Myrmikan Research Update

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Liftoff

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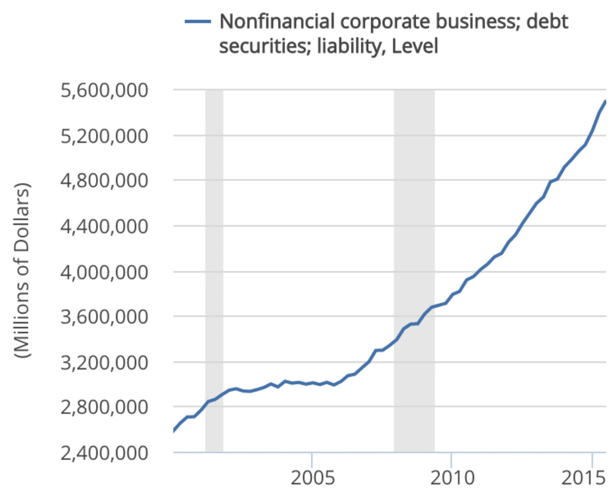
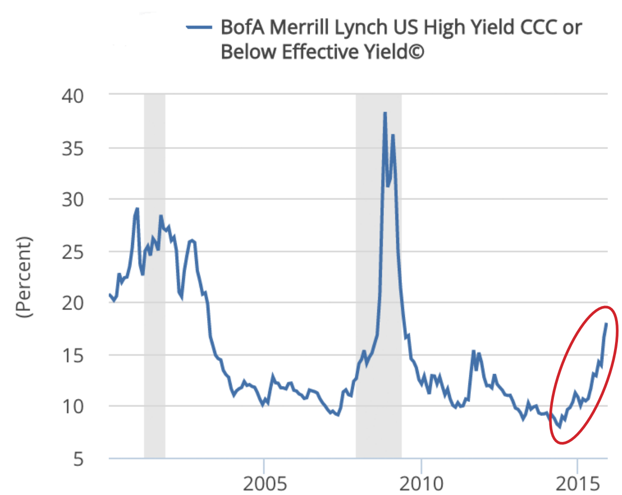
Myrmikan maintains that the 1920s are a perfect analogy for the past decade: overcapacity induced by artificial credit caused a great crash; the Federal Reserve operating with a mandate to stabilize prices bought government securities to return prices to bubble highs; which stimulated new capacity and additional pressure for prices to fall; two subsequent rounds of easing "stabilized" consumer prices; but created an epic asset bubble. Finally, in 1928, the Federal Reserve began to tighten to rein in the asset markets, and the whole credit structure came tumbling down.

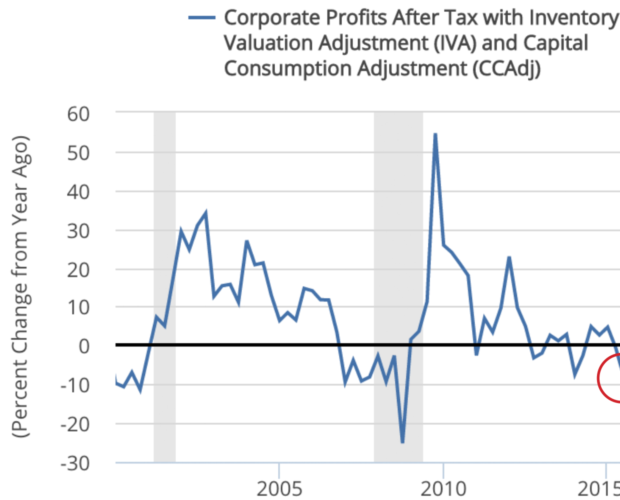
The difference is scale. Freed from the constrains of the gold standard, the Federal Reserve has been able to intervene far more forcefully than in the 1920s, and the resulting imbalances are that much greater. Behold the top chart, which shows what has happened to corporate debt since the great financial crisis. Companies were supposed to use the Fed's largess to delever...



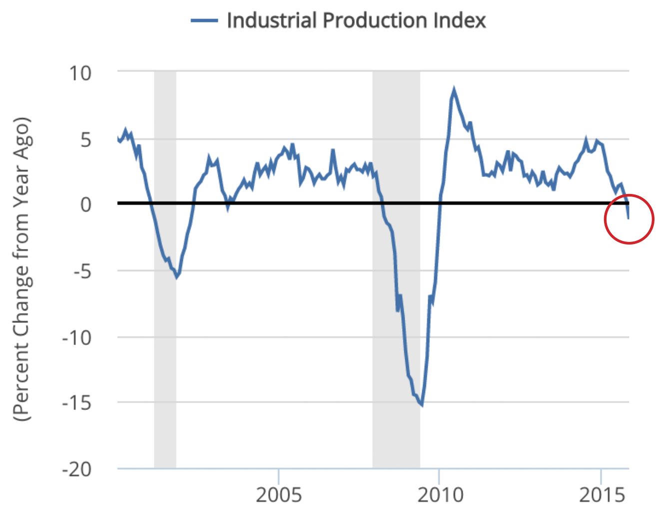
The bottom chart shows the yield on subprime corporate debt—the cost of capital for the marginal user. The absolute level is less important than the slope—straight up—and applied to a much greater amount of debt than in the previous spikes of 2000 and 2008. And now the Fed decides to raise interest rates.



