Myrmikan Update

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QEII: Dingy in Disguise?

On November 3rd the Federal Reserve seemed to meet, and even exceed, market expectations of money printing. Financial markets cheered, and speculators bid risk assets higher. However, the future outcome for nominal prices is far from certain.

Accepting the Austrian view of the credit cycle, each inflationary cycle requires greater money printing and lasts for a shorter period. History, including recent history, supports this thesis. The 1990s recession was mild, requiring little intervention since the system was still robust from Volcker's shock treatment ten years earlier: Greenspan merely had to keep interest rates below 5% for three years to reflate the economy. Ten years later, in the greater recession of 2001, Greenspan took interest rates below 2% for three years. Only seven years later, in the crisis of 2008, Bernanke had to take rates negative by printing $1.3 trillion to prop up the economy. That recovery lasted a mere two years before rolling over.

Now, despite nearly a year of discussing "exit strategies," Bernanke is embarking on additional money printing. Goldman Sachs estimates that the economy needs $4 trillion of additional printing to stabilize. Indeed, Austrian theory would suggest that the additional printing should be greater than the previous episode to create an expansion. Instead, Bernanke announced only $600 billion of printing, less than the printing in 2008. One should, therefore, expect the economy not to show similar signs of recovery as in 2009. Instead, the economy should continue to worsen, putting pressure on financial markets and banks' balance sheets until QE expands.

The Goldman Sachs report calling for the $4 trillion figure did not anticipate that Bernanke would announce such a figure all at once, but suggested the dose would be increased over time. Even one of the Fed governors, Charles Evans, called the $600 billion merely "a good place to start." But without knowing if and when the Fed will embark on the expanded printing, it is impossible to predict the direction of the market prices since it is impossible to gauge market expectations. As usual, Mises best describes the dynamic:

> [The price premium] comes into existence step by step as soon as first a few and then successively more and more actors become aware of the fact that the market is faced with [inflationary] cash-induced changes in the money relation and consequently with a trend orientated in a definite direction. Only when people begin to buy or to sell in order to take advantage of this trend, does the price premium come into existence.
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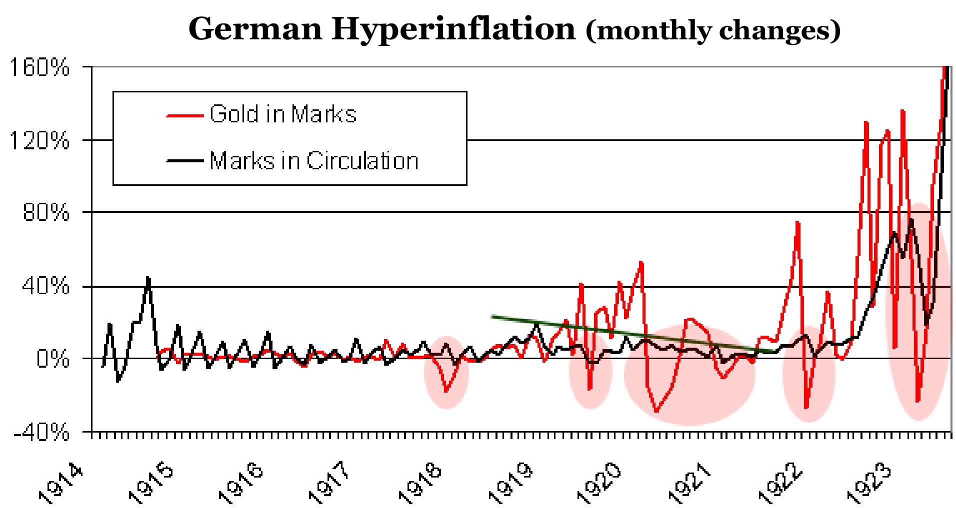
> It is necessary to realize that the price premium is the outgrowth of speculations anticipating changes in the money relation. What induces it, in the case of the expectation that an inflationary trend will keep on going, is already the first sign of that phenomenon which later, when it becomes general, is called "flight into real values" and finally produces the crack-up boom and the crash of the monetary system concerned. As in every case of the understanding of future developments, it is possible that the speculators may err, that the inflationary or deflationary movement will be stopped or slowed down, and that prices will differ from what they expected.

It is the last sentence of the preceding quotation that should concern speculators in the gold market, since gold is most sensitive to changes in the money relation, and gold mining stocks are more sensitive than gold. As the price premium grows in response to greater and greater money printing, small changes in the inflationary acceleration that deviate from market expectations can cause great dislocations in market prices.

