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MYRMIKAN UPDATE OCTOBER 4, 2010

Consistent with the seasonal pattern discussed in the previous Myrmikan update, gold has reached new all time highs. But Brazilian Finance Minister Guido Mantega identified the real price driver when he said last Tuesday: "we are in the midst of an international currency war." Ambrose Evan Pritchard of the Telegraph, the only mainstream journalist who understands the global economic crises, titled a recent article: "Capital controls eyed as global currency wars escalate: Stimulus leaking out of the West's stagnant economies is flooding into emerging markets, playing havoc with their currencies and economies." Not much more needs to be said, though it's worth reading the body of the piece, found here:

http://www.telegraph.co.uk/finance/economics/8031203/Capital-controls-eyed-as-global-currency-wars-escalate.html

Pritchard, writing freestyle in his blog, has even more forceful words for the managers of the global reserve currency as he switches from supporting the emergency stimulus programs to calling for the Federal Reserve to be abolished. The trigger issue is Bernanke's recent speech in which he advocates using quantitative easing not just to prevent deflation but to return inflation to levels "consistent with its mandate."

The problem with Bernanke's economic thesis is that a growing economy is always in deflation, at least as against a stable currency like gold. As rising productivity increases the amount of goods and services in an economy, prices must fall – assuming a stable money supply – since the same amount of money needs to cover more goods and services. The Fed missed the credit bubble their low interest rates caused in the 1920s because the price level stayed constant: increasing availability of electricity created enormous productivity growth that counteracted the price increases that would have otherwise occurred. Similarly, the economic growth due to technology and outsourcing masked the credit growth of the past twenty years.

Treasury Secretary Andrew Mellon figured it out after the crash and advised Hoover:

> liquidate labor, liquidate stocks, liquidate farmers, liquidate real estate… it will purge the rottenness out of the system. High costs of living and high living will come down. People will work harder, live a more moral life. Values will be adjusted, and enterprising people will pick up from less competent people.

While no politician ever wants to follow Mellon's prescription, the Federal government in the early 1930s did not have the power to resist the credit liquidation which ran until 1933 when Roosevelt defaulted on America's debt by confiscating and revaluing gold. Not so today when Bernanke can print dollars by the trillions to bail out favored institutions under the pseudo-intellectual moniker Quantitative Easing. Pritchard thus asks:

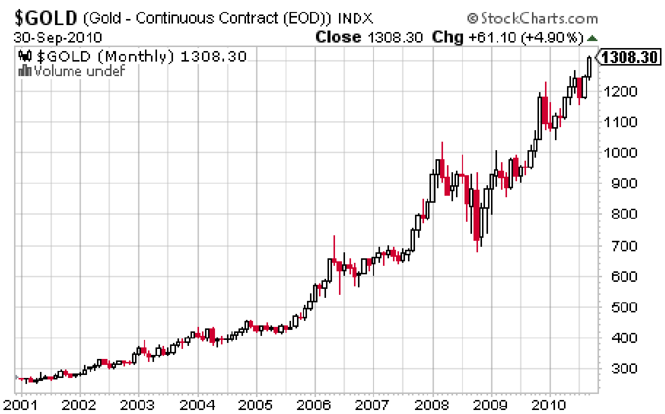
> Are the Chinese right? Are the Americans and the British now so decadent that they will refuse to take their punishment, opting to default on their debts by stealth?

As if to answer Pritchard's question, Paul Krugman recently wrote in his blog:

> I think it's fair to say that a majority of economists believe that excessive private debt played a key role in getting us into this economic mess, and is playing a key role in preventing us from getting out.… In the end, I'd argue, what must happen is an effective default on a significant part of debt, one way or another. The default could be implicit, via a period of moderate inflation that reduces the real burden of debt; that's how World War II cured the depression. Or, if not, we could see a gradual, painful process of individual defaults and bankruptcies, which ends up reducing overall debt.
> http://krugman.blogs.nytimes.com/2010/09/25/default-is-in-our-stars/?src=twt&twt=NytimesKrugman

Krugman's piece is a stunning admission that the Austrian thesis – too much debt causes depressions – is correct. What he doesn't address is why there is too much debt. The cause, of course, is that our Keynesian managers manipulated interest rates below market rates which reduced the propensity to save and increased the propensity to borrow thus hollowing out the economy's capital structure.

In any case, Krugman reveals the true purpose of Quantitative Easing 2.0 to be a not-so-stealth debt default. Gold (left) and commodity (right) prices are already anticipating the terrifying consequences. It's frightening to consider where those graphs will be if the Fed actually goes forward with QE2 in November, as is now widely anticipated. But what happens to the equity markets if they don't?



The commodity chart above right shows how close input prices are to levels that caused the global economy to lock up in 2008 when, arguably, it was a lot stronger. It should be no surprise that business and employment are suffering as input costs soar. From the Austrian thesis, the manipulated interest rates of fiat currency obscure the true state of various surplus goods: the Fed can print all the money it wants (money supposing to represent wealth), but it can't create the goods that actually are wealth. As ever more people and companies go into the market to spend their new dollars, prices must rise proportionally to allocate the scare resources. As prices rise, it frustrates business expectations and plans fail. Additional quantitative easing will delay the final reckoning, but will also widen the disconnect between perceived and actual wealth.

