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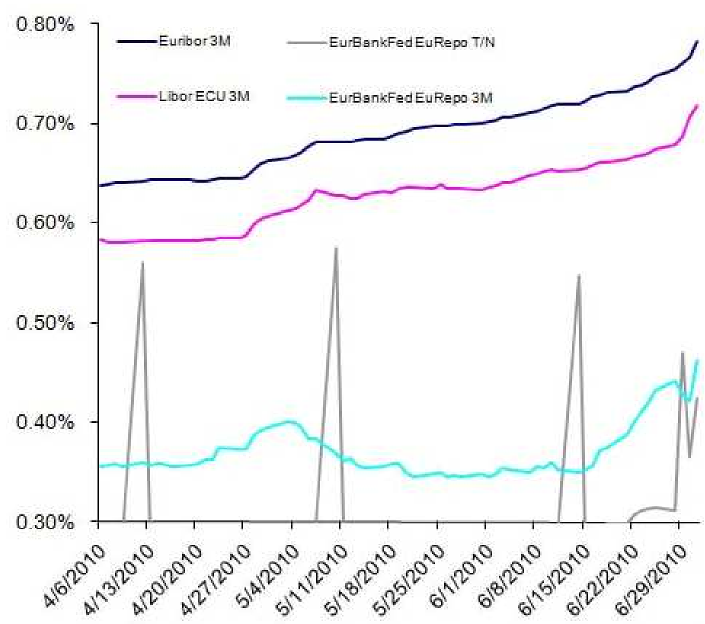
MYRMIKAN UPDATE JULY 8, 2010

Shortly after the previous update, gold fell from a high of $1243 to a low of $1195 in less than eight hours, bringing gold stocks along for the ride. Meanwhile the euro soared from 1.22 to 1.25 in the same time period. Mainstream commentators report that euro rally was due to optimism about Europe's banking sector. From the Wall Street Journal:

> The euro advanced strongly against the dollar Thursday as a successful Spanish government bond auction sparked some confidence in the region's banking system, despite a ratings agency's warning a day earlier that Spain could lose its coveted top-shelf credit rating.…

Spain's "success" was in selling €3.5 billion in 5 year bonds at 3.657% versus 3.532% in the previous 5 year auction. Back in March, Spain had to pay but 2.8%. Combined with the Moody's action, Spanish debt "improvements" seem an unlike source for a euro rally.

More likely the culprit was the instability caused by the rolling off of the ECB LTRO (Long-Term Refinancing Operation). In June 2009 the ECM injected €442 billion into the banking system, which the banks had to pay back on July 1, 2010. Needless to say, when the date arrived and the banks had to come up with the cash, it turned out there were fewer euros floating around than anticipated.



On June 30 it looked like the ECB had things under control, with only €132 billion of the €442 billion rolling onto a 3 month LTRO. The next day banks bid for another €111.2 billion of reverse repo cash, and the ECB's deposit facility hit a new record high at €309 billion, giving banks in need of cash even fewer places to get it, and the scramble was on. The chart at right shows the cost of euros spiking, as a new liquidity crunch threatens.

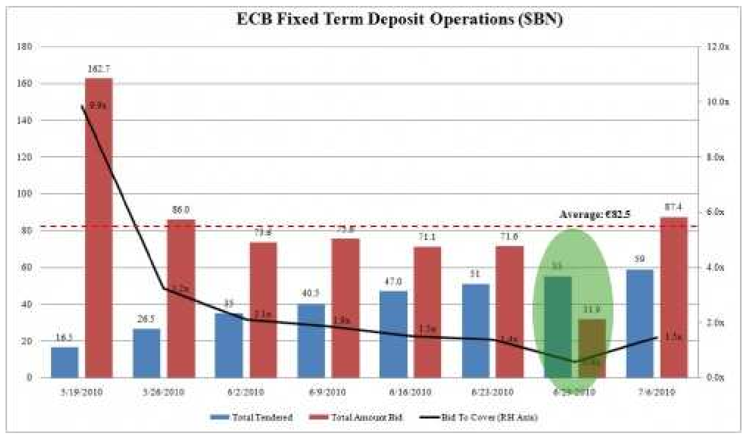
Over the past few months, euro zone sovereign debt troubles have attracted massive euro short positions from aggressive hedge funds. As the euro rallied, these positions were wiped out, and a short-squeeze added fuel to the rocket. Many of these hedge funds shorted the euro not against the dollar, but against gold, which explains the carnage in the gold market. Neither of these developments – a European banking crisis and hedge fund liquidation – is good for the euro or bad for gold long-term, but the short-term is a different story. As margin calls come in, the pressure could continue.

To explain the dynamics of the current situation requires revisiting Austrian Business Cycle Theory. As explained in previous materials, the Austrian School of Economics demonstrates why a credit boom is unsustainable. Excess credit fools businesses and entrepreneurs into thinking there is more savings and resources in society than actually exist, lowering the expected future price of inputs which encourages business expansion. As the boom proceeds, the excess demand for inputs pushes prices up, projects fail from lack of funding, and the boom ends in a deflationary crash. The first symptom of the end of the boom is a liquidity crunch as businesses that had been fooled by the artificial interest rates try to refinance.

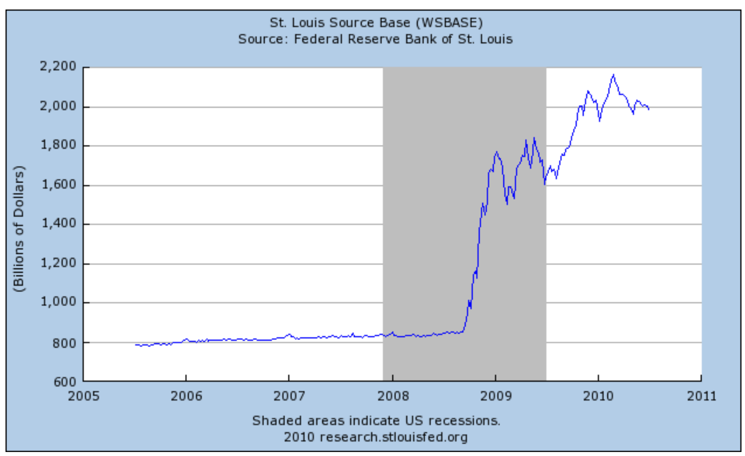
Mises is very clear on this. When the boom turns to bust, the state can either do nothing and allow the system to reset in a deflationary panic. Or, the state can offer additional credit to restart the boom. This latter course merely continues the illusion, and makes the underlying economic reality even more out of balance, and the necessary deflationary crash larger. The boom does not last as long, and the ultimate reckoning becomes worse.

> There is no means of avoiding the final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as the result of a voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the currency system involved.
>
> \- Ludwig von Mises

It is important to note that to continue the illusion of non-existent resources necessary to keep the boom alive requires an increasing pace in the amount of credit being introduced into the economy. The moment the credit expansion halts, or even slows down, a deflationary liquidity crunch develops as the mis-lead businesses scramble for resources by selling assets to raise funds. The credit injection of 2001 lasted until 2008 and was tiny in comparison to Bernanke’s emergency actions. But a mere two years later, that credit injection is already wearing thin.



If one accepts this framework, then there is no question that when the ECB attempts to remove net €442 billion, a liquidity crunch will occur. While the ECB has been buying sub-prime sovereign debt, it has been sterilizing the purchases through the banking system. Because of the liquidity crunch last week, not all of the purchases were sterilized as the bid-to-cover ratio went below 1. Notice how the chart at right shows an increasing trend of purchases from the ECB necessary to keep the sovereign debt markets from falling apart, and decreasing interest from the banks.



In the U.S., the monetary base has stabilized, confirming Bernanke’s stated goal of halting the printing presses at that point. Only a few months later, unemployment is rising, home sales are plummeting, asset prices are plunging (with the S&P down 13% since April) and the Baltic Dry Index is sinking.

Keynesian models are sensing the ebbing liquidity and, true to Mises’s expectations, the establishment is calling for additional stimulus to keep the boom alive. Ambrose Evans Pritchard reports that the head of Fitch’s sovereign ratings has called on the ECB to buy hundreds of billions of unsterilized bonds and, in the same article, quotes a ECB council member as saying: “We will continue to buy bonds until the situation is stabilized.” Since the excess credit caused the problems, that could be a long time.

Meanwhile RBS has told clients to expect a "monster" quantitative easing, predicting $5 trillion from the Fed and an equal amount from other central banks. Albert Edwards of Societe General writes:

> Our view that this economic and market recovery will collapse like a pack of cards as soon as the steroid-like stimulus is reduced is gaining ground.... The response to the coming deflationary maelstrom will be additional money printing that will make the recent QE seem insignificant.

None of these writers refer specifically to Austrian Business Cycle Theory, citing instead leading indicators such as employment, housing, LIBOR, the Baltic Dry Index, etc. And, because they are calling for the action, they must think that an extra $10 trillion or so of liquidity would stabilize the system. Mises, on the other hand, instructs us that it would make the system even more unstable.

These analysts are not writing in a vacuum, but have support from the authorities. According to a recent paper by the San Francisco Fed, current conditions warrant a negative 5% interest rate, whereas the current rate of zero combined with the current QE programs results in only a negative 2% level. The obvious policy prescription is to boost QE by another $2 trillion.

Before his recent golf outing to Toronto, Obama wrote: "Should confidence in the strength of our recoveries diminish, we should be prepared to respond again as quickly and as forcefully as needed to avert a slowdown in economic activity," leaving no doubt where he stands on the issue of QE.

Although it's true that politicians of all stripes like to print money – they get to fund bread and circuses without raising taxes – the current money printing is occurring through fear not greed. To quote from Societe General Analyst Dylan Grice:

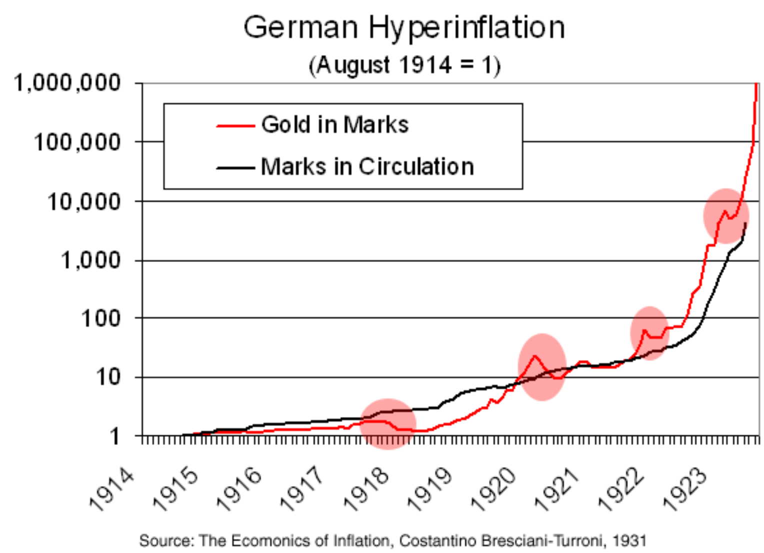
> What's interesting is that central banks feel they have no choice. It's not that they're unaware of the risks (although there are profound behavioral biases working against them in their assessment of those risks). *They're printing money because they're scared of what would happen if they don't*…. (italics original). It's like they're on a train which they know to be heading for a crash, but it's accelerating so rapidly they're scared to jump off.
>
> Incidentally, this is exactly the train Rudolf von Havenstein found himself on as President of the Reichsbank during the German hyperinflation. According to Liaquat Ahamed's work on von Havenstein's dilemma, in his majestic book "Lords of Finance" '. . . were he to refuse to print the money necessary to finance the deficit, he risked causing a sharp rise in interest rates as the government scrambled to borrow from every source. The mass unemployment that would ensure, he believed, would bring on a domestic economic and political crisis, which in Germany's [then] fragile state might precipitate a real political convulsion.'"

In our case, it's not just the government that would scramble to borrow money, as is already occurring in weak sovereign states, but the banking sector as well as is evidenced by last week's events. The longer the Fed and the ECB delay restarting the printing presses, the more liquidity problems there will be, and the lower markets will go including, of course, gold.

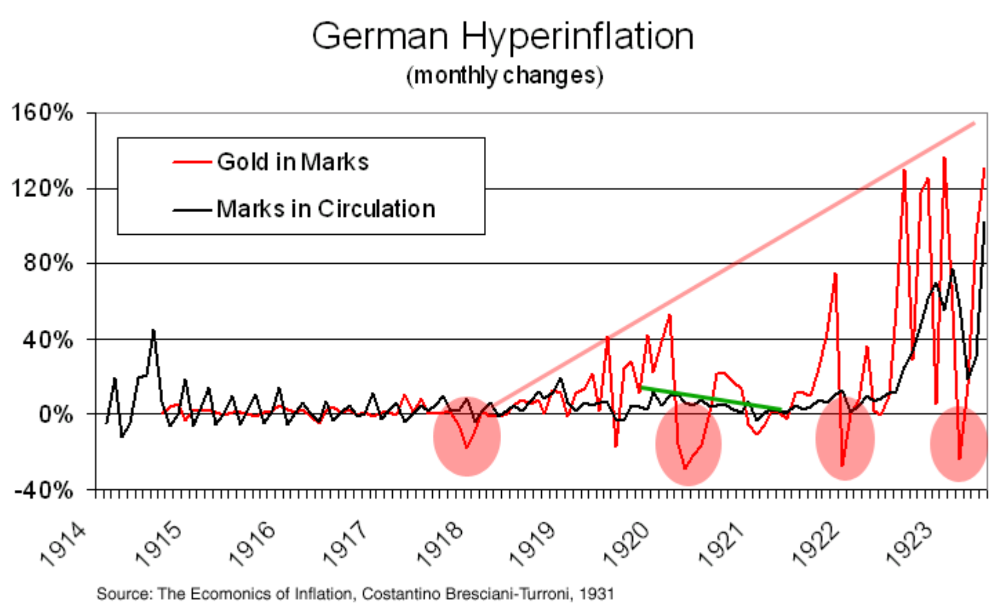
One take away from the above quotes by Mises and about Havenstein is that the entire trip to hyperinflation occurs on the cusp of "hyperdeflation." If at any point the central bank decelerates the injections of credit, then rates spike as borrowers try to avoid default. Havenstein actually tried this a few times, but quickly had to reverse course as banking system teetered.

As markets vacillate between anticipating the increasingly severe deflationary crash that free market forces demand versus expectations of increasingly large injections of credit provided by the central bank, volatility spikes. Perhaps the most extreme example of this occurred in the German hyperinflation.

The graph at right shows the price of gold in marks during the Weimar hyperinflation on a logarithmic scale (and ends before the real craziness begins). One interesting observation is that gold lags growth in money supply during the initial stages of hyperinflation. Even so, the strategy seems obvious: to survive the hyperinflation, just buy and hold gold. The small corrections in the red areas seem minor annoyances to an easy way to preserve capital.



But what seems obvious in hindsight may not be quite so contemporaneously. The graph below shows the same data as at right, except using monthly changes instead. The first observation is that gold is an increasingly wild ride. The little blips on the logarithmic scale represent monthly losses of up to 30%, even while the currency in circulation never materially shrinks. Gold reacts in these periods because expectations about the rate of additional printing is frustrated (NB: the graphs show the monthly average price of gold versus the end of month currency in circulation, which accounts for the dips being slightly off). The worst performance for gold is during 1920 when over a three month period it falls 60% as Havenstein tries to slow the growth of the money supply (declining green line). Any German gold bugs with leveraged positions would have been wiped out. Even in mid-1923, when the hyperinflation is raging and obvious to all, in one month Havenstein heroically constrains money supply growth to a mere 19%, and gold tanks, with a monthly nominal decline of 24% -- devastating in the context of a hyperinflation. No doubt the daily figures would provide an even more violent story.



The point of this discussion is not to wade into the inflation/deflation debate raging in hard money circles, but to demonstrate that even in seemingly obvious situations such as the Weimar German hyperinflation, trading gold and financially leveraging gold positions are dangerous enterprises. Even if losing 60% on a nominal basis during a hyperinflation seems catastrophic, the top graph on the previous page provides the best orientation. The strategy should be to ride up the logarithmic parabola and ignore the massive volatility.

There are many sophisticated gold investors who believe that we're in for a repeat of 2008: a banking panic in which gold will collapse below $1000 for a time (along with other markets), wiping out speculators, then the central banks will print, and gold will come roaring back. They may well be correct, as telegraphed by the liquidity problems in Europe, in which case the obvious strategy would be to wait for better entry points.

However, there is a difference between current events and 2008. Back then Bernanke was taken by surprise, believing sub-prime real estate had been contained. As late as June 9, 2008 Bernanke stated: "The risk that the economy has entered a substantial downturn appears to have diminished over the past month or so." There is no such confidence now. And that opens the probability of action before an all-out liquidity melt-down occurs.

There is no question that if an investor is able to accurately time central bank policy, his returns would be multiples ahead, but that strategy is likely to become an increasingly difficult endeavor. The lower graph on the previous page also shows that missing the spikes can be even more damaging than getting the dips right.

Hopefully the discussion above provides support for an alternative view that a non-leveraged buy and hold strategy in the gold market is preferable, even at the expense of massive intermediate mark-to-market losses as continued Keynesian credit expansion is punctuated by occasional liquidity crunches.

While history suggests that financially leveraging gold positions is a poor strategy, it also suggests that the operationally leveraged positions represented by gold stocks yield fantastic returns in these environments. Of course, the dips should be correspondingly more severe, but likely they will barely be noticeable reflecting on a future log graph a few years hence.

Yours,

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