

Myrmikan Research

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Winter of our Discontent

The central thesis of Myrmikan Gold Fund is that gold is anti-correlated to the credit/business cycle, corollary to the Austrian Business Cycle Theory developed by Ludwig von Mises. In brief, the theory holds that savers and borrowers meet in the loan market to set interest rates. Since demand is effectively infinite (until utopia), the interest rate signals the amount of available savings.

When the Fed lowers interest rates through interventions in the money market, it sends a false signal that there are more savings than actually exist. Submarginal projects suddenly seem productive. Once businesses begin to develop these projects, demand outstrips supply, forcing input prices higher until the projects fail, putting pressure on the banking system that financed them. The central bank has a choice: either allow the market to correct in a deflationary depression, or print money to bail out the banks and lower the interest rate still further to start the next cycle.

Since the Fed's action cannot create savings but can merely fool economic actors into thinking there are more savings, each intervention must be stronger to move rates consistently lower in order to achieve the same effect. The further the Fed pushes the interest rate from the level the unfettered market would set, the worse the eventual adjustment must be because the more malinvestments must be cleared: it becomes ever scarier for the Fed to allow market forces free reign. But, if the Fed pushes rates too far negative, eventually the currency will lose its store of value function and hyperinflation will ensue.

Falling discount rates affect more distant cash flows more than shorter term cash flows. As the sample project in the chart below shows, lowering the discount rate not only turns projects from unprofitable to profitable, but also makes long term cash flows much more important. Falling rates thus favor projects such as ships, buildings, houses, factories, airports, etc., which demand huge quantities of industrial commodities.

IDEALIZED DISCOUNTED CASH FLOW MODEL

Year	0	1	2	...	19	20	NAV
Nominal Cash Flow	-\$1,000	\$100	\$100	\$100	\$100	\$100	\$1,000
Discounting at 10%	-\$1,000	\$90	\$81	...	\$14	\$12	(\$209)
Discounting at 5%	-\$1,000	\$95	\$90	...	\$38	\$36	\$219

↓ 6.5% ↓ 3.3%
 of project cash flows

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The chart at right shows how commodity prices have responded to this dynamic. Greenspan lowered rates in 2001 to juice the economy following the collapse of the internet bubble. The market responded to the signal that new savings had become available by building long term assets such as housing, until the lack of supply of real savings sent prices shooting higher, choking the economy.

MALINVESTMENTS BID UP RESOURCES UNTIL THERE IS A CRASH THE MARKET ATTEMPTS TO UNWIND THE EXCESSES. THE FED LOWERS RATES (OR PRINTS), AND THE CYCLE BEGINS AGAIN, ONLY WORSE

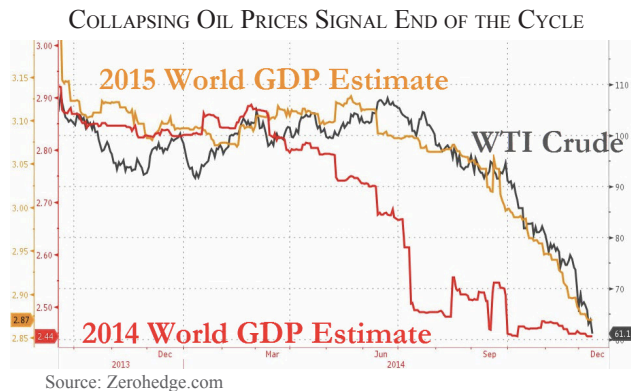


Bernanke then sent rates negative through QE1 and QE2 to save the malinvestments, which sent industrial commodity prices flying higher again. But, he failed to continue to increase the interventions at the accelerating pace necessary to continue the credit fueled boom. Commodity prices began falling in 2011. QE3 halted the decline, but, again, was too weak to continue the cycle. With the tapering and now end of QE, commodities are now in free fall.

Jan Hatzius, chief economist of the Goldman Sachs investment bank, recently admitted: “It’s hugely difficult to forecast the business cycle. Understanding an organism as complex as the economy is very hard. . . . Nobody has a clue.” Indeed, the economy is the aggregate action of each individual in the globe and is thus incomprehensibly complex—in that context the graph above paints a stunningly accurate picture. It takes almost willful blindness not to see the pattern.