Don't look for these rising inputs costs to appear in the CPI. Housing costs (including owner's imputed rent) comprise 42% of the CPI anchoring the index for the foreseeable future. And, until recently, foreign workers have been absorbing rising costs. But now workers in China, Vietnam, Bangladesh, Cambodia, etc., are demanding higher wages through widespread strikes, so that may change soon.

As discussed in Pritchard's article, even assuming China and other exporting countries understand the Faustian bargain the Fed's dollar system demands, they must keep their currencies low to stimulate their export sector to maintain social stability tied to economic systems based on the dollar. This requires dollar purchases despite the unpleasantness of buying a valueless currency, and casts doubt on the decoupling thesis.

The opening salvos of the currency war have been standard market interventions, such as tiny Peru buying $400 million USD in the last three days of September. But the level of sophistication is rapidly increasing. China has been using Japan as an unwitting proxy, buying Yen to force the Japanese to intervene in the dollar market and take the blame. Similarly, Mexico on Thursday sold $600 million of U.S. dollar put options in a move that dramatically raises the potential volatility of relative currency values if things go wrong.

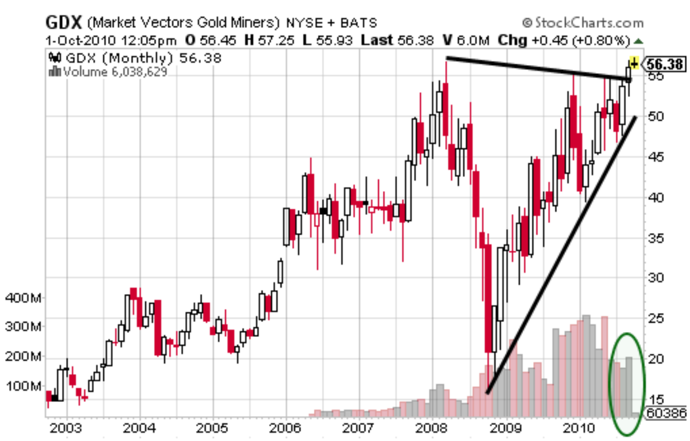
Against this backdrop it would be insane or irresponsible for anyone with capital not to seek to protection against feral central banks. Hence the recent surge in gold prices, along with all other non-cash assets. And, it's no coincidence that the U.S. mint last week ran out of 1oz Gold Buffalo coins and raised the dealer premium on Silver Eagles 33% from $1.50 to $2.00. As the ship sinks, the life rafts keep increasing in price.

But, as pretty as the gold chart looks, gold bugs should not get overly excited yet. A previous Myrmikan update described why commodities generally outperform gold as a first effect of money printing (or credit injection), with gold outperforming only as the stimulus wears off. Since credit injections correspond to higher nominal prices, gold tends to increase in real value when its price is declining, not when it's rising, as it did during the crash of 2008.

True to this thesis, the gold-to-commodity ratio (below left) has been in a down draft since talk of QE2 began in June. As impressive as gold's recent performance has been, commodities have risen even faster during this time period. Of course, the entities that actually use commodities – companies – have not done as well. Stocks will not serve as a safe haven from the accelerating credit crisis. In fact, as argued previously, they will be worst thing next to bonds. The DOW-gold ratio, presented here in logarithmic format, continues its secular decline, now only 18% above the panic lows of 2008.

If the gold-to-commodities ratio has been slipping recently, it remains safely in the higher range it reached during the market crash of 2008. Moreover, it is important to remember that there is a large time lag between a rising ratio and increased earnings for gold mining companies. The ratio is not a trading signal, but a long-term guide for fundamental value.

These improved fundamentals are finally starting to be reflected in share prices as the GDX, an index of large-cap gold miners, looks as though it's trying to break out from its trading range. However, volume is less than impressive. Meanwhile, GDXJ, an index of mid-cap gold mining stocks, is up a stunning 28% since the beginning of August. Nevertheless, the GDX-to-gold ratio has yet to break its long term downtrend, meaning that since 2006 gold has been the better bet over gold stocks. As the real price of gold rises, this relationship will switch, probably violently.



Many observers wonder, given the recently impressive gains of gold and gold stocks, if they've missed the boat. To continue an earlier analogy, they haven't missed the boat, they're on the boat, and the boat is sinking. Survivors of the Titanic recounted the suspension of disbelief required to leave the great liner for the dinghies bobbing in the ice cold water below. At first, when the ship was still horizontal, many of the seats went empty. Not so later, when the ship began to list visibly. So it will be with gold and gold equities.

Of course, the higher the gold market goes, the more volatile it will be. To paraphrase the Delphic Oracle, there will be a great correction – but the oracle won't tell if it will happen from $1300 or from $1650. A study of historical analogs suggests that trading is not a winning strategy at this point in the cycle. Instead, the inevitable sickening lurches downward must be endured to participate in the unexpected and larger spikes upward. The proper strategy is to buy now, while gold equities are still historically cheap, and sell during the final panic stage when they should be many multiples higher.

Yours,

Dan

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