Myrmikan Update

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On February 29, Federal Reserve Chairman Bernanke testified before the House Financial Services Committee. The hearing began at 10:03, Bernanke began speaking at 10:23, but gold began falling at precisely 10:00, the moment at which the transcript of his remarks were released. The fall accelerated into a rout forty-five minutes later during the question and answer period, finishing down nearly 5% for the day, the largest daily drop in three years. Gold has continued falling, now down 8% since Bernanke's testimony.

Bernanke's remarks were not positive. On unemployment he said:

> The unemployment rate remains elevated, long-term unemployment is still near record levels, and the number of persons working part time for economic reasons is very high.

On wealth:

> The fundamentals that support spending continue to be weak: Real household income and wealth were flat in 2011, and access to credit remained restricted for many potential borrowers.

On economic activity:

> [the Federal Reserve Banks] projections for growth in real GDP this year . . . have a central tendency of 2.2 to 2.7 percent. These forecasts were considerably lower than the projections they made last June . . . [partly because] fiscal and financial strains in Europe have weighed on financial conditions and global economic growth.

On the outlook:

> Looking beyond 2012, FOMC participants expect that economic activity will pick up gradually as these headwinds fade, supported by a continuation of the highly accommodative stance for monetary policy.

No reading of his prepared remarks could interpret his comments as threatening to remove the proverbial "punch bowl" and justify gold's plunge. Instead, the drop was blamed on Bernanke's failure to provide a firm target date for additional money printing. Goldman Sach's Jan Hatzius reinforced this view in a March 15 report: "we still expect another asset purchase program . . . either at the April 24-25 FOMC meeting or the June 19-20 meeting" because "not easing might be equivalent to tightening."

With this comment, Goldman unknowingly stumbles into Austrian Business Cycle theory. As Mises explained long ago, an economic boom brought about by credit expansion can only continue if interest rates continue to fall, meaning money printing must expand at an accelerating rate. Even though QE2.5, Operation Twist, remains ongoing, QE3 must begin soon to keep growth at 2%. Goldman knows it, and so does the Federal Reserve. But many market participants do not.

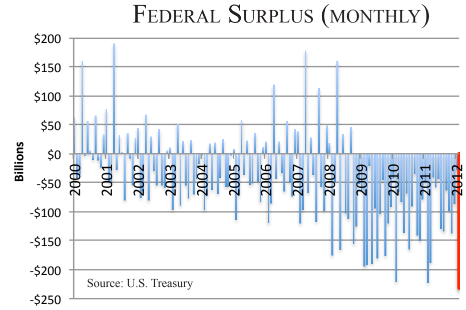
The Federal Reserve is different than most other central banks in that it has a dual mandate to promote not just a stable price level but also full employment. The consensus view is that if unemployment numbers are falling and prices are rising near the Fed's target rate of 2%, at least officially, then no more action may be required, providing less reason to hold gold as a safe haven.

There are two problems with this view. First, unemployment may be falling, but it is still remarkably high. And, as former head of the Federal Reserve's monetary division Vincent Reinhart told Bloomberg this week: "It's a simple formula. The Fed has a dual mandate. It's noticeably short on one, and the other is not a risk. Therefore, it has a responsibility to act." Reinhart, currently a Visiting Scholar at the American Enterprise Institute, is supposed to be a conservative.

Second, it misses the subsidiary role of the Fed, which is to ensure the government remains fully funded: if the government cannot sell its debt, then interest rates would rise, and that would cause the economy to decelerate and unemployment to increase. If unemployment increases, then tax revenues decline and demand for government services rises, creating additional funding needs and even higher interest rates. The PIIGS countries have recently discovered this feedback loop, and the only reason the U.S. has avoided it so far is the willingness of the Fed to engage in multiple rounds of asset purchases to keep the government funded and interest rates low.

For this reason, the key metric to anticipate Fed action is not the much manipulated unemployment rate published by the Bureau of Labor Statistics, but instead the size of the Federal deficit, a real time measurement of economic activity. As the chart at right shows, February had the largest deficit ever, revealing the recovery to be imaginary.

FEDERAL SURPLUS (MONTHLY)



It is not coincidence that this record deficit, along with a view that the Fed will not increase its asset purchases, corresponded with the 10-year Treasury yield breaking out to the upside.

Although rates are still absurdly low, the Fed cannot risk any instability in the Treasury market. Indeed, in order to keep the credit bubble intact, rates must continue to decline. Thus, things will rapidly become more interesting since federal deficit figures are set to increase dramatically.

