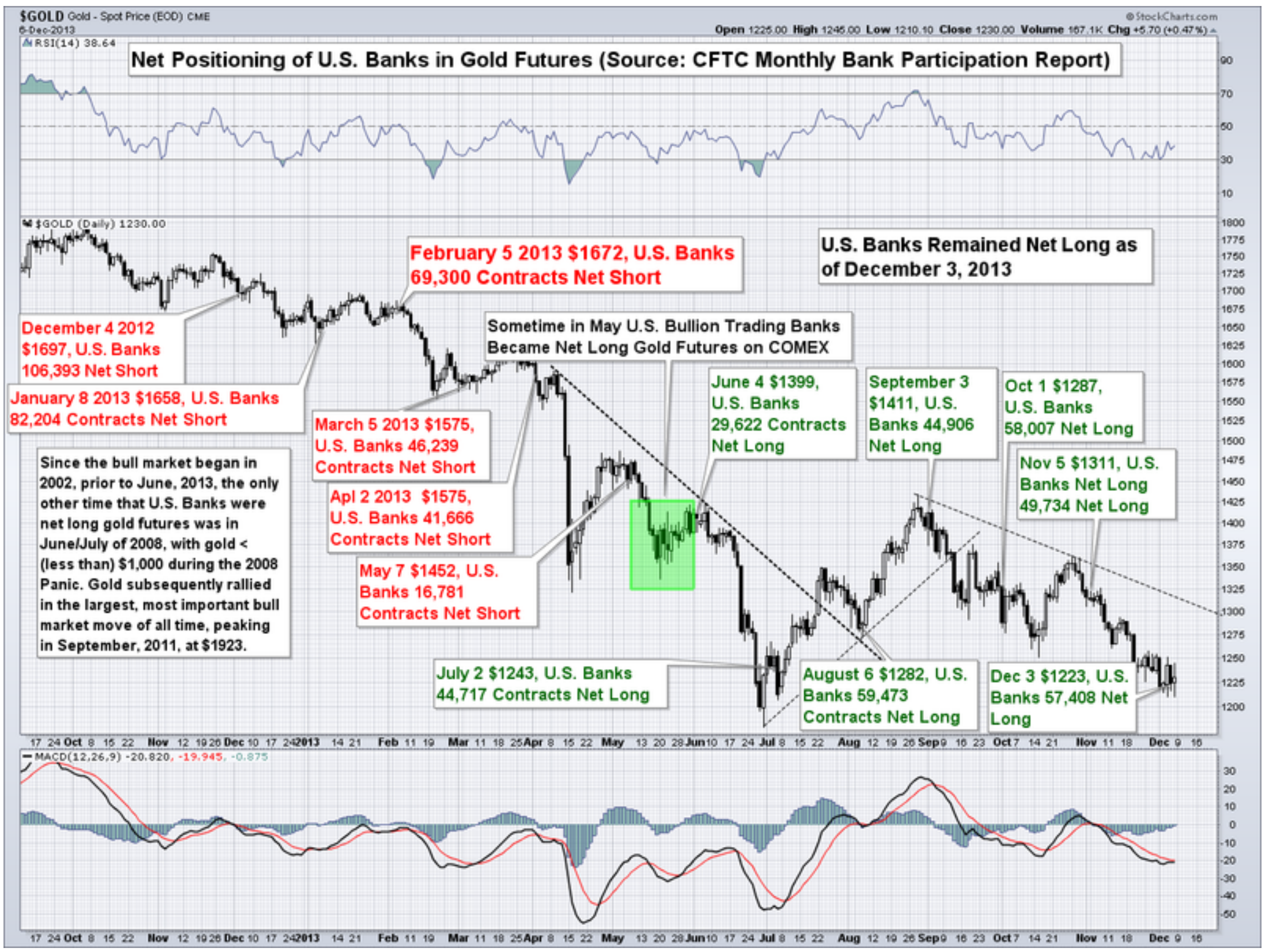
Monday, December 09, 2013

U.S. Bullion Banks Positioned for Higher Gold Prices

Edit 1: Adds the chart of Non-Reportable gross shorts, by request and a trade opinion/comment.

