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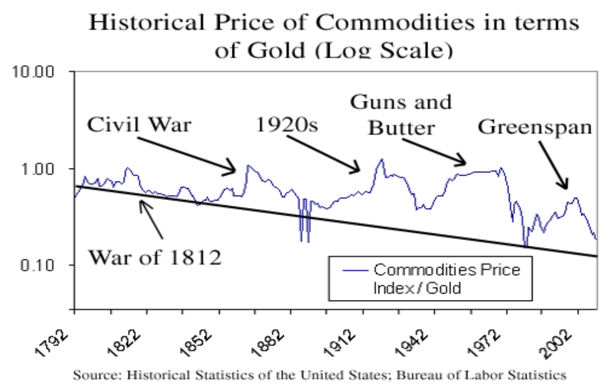
The primary assumption behind the Myrmikan investment thesis is that, as J.P. Morgan told Congress in 1912, “Gold is money and nothing else.” Taking an economy with a fixed amount of money, and adding more goods and services to that economy, the price level must fall. Therefore, if gold is money, and if economic growth is greater than the percentage increase in gold supply due to mining, gold should always rise in economic value.

In fact, for the past 50 years, the pace of global economic growth has outpaced gold production by about 3% per year. This should mean that if one’s savings were all in physical gold, and one consumed only 3% of the pile each year, the pile would never run out. The increase in the value of the remainder would make up for the fact that pile was smaller. (NB: Most gold would not be in retirement hoards, but instead lent out at extremely low interest rates).

Unfortunately, volatility destroys this easiest method of retirement planning. But the volatility is not in gold, the volatility is in the Keynesian boom/bust economic cycles. Looking at a long term chart of a commodity index priced in gold, the logarithmic downward trend is clearly visible. Equally visible are the government induced inflationary periods, which can last decades.



These inflationary booms are built on the quicksand of excessive credit caused by low interest rates, as elucidated by the Austrian Business Cycle Theory. The low interest rates discourage saving and encourage debt and its inverse, credit. To understand the true nature of credit, once again we turn to Mises:

> The moneylender is always an entrepreneur. Every grant of credit is a speculative entrepreneurial venture, the success or failure of which is uncertain. The lender is always faced with the possibility that he may lose a part or the whole of the principal lent.
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> …
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> There can never be perfect safety either in moneylending or in other classes of credit transactions and deferred payments. Debtors, guarantors, and warrantors may become insolvent; collateral and mortgages may become worthless. The creditor is always a virtual partner of the debtor or a virtual owner of the pledged and mortgaged property. . . . He has linked his fate with that of the debtor or with the changes occurring in the price of the collateral. Capital as such does not bear interest; it must be well employed and invested not only in order to yield interest, but also lest it disappear entirely.
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> -Chapter 20, Human Action, Ludwig von Mises

It is important to note that nearly everyone is a money-lender, even if they do not know it. Primary examples are depositors and pensioners, both of whom rely on deferred payments. In fact, one could argue that anyone holding dollars in any form is a money-lender, dollars being merely a liability of the Federal Reserve, a promise of deferred value.

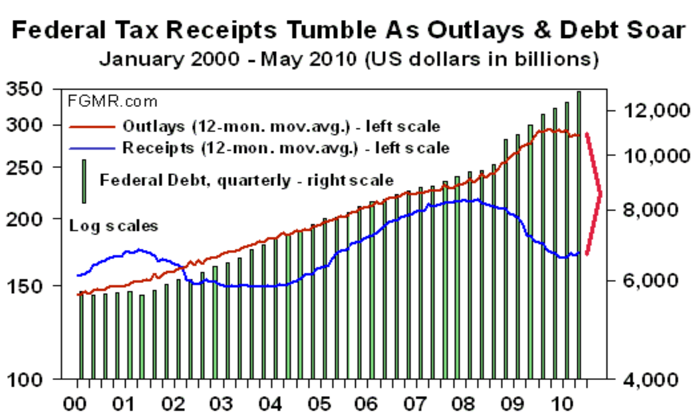
As Mises warns, malinvested capital can disappear entirely. The worst investor of all, of course, is the government, which spends money on bridges to nowhere and on transfer payments to the unproductive, and then must tax the productive sector to maintain interest payments on the capital that has been destroyed. The false interest rate signals of a credit boom also lead rational businessmen astray as they overbuild houses, ships, mines, and other long-term capital assets. Capital spent on these items is no less destroyed, and any value given to assets backed by the destroyed capital, such as government bonds or mortgage backed securities, is illusory and fleeting.

These ideas are not just idle philosophical musings, but are a call to action for anyone desiring to maintain their wealth during the ongoing credit collapse, the evidence of which continues to grow. One effect of a credit collapse – a loss of confidence – is that the market begins to insist on solvency as a measure of value as it ceases to trust counterparties. This is occurring presently in the banking system and the sovereign debt markets of smaller countries. Soon this insistence will be directed at the larger countries.

It is interesting to note that the Federal Reserve now has $2.3 trillion on its balance sheet, made up mostly of Treasuries and mortgage backed securities. If we assume those assets to be worthless (which can occur either because of default or because of very high interest rates), and we also assume the Fed still has the 8,300 tons of gold it says it has (which has not been seen since the 1950s), then the implied price of gold would be $8,750 per ounce to make the balance sheet balance. Going one step further, considering the balance sheet of the Treasury and the Fed as one – thereby including federal debt held by the public (and excluding intergovernmental holdings) – the implied price of gold jumps to $38,000 per ounce. Adding FDIC, Fannie and Freddie, and other guarantees sends the implied price far higher.

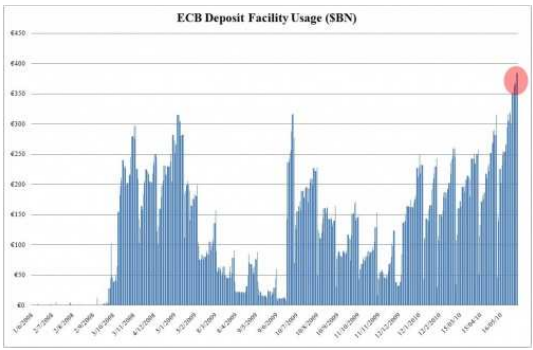
Such calculations seem dystopian fantasy, but, in fact, the Federal Reserve has been solvent twice in the last century. In both 1980 and 1933, the price per ounce of the gold hoard made the U.S. monetary base completely backed by gold. And who knows how many Federal obligations Bernanke will monetize before the market revolts. If Morgan was right, and gold really is the only money, its potential price is astronomic.

The graph below should force anyone with wealth to consider what effect a demand for solvency would have on the dollar today. Needless to say, at $38,000/oz hoards of foreigners would arrive buying everything in sight, but that's what happens in credit collapses: just ask any European or American in Argentina or Mexico or Russia during their credit woes. Wonderful hotels become very cheap. Of course, the state would intervene long before gold reached those levels through default, capital controls, wealth confiscation, etc.



Currently the stress is on the periphery. In the last couple of weeks, Spain has had to deny repeatedly that it is considering a €250 billion bailout from Germany as its 1-year yield jumped from 0.9% to 2.45%. Portugal managed to sell nearly $1 billion of 5-year debt at 4.67%, but compared to a similar auction at

3.7% only one month previously it is an ominous sign. Romania had its second failed auction in a month. Aware of the difficulties, European banks are wary of lending to each other, driving deposits at the ECB up to record levels (below left). The whole point of the $1 trillion euro bailout was to prevent Greek debt from toppling the European banking system. But, given the CDS pricing on Greek debt (below right), the action has failed to convince the market. The two graphs are related since the more stress there is in the sovereign debt markets, the less the banks will trust each other.



As the credit collapse continues, capital is accelerating its flight to safe havens. Switzerland is one repository, forcing the Swiss National Bank to buy euros to keep their currency from appreciating too much: in one month Swiss FX reserves have jumped from 28% of GDP to 43%. But gold is the capital preserver par excellence. According to a source at the trading desk of UBS, large institutional clients are selling their GLD ETF holdings and instead buying physical gold to be stored in Zurich. Reasons given include concern that GLD does not have all the gold it claims and the anonymity that physical possession provides. Since physical gold is not nearly as liquid as GLD, the gold that goes into the vault is likely to stay there for years. And, despite the reported exit of these institutions, GLD has added 5.2 million ounces in the past two months as even individuals head for the exit of the credit-based fiat currency system.

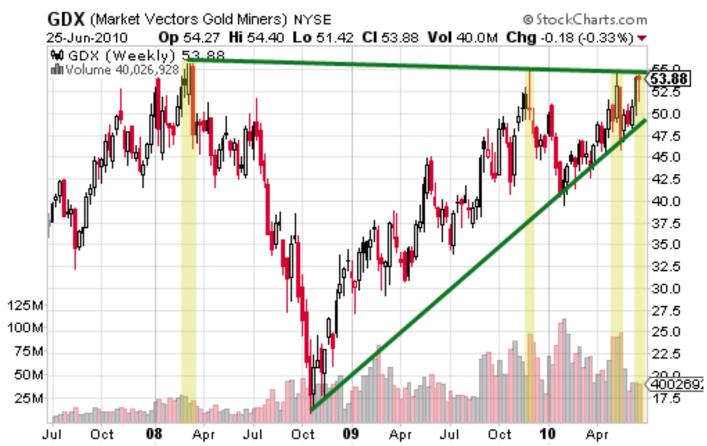
In addition to the flawed GLD, the Central Fund of Canada has been adding gold to their vaults, Saudi Arabia announced their gold hoard is double previous estimates, Russia added another 1 million ounces last month, and gold coin sales continue apace. Physical gold is going into hiding, as it always does before a currency collapse.

In testimony on June 11, Fed Chairman Bernanke admitted: “I don’t fully understand movements in the gold price” suggesting that his gold-friendly policies will continue. Perhaps he should consult his predecessor, Alan Greenspan, who on June 18 warned in the Wall Street Journal, “the inexorable rise in the price of gold indicates a large number of investors are seeking a safe haven beyond fiat currencies.” In the article, Greenspan, who more than anyone else helped create the debt mess, also wrote: “Only politically toxic cuts or rationing of medical care, a marked rise in the eligible age for health and retirement benefits, or significant inflation, can close the deficit.”

None of the prescriptions offered by Mr. Greenspan are conducive to economic growth, and since the rest of the developed world shares the same predicament, it does not bode well for industrial commodities. The choices governments face is to devalue their currencies massively, or to save their currencies at the cost of an austerity that would precipitate terrible economic pain. Either path is good for the gold-to-commodity ratio, which is at the heart of the investment thesis here.

Early last week, gold plunged $42 over three days, from $1266 to $1224. But not only did it finish the week nearly flat at $1256, the gold commodity ratio actually rose during this sell off, meaning it was a good move for the miners. Daily fluctuations do not affect the fortunes and stock prices of the miners, of course, but watching the gold-to-commodities ratio rise during sharp sell offs helps maintain confidence in a down market.

The larger cap miners comprising the GDX ETF have returned to the two-and-a-half year neck line, although not on the volume one would expect for an imminent break out. There is still some room to bounce between the converging trend lines, but the break point is near.



Obviously, the direction that the large caps break will determine that of the micro-caps, and there is a risk of a breakdown. But, as long as the gold-to-commodity ratio continues rising, the gold mining shares will ultimately pay off. Logic and history suggest the micro-caps will pay off the most.

Yours,

Dan

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