The case of Germany in 1920 has been discussed in a previous Myrmikan update, but it is worth revisiting briefly to elucidate this point. As the chart below shows, in 1920 even though the number of marks in circulation continued to rise, the rate of increase slowed. It is clear from the chart of gold that the speculators erred: they did not anticipate the deceleration of money printing. Even though the number of marks in circulation was always expanding, the gold price crashed 60% in mid-1921. This also occurred during the periods highlighted by the other red circles: every time money printing slowed gold crashed, even though the number of marks never shrank. The end game was clear, and those that clung to the gold life-raft saved their wealth, but those with a short-term perspective were wiped out.



Examining why the Reichsbank behaved as it did reveals parallels that may portend a sharp gold correction in the intermediate future. From 1914 to 1919 the German money supply grew 11.2 times, but prices increased by only 52%. This discontinuity is explained by the discussion of cash balances in the previous Myrmikan Report. As long as the authorities were able to print without price increases, it seemed like a free lunch. But then the damn burst. Prices rose five fold during 1919. This inflation surge forced a chastened central bank to slow the printing rate, as the green line on the chart above shows. They held the line until mid-1921, during a period which the press at the time described as "general liquidation," before the economic pain forced a resumption of the money printing. After that prices went vertical.

In our own time, Bernanke defended his latest bout of money printing by pleading that most measures of inflation are running below 2 percent. The flawed CPI, which confounds asset values with goods prices, gives Bernanke his cover, just as the slow increase in prices until 1919 allowed the recklessness of the Reichsbank. But, like 1919 Germany, the inflation in goods prices which currently is noticed by some will be soon be obvious to all.

It is well known by professional traders that commodity prices have surged higher in the past few months, but consumer inflation has not risen nearly as much. This is because futures prices are abstract concepts, battlegrounds for hedge and pension funds, at least until the settlement date. Once real economic actors, such as primary producers, begin taking delivery at elevated prices, price increases flow up the supply chain, and inflation hits the consumer within months. This process has just started.

According to Bloomberg, low-cost clothes stores, such as Gap, are facing price hikes of 30% from their Chinese suppliers. This seems cheap given that cotton prices themselves have risen 70% in the past year. The missing 40% comes out of profits and wages, putting additional pressure on asset prices and consumption. The commodity costs of food have similarly spiked in the past few months. Few of these increases have hit the retail consumer yet, but they're in the pipeline as the primary and then intermediate producers adjust.

It is impossible to say what affect this transformation will have on gold prices. On one hand, perhaps a terrified public rushes to physical gold and silver, overwhelms the massive paper shorts held by the major banking cartel, and pushes prices into the stratosphere as the LMBA and COMEX default. Trying to temper this rush, last week the CME raised margin requirements on silver by 30%, sparking the initial sell off. On Tuesday, the CME raised the silver margin requirement an additional 12% and gold by 6%, sparking another massive sell off. These actions are bullish for the metals, not bearish. Although the initial effect is to clean out highly levered participants who don't have the resources to post additional margin, it's a signal that capital is racing to the safety of precious metals.

Moreover, higher inflation will increase gold-standard chatter that now emanates even from respectable sources such as Robert Zoellick, head of the World Bank. Mainstream media stories reporting these musings don't mention that any such move would require gold to be valued at several thousand dollars an ounce.

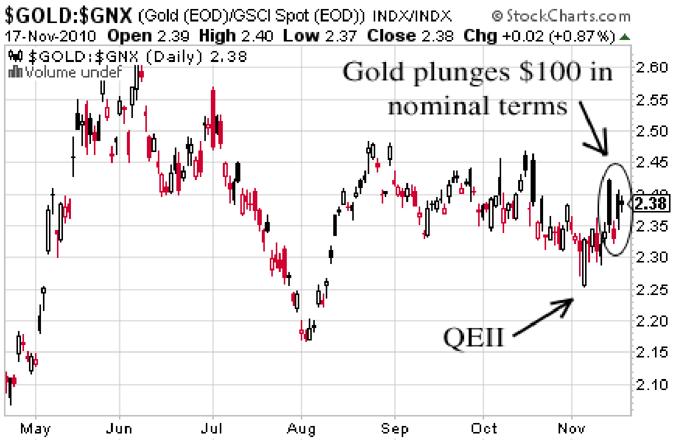
On the other hand, a raging inflation obvious to all may create a political environment that forces the Fed to suspend QEII, as it did to the German Central Bank in 1919, upsetting market expectations, which would cause a deflationary shock sending nominal asset prices, including gold, plummeting. Of course, the shock would also cause banks to close, businesses to fail, unemployment to spike, and politicians to be defunded. It is likely that, as in 1921 Germany, the country would be willing to accept only so much pain before demanding a resumption of money printing, which would cause the hyperinflationary end-game.