HOUSTON -- As we reported on Friday, the CFTC Bank Participation Report (BPR) showed the four reporting U.S. bullion-trading banks holding 71,897 COMEX gold futures contracts long and 14,489 short, for a net position as of December 3 of 57,408 contracts net long. Below is a graph which tracks the U.S. bank positioning and gold.



As mentioned in the chart, U.S. bullion trading banks became net long gold futures with the June 4 BPR, with gold then near $1400 the ounce.

For a sense of how unusual it is to have the bullion banks net long gold futures, check the graph at the bottom of our [Friday offering here](#).

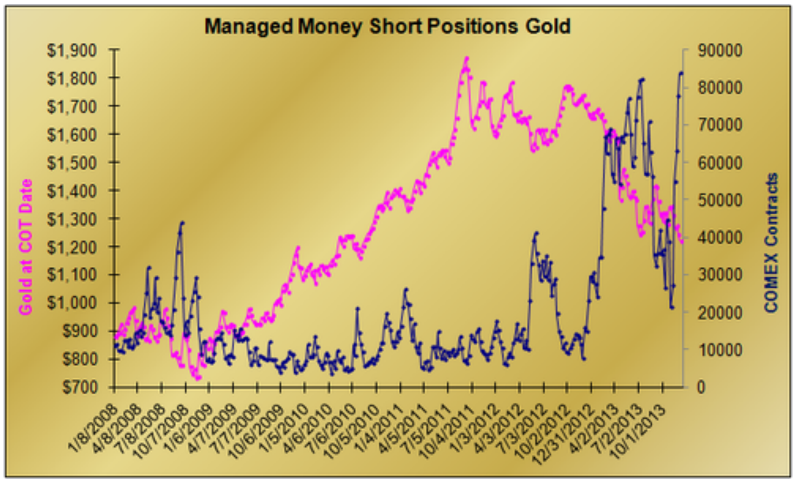
Clearly, with gold in a $1200 to $1400 trading range, the U.S. bullion banks' customers have positioned to benefit from higher gold prices more than not.

What is interesting about that is that, because of the nature of their business being dominated by hedging, the U.S. bullion banks are typically on the net short side of the gold futures battlefield.

There are any number of ways of looking at this important change in positioning, but one of them is that, just recently, as the momentum following hedge funds have ramped up their gross shorts on gold to [record high levels](#) (pressing gold lower), the bullion banks (and the category of traders the CFTC calls Producer Merchants, of which the bullion banks are a part, we believe) have "answered" in a way, with the usually net short bullion banks now net long and the normally hugely-net short Producer Merchants also net long gold futures.

Intuitively the setup suggests to us that the largest traders of gold futures – the people in the gold trade itself and the bullion banks they often trade through – are no longer positioned to benefit from lower gold prices. To the contrary.

Or maybe the gold trade and the bullion banks just see an enormous amount of speculative short bets on gold?



(Chart shows the record-high gross short position currently held by Managed Money traders. As of December 3, 83,730 short contracts, the highest in DCOT history, with data since 2006. Not shown, smaller traders the CFTC classes as Non-Reportable held another 38,099 short contracts. Non-Reportable traders were actually slightly net short as of December 3.)