The spike in corporate yields, which is just beginning to bleed into BBB rated bonds, is occurring at the same time that corporate profits are actually shrinking (top chart), a curious time to raise rates.



It is a basic feature of capital structure that when a company defaults on its debt, equity holders get nothing. Increasing the cost of debt, therefore cannot boost the value of equity, whatever temporary liquidity flows to do short-term prices.



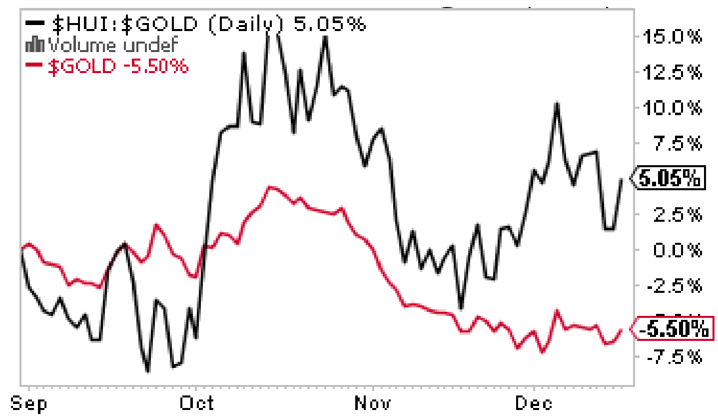
Combine falling profits with shrinking industrial production (middle chart), collapsing commodity prices and shipping rates, stagnant retail sales, employment growth tilted toward retirees—the metrics the Fed itself says it monitors are soft or in actual decline. The great unwind is not a future threat, it is happening at this very moment. And, yet, the Fed decides to raise rates.

Credibility demanded they raise rates, even though doing so required abandoning their intellectual construct and can but accelerate the next debt crisis, which will dwarf the last.

Gold senses the danger—a bold claim given that gold has plunged to cycle lows. But the nominal price of gold is a function of fiat dollars, caught in an epic short squeeze—there are only $4 trillion of base money with which to service $90 trillion of debt—tightened by Fed action. The real price of gold is its value against commodities and, as the chart above shows, gold is trading at record highs—or, rather, commodities are trading at record lows.

The spread between industrial commodities and gold captured in the chart approximates the margin of gold mining in gold terms. The gold mining companies themselves have been guilty of great sins, loading up on debt to empire-build. But the worst offenders have been swept away, and the survivors have had no choice but to rationalize their balance sheets.

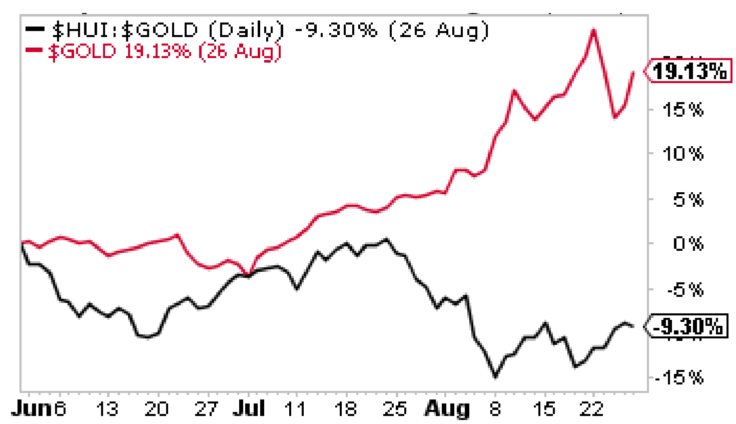
Gold Stocks Show Positive Divergence



The chart at right shows the first glimmers of hope for the sector. Gold mining stocks are operationally levered to the price of gold and, therefore, should trade in the same direction but with greater magnitude. The red line is the performance of gold, and the black line is a ratio of gold mining stocks to gold.

In September softness in gold produced a mild decline in the relative value of gold miners. Gold strength in October saw a sharp rise in gold mining value, as would be expected. However, as gold has weakened to new cycle lows, the ratio has been rising. In other words, gold stocks are beginning to respond to the gold / commodity ratio as opposed to gold's nominal price.

Gold Stock Negative Divergence Signaled Top in 2011



To be clear, gold stocks have fallen since November, just not as much as gold. A thin reed to hang hopes of a turning of the nearly-five year bear market, perhaps. But, it was precisely such a divergence that signaled the end of the bull market in late 2011, when gold roared higher and the stocks failed to follow.

Just as Myrmikan maintains its view that the world approaches rapidly its 1929 moment, so it remains convinced of the policy response. The Fed's mandate is to stabilize prices—once asset and goods prices are both in free-fall, the Hamlet moment will pass—the Fed will act and act powerfully.

Most investors discount this possibility. For example, in a November report called "The Ninth Inning of the High Yield Bubble," Elliot Management reasoned: "unlike the start of most deleveraging cycles, the policy easing tools of central banks are largely exhausted." But, then, went on to say: "Without direct purchases of risky assets, there is not much more the Fed can do aside from negative rates or more QE." And there you have it—three policy options the Fed can and will take to "stabilize prices" after the coming collapse. QE magnitudes larger. This is what gold protects against. And the premium for the insurance—magnified by the miners—is now at rock-bottom prices.