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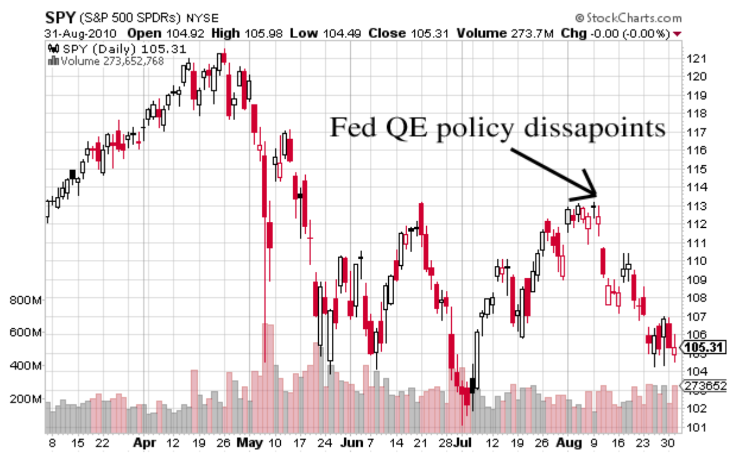
MYRMIKAN UPDATE SEPTEMBER 2, 2010

The previous Myrmikan update exposited on the theme that the path to hyperinflation occurs on the cusp of "hyperdeflation." The nature of the fractional reserve banking system, exacerbated by central banks, operates to create excess credit. The free market rebels, demanding a deflationary cleansing of the credit excesses. But politicians, through the central bank, resist the recession, inflating even more. To quote Hayek:

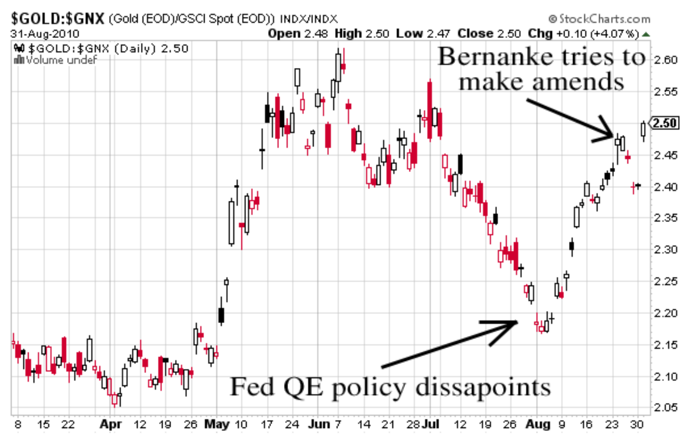
> The thing which is most needed to secure healthy conditions is the most speedy and complete adaptation possible of the structure of production. If the proportion as determined by the voluntary decisions of individuals [i.e., the free market] is distorted by the creation of artificial demand [through credit creation,] resources [are] again led into a wrong direction and a definite and lasting adjustment is again postponed.

As the natural liquidationist forces strengthen, the unnatural central bank inflationist policies must similarly increase in scale to ward off the deflationary collapse. This context explains why the August 10 announcement by the Fed that they would recycle expiring mortgage backed securities into Treasuries to keep their balance sheet constant was a profound disappointment to the Keynesians. Paul Krugman, chief court economist, called the change "trivial" and wrote the action was "far short of the major asset-purchase program the Fed should be undertaking."

Krugman is correct, in a sense. By replacing low quality real estate bonds with presumably higher quality government securities, the Fed, in fact, retains a slight tightening stance. It should not come as a surprise, then, that the day of the announcement marked an interim peak in the broader markets as stocks, an asset bubble perched on top of a credit bubble, are drained of their fuel. This trend ought to accelerate until the Fed relents and implements the much anticipated Quantitative Easing II.



If Krugman accurately judged the Fed action to be largely irrelevant, many commentators in the gold space exhibited a profound misunderstanding as to the effects money-printing has on prices by expecting gold prices to launch higher with the Fed's additional printing. First, as explained above, the Fed isn't printing but still tightening, and, second, the histories of inflation are clear that the first effect of money printing is to boost the economy and demand for commodities at the expense of precious metals. It's when the injection wears off that gold excels in real terms. And, each successive credit injection creates a weaker and shorter bounce.

