Myrmikan Research

May 17, 2016

Daniel Oliver
Myrmikan Capital, LLC
doliver@myrmikan.com
(646) 797-3134

Myrmikan has recovered three years of losses in three months: at the end of April Myrmikan's ITD return stood where it did at the end of March 2013, when gold was trading at $1602, before the big smash. Although tripling in three months is a sharp enough ascent so as to make any student of the markets nervous, at least part of the performance is due to active management: the GDXJ remains 42% below where it was in March of 2013.

Adding value against an index is a rare thing: a recent study revealed that over the past ten years only 20% of active managers beat their benchmark index. The reason is simple: in most industries, the larger a company gets, the better credit terms it receives, lowering its costs, enabling it to underprice and drive competition from the market to grow larger still. Since most indices are capitalization weighted (meaning the biggest companies have the largest influence), indices have the best available strategy—active managers are left copying the index, a low-fee activity, or gambling on which components will be swallowed up by the mammoth firms angling to fill any strategic gaps while trying to avoid the losers squeezed out of concentrating industries.

The forces that drive industry toward monopoly are not a feature of capitalism in general, but of fractional reserve banking in particular. In nineteenth-century England, as a counter-example, banks didn't finance firms according to the ownership of illiquid, fixed assets, such as real estate, but instead by how quickly circulation capital passed through them. If two shoe stores were in competition, for example, one on the high street and one in the back-alley, their relative size and the relative value of their real estate holdings made no difference as to their credit terms—all that mattered was how fast each consignment of leather passed through the store: the faster the velocity of the leather through the store, the better the credit terms that could be had.

Melchior Palyi described the precise workings of so-called liquid banking in 1936:

> A liquid [banking] structure tends to give preference to "labor intensive" industry, as against the one with larger fixed capital requirements per unit of labor, and *ceteris paribus*, to a commercial enterprise rather than to an industrial one. The preference for providing circulating capital also tends to strengthen the medium-sized business as against the mammoth concern which in turn is favored by an illiquid system.

NOTE: *This material is for discussion purposes only. This is not an offer to buy or sell or subscribe or invest in securities. Performance data presented is as of April 29, 2016, is unaudited, represents past performance, and does not guarantee future performance. The information contained herein has been prepared for informational purposes using sources considered reliable and accurate, however, it is subject to change and we cannot guarantee the accurateness of the information.*

> It is no mere accident that countries in which banks are continuously engaged in long-term industrial finance (as in Italy and Germany), or in the financing of industrial securities (as in the United States), have witnessed a most spectacular growth of large-scale units and monopolies. In England, on the other hand, and especially in Holland and France, where liquidity rules were abandoned at a less rapid rate, the development of large-scale units and monopolies was much slower and the independent units, both in manufacturing and in wholesale trade, had a much better chance for survival.

This is why industry has concentrated in the United States (and why good jobs have disappeared), why half the restaurants in America are chains, every one striving to serve exactly the same thing, why four companies control 84% of the beef slaughter business (up from 70% in 2001 and 39% in 1984) and three firms control more than half the seed industry, why three firms control 94% of the soda market, why three companies produce 92% of light bulbs, why 90% of appliance manufacturing is controlled by just four companies, the list goes on.

Even industries with almost no economies of scale have concentrated: according to the Federal Reserve Bank of Atlanta, in 2005, in a country of 300 million people, the top ten home construction firms had "just" 25% of the market:

> Not surprisingly, these numbers started to shift during the recession, especially in areas hit harder by the housing bust—when bank lending to small builders all but disappeared. According to Bloomberg, the market share of the top 100 firms in the West and South grew by 10 percent during the crisis. In the Midwest, the market share of closings of the top 10 builders grew from 20 percent to 30 percent after 2007. Note that small banks—and therefore small bank failures—had also been concentrated in these three regions.

In our system, a company is only as strong as the credit engine of its bank. As small banks close or are acquired—so, too, their customers. Except in the rich enclaves inhabited by those at the top of the credit pyramid, every town in America becomes like every other: efficient and sterile.

Now is not the first time the business world has radically centralized, as Benjamin Anderson noted in 1949:

> The new era of 1924-1929, like the earlier new era of 1896-1903, was characterized by a great consolidation movement. The alleged "inevitable tendency toward monopoly" in American business has been largely confined to these two "new eras." It has not been due to technological or industrial reasons, but rather has been due to the ease with which new securities can be issued when money is excessive and stocks are rising—which makes it easy and profitable to organize holding companies and buy out competing concerns. There have been, in fact, only two great periods of consolidation in our history, the three-year period 1899-1902, and the five-year period 1924-1929. Both were periods of cheap money and excited stock markets. There were, in fact, a great many consolidations in the years 1924-1929.

