Myrmikan Research Update

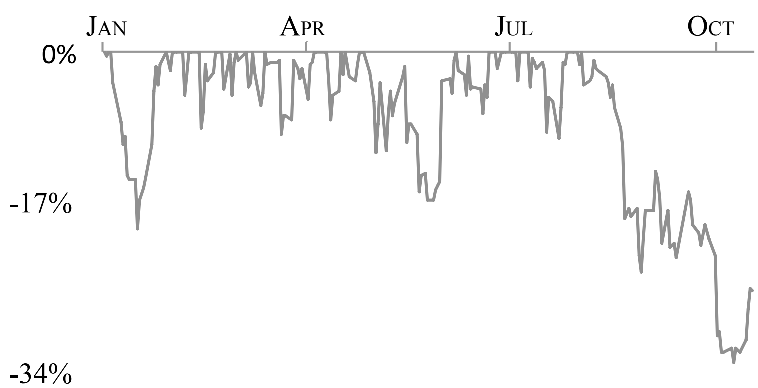
October 24, 2016

Correction

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

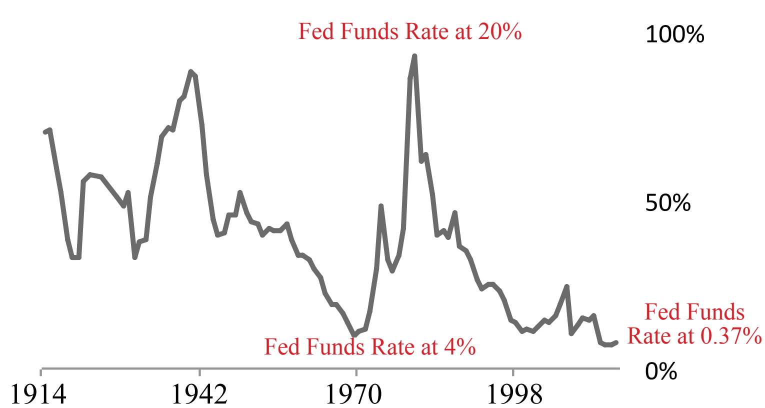
Gold mining stocks are facing their first large correction since the rally began in January. While the HUI gold miners index is up 96% since January 1st, it is 24% below the high made on August 4th.

HUI Gold Bugs Index Drawdown From Previous High



The biggest near-term threat to gold, as perceived by market analysts, is increasing interest rates, which the Federal Reserve has delayed for political reasons and now promises to commence after the election. As detailed exhaustively in these pages, Myrmikan disagrees with the conventional analysis. As rates rise, the bonds the Fed holds will devalue—the dollar will be stripped of the assets that back it and will decline as well. Anyone who disputes this thesis must then find an alternate explanation for the graph at right.

Percentage of Federal Reserve's Liabilities Backed by the Gold on the Federal Reserve's Balance Sheet



The surge into 1942 on the preceding graph was caused by Roosevelt's devaluation of the dollar. Roosevelt made holding gold a felony for Americans, but foreigners were able to deliver gold to the Fed to get $35 dollars (instead of $20 pre-devaluation) to buy assets that had fallen 90% during the market crash. Gold flooded in. The first big dip was caused by the Federal Reserve's buying bonds to finance World War II, diluting the gold backing of the dollar. Deficit spending under Kennedy and Johnson caused the long slide into 1970: foreign governments were still permitted to redeem dollars for gold, and many did, leaving behind the government bonds. Rates then shot up from 4% to 20%, which crushed the value of the bonds. Gold neither entered nor left the vault after 1970, but as the market devalued the bonds, so it also devalued the dollar, leaving gold as the primary asset behind the dollar. In 1969, gold at $35/oz backed the Fed's liabilities by 10%—by 1980, gold peaked at $875, backing the Fed's liabilities by an absurd 133%.

From the peak in 1980, interest rates have fallen steadily, boosting the value of bonds held by the Federal Reserve and the dollar, to gold's detriment. At the current gold price of $1260/oz, gold backs the Fed's liabilities by only 7.4% To return to a 28% backing (the average since 1971) would require gold to trade at $4,700/oz. To match the peak in 1980, gold would have to trade at $22,600/oz. That is how crazy a gold bull market can get, and that's how crazy it will get once interest rates start rising.

Howard Buffett (father of crony-capitalist-in-chief Warren Buffett) once wrote: "The gold standard acted as a silent watchdog to prevent unlimited public spending . . . [i]f Congress seemed receptive to reckless spending schemes, depositors' demands over the country for gold would soon become serious."