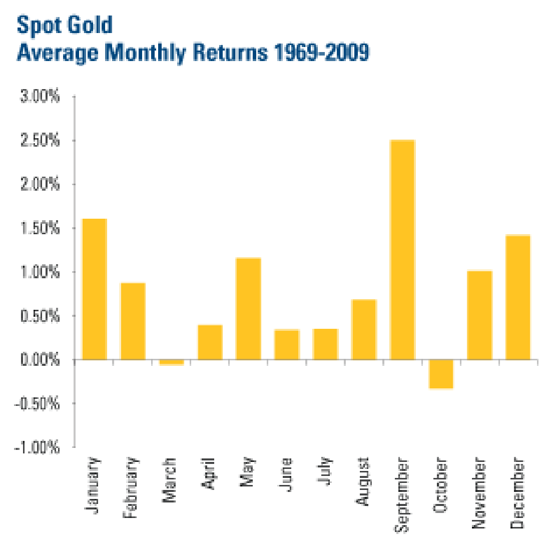


The lower chart at right shows that as the chorus of experts calling for and anticipating QEII strengthened throughout July – joined by the self-described "north pole of inflation hawks" Federal Reserve Bank of St. Louis President James Bullard – gold began to underperform. But the whimper of August 10th sharply reversed the trend and the real price of gold rose even more steeply than it had fallen. Although it's unlikely

Bernanke keeps track of the lower chart, he surely follows the upper chart intently and, thus, at Jackson Hole last week he endeavored to calm the markets saying: "Notwithstanding the fact that the policy rate is near its zero lower bound, the Federal Reserve retains a number of tools and strategies for providing additional stimulus [including] conducting additional purchases of long term securities." And, even better: "the FOMC will strongly resist deviations from price stability in the downward direction." Armed with a renewed commitment to the "Bernanke put," the risk trade was back on with oil rallying 3% on the day. But talk is cheap. Unless and until the Fed implements additional quantitative easing measures, markets ought to move lower and the real price of gold higher.

Gold's monetary attribute has far greater affect over its value than its commodity attribute, which includes jewelry and electronics. Whereas a responsible investor might put 10% or more of his wealth into gold, the reasonable man would never put 10% of his wealth into jewelry as such. However, in some parts of the world the line between commodity demand and monetary demand is fuzzy. The Indians may shower gold on their brides, but this practice reflects the ancient traditions of dowry and wealth transfer rather than trendy tastes for "bling."

As a monetary commodity, gold ought to be largely immune from the seasonal factors that affect other commodities such as wheat. But, in fact, the Autumn has been historically strong for gold reflecting the Indian wedding season and the Western Christmas season. In addition, Asian farmers sell their harvest during this time and place part of their surplus into wealth storage. This year appears to be no exception as gold has lifted strongly from the interim bottom set in late July.



Source: U.S. Global Research

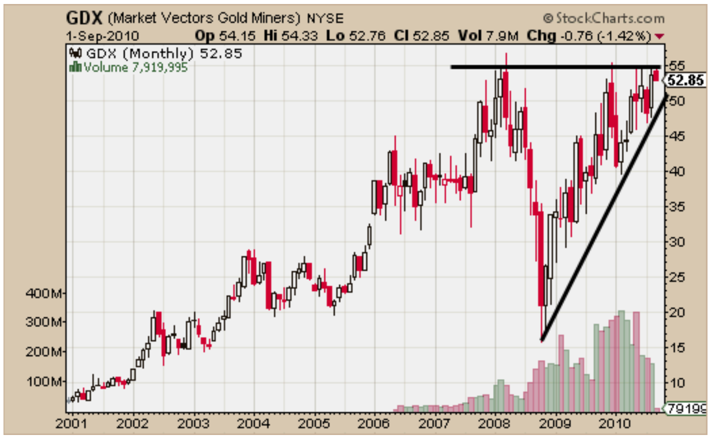
While the current surge in gold may be seasonal, there is also a monetary aspect underlying the demand. Many emerging countries keep their currencies low in relation to the dollar so as to boost exports. As a result, every time the Fed prints money, these countries are forced to print money as well to keep their currencies in equilibrium. Many commentators have opined that the increase of the U.S. monetary base by 136% over the past two years has had no consequence since the CPI has not increased. It's true the inflation isn't visible in the U.S. yet. Instead it's in China and Russia where food prices have been surging. It's in Vietnam, which has recently devalued its currency for the third time in a year. It's in India, where the inflation rate recently cracked 13%. And it's also in the U.S. in sectors like medical care that can't be outsourced to other absorbers of inflation.

