Myrmikan Research

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Treatment or Overdose

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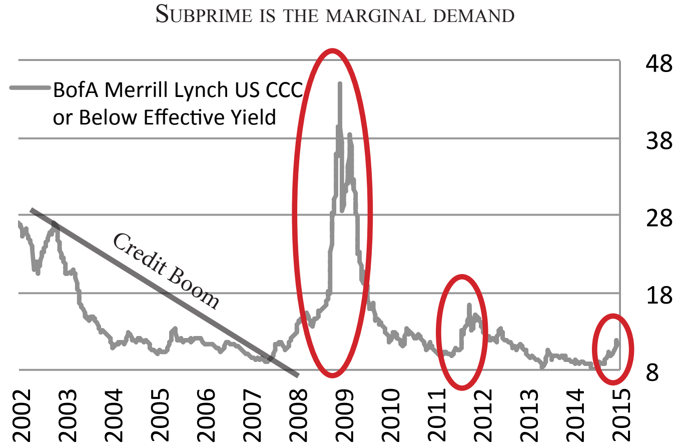
Myrmikan's previous update reviewed Austrian Business Cycle theory and discussed why the movement of interest rates is more important than height, why rising subprime rates signal the end of a credit cycle, and why end of the credit cycle forces gold to rise against commodities. It is worth reviewing because the trends it discussed have intensified over the past month.

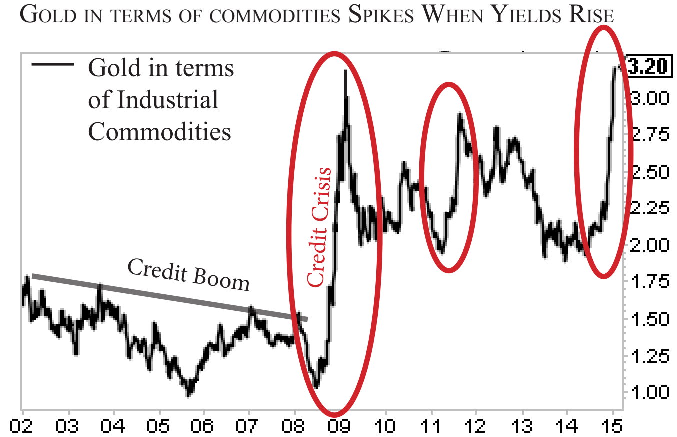
At the depth of the 2008 crisis, subprime rates spiked to 45%, and the ratio of gold to industrial commodities went vertical. Gold stocks plunged as hedge funds liquidated their positions, even while the economic conditions for gold mining were dramatically improving, setting the stage for the enormous rally through 2011.

Rates must continually Fall to Maintain the Bubble; Subprime is the marginal demand



As the top graph shows, subprime rates had a little spike in the second half of 2011, right as QE 2 was ending, driving the real price of gold higher. A chastened Fed quickly began QE 3, which drove up risk assets and the demand for commodities as against gold.

Gold in terms of commodities Spikes When Yields Rise



Now the Fed has ended QE, it says for good, and subprime rates are rising again. They are still well below 2011 levels, but the economy is that much more levered, meaning the effect is that much greater. In fact, the ratio of gold to the Goldman Sachs

Commodities Index has now surpassed its 2009 panic high, and the panic hasn't even started yet, at least not in the broader markets. It will.

The financial and mainstream media continue to report the oil crash as a supply story. *Ceteris paribus*, if energy had suddenly become more abundant, the rest of the economy would be alight. How to explain, then, the ongoing rout in copper, which appears to be on the precipice as well, and iron ore, which is down over 50% in the past twelve months. These prices should be rising if the production bottleneck of energy had been relieved by copious supply.