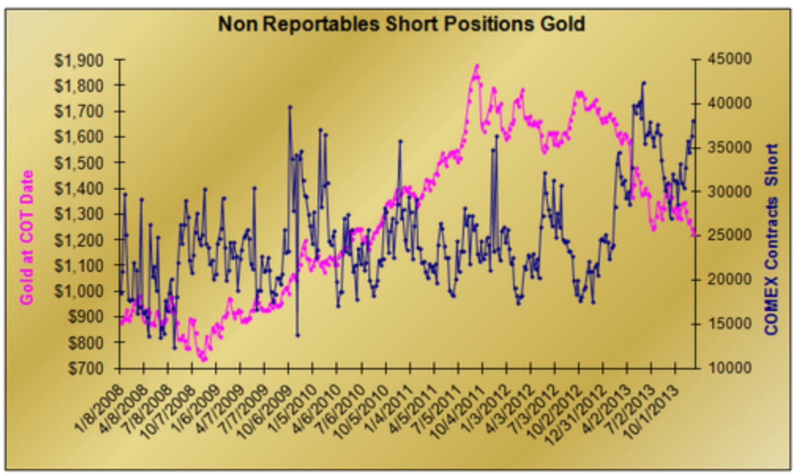
As our readers already know, speculative shorts for gold futures are the highest of high octane rally fuel for gold – under the "right" conditions. Spec shorts for gold are as naked as they can be and thus must be bought back at some point. In that respect spec shorts are "bottled buying power" waiting to be un-corked.

One wonders where, exactly, the pertinent technical levels are to trigger the coming fireworks and what the catalysts for it will be. Alas, both will be only be confirmed in retrospect, but that doesn't mean we can't be on the lookout for it...

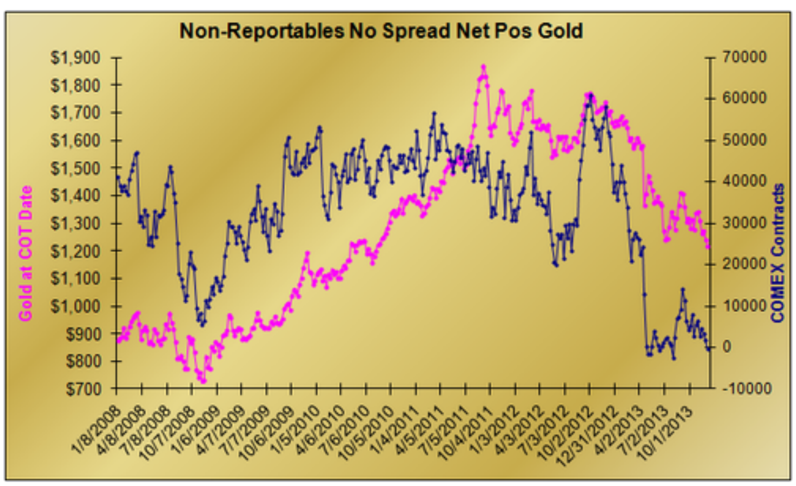
It will be interesting to see how it fleshes out in the days and weeks ahead.

That is all. Carry on.

Edit 1: Adds the chart of Non-Reportable gross shorts, by request.



(Smaller Non-Reportable gross shorts, 38,099 contracts as of December 3. As shown below, the Non-Reportables are actually slightly net short as of December 3.)



(Non-Reportable net position = 392 contracts net short Dec 3.)

Trade comment: There are a large number of spec traders on the same (short) side of the boat. Look for gold bears to ramp up the rhetoric, especially in the event that gold edges higher to test the key $1256 region just ahead. Somewhere between there and the low $1280s is a likely gang-up of buy and short trailing stops that the gold bears will hope not to have to defend.

At least that's where I expect they may have bunched up as of now.

Above about $1307 at this stage would be modestly shocking to the overly confident short sellers and would almost certainly trigger much more aggressive short covering and even larger buy stops. Watch for it, although I am at a loss as to what the catalyst might be to trigger it so far. That does not mean there is not a trigger, just that I cannot identify one this minute. GA

Posted by Gene Arensberg at 11:00:21 AM in Got Gold Blog

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Comments

Markus said...

And the LBMA gold forward rate has just gone negative again.

Reply Monday, December 09, 2013 at 10:48 PM

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