Myrmikan Update

February 1, 2012

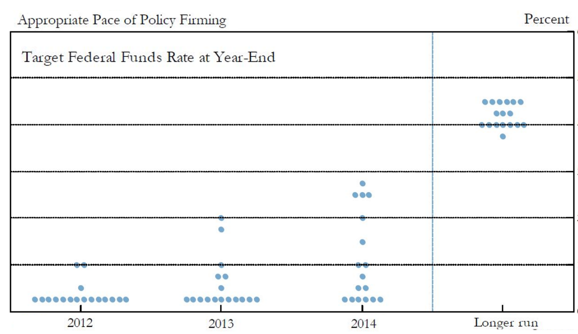
Daniel Oliver
Myrmikan Capital, LLC
doliver@myrmikan.com
(646) 797-3134

Déjà Vu

On January 25, the Fed announced it expects to keep interest rates at zero – not just until mid-2013, which it had announced on August 9, but until the end of 2014. As discussed in the Myrmikan Update dated August 10, the yield curve does not react to inflation expectations, but is instead completely self-referential: the 3-year bond yield is nothing more than the expected average of short-rates for the next three years. Yet again, the market believes the Fed. From January 24 to 31, the yield on 3-year Treasury dropped from 0.39% to 0.30%, and the yield on the 5-year dropped from 0.92% to 0.71%.

In the aftermath of the August 9 announcement, gold quickly rallied to all times highs. The market understands that interest rates at zero imply inflation, negative real rates, and, therefore, wealth confiscation by the state of those holding dollars. The longer rates are held at zero, the more inflation there will be, and the more detrimental it will be to hold dollars. Not surprisingly, gold has gone straight up since the Fed's latest action.

At the press conference following the announcement, Chairman Bernanke displayed a graph showing future rate expectations of each member of the committee. The two anonymous raised dots above 2012 represent the hawks who are the most economically sound. The six on the bottom in 2014 represent the politically astute. But, all lack imagination by assuming the 0% lower bound on nominal interest rates.



On January 31, the Treasury Borrowing Advisory Committee of the Securities Industry and Financial Markets Association (consisting of JP Morgan, Goldman Sachs, Bank of America, PIMCO, BlackRock, etc.) wrote a letter to the Secretary of the Treasury saying: "It was broadly agreed that flooring interest rates at zero, or capping issuance proceeds at par, was prohibiting proper market function. The Committee unanimously recommended that the Treasury Department allow for negative yield auction results as soon as logistically practical." Once and future Goldmanite Secretary Geithner will act on this proposal.

If predictions of 0% rates represent optimism, the cluster in the "Longer run" box represents pure fantasy. By now it should be clear that rates will never rise, at least not until the dollar has passed the event horizon of hyperinflation, just as the "temporary" increase in the Fed's balance sheet in late 2008 was not and cannot be reversed. Ludwig von Mises may have provided the best explanation as to why, but, long before his writings, harsh experience had already taught that an economy dependent upon inflation must receive accelerating doses of money printing to remain stable. The only two possible outcomes for an inflationary economy are an economic crash if the printing ceases, or else destruction of the currency through hyperinflation. In 2015, rates will either still be at zero (or lower) if the currency remains viable, or they will be well into the double digits chasing inflation higher.

Most market participants do not understand Austrian School economics and allow nominal price changes to shake them out of their gold positions, the best protection from currency destruction.

For example, Dennis Gartman, currently the most widely followed trader, declared the death of the gold bull market on December 13 at $1660 an ounce. True to his calling, he avoided a year-end plunge to $1531. The week of January 25, having missed the large gold rally, and facing the prospect of buying gold back at a higher price, Gartman opened a position in copper. Instead of holding the money of ascendent Western Civilization, he got stuck with the money of ancient Mesopotamia. This is not progress.

Gold investors who understand the Austrian School theoretical framework can ignore short term prices and instead focus on long term trends. Most market participants had to wait for the Fed's announcement to panic back into gold, which shot higher. Austrians anticipated the announcement, and understand why many more will come.

Bernanke built his reputation as an expert on the Keynesian perspective of the Great Depression. In this view, three main errors were committed: first, the government did not spend enough; second, the central banks did not print enough and; third, central banks did not coordinate their actions.

No massive spending program will emerge in this election year, meaning monetary authorities must lead. Moreover, they must lead together. As Bank of England Governor Mervyn King remarked after announcing more money printing last October: "Our fate rests to a considerable extent on the policies pursued by our trading partners. . . . Countries have responsibilities to each other, and we need to work with our partners."

King took credit for the November 30 coordinated action to expand the swap agreements among the Bank of Canada, the Bank of England, the Bank of Japan, the European Central Bank, the Federal Reserve, and the Swiss National Bank. What matters is not who led it, but that all the central banks were willing to participate.

The purpose of the swap agreement was to flood the world with dollars in a stealth QE. In his infamous 2002 deflation speech, Bernanke said:

> The Fed can inject money into the economy in still other ways. For example, the Fed has the authority to buy foreign government debt, as well as domestic government debt. Potentially, this class of assets offers huge scope for Fed operations, as the quantity of foreign assets eligible for purchase by the Fed is several times the stock of U.S. government debt.