That wasn't quite right. Economic growth cares about spending—gold cares only about bank-financed deficits. Even the Federal Reserve knows this, as it admitted in a 1947 publication:

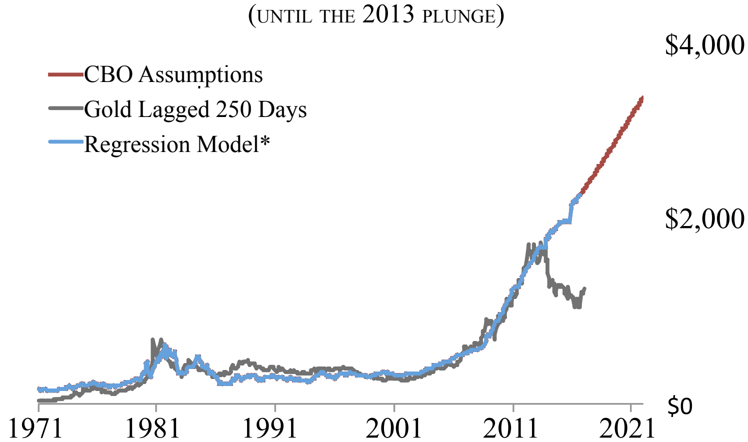
> When an individual or a corporation pays taxes or buys a Government bond, the Treasury comes into possession of money that was already in existence and owned by the taxpayer or bond purchaser. There is no addition to the money supply and no additional upward pressure on prices . . . When, however, a bond is bought by the banking system, no one gives up his money to the Government; new money is created in the form of a bank deposit to the credit of the Government. As the Government spends this money . . . it results in an upward pressure on prices.[1]

In other words, additional federal debt at any interest rate causes prices to head higher; but when rates rise, prices really take off. That this analysis is correct is further supported by running a multiple linear regression analysis of the price of gold (lagged 250 days) against the square of federal debt outstanding and the square of the nominal 10-year Treasury bond yield. From 1971 to mid-2013 this regression model achieves an

1 Board of Governors of the Federal Reserve System (U.S.) , 1935-. The Federal Reserve System : Its Purposes and Functions , (1947) , Washington, DC: Board of Governors of the Federal Reserve System, 1947, https://fraser.stlouisfed.org/scribd/?title_id=3604&filepath=/docs/meltzer/bog1947.pdf, p. 106-107.

R^2 of 0.94.[2] In other words, the model explains 94% of the variance of gold prices . . . until the smash of 2013.

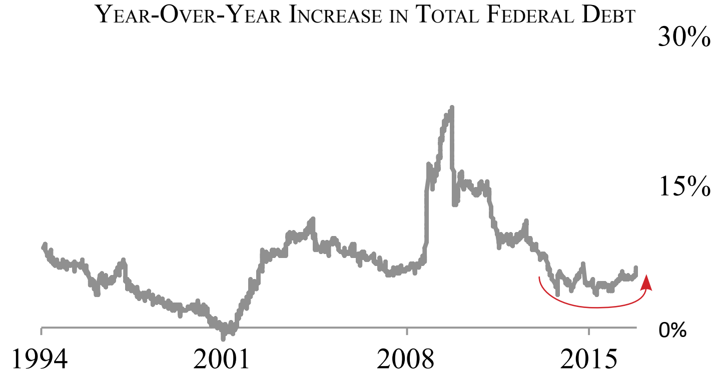
REGRESSION MODEL STUNNINGLY ACCURATE
(UNTIL THE 2013 PLUNGE)



*Gold = 64.83 + 6.04 * gross federal debt squared + 2.4 * 10-year yield squared
Source: Federal Reserve Bank of St. Louis; Myrmikan Capital

The CBO assumptions are highly optimistic: when rates rise, economic activity and tax revenue will fall — interest payments and government handouts will increase, exacerbating debt levels and solvency risk, which will power gold to prices currently unimaginable.

YEAR-OVER-YEAR INCREASE IN TOTAL FEDERAL DEBT



It is also worth noting that the trend toward higher deficits has begun already under Obama, nor does it matter who wins the presidential election. Trump has promised to lower taxes and keep entitlements, sure to increase deficits whatever the effect on economic growth. Hillary has promised to increase taxes, massively, which would be bad for gold, except that her spending plans are even more massive. If she has a compliant Senate, and with Paul Ryan in charge of the House, she will have free reign to spend. She is also sure to take us to war, the ultimate power grab cum economic stimulus. All of this argues for much, much higher gold prices and soon.

2 Because the model is a time series with auto-correlating residuals, it cannot be used to prove causation statistically; it does, however, show correlation and lends support to the theory that it is not the quantity of dollars that determines their value, but rather the value of the assets backing them.