Myrmikan Research Note

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Recovery

Global stock markets have made sharp recoveries in recent days, driven by a bounce in emerging market currencies. This market action is likely to prove short lived and serves mainly to squeeze overly aggressive shorts.

Stocks are currently supported by three layers of debt: an indebted consumer buying products from companies that have issued debt to buy back equity owned by speculators on margin. Any diminution in the availability of credit will collapse the accordion of debt and send markets far lower than most observers think possible.

Credit contagions always begin with the weakest debtors: sub-prime housing in 2007 and emerging markets currently. The cycle of emerging market booms and busts has repeated for hundreds of years, usually corresponding to credit bubbles in the senior global economy. Capital flees the artificially low rates of senior investments for high yield, speculative gambles domestically and internationally. When the banking system is finally forced to pull in credit to protect its own solvency, the speculative markets collapse amid realized capital destruction. Since banks generally keep very little equity on their balance sheets, even small losses can tip the banking system into insolvency, forcing credit liquidation, economic depression, and market panic in the senior economy.

Tapering is tightening, as various members of the Fed have admitted, and there seems little doubt that the Fed will continue with the taper, for the moment, starving malinvestments of capital. The Fed is aware of but not yet worried about the consequences to the credit periphery. Tuesday, at Janet Yellen's first appearance in front of Congress as Chairman of the Federal Reserve, she testified: "We have been watching closely the recent volatility in global financial markets. Our sense is that, at this stage, these developments do not pose a substantial risk to the U.S. economic outlook."

Yellen's testimony echoes eerily testimony given to the very same House committee in July 2007 by then-Fed Governor Kevin Warsh: "[subprime losses] don't appear to be raising, to this point, systemic risk issues." Observers should recognize that all experienced government officials know to pepper speeches with *at this stage*, *seems*, *appears,* etc., as necessary disclaimers when speaking falsehoods.

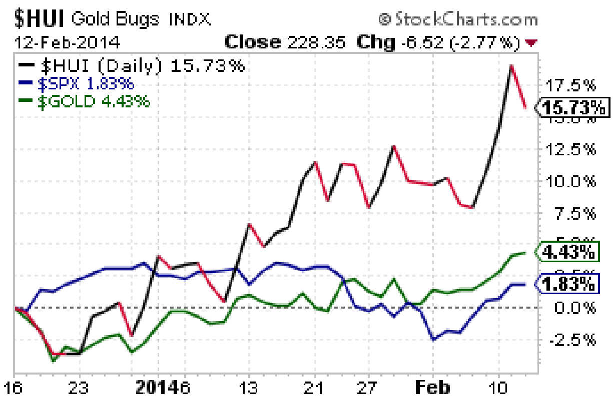
There is, in fact, an intellectual reason why the academics at the Fed are professionally blind to the systemic risks posed by excess credit. Keynesians look at economic statistics in aggregate and, in aggregate, total debt owed by borrowers precisely equals total payments expected by creditors. In aggregate, debt is merely a promise society makes to itself, the left pocket to the right, and thus can be canceled out and removed from economic calculations. But, does no one suffer when Turkey doesn't pay?

Once the risks to Western banks do become manifest, the Fed will announce the problems have been "contained," as it did during the festering of the sub-prime problems. The containment efforts for sub-prime involved dropping the target fed funds rate from 5.25% in August of 2007 to 2% by April of 2008, and then to 1% by October. But falling interest rates did not save Bear Stearns or Lehman Brothers, and only huge doses of money printing saved the banking system.

It is not obvious what tools the Fed will use when called upon to contain the credit contagion from emerging markets and overly exposed European banks. The fed funds rate is already at zero and money printing remains ongoing. One possibility is QE^4 – money printing on a massive scale involving not just Treasury and mortgage backed securities but also corporate debt and perhaps foreign bonds as well (expansion of bureaucratic authority is swift during a crisis). Opaque guarantees of the shadow banking system and even capital controls are also possibilities.

Whichever method the Fed will choose, it will not be healthy for the dollar or for creditors (e.g., depositors). But, act the Fed will, and mightily, for the credit imbalances are now worse than in 2007, and inaction will mean the destruction of the banking system.