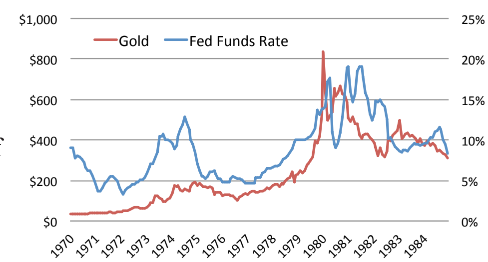
Government projections show the deficit, which is running at $1.3 trillion this year, should begin to decline. Not only do all of the temporary and extended tax cuts expire at the end of 2012, but many of Obama's tax hikes commence at the same time, safely after the election. Moreover, the formulaic spending cuts from the failure of the deficit super committee are also scheduled to begin in 2013. Even with these transformations, the Congressional Budget Office projects a deficit of $977 billion under Obama's proposed 2013 budget. The actual deficit will be much larger.

The CBO is infamous for its use of static analysis. For example, the CBO assumes that if tax rates double, then revenue will double as well. The U.K. recently demonstrated the absurdity of this assumption when its government reported on February 21 that increasing the top income tax rate to 50% from 40% actually produced a decrease in revenues.

If Congress once again delays implementation of fiscal austerity (the more likely outcome) then deficits will remain outsized. Conversely, if tax rates in the U.S. increase according to plan, not only will revenues shrink, but the economy will suffer prompting additional government expenditures, expanding the deficit still further. Either way, the Fed will heed the call to monetize the new, "transient" deficits. When it does, be it in April or June, gold should run strongly to the upside.

In the meantime, gold and gold stocks remain under pressure. Most Wall Street presentations on gold ownership premise the investment on the fact that there is no opportunity cost to holding gold at zero interest rates. If this view were correct, then the rising rates exhibited in the 10-year Treasury chart would serve as another reason why gold has fallen sharply since Bernanke's testimony. But, as explained in numerous other Myrmikan materials, the reality is exactly the contrary.

The dollar is defined as a liability of the Federal Reserve and is backed by its assets. When the market forces interest rates up, the Fed's liabilities remain constant while the value of its bonds fall. Gold must increase in terms of dollars to keep the balance sheet balanced. The chart at right is a constant reminder that rising rates are not negative for gold.



In the short term, gold is faced with a multitude of crosscurrents, including rumors of European banks selling to meet margin calls and louder rumors of government manipulation. According to multiple sources, an order to dump 3 million ounces at market was received during Bernanke's testimony. Of course, no economic actor would place such an order, as it guarantees the worst possible price. The sharp sell off triggered stop loss orders and margin calls that sent gold tumbling further.

It had become an open joke that gold rockets every time Bernanke speaks, and perhaps this was his revenge. Myrmikan allocates little time to analyzing accusations of manipulations in the gold market, since they are difficult to prove and are by definition temporary. A marvelous little book called Forty Centuries of Wage and Price Controls by Robert L. Schuettinger and Eamonn F. Butler quickly removes any doubt that markets are more powerful than men:

> For the past forty-six centuries (at least) governments all over the world have tried to fix wages and prices from time to time. When their efforts failed, as they usually did, governments then put the blame on the wickedness and dishonesty of their subjects, rather than upon the ineffectiveness of the official policy.

Most recently, on February 22 Nancy Pelosi berated her wicked subjects for daring to discover price through markets:

> Independent reports confirm that speculators are driving up the cost of oil, hurting consumers and potentially damaging the economic recovery. Wall Street profiteering, not oil shortages, is the cause of the price spike.

Obama sprang into action on March 15 to punish the speculators by threatening to release part of the strategic oil reserves. No actual release being forthcoming, oil did not react, suggesting not that oil is scarce, but money too plentiful.

Whether gold is currently suffering from margin sales, Indian bullion dealers on strike to protest new taxes, Wall Street modelers who confuse gold's relationship with interest rates, or elicit sales by the government, in the long term gold will serve its ancient and unchanged function of measuring wealth and debt. Gold will continue to climb until the reckless spending by Congress is halted. Given that even Paul Ryan's draconian budget doesn't balance the books until 2040, there is no danger of gold ending its bull market soon.

As always, the short term outlook is much harder to predict. With economic weakness spreading to China and the stabilizing effects of LTRO wearing off in Europe, any hawkish comments from the Fed (meaning lack of dovish comments) could send the markets reeling, taking the gold markets down even further. However, a surprise announcement of additional easing would have the opposite effect, and gold would have to slingshot higher to realign with the broader equity markets.

Either way, gold remains the best defense against monetary mismanagement, and gold stocks remain extraordinarily cheap and levered to gold. It is important to remember that, first, all the money necessary for massive inflation has already been printed and, second, the Fed can control the nominal prices of assets, but not their real value. Regardless of what liquidity shocks may do to asset prices in the short term, deep economic trends will control asset valuation in the long term. It is for this reason that the best strategy with gold and gold stocks is to buy and hold, rather than trade for transient gains.

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