Myrmikan Performance Update

March 2012

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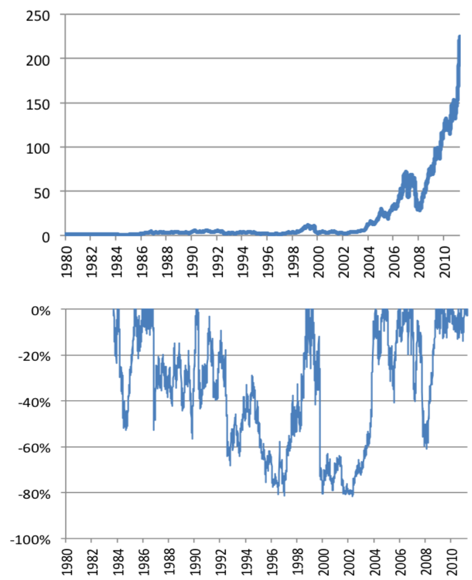
Drawdowns: On Volatility

Investors who liked gold shares a year ago have to love them today. Despite continued favorable macro trends and the opportunities for business development that rising cash flow and NAVs provide, gold shares have been slaughtered. As of last week, the large-cap GDX gold mining ETF was down 27% over the past twelve months, and down nearly 10% year-to-date, the January rally having reversed into another plunge. The mid-cap GDXJ gold mining ETF was down 47% over the past 12 months, and 9% year-to-date. Not a few gold investors have bailed out in disgust, driving shares still lower as institutions are forced to sell to meet redemptions.

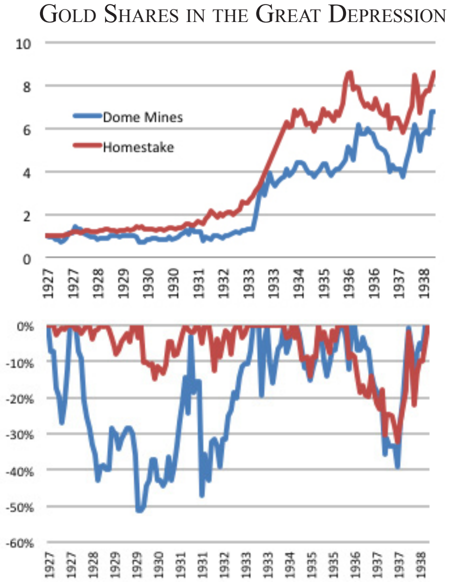
However, it is a comforting reminder that "bull markets" are so-called because volatility throws off most riders. For example, the chart at right shows the value of Apple stock, setting the initial public offering price at 1. Those that bought and held have made 225 times their money before dividends.

APPLE COMMON STOCK (IPO = 1)



The chart below shows the drawdown after each new all-time high. Apple stock has spent 30% of its trading days at less than half its interim highs. Those who held since the IPO had to experience peak-to-trough losses of 80% – twice! – and losses exceeding 40% several times. The most recent vertical spike beginning in 2008 occurred only after a 60% drawdown. The market exacts an emotional price even for those who can see the long-term future perfectly.

GOLD SHARES IN THE GREAT DEPRESSION



Gold bull markets are unlike other markets because of their force and violence. During the Great Depression, gold stocks rallied from around 1927 to 1938. It is difficult to find price series of individual stocks from this time period, but two of the biggest gold miners are available: Dome Mines and Homestake Mining Company.

As with Apple, the chart is clear. Whereas gold rose from \$20 to \$35, a 75% increase (and owners of gold risked prison since holding gold was a felony), these two mining companies climbed 7+ fold. Yet, investors had to stomach plunges along the way. Anecdotal evