Myrmikan Update

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Capital Loss

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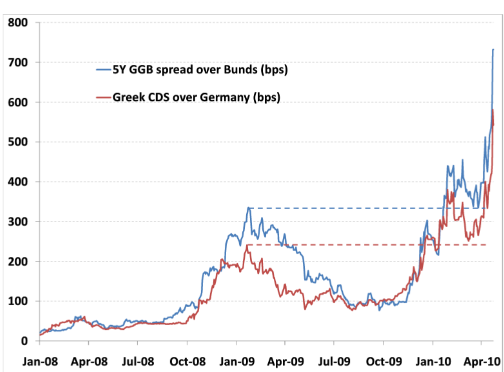
Over the past few weeks, the various trends that affect the gold market have dramatically escalated, perhaps the most important being the anticipated collapse of sovereign debt markets. At the end of this update is a long quotation from Ludwig von Mises who, as ever, crystallized basic, unpleasant, economic truths, including why long-term government debt is almost never paid back in good money.

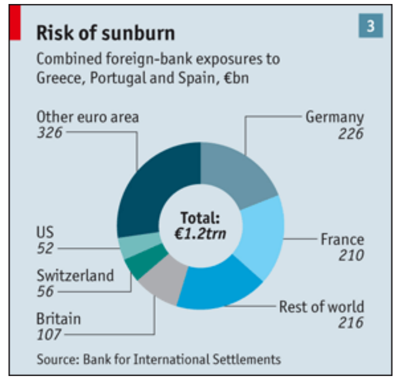
While his argument is elegantly simple, Mises himself realized that markets can stay irrational longer than a speculator can stay solvent. As he wrote elsewhere, it was clear by the 1890s that the debts of the Central Powers were unsustainable, but no speculator could have financed a short position for the 20 years it took for the debts to collapse.

Be that as it may, some speculators do make money, and perhaps the key is not in guessing when the end will begin, but in recognizing the end after it has begun and playing the middle stages. From that perspective, we have Greece as the canary in the sovereign default coal mine. It ought to be clear that Greek debt levels cannot stand – the only question being whether default (either through non-payment or euro inflation) comes sooner or later – and that many other developed countries face similar outcomes. In fact, given that Greece has been in a state of default 50% of the time since 1830, according to Reinhart and Rogoff, it should have been clear from the beginning of the euro experiment that they would abuse the privilege of German level interest rates. While it would have been difficult to maintain a short for the past 10 years, when the end comes it is swift and brutal.



But every trade has a counterparty, meaning someone must have been buying/holding Greek debt six months ago at 1% spreads to German debt. The mainstream, Keynesian view some major banks peddle is that Greece faces a liquidity crisis, not a solvency crisis. If only it can make it through to the recovery, then all will be well. This view explains why when the Europeans announced their $1 trillion bail out package last weekend, the mainstream believed the euro to have been saved.

For example, Bank of America distributed a research piece (available here: http://www.scribd.com/doc/31136957) calling the crisis political, not economic, and arguing that $1 trillion is enough to float Greece, Spain, Portugal, and Ireland until the end of 2011 by which point the recovery will be well underway, tax revenues will flow back into government coffers, and the PIIGS will be able to maintain their own debt. Bank of American maintains its forecast that no Eurozone country will default. Indeed, early Monday morning the euro rallied from $1.27 to $1.30, gold plunged from €962 to €908, and Bank of America rallied nearly 7%.



But two days later, the euro has hit $1.26, and gold is trading above €985. The reason is that Mises is right and Bank of America is wrong. By its nature, the capital raised by government debt is apt to be squandered and lost. The debt crisis is a solvency crisis, not a liquidity crisis. At a recent Milken Institute program, Nouriel Roubini delivers a detailed and devastating analysis of European debt problems from this perspective, available at the following link starting at 21:45:

http://www.milkeninstitute.org/events/gcprogram.taf?function=detail&EvID=2257&eventid=GC10

Because the capital raised by the debt is gone, there is no appetite from the Greek people to pay interest on it, just as there was none in Argentina, there is none in Iceland, nor will there be, eventually, in any other country in the same situation, including the United States.

Interestingly, a very similar situation to the Euro-debt crisis played out in America during the boom of the late 1830s. As accounted by the 1982 Minority Report of the U.S. Gold Commission, state governments used easy credit from British and Dutch banks to fund massive public works projects, most of which were wasteful. Total state debt increased from $26 million in 1830 to $170 million by 1839, an impressive rise during a gold standard. During the crisis of 1839, in which the money supply fell 34% from $240 million to $158 million, many states become insolvent and begged the federal government to assume the debts. According to the report:

> The American people, however, spurned federal aid, including even the citizens of the states in difficulty, and the advent of the Polk administration ended any prospects for federal assumption. The British noted in wonder that the average American was far more concerned about his personal debts to other individuals and banks than about the debts of his state. In fact, the people were quite willing to have the states repudiate their debts outright. Demonstrating an astute perception of the reckless course the states had taken, the typical American response to the problem: "Suppose foreign capitalists did not lend any more to the states?" was the sharp retort: "Well who cares if they don't? We are now as a community heels over head in debt and can scarcely pay the interest." The implication was that the disappearance of foreign credit to the states would have the healthy effect of cutting off their wasteful spending—as well as avoiding the imposition of a crippling tax burden to pay for the interest and principal.
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> A Minority Report of the U.S. Gold Commission, Ron Paul and Lewis Lehrman, Congressional Record, Washington D.C., 1982, page 58,

Americans simply were not willing to work for years or decades to pay off debts incurred by profligate politicians, and, after some sharp, quick pain, the country benefited enormously. Of course, the politicians won't agree, as their power stems from the public purse. With politicians firmly in control of the fiat printing press, Bank of America may well be technically correct. Perhaps no Eurozone country will default, but if so it will be because the policy makers choose inflation.

Assuming this perspective to be correct, any bailout money or purchases of sovereign debt by the ECB serves only to devalue the euro. It took one day for markets to come to the same conclusion and end the counter-trend euro rally. It is also worth note that the Federal Reserve reopened its unlimited swap lines to foreign central banks, the idea being that as long as all fiat currencies devalue simultaneously no one will be the wiser. But the gold market is not so easily fooled, and today gold rocketed to a new all-time high in dollars, surpassing $1245. In fact, the Austrian mint announced it sold more gold coins in the past three weeks than in the entire first quarter calling the trend "panic buying." The market will eventually trump politics, whatever analysts at Bank of America and elsewhere think.

The above discussion concerns the performance of gold in currency terms, but while currency and stock market fluctuations have immediate effect on gold stocks (the primary concern here), over the long term they respond to the spread between gold and commodities. As a reminder, the thesis is that during times of credit growth in an economy gold underperforms commodities, and in times of credit contraction gold outperforms causing gold mining margins and NAVs to increase.

Not surprisingly, the credit strife in Europe last week caused a swoon in the broader markets, including the commodities market. Very surprisingly, gold shot up. Up until last week, gold had been rising in a relative fashion, in that when markets fell it also fell but less, and when markets rose it also rose but more. Starting last week, for the first time, gold traded directly contrary to the other markets. This means, especially in relative terms, the increase in gold is becoming more visible and will accelerate. There is not only the headline news in Europe to thank for that, but the unreported credit news in the U.S. as well.

Since the last update on April 21, 18 banks have failed which had a combined $32.9 billion in assets and $26 billion in deposits. As discussed in the previous update, old math would suggest that depositors were covered by $6.9 billion, and yet the FDIC took a loss of $8.5 billion. This suggests that the FDIC estimates the assets to be worth really only $17.5, meaning the banks collectively were carrying the assets on their books with a markup of 87% above market value. Of course, there is no suggestion of impropriety, since current FASB rules allow banks to carry assets at mark-to-model as opposed to mark-to-market. It is also worth noting that while the FDIC estimates its loss to be $8.5 billion, it entered into loss-share transactions worth $23.9 billion, so it has potential liabilities of an additional $15.4 billion. The FDIC has not published its balance sheet since the end of 2009, but at the time the Deposit Insurance Fund's balance was negative $20.9 billion.

Below is the chart that anchors gold's value in terms of the cost of digging it up: the gold-to-commodities ratio. As expected, and similar to its massive spike in 2008, the rise in this line occurred in the context of a falling market, even in gold shares. But, it is still far from the peak achieved during the panic of 2008, suggesting more volatility ahead for all markets as this chart moves higher.