Austrian Business Cycle Theory explains why the popping of the internet bubble affected the entire economy, not just a few twenty-year-old dot.com billionaires; the bubble was merely the symptom of a credit cycle that affects every project in the economy; it explains why the sub-prime housing crisis could not be “contained” by the authorities, absent huge interventions in the economy to send rates negative; and it suggests that the collapse of oil prices is not a function of a dysfunctional OPEC or a Saudi scheme to bankrupt U.S. shale operators, but signals the end of this credit cycle.

If the script holds, the banking system that funded the malinvestments in the oil space will soon find itself illiquid and in trouble, and credit contraction will bring down both the economy and the broader markets.



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Zerohedge.com once again does yeoman’s work digging up some of the more questionable instruments that have been used (via intermediation) to finance the shale boom, such as the BNP Paribas “1 Year Digital Certificate Plus Notes Linked to WTI Crude Oil”; the pitch is almost comical:

Philosophy

The 1 Year Digital Certificate Plus Notes Linked to WTI Crude Oil are intended for investors who:

- Are seeking upside participation, up to a Contingent Maximum Return;
- Want to benefit from a 15% buffer in case of market downturn;
- Are looking for a contingent minimum return if there is no substantial decline in the market;
- Are willing and able to hold the Notes to maturity;
- Are able to, if at maturity the closing level of the underlying has declined below the 85% Barrier Level, lose some or up to 100% of their principal.

As is the return profile:

Doesn’t everyone investing in a volatile sector “seek” to limit their gain to a contingent maximum? while putting 100% of their capital at risk? Zerohedge dug up similar instruments at other banks: the Credit Suisse “USD Trigger Twin-Win Certificates WTI Crude Oil” and Barclays’ “Leveraged Contingent Buffer Enhanced Notes Linked to the Performance of WTI Crude.” One can only assume that the “plus,” “win,” “enhanced” featured in the titles were test marketed first at sub-prime auto dealerships for effectiveness. Since these kinds of structured notes are not marketed toward retail investors, one wonders which institutional investors were seeking to limit their upside while retaining all the downside.

Hypothetical Final Level of the Underlying	Hypothetical Redemption at Maturity ⁽¹⁾	Hypothetical Return on the Notes ⁽¹⁾
150	112.50%	12.50%
140	112.50%	12.50%
130	112.50%	12.50%
120	112.50%	12.50%
110	112.50%	12.50%
105	112.50%	12.50%
100	112.50%	12.50%
90	100%	0%
85	100%	0%
70	70%	-30%
50	50%	-50%
40	40%	-60%
20	20%	-80%
0	0%	-100%

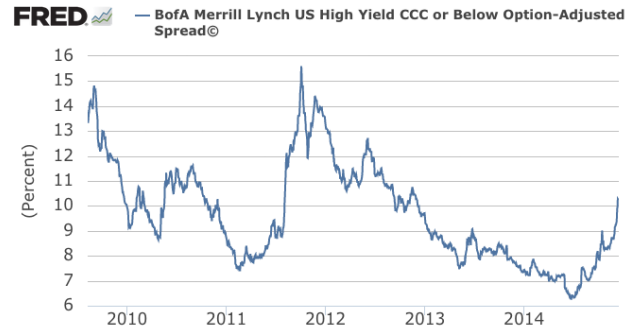
The answer, of course, is that institutional money managers are option holders on their own funds who get paid for generating alpha (steady gains noncorrelated with the broader market). Making too large of a gain can increase volatility, and so it is not sought after. However, if the whole system blows up (as \$50 oil would imply), then they’re out of a job anyway, and it’s not their money at risk.

Wall Street has long been enamored of martingdale bets, that is, bets that have a high likelihood of a small gain, balanced by a small risk of a catastrophic loss. Alpha generation for using these kinds of bets is enormous until the black swan event occurs. John Meriwether, a pioneer of fixed income arbitrage, best personifies this strategy. In 1994 he launched Long Term Capital Management, recruiting Myron Scholes as a partner. Scholes, who won the Noble Prize in Economics for helping to develop the Black-Scholes model of valuing options, described the firm’s strategy as a giant vacuum cleaner sucking up nickels from all around the world. Small, steady gains.

