Myrmikan Update

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Summer PIIGSUS Roast

The May 2010 Myrmikan update predicted that Greece, the other PIIGS, and eventually even the U.S. would default on their sovereign debt. The argument rested on an insight by Ludwig von Mises that the function of debt is to expend capital in order to create a new capital asset that repays the debt with interest. But, in Mises's words:

> if the government invests funds unsuccessfully and no surplus results, or if it spends the money for current expenditure, the capital borrowed shrinks or disappears entirely, and no source is opened from which interest and principal could be paid. Then taxing the people is the only method available for complying with the articles of the credit contract. In asking taxes for such payments the government makes the citizens answerable for money squandered in the past. The taxes paid are not compensated by any present service rendered by the government's apparatus. The government pays interest on capital which has been consumed and no longer exists.

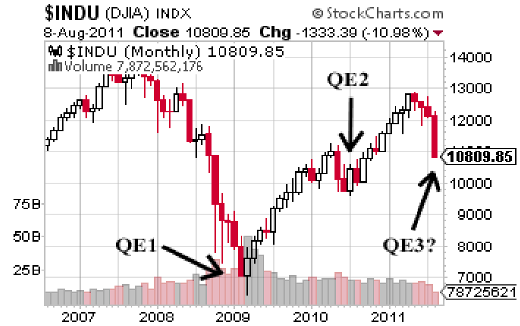
Since government debt is nearly always malinvested, or used for present consumption, the capital represented by government debt rarely exists. Eventually, taxpayers tire of paying ever more money for which they receive no present services, they revolt, and the government defaults.

A Bank of America research report, referenced in the same Myrmikan update, took the opposite, then-mainstream view of the debt crisis. The report argued that the Euroland bailout fund would easily float the Eurozone until the end of 2011, at which point the recovery would be underway and tax revenue would enable the euro countries to pay their debts. Bank of America specifically forecast that no country in the Eurozone would default.

The events of the past week dramatically support the Austrian view. That Greece will default is now a given, and the question has moved to whether Italy and Spain will also default. Meanwhile, the downgrade of U.S. debt by S&P brings into focus the appalling fiscal conditions in this country, worsened by the recent debt ceiling deal that back-ends illusory spending cuts.

The U.S. likely will never technically default because, as Alan Greenspan said on Meet the Press last Sunday: "The United States can pay any debt because we can always print money to do that. So there is zero probability of default." But this should be small comfort to bond holders, who will be paid back in worthless currency.

Another holding of Austrian economics that has been proved correct is that a credit bubble economy relies on falling interest rates first, and then increasing rates of money printing. In addition, the fractional reserve banking system is always insolvent and similarly depends on accelerating money printing to remain liquid.



It should be no surprise that the market rallied off the bottom in 2009 when the Federal Reserve began its initial round of money printing. Then, as the injection wore off in mid-2010 the economy rolled over and the market fell. QE2 sent the market higher and eased credit concerns in the banking system. Now that injection has worn off, and, as predicted, the banks are again experiencing liquidity concerns as spreads widen and the stock market is collapsing.

True to script, ever more commentators and officials are calling for more monetary and fiscal stimulus. On Monday, Kenneth Rogoff, despite authoring a book subtitled Eight Centuries of Financial Folly, nevertheless called on the Fed to expand its asset purchase program saying "they need to move much more decisively."

Tuesday's action, in which the Fed suggested it will hold rates at 0% for at least two years, will not suffice, but should not be underestimated. The Fed often claims it controls short rates, but the market controls long rates. This is untrue. Long rates are merely the anticipated average of a series of short rates. To illustrate, let's say the Fed were to set one-year rates at 3% and the market were to set the two-year rate at 5%. In this case, the market is really predicting that a year hence the Fed will fix one-year rates at 7% (ignoring compounding for simplicity). Otherwise, if, for example, the market thought the one-year rate a year hence would be only 5%, all borrowers would borrow for a year at the 3% rate and then roll over for the succeeding year at 5%, for an average rate of 4%. No one would borrow money on a two year term 5%. For their part, speculators would sell the current one-year (driving up the yield) and buy the two-year (driving down the yield) until the three rates were in equilibrium.