Speaking of volatility, back in January Sprott Asset Management managers Kevin Bambrough and David Franklin warned in a research report that the next leg of the gold bull market was likely to extremely volatile, writing:

> Gold bull markets are unique in that buying becomes driven by both fear and greed. Gold is quickly moving into the hands of those who are unwilling to gamble on fiat currencies or bonds as a store a value. The new owners of gold are unconcerned with its lack of yield but instead are focused on its historic ability to preserve wealth and its unquestionable value. Given the difficulty we have valuing paper money, it becomes extremely difficult to come up with a reasoned price target for gold. Today's gold market is significantly different from the gold market of the 1970s for two reasons: 1) Central Banks are more likely to be buyers of gold today and 2) They clearly have little ability to dramatically raise interest rates with the massive increases in government issued debt.
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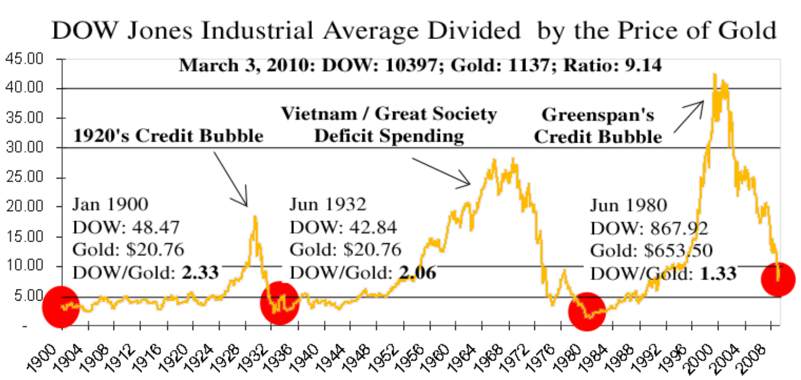
> http://www.sprott.com/Docs/MarketsataGlance/01_10%20Beware%20Counterfeiters.pdf

Events are certainly unfolding as they predicted. But it is important to keep in mind that gold's volatility is in in terms of currency prices, not necessarily value, and it is short term phenomenon that has the effect of spooking and driving out as many bulls as possible, forcing them to come back into the market later and chase prices higher. Viewed in the long run, the gold price is quite orderly, falling when credit levels rise and vice-versa, just as Austrian theory would predict.

The 110 year graph of the gold-to-DOW ratio below shows that at the end of credit bubbles the ratio settles at a value of between 1 and 2, although the bigger the bubble the lower the ratio. In the past month, the DOW has resumed its slide against gold, falling 13% from 10X the price of gold to 8.7X. Since September, the DOW has lost more than a third of its value as against gold, demonstrating the continuing value shift from paper to hard assets.



As discussed previously, gold stocks are special cases in that they are stocks, meaning they correlate with the market as well as with gold. Last week, when gold was rising and the market falling, the GDXJ EFT, the closest thing to an index in the small cap gold mining sector, lost 7% even while gold gained 2.5%. This week, however, is a different story since both gold and the broader markets are up. Gold has gained another 2.5% while GDXJ is up 12.4%.

In any bull market, it is generally the large caps that lead, the mid-caps that follow, and the small-caps that move last but furthest. This makes sense especially with gold. As the price rises, the large miners see immediate increases in cash flow and therefore trade as near proxies to gold. Whereas, small and micro-cap tend on a day-to-day basis to trade on market perception of the viability of the projects. The market may not perceive that a 5% increase in the spot price of gold significantly alters the landscape for a long-term micro-cap project. But there is a threshold point, and the investment thesis is that the largest percentage gains will be had by projects for which a rising gold price changes from non-viable to viable. The returns will occur later in the cycle than for the larger companies, but they should be spectacular when they come.

Excerpt from Chapter 12 of Human Action by Ludwig von Mises on the Problems of Long-term, Irredeemable Sovereign Debt

The problem assumed much greater importance when governments initiated their policies of long-term irredeemable and perpetual loans. The state, this new deity of the dawning age of statolatry, this eternal and superhuman institution beyond the reach of earthly frailties, offered to the citizen an opportunity to put his wealth in safety and to enjoy a stable income secure against all vicissitudes. It opened a way to free the individual from the necessity of risking and acquiring his wealth and his income anew each day in the capitalist market. He who invested his funds in bonds issued by the government and its subdivisions was no longer subject to the inescapable laws of the market and to the sovereignty of the consumers. He was no longer under the necessity of investing his funds in such a way that they would best serve the wants and needs of the consumers. He was secure, he was safeguarded against the dangers of the competitive market in which losses are the penalty of inefficiency; the eternal state had taken him under its wing and guaranteed him the undisturbed enjoyment of his funds. Henceforth his income no longer stemmed from the process of supplying the wants of the consumers in the best possible way, but from the taxes levied by the state's apparatus of compulsion and coercion. He was no longer a servant of his fellow citizens, subject to their sovereignty; he was a partner of the government which ruled the people and exacted tribute from them. What the government paid as interest was less than the market offered. But this difference was far outweighed by the unquestionable solvency of the debtor, the state whose revenue did not depend on satisfying the public, but on insisting on the payment of taxes.