NOTE: *This material is for discussion purposes only. This is not an offer to buy or sell or subscribe or invest in securities. Performance data presented is as of April 29, 2016, is unaudited, represents past performance, and does not guarantee future performance. The information contained herein has been prepared for informational purposes using sources considered reliable and accurate, however, it is subject to change and we cannot guarantee the accurateness of the information.*

Anderson missed another period of great consolidation: the inflationary Greenback period, as recorded by Charles Mann in 1867:

> At the commercial centres the strong houses have constantly become stronger, while the weak ones have been swallowed up by the former, or have perished and disappeared. The tendency in commerce has been steadily toward the aggregation of a few immense fortunes, whose possessors can crush out their weaker competitors at a blow.
>
> This tendency is inseparable from paper money, with its risks and fluctuations. These necessarily produce an unequal distribution of wealth, and thus divide society into separate classes.

What was obvious to an observer a century and a half ago remains a mystery to modern economists and politicians, who call for strong antitrust laws and progressive taxation to resist what is, in fact, solely an artifact of a fractional reserve banking system. Nor are these political tendencies anything new. Writing during the wildcat banking bubble of the 1830s, William Gouge noted:

> There is a class of politicians, (and they are unfortunately numerous and powerful,) who have for each particular social evil a legal remedy. They are willing to leave nothing to nature: the law must do every thing.
>
> This is, most unfortunately, the kind of legislation which public distress is almost sure to produce. Instead of tracing its cause to some *positive* institution, the removal of which, though it might not immediately relieve distress, would prevent its recurrence, men set themselves to heaping law upon law, and institution upon institution. . . .
>
> These projects of relief and efforts at corrective legislation, will be numberless in multitude and diversified in character: but as they will not proceed on the principle of "removing the cause that the effect may cease," they will ultimately increase the evils they are intended to cure.

When the bubble finally bursts, the monopolies are found to be terribly inflexible, unable to satisfy consumer demand in the free market; they collapse along with the securities backed by them to the gnashing of teeth of the powerful crony capitalists and their media flunkies.

In the meantime, however, gold mining corporations benefit very little from scale and, therefore, are naturally resistant to banking-induced industry concentration. Two men with a shovel can show a higher profit margin than Barrick, if the grade of their deposit is high enough. Nor can the large miner move men and equipment from mine to mine without huge expense. Most importantly, gold mining firms are not in competition with each other—the entire industry digs up only 1.5% of the above ground supply every year, meaning price is determined by total supply versus total demand, not marginal supply against marginal demand, so the big firm can't muscle the small ones out of business. The reason George Soros bought 1.7% of Barrick last quarter is not because Barrick is the best gold miner, but because it is one of only very few gold mining companies able to absorb the $264 million Soros wanted to deploy, forcing him into a suboptimal position.

NOTE: *This material is for discussion purposes only. This is not an offer to buy or sell or subscribe or invest in securities. Performance data presented is as of April 29, 2016, is unaudited, represents past performance, and does not guarantee future performance. The information contained herein has been prepared for informational purposes using sources considered reliable and accurate, however, it is subject to change and we cannot guarantee the accurateness of the information.*

Since gold mining does not naturally concentrate, the gold mining indices have no natural advantage compared to active management. In fact, they have a distinct disadvantage: they cannot adapt to changes in the market. Since the beginning of the year, for example, the levered producers have had an extraordinary run, far outpacing the developers and explorers, and for good reason. The market had assumed, with gold falling and Goldman Sachs pounding the table that it was going lower still, that these firms would not be able to pay or even roll their debts as they came due. The equity was nearly worthless, at best an out-of-the-money call option, the reason Myrmikan was very overweight these names. With gold now rising even as mining costs continue to fall, the threat of financial distress has vanished, sending equity values soaring.

The explorers were not subject to the same dynamics. The ones with good projects weren't priced for bankruptcy, rather for the risk of massive dilution as management teams issued shares to push projects forward. Thus, a modest rise in the gold price has not lead to as dramatic a rise in share price. This will change: the producers must acquire exploration and development targets to maintain production profiles. Given industry distress, there has been a multi-year dearth of deals, but last week Goldcorp snapped up Kaminak for $520 million, a harbinger of things to come.

Gold is set to go a lot higher and soon because the Federal Reserve is completely stuck. If the FOMC lowers rates to negative, gold takes on a positive carry (as it has in Europe already) and will fly higher; if the FOMC raises rates, the over-levered corporate sector will collapse and bring down the banking sector with it. Gold will wins either way, as ever more market participants are realizing. There is no escape for the Fed or the dollar.

The producers will continue to go higher over time, but the explorers and developers need to play catch up and will begin to outperform. Even better, since many of them need to raise capital to restart their projects, there is an opportunity to enter through private placements, usually offered at a discount or with a warrant, sometimes both, lending an additional advantage to active management over an index.

It would hubristic to claim to *know* where markets will go next, and gold mining stocks are inappropriate for any capital allocation other than risk capital. But, given current credit conditions, it would be foolish not to have a full position.

NOTE: *This material is for discussion purposes only. This is not an offer to buy or sell or subscribe or invest in securities. Performance data presented is as of April 29, 2016, is unaudited, represents past performance, and does not guarantee future performance. The information contained herein has been prepared for informational purposes using sources considered reliable and accurate, however, it is subject to change and we cannot guarantee the accurateness of the information.*