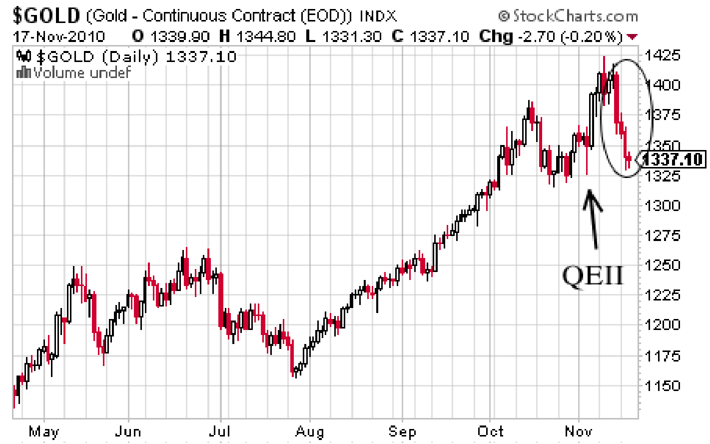
These possibilities are a few months out. In the immediate future, the market is waiting to see how the ECB reacts to new pressures on the weaker European states. On Sunday the Portuguese foreign minister suggested that his country may leave the eurozone. On Tuesday Austria announced that it would not fund its share of the Greek bailout because Greece has breached its fiscal commitments. And today the head of Ireland's central bank announced they would accept a European bailout.

Assuming the Europeans in the form of the ECB are not ready to let the grand experiment collapse, Europe may find itself shortly in need of its own QE, perhaps backed by expanded swap lines from the Fed. Perhaps this back door expansion of credit will give the economy the extra kick it needs to expand one more time. In any case, it is hard to imagine that any such outcome would be anything other than extremely bullish for asset prices in the short term.

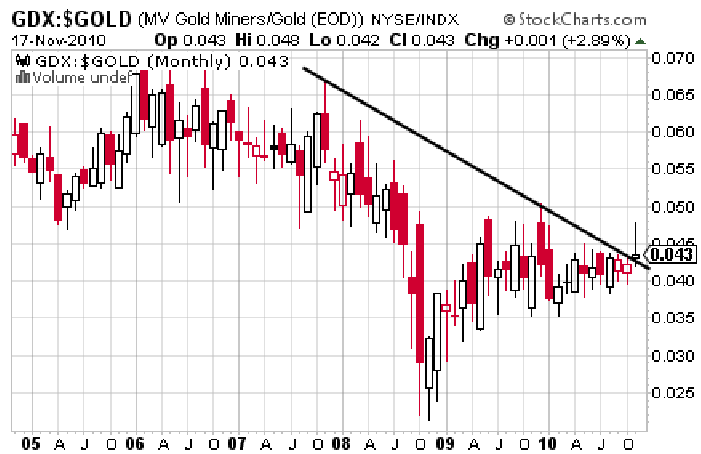
Given all of these cross-currents, each of which can have dramatic effects on nominal prices, a trader plays a dangerous game. Fortunately, the gold investor with a long-term view need not worry about which outcome transpires and when, since the inflationary outcome speaks for itself, and even in the deflationary case gold will vastly outperform in real terms as credit levels plummet through default. Of course, bank statements don't show purchasing power terms, only dollar nominal values, which would fall, shaking confidence.

Gold mining shares will be even more affected by these outcomes, perhaps experiencing a repeat of the 2008 crash if the Fed actually puts on the brakes. Nevertheless, as the real value of gold continues to rise, these shares will ultimately pay off vastly more than an investment in gold itself because of operational leverage on improving fundamentals. In fact, as the gold-to-commodity ratio chart on the next page shows, during the sell-off this week the real price of gold rose, having bottomed on the very day QEII was announced. Whereas, the nominal price is back to where it was before the announcement.





Meanwhile, as the chart below left shows, the gold shares, which had just poked their heads above the three year chart neckline, got pummeled along with the nominal gold price. Given improving fundamentals, this is likely a test of support before the real spurt begins. The chart below right shows gold shares in terms of gold, which is similarly testing its breakout.



It seems right now is a time to be aggressive since current news and the charts remain extremely bullish for gold. But central bankers are not insane – they will not go easily into the hyperinflationary vortex. Once they start resisting, the real volatility will begin. Presumably by then gold and gold shares will be much higher. But even if the short-term disappoints, the end-game is clear.

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