Domestic politics currently prevent the Fed from purchasing foreign assets, but the swaps achieve the same thing. The Fed prints dollars, which it swaps for newly printed euros from the ECB. The ECB lends the dollars out to banks in exchange for collateral. If the collateral is, for example, European government bonds, then the Fed achieves its goal without one man in a million understanding the shell game.

But the trick didn't work. The current pain point in Europe is sovereign debt denominated in euros. The Germans will not permit the ECB to engage in wholesale money printing, memories of Weimar hyperinflation being too fresh, so the ECB was forced to engage in its own subterfuge to ease the credit crisis. On December 21, the ECB launched a program whereby banks could borrow money for three years at 1% in exchange for virtually any kind of collateral. The ECB lent 523 banks €490 billion in exchange for tainted sovereign debt.

The effect of the ECB's action has been widely debated among strategists. Some argue that it is no more than stealth QE. The banks can now borrow unlimited amounts of money at 1%, and then lend it out to the sovereigns at much higher rates, capturing a spread while funding profligate countries. Others, such as Marc Chandler of Brown Brothers, argue that the banks are already too exposed to sovereign debt, and so they will instead use the new money to reduce their own leverage, meaning no QE. Both views are myopic.

The market will not allow the value of a bank note to be worth more than the assets backing it, unless there are liquidity dynamics whereby a critical mass of economic agents require the notes to pay current debts. As discussed in the Myrmikan Research Report *Liquidity*, this is precisely the situation developed economies find themselves in. Money is fungible, and so it is not material whether the newly printed money alleviates the cash needs of intermediary banks or sovereigns. An added supply of euros satiating the immediate needs of debtors, the overall demand for the currency will slacken, and its value will fall. And so it did, helping debtors and exporters alike.

There was a view in late December among serious people that the Eurozone might not make it to 2012. Though the endless conferences continue, the newly printed euros removed the immediate danger. As ECB President Draghi commented in Davos:

> If you take 0.5 trillion euros and then you take off the reimbursement of other short-term facilities by the banking system in December, you get a figure of roughly 220 billion euros which is exactly the amount of bank bonds that were to come due in this period of time. So we know for sure we have avoided a major, major credit crunch, a major funding crisis.

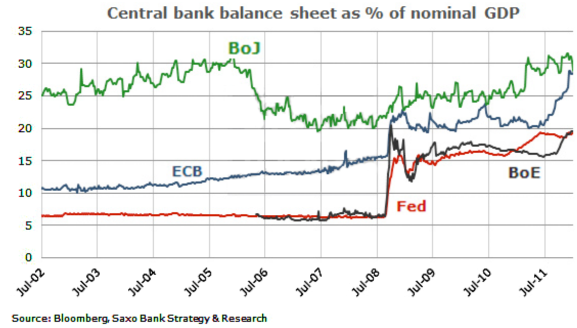
The next Long Term Refinancing Operation is scheduled for February 28 and promises to be even larger than the first. In fact, the Financial Times reports estimates topping €1 trillion.

With the Europeans in full print mode, coordination demands the other central banks follow suit. The Fed's January 25 action was met by the Bank of England, which, on the same day, released the minutes of its previous meeting: "For some members, the risks of undershooting [the inflation target] meant that a further expansion of asset purchases was likely to be required." "Further" and "likely" are the words to focus on.

The Bank of Japan made news by rebuffing calls from lawmakers to expand its asset purchase program. But, this overlooks the fact that as recently as October the BoJ expanded it current QE program to 5 trillion yen. It is only the "further" part to which the BoJ objects, and perhaps not even that strongly. In late January, Governor Shirakawa commented: "We need to pay attention to the impact of the yen's strength on the economy," telegraphing more printing when required.

Meanwhile, the Swiss National Bank is currently neutered having had its head ousted by opposition politicians who discovered his wife was front-running the central bank with currency trades of her own, in one more example of the crumbling edifice of central bank respectability.

With the ECB, BoJ, and BoE all printing, the Fed must act in a coordinating fashion. And, given the introduction of politics into central banking, Bernanke has an extreme, even personal, interest in seeing Obama reelected. Telegraphing interest rates will not suffice. The next round of money printing must be well timed to take maximum effect in the lead up to the election, which means soon.



While the central bankers move the pieces around the board, secure in their mathematical models, the real world reacts. On January 23, Israeli news source DEBKAfile, which has a decent track record of leaking accurate confidential Middle East security matters, reported that Iran had set up agreements with India and China to trade oil for gold, bypassing the global financial system controlled by Western central banks.

The fact that the story even could be true illustrates that there are alternatives to fiat currency to which economic agents can flee when the political and economic costs mandate. It also reminds that gold is the only viable alternate currency for trade -- swapping oil for any other hard asset would be mere barter.

On January 27, Dennis Gartman repurchased gold in euro terms, well above where he had sold it. And so, the momentum of the trader, which had pushed gold to oversold levels at the end of 2011, is now operating to slingshot it, along with the gold miners, in the other direction. When QE3 is announced, as it inevitably will be, the momentum traders will be joined by new investors, frightened out of their dollar holdings, to drive gold and gold stocks to new highs.