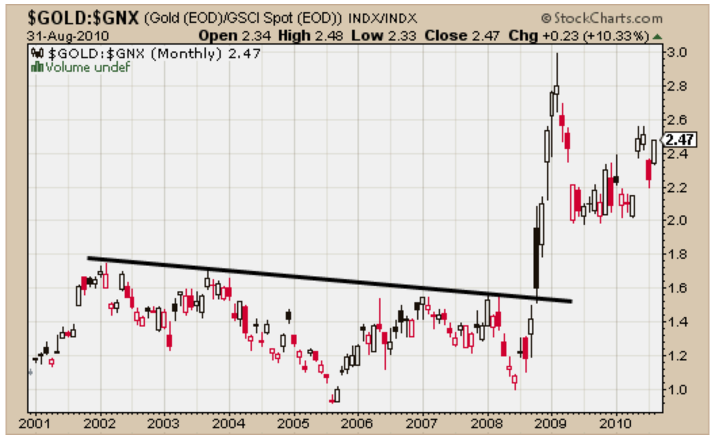
In the 1970s, each individual oil price spike was blamed on geopolitical factors, but when viewing the entire decade it's clear that U.S. monetary policy was the culprit. Similarly, the sharply rising price of global food prices is being blamed on drought, fire, politics, etc. While all of these factors are as real as 1970s Middle East turmoil, they serve to show the market just how much extra cash there is to bid on these commodities, rather than causing a change in commodity value.

While the governments of exporting countries continue to print money to pursue their mercantilist trade policies, the little people all over the globe accelerate their escape from fiat currency into precious metal alternatives. The sharp price movements may be determined by leveraged financial traders, but the steady accumulation should result in a continuation of the pattern of higher highs and higher lows that characterizes a bull market.

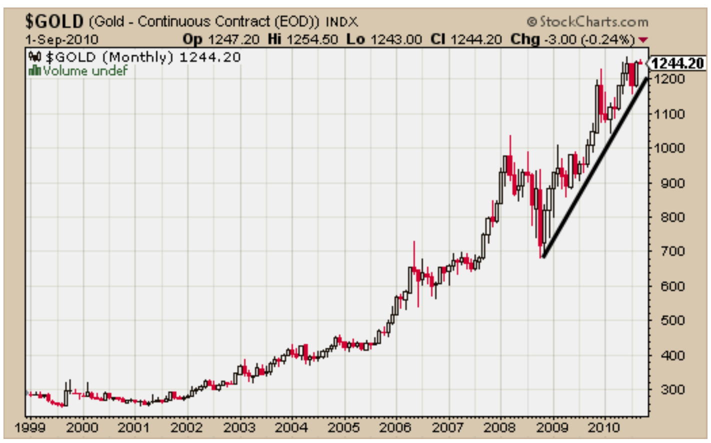
Meanwhile, senior gold stocks continue to flirt with the neckline of a three year consolidation pattern. For this kind of pattern, the theory is that that the projection price is equal to the difference between the neckline and the trough, which in this case would target an increase of around 68%. Needless to say, if the senior gold stocks rally 68% over the next 18 months, the junior stocks should participate as well.

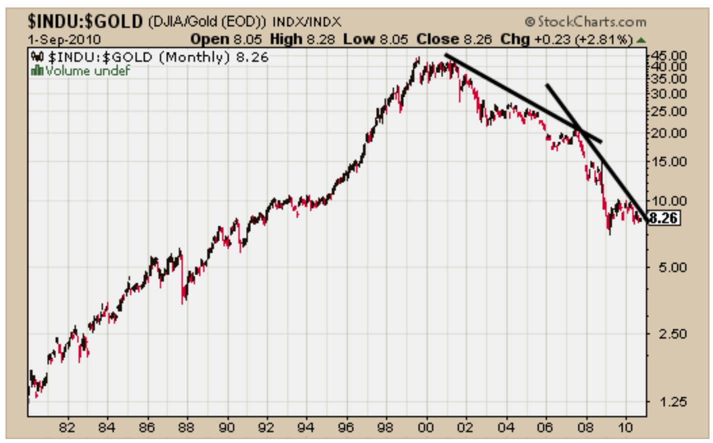
Although a chart pattern can seem abstract – viewed as a mathematical creation, breaking down would seem as likely as breaking out – the chart at right shows the long-term trend of the gold-to-commodities ratio. As that ratio rises, the real profits of gold mining companies also rise. The GDX reflects senior gold mining companies that are unhedged and in production, meaning the increase in the real gold price flows straight to the bottom line. Given this dynamic, it seems unlikely that the GDX will fail at the neckline, although a shakeout below the trend line is always possible before the breakout.





The gold price itself remains in its accelerated three year uptrend, and the DOW-to-gold ratio remains firmly in its ten year down trend. Having fallen from a high near 45 to its current value of 8.26, one might think its nearly at the bottom. But the log chart shows how much further the ratio has still to fall.





Interestingly, the most widely held December futures option for gold is the $1500 strike price. Gold stocks of all stripes can breakout with gold at current levels, but if $1500 is reached by year end, the junior space should go berserk.

Yours,

Dan

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