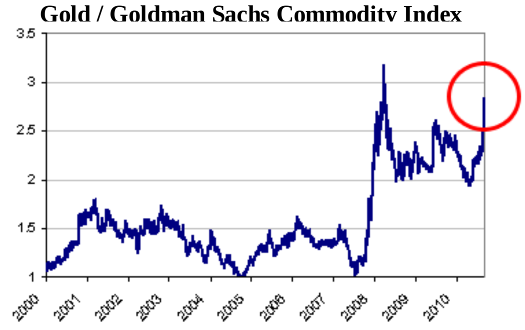
In this way, the entire yield curve has no relationship with inflation, but is completely self-referential, determined by the expectations of Fed controlled short rates over time. The hope and assumption of conventional market analysis is that inflation does drive interest rates because over the long term the Fed will alter short rates to contain inflation. But this assumption may be incorrect. For example, Rogoff also called for a "sustained burst" of 4-6% inflation for several years to reduce societal debt burden, a suggestion welcomed by the Keynesian set of Krugman et al.

So, on Tuesday, when the Fed governors replaced the assumption of inflation-containing short rates with an expectation of 0% rates for at least two years, the two-year rate sank from 0.27% to 0.19%, along with the rest of the yield curve. The market believes them. The fact that these rates are strongly negative in real terms and imply wealth confiscation for bond holders is irrelevant. It is the spread-traders operating on massive leverage that control the price, and they make money on the shape of the yield curve, not on its height.

The expectation of low rates is intended not just to help debtors stay liquid, but also to force capital into higher yielding assets. This is why the S&P surged over 6% after the announcement. Of course, gold also responds to negative interest rates, and it too surged to new highs. A Goldman Sachs report stating the widely held opinion that QE3 is now likely by early 2012, also helped both markets.

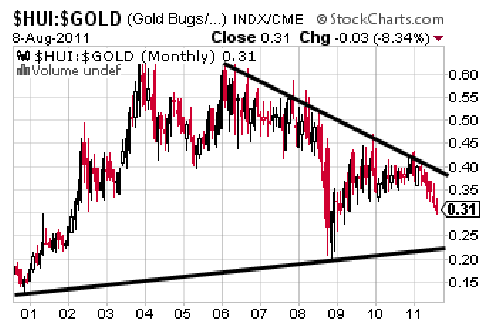
Meanwhile, over in Europe, EuroQE1 has already begun with the ECB buying Spanish and Italian bonds without sterilizing them. The purchases are still small, kept tentative by the Germans, whose collective memory still retains the horrors of hyperinflation. But, given Germany's interest in keeping the Europroject alive, it is likely it will relent and allow the multi-trillion euro printing required to delay collapse.

Fortunately, investors in gold need not speculate on which kind of default, non-payment or inflation, Europe and the U.S. will choose. Default in either form will cause credit levels to fall, and the core Myrmikan thesis, inferred from Austrian economics, is that gold's purchasing power rises when credit levels fall. This position, too, has been proved correct. Over the past week oil and copper, the bellwether industrial commodities, have collapsed even as gold surged. While most investors focus on the dollar price of gold, which can fluctuate wildly, few see through the Fed's charade and focus on gold's purchasing power which, as the graph above shows, is approaching 2009 panic highs.



Unlike Keynesian models, which have routinely failed in their predicative abilities, the implications drawn from Austrian economics have provided a perfect roadmap for the bubble economy and now its implosion.

One thing the Austrian perspective has yet to provide is extraordinary returns in the gold mining sector. All gold stocks, especially junior gold miners, have underperformed as against gold. The chart at right shows the ratio of the large cap gold stocks to gold itself. The downtrend that began in 2006 continues, with August being the worst month since the recovery from the crash in 2008.



But, the present is the mirror imagine of the peak in 2004. As the gold to commodity ratio chart above shows, the fundamentals of gold mining worsened from 2001 to 2008. Gold stocks in mid-decade were held aloft only by Greenspan's liquidity. Currently, the fundamentals for gold mining are dramatically improving, yet the stocks are being held down by the lack of liquidity in the market. It important to remember that gold stocks are still stocks, and margin calls in other market sectors can turn owners into forced sellers. Eventually the fundamentals will dominate valuations.