The collapse in commodities is a demand story. When the economy was younger—in the crash of 1987, the 1990s Savings & Loan crisis, the 1998 Long Term Capital Management crisis, the popping of the internet bubble—a credit injection from the Fed was enough to get it out of bed and back to work. That was during the Commitment Stage, from http://www.heroinaddiction.ws/:

> The user is now an addict and starts using the drug on a regular basis and begins associating with other heroin users. The addict now takes heroin anytime, alone or around others. The addict now takes heroin to prevent the negative effects of withdrawal symptoms. Relationships, work, and health begin to suffer. The addict begins to suffer financially after spending tons of money on continual heroin use.

The Fed has become indifferent to whether it prints alone or among others, but there is no doubt peer pressure plays a role. Defending QE, Ben Bernanke whined: "The Bank of England has used LSAPs [large-scale asset purchases] in a manner similar to that of the Federal Reserve," and then blame-shifted: "[Milton] Friedman argued for large-scale purchases of long-term bonds by the Bank of Japan to help overcome Japan's deflationary trap." The Fed's habit has already cost trillions warding off the withdrawal symptoms, but causing the addiction to deepen.

The fact that the economy began to roll over the moment the Fed began tapering QE suggests the economy has now reached the Dysfunction Stage:

> The addict can no longer hold any sort of employment and loses contact with family and those that don't use heroin. . . . . Also, many may attempt to seek minimal treatment but will often be unsuccessful and drop out.

Bernanke was a monetarist. He was driven by a misguided mandate to keep the money supply constant, even though the supply of money had been enormously augmented by counterfeit means through sophisticated derivative transactions of the shadow banking system.

Janet Yellen is not a monetarist; she is a Keynesian. She will stop at nothing to prevent deflation. She has declared privately that, like Bernanke before her, she will not be the Fed Chair to preside over a second Great Depression. The problem is, all of the tools in the Fed's toolbox are merely different flavors of the same medicine: printing money.

The Fed has tried to go straight these last several months, and made grand gestures to a future of normalized interest rates. But, the global dollar economy is experiencing "severe discomfort," the initial withdrawal symptom, soon to be followed by "vomiting" up all the malinvestments of the past decades enabled by the Fed's behavior.

Reuters reported the first casualty yesterday: "Asia-focused bank Standard Chartered could need $4.4 billion of extra provisions to cover losses from commodities loans, potentially forcing it to raise billions of dollars from investors, analysts said on Monday." There will be many more such stories.

What is critical is whose balance sheets are affected. If a hedge fund blows up, likely some wealthy people got a little less wealthy. If a pension fund blows up, the beneficiaries have to get used to a less rosy retirement, until they succeed in the lengthy process of getting the authorities to raise taxes. When a bank blows up, derivatives ensures it takes down all of its counterparties.

In the blink of an eye, when the banking system hits Paul Singer's "black hole," Yellen will be thrust into the final stage: Treatment or Overdose. Treatment means allowing the malinvestments to liquidate, allowing the stock market to settle dramatically lower, allowing the mega-banks to default and wipe out their creditors, allowing the government to be defunded.

There is no chance Yellen will seek treatment. She will defiantly choose overdose; after all, it felt so good in the past. No doubt this is why equities remain resilient. Equity can float on the airy clouds of credit for far longer than commodities, the production and storage of which yield large, real losses when they are not needed. The risk is that the Yellen Put is far lower than the market thinks and that the nominal recovery that is sure to come after the next Fed intervention nevertheless entails real and permanent losses of purchasing power.

Can the economy stand another round of massive QE? Gold investors should be cautious. The Fed showed itself willing to break all the rules and run huge risks to stuff credit back into the system following 2008, and gold does not do well when credit levels rise. But, even if this happens, it will be in a context following a massive bout of QE that sends nominal prices up substantially. The previous gold correction bottomed around $700, and the current appears to have bottomed at $1130, a full 62% higher.

It is hard to imagine a better set up for gold mining companies. Energy and labor are the two largest input costs. The oil collapse is relieving the former, and as base metal mines close, they will release competitive labor and equipment on to the market, driving prices down. The equities persist just off crash lows, but margins are set to explode in percentage terms, especially for the highest cost gold miners. The shares are just beginning to take notice.