In spite of the unpleasant experiences with public debts in earlier days, people were ready to trust freely the modernized state of the nineteenth century. It was generally assumed that this new state would scrupulously meet its voluntarily contracted obligations. Capitalists and entrepreneurs were fully aware of the fact that in the market society there is no means of preserving acquired wealth other than by acquiring it anew each day in tough competition with everybody, with the already existing firms as well as with newcomers "operating on a shoe string." The entrepreneur, grown old and weary and no longer prepared to risk his hard-earned wealth by new attempts to meet the wants of consumers, and the heir of other people's profits, lazy and fully conscious of his own inefficiency, preferred investment in bonds of the public debt because they wanted to be free from the law of the market.

Now, the irredeemable perpetual public debt presupposes the stability of purchasing power. Although the state and its compulsion may be eternal, the interest paid on the public debt could be eternal only if based on a standard of unchanging value. In this form the investor who for security's sake shuns the market, entrepreneurship, and investment in free enterprise and prefers government bonds is faced again with the problem of the changeability of all human affairs. He discovers that in the frame of a market society there is no room left for wealth not dependent upon the market. His endeavors to find an inexhaustible source of income fail.

There are in this world no such things as stability and security and no human endeavors are powerful enough to bring them about. There is in the social system of the market society no other means of acquiring wealth and of preserving it than successful service to the consumers. The state is, of course, in a position to exact payments from its subjects and to borrow funds. However, even the most ruthless government in the long run is not able to defy the laws determining human life and action. If the government uses the sums borrowed for investment in those lines in which they best serve the wants of the consumers, and if it succeeds in these entrepreneurial activities in free and equal competition with all private entrepreneurs, it is in the same position as any other businessman; it can pay interest because it has made surpluses. But if the government invests funds unsuccessfully and no surplus results, or if it spends the money for current expenditure , the capital borrowed shrinks or disappears entirely, and no source is opened from which interest and principal could be paid. Then taxing the people is the only method available for complying with the articles of the credit contract. In asking taxes for such payments the government makes the citizens answerable for money squandered in the past. The taxes paid are not compensated by any present service rendered by the government's apparatus. The government pays interest on capital which has been consumed and no longer exists. The treasury is burdened with the unfortunate results of past policies.

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The long-term public and semipublic credit is a foreign and disturbing element in the structure of a market society. Its establishment was a futile attempt to go beyond the limits of human action and to create an orbit of security and eternity removed from the transitoriness and instability of earthly affairs. What an arrogant presumption to borrow and to lend money for ever and ever, to make contracts for eternity, to stipulate for all times to come! In this respect it mattered little whether the loans were in a formal manner made irredeemable or not; intentionally and practically they were as a rule considered and dealt with as such. In the heyday of liberalism some Western nations really retired parts of their long-term debt by honest reimbursement. But for the most part new debts were only heaped upon old ones. The financial history of the last century shows a steady increase in the amount of public indebtedness. Nobody believes that the states will eternally drag the burden of these interest payments. It is obvious that sooner or later all these debts will be liquidated in some way or other, but certainly not by payment of interest and principal according to the terms of the contract. A host of sophisticated writers are already busy elaborating the moral palliation for the day of final settlement.8 The fact that economic calculation in terms of money is unequal to the tasks which are assigned to it in these illusory schemes for establishment of an unrealizable realm of calm removed from the inescapable limitations of human action and providing eternal security cannot be called a deficiency. There are no such things as eternal, absolute, and unchanging values. The search for a standard of such values is vain. Economic calculation is not imperfect because it does not correspond to the confused ideas of people yearning for a stable income not dependent on the productive processes of men.

8. The most popular of these doctrines is crystallized in the phrase: A public debt is no burden because we owe it to ourselves. If this were true, then the wholesale obliteration of the public debt would be an innocuous operation, a mere act of bookkeeping and accountancy. The fact is that the public debt embodies claims of people who have in the past entrusted funds to the government against all those who are daily producing new wealth. It burdens the producing strata for the benefit of another part of the people. It is possible to free the producers of new wealth from this burden by collecting the taxes required for the payments exclusively from the bondholders. But this means undisguised repudiation.

http://mises.org/pdf//humanaction/pdf/ha_12.pdf