Myrmikan Research

June 13, 2014

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The close of 2013 seemed to mark the high point in stocks and the low point in gold as managed money juiced prices to their extremes to collect extra fees, picking the pockets of their investors. Almost immediately, the overextended stock market began to wilt and gold bounced.

This market shift reflected one of the key truths of stocks, expressed by Daniel Drew 150 years ago: "The money market is the key to the stock market. They who control the money rate also control the stocks." In Drew's day, the market controlled the money rate, though, as he discovered, rates could be influenced by coordinated bank withdrawals forcing rates up and stocks down.

Today the money rate is controlled by the Fed. While officially stuck at 0%, the consensus view is that quantitative easing creates negative money rates and, therefore, the taper is akin to tightening. Tightening should be bad for stocks and bad for credit, which means good for gold.

On cue, shaky credits began to teeter. Emerging market currencies, notably in Turkey, Brazil, Mexico, India, etc., began weakening, along with commodity currencies that provide the raw materials for the developing market building binge.

It has been ever thus. Stretching back hundreds of years, when the banking system of the senior economy drives rates excessively low, capital flees to parts unknown in the search for yield. Lousy credits showered with easy money squander most investment capital on boondoggle projects. When conditions finally tighten in the banking centers, capital attempts to return, until it realizes it is stuck in illiquid and unproductive emerging market assets, often in countries with scant legal protections. Capital destroyed, soon the credit crisis spreads from the periphery to the center. It is normally when solvency of the center is finally questioned that capital flees to the only place left: gold.

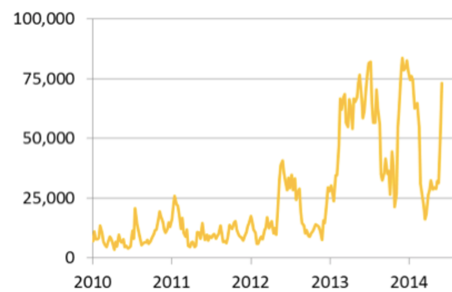
As this dynamic began to play out in the first quarter, gold had a nice run from below $1200 to $1390, and gold stocks roared higher. With averge production costs hovering around $1250, the rise in gold pushed many companies from accounting losses, or even negative cash flow, to profits, resulting in a large move in valuations.

Then, in mid-March, the trend reversed. Emerging markets began strengthening against the U.S. dollar. Since the U.S. dollar is the global funding currency, this signalled that dollars were less scarce than feared. Stocks began to fly higher, and gold came under pressure. With gold breaking through $1250, briefly, the dynamic seen in first quarter reversed. Positive cash flow no longer a certainty, corporate valuations, especially for the more marginal mines, plunged once again.

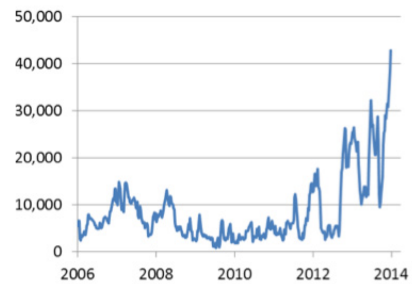
Markets emerge from reason: as Adam Smith showed, each individual pursuing his own interests affect the prices that coordinate effort to expand wealth. Markets can also respond to will: a powerful, concentrated short seller can move a price lower, whatever the fundamentals of the market.

The charts below, prepared by Alasdair Macleod, suggest the latter is the case for gold and silver. It is not the general market that is selling the two metals, but concentrated action by large funds that are imposing their view upon the market with massive leverage. The three peaks on the gold chart correspond to the mid-2013 crash, end of 2013 test of $1180, and now the test of $1250.

Comex Gold Managed Money Short Contracts



Comex Silver Managed Money Short Contracts



Of course, the reason for the price movement does not necessarily negate its validity – it's always possible the funds have it right and the general market will follow, allowing them to cover at lower prices. But, the fact of lower prices given the context does not itself provide useful market information. If the funds have it wrong, and are forced to cover into a generally rising market, gold and silver could move dramatically to the upside, as they have already begun to do.

One should acknowledge that the charts above reflect gross fund positioning, not net. Nevertheless, U.S. banks remain long gold, which is odd because they should always be short to cover their natural physical long exposure. Banks being long in the futures markets implies they have sold the physical gold belonging to their beneficiaries, and need to recuperate gold from the mines by holding their long positions for delivery.