LTCM’s returns for the first four years were steady and high, and investors scrambled to join. But, levered up 26 to 1, LTCM could not withstand the market turmoil caused by the Russian default in 1998. Its losses were so huge the Federal Reserve had to organize a rescue to save the financial system.

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The collapse in oil prices and the high yield debt that financed marginal oil production will not be contained. Already, the yield on the entire subprime complex marches higher: the movement of rates is more important than their level. When the disorderly panic begins, the interventions needed to save the system will have to be as unimaginable now as the 2008 interventions were in 2007.



Fund manager Paul Singer's 2012 speech detailing his view on the dynamics of the next financial crisis suddenly gains urgency:

The major financial institutions in the US and around the globe are utterly opaque; and the next financial crisis will happen faster, more suddenly. We cannot (I have 110 investment professionals), and I surmise that you cannot, understand the financial condition of any bank, major financial institution. You can't see the actual size of the balance sheet. You have no idea what that derivatives section means...it's 10 to 100 times the size of the actual balance sheet. . . . Is that composed of trades that are basically unwound where all you have is counterparty risk? Is that composed of actual hedges of upper tranches the way we would have in an admitted hedge fund? . . . which of these trades or trillions of dollars of trades, which in normal times oscillate like this [very small motion] and that's why they're so big, would in really bad times start going like this [large motion.] And if you actually have capital of only half a percent, or one percent or five percent of your actual footings, not just the unwound trades that happen to still be on balance sheet, but actual footings, you're in trouble.

. . . what you realize is that the lessons of '08 will actually result in a much quicker process, a process that I would describe as a "black hole" if and when there is the next financial crisis. . . . The lesson of '08, which is indelibly stamped upon every hedge fund forehead and trading desk head, is: Move your assets first, stop trading first, sell the paper first, and ask questions later. . .

In my opinion, what Dodd-Frank has actually done is to make the system more brittle and complete the picture, in my mind, of a black hole, meaning a very vicious, sharp and abrupt process . . . under this process the FDIC has the authority, contrary to all US bankruptcy practice and law, to seize financial companies which are quote "in danger of default."

. . . Under previous bankruptcy law, companies had to default, actually default, or managements voluntarily put them in bankruptcy in order for them to be in bankruptcy. "Danger of default," if you think about that . . . means that if a company is in trouble, and it's large and opaque, then it's in danger of default and can be seized any day. And if I say any moment it's only a slight exaggeration, because by statute the process of throwing a company into the Orderly Liquidation Authority is about 48 hrs long, and is effectively unreviewable. . . .

So the whole thing militates toward stepping away abruptly from any company that is designated as systemically important. So I think that the opacity, the lessons of '08, the vicissitudes and thoughtlessness of Dodd-Frank, militate in favor of a very, very abrupt resolution

Gold investors have had no solace for their deeper understanding of money and credit, the market having delivered only enormous losses. But, gold investors should realize that the outcome gold protects against is not the small motions—whether the Fed moves a lever this way or that; whether some economic report is up or down—but against the black hole. To get the discontinuous move higher, in which gold simply opens one day a magnitude higher or, indeed, the futures market go no ask and trading is done only in physical, requires the black hole that will result from a puncturing of the banking system's balance sheet.

Price declines in the subprime real estate market, insignificant as a percentage of the economy, were enough to trigger cascading defaults that resulted in a 36% decline in the price of the nation's housing stock. The resulting hole in the balance sheet of the banking system forced the QE response. It takes an enormous amount of capital to produce oil, and the value of that capital, which is sitting on someone's balance sheet, was just written down significantly. Given the levered and brittle nature of the banking system, the oil plunge may well be the catalyst for which gold investors have been waiting.

Meanwhile conditions for gold miners are far brighter than nominal prices would suggest. A gold mine is essentially a spread trade between industrial commodities as the input and gold as the output. During the credit boom, defined by artificially low interest rates and frenetic demand for commodities, gold does not participate. It has no yield and is no use in industry. Gold always falls relative to commodities during a boom, compressing gold mining margins.

The converse is also true. The big spikes in 2001 and 2008 are clearly visible on the graph. Who knows how high this one will go? And how profitable the currently submarginal and worthless gold mines will become?



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