A case in point is Newmont Mining, with a current market capitalization of $27 billion. Two weeks ago the company announced that its net income for the quarter rose 37% to $1.06 per share for continuing operations (against analysts expectations of $0.99) and boosted its quarterly dividend 50% to $0.30. The stock fell 4.5% over the next two trading sessions, pushing its PE ratio below 12 and its yield above 2.2%. For comparison purposes, this is the same yield as the 10-year Treasury, an instrument guaranteed to lose value to inflation.

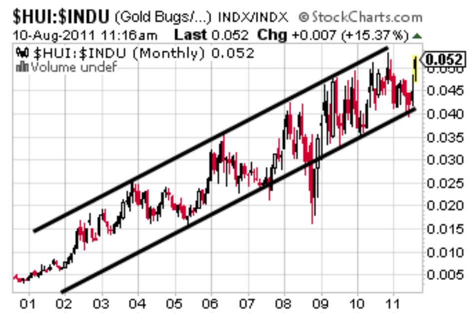
Pierre Lassonde, president of Newmont from 2002 to 2006, commented on King World News:

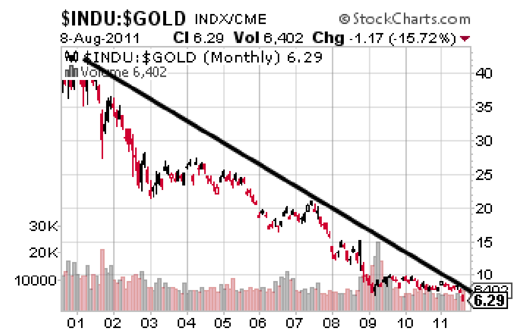
> When I was president of Newmont in 2004 gold was $450 and the stock was $60. The stock today is $55 and gold is $1600. Is that normal? No! Not at all! It's way, way undervalued! The stock should be easily between $80 and $100, minimum. And at $2000 gold it should be more like $150.
>
> The portfolio managers are completely oblivious to what's happening. They think that the gold price at $1600 is a bubble. They're going to find out it's not a bubble, and then they'll all want to pile in, and that's what will give the performance to the gold stocks. It's a great bargain; it's an occasion for the smart people.

While it's true that costs have gone up since 2004, they have not risen nearly as much as gold prices: Newmont's income in 2004 was $1.00 per share, as opposed to analysts' estimates of $4.25 per share for 2011. And, there is no doubt that the gold price and Newmont's income will both be higher than analysts' expectations. In short, the stock price is ridiculously cheap.

What is true of the majors like Newmont is far more so for the juniors because they are more operationally levered to the gold price. In addition, the majors must buy juniors to replenish resources, and so valuations of the majors have a direct influence on takeover prices, and therefore implied valuations, of the juniors.

Lassonde's comments about portfolio managers is also worth noting. On one hand, physical gold is bought mostly by sovereigns and other very large institutions like the University of Texas. Those buyers don't need convincing. Shortly after gold cleared $1000 an ounce, India bought 200 tons of IMF gold in a move some claimed was pegging the top of the market. In the last two months South Korea, Thailand, and even Greece have been accumulating gold above $1500. This suggests central bank support if the price should fall.





Gold stocks, on the other hand, are bought by portfolio managers, who mostly still agree with Keynes and Warren Buffet that gold is a barbarous relic. They are oblivious of the chart at right, which shows the ratio of gold stocks against the DOW Industrials. Even if goldbugs are disappointed with the gold stocks' return against gold, at least they have been massively outperforming the broader market. Funds won't be able to ignore this performance forever, especially since investors in conventional stocks have been slaughtered over the past ten years. The lower chart shows the DOW divided by gold. It represents the retirement dreams of millions of Americans, and it has now burst through the panic low of 2009. The difference, of course, is there is no volume spike. Thanks to Bernanke's dollar depreciation, nominal prices seem stable compared to 2008, so retirees, unaware that their wealth is slipping away, haven't dumped all their holdings, yet. They will. This chart is going below 1.

Manipulation of nominal prices can't hide economic reality beyond the short term. The economy and the broader markets are going to get much worse. QE2 provided a short opportunity to get out of conventional stocks and into gold. QE3 may also halt the decline for a short period, at a lower level. But the processes are accelerating and the total credit collapse, which would put gold over $10,000 an ounce, while still distant, is now visible on the horizon.