The funds being net short, they have no choice on how to cover: they must buy back futures contracts in the market, which brings to mind another saying of Daniel Drew: "He who sells what isn't his'n, must buy it back or go to pris'n."

There is another dynamic present in Drew's day, but far more pronounced now. Funds operate on huge leverage, meaning if the gold price starts to rise, the longs are granted increasing amounts of margin with which to buy more, whereas the shorts will start having to post margin calls or cover their positions by buying. It is this dynamic that can make highly levered futures markets so volatile, and the reason that gross positioning matters, irrespective of net.

Beyond the fact that gold trades near the lowest level in 300 years in terms of the dominant central bank's balance sheet, there are a few reasons to think that gold should be heading higher now: most importantly that inflation in goods, not just assets, is becoming obvious, whatever government statistics may say.

The most recent Bureau of Labor Statistics CPI news release repeated the mantra that: "Over the last 12 months, the all items index increased 2.0 percent before seasonal adjustment." Yet, the index for meats, poultry, fish, and eggs is up 6.4% over the past year, 3.9% over the past three months, and 1.5% in April. Annualizing the latter two numbers to make them comparable returns a 16.5% rise over the past quarter and a 19.6% increase in April.

Oil is similarly back to levels that threaten disposal income for many. Even members of the Fed are getting the message, with James Bullard, the president of the St. Louis Fed, admitting on Monday that inflation is now "moving higher."

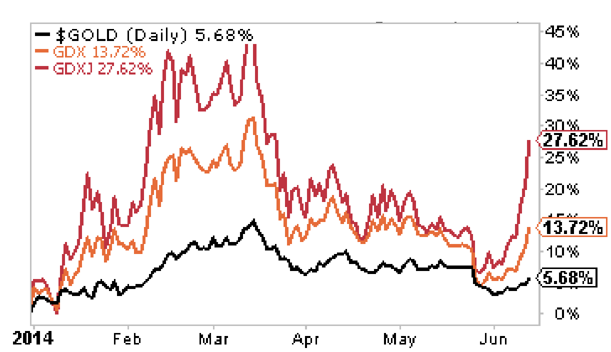
Most financial bureaucrats may notice only the prices of the latest iPad, but for many Americans it's the prices of core proteins and gas that matters. For them, the current inflation rate well exceeds that of the 1970s. The lower someone's income, the more they notice inflation in food prices, forcing cutbacks in other expenditures and increasing the likelihood of civil unrest, especially in the context of sluggish GDP, for which first quarter estimates have been revised downwards toward -1.6%

No doubt, the increases in oil and foods prices are caused by specific events, such as the draught in California and unrest in the Middle East. But, one should remember that price increases in the 1970s had similar causes, yet when the unrest stopped, oil never returned to the 1969 price of $3.35 a barrel. The money printing sets the stage for higher prices, though a geopolitical spark may be necessary to trigger it.

As inflation begins to slip from assets into goods, it is difficult to imagine gold failing to respond vigorously, especially in the context of Obama's collapsing foreign policy. Perhaps any one of the failures in Syria, Libya, Egypt, the Ukraine, the South China Sea, and now most dramatically in Iraq, might be thought merely unfortunate. The world is a volatile place. But, to have all of these regions in turmoil simultaneously reveals an unbelievably swift collapse of the post-World War II American world order.

Such dramatic diminution of America's power and role in the world, not easily reversible, undermines the credibility of the dollar, which is supported but by confidence, and the international monetary institutions based on the dollar. Gold remains absurdly cheap given the context.

Interestingly, gold stocks so far in June have vastly outperformed gold, and junior gold names are outperforming seniors. The chart at right shows the year-to-date performance of gold versus the GDX and GDXJ, which are well above where they were when gold was trading at $1300.



One reason for this outperformance is that gold stocks are effectively options on gold, and the more marginal the mine, the more optionality is embedded in the price. Options obviously rise in price if the underlying reference price rises, but they also rise in response to increases in expected volatility. Gold stocks are confirming what long-time gold investors already know – the world faces monetary traumas, whether brought by markets or politics, that threaten the current dollar hegemony.

Perhaps what ended the nascent emerging market crisis in March was the sudden arrival of serious dollar inflation – it's a lot easier to pay back debt in a weakening currency. In that case, gold won't wait for the defaults to reach from the periphery to the center, but will sense the immediate destruction of debt through devaluation, upon which it feeds. Should the inflation the Fed has been engendering for six years finally hit the economy, gold stocks will make up their last three years of losses very quickly.