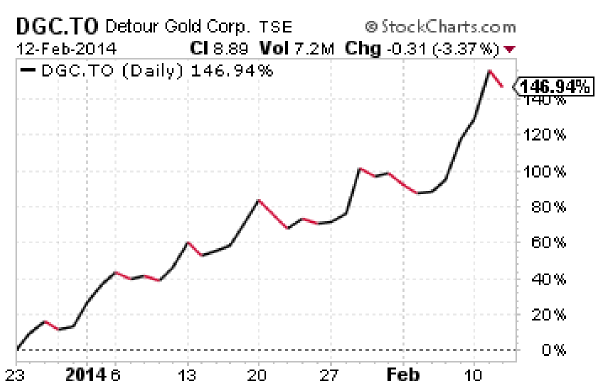
Gold's performance since the taper reflects the sophisticated money locking in paper gains from various assets and tiptoeing quietly away. Meanwhile, the gold shares have continued to surge higher, with the senior shares up over 15% since the day before the taper was announced. The junior shares are up far more. How ironic for those who trusted Goldman Sach's December call that post-taper "Gold is now likely to grind lower throughout 2014."



Bull markets are called such because they are very difficult to ride. The 1987 crash threw off many trend followers, who had to chase the market higher thereafter. The 1976 crash in gold had the same effect, as has the current crash in gold stocks.

Volatility is merely one way to throw off investors – straight moves higher after bottoming is perhaps even more psychologically difficult. Investors who were waiting for the bottom all of a sudden realize they've missed it. If a market rises too quickly, the would-be investor waits for a good correction, a last chance to get in that never comes, while bottom buyers take profits too soon.

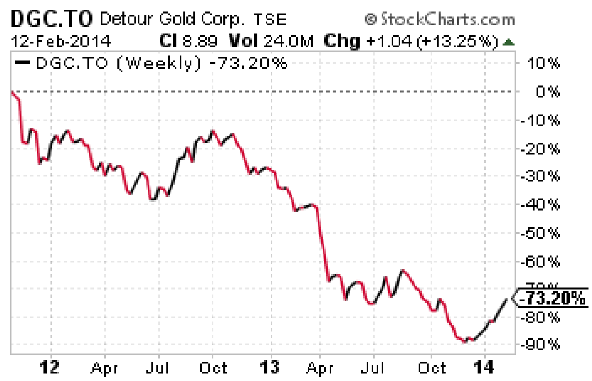
A good stock to illustrate this point is one discussed recently in these pages: Detour Gold. In the past two months, the stock is up 147%. After it had risen 40% in 10 days, profit taking – even for the very bullish – surely seemed sensible. For those wanting in, such a large move *must* offer a correction to allow a better entry point. And, if not at 40%, surely rising 80% in under a month must



presage a significant drawdown, prompting prospective investors to wait still longer and inducing those who did buy at the bottom to sell, hoping to buy back in after a sharp correction. And then it surges another 55%. Is now the time to take profits?

The great trader Jesse Livermore offered advice on this market phenomenon in the 1923 book *Reminiscences of a Stock Operator*:

> After spending many years in Wall Street and after making and losing millions of dollars I want to tell you this: It never was my thinking that made the big money for me. It always was my sitting. Got that? My sitting tight! It is no trick at all to be right on the market. You always find lots of early bulls in bull markets and early bears in bear markets. I've known many men who were right at exactly the right time, and began buying and selling stocks when prices were at the very level which should show the greatest profit. And their experience invariably matched mine – that is, they made no real money out of it. Men who can both be right and sit tight are uncommon. I found it one of the hardest things to learn.



It may seem madness not to take profits on a 147% two-month gain, but the longer term chart tells a different story. Detour bottomed down more than 90% and remains more than 73% below its all-time high. It can rise another four times and still not exceed its all-time high, which occurred before the mine had been built. As gold grinds back through $1800, Detour will likely well exceed its old high, skewing the risks to the upside.

From a more sophisticated perspective, those who bought at the bottom can now be sellers of Detour, not because of a trader's expectation that it can be repurchased at a lower price, but as demanded through risk diversification and because the some of the quick, outsized gains in Detour can be reallocated to other gold stocks that have higher strike prices and have yet to run, which should magnify returns.

Gold investors have experienced a painful three years. Now is the time to sit tight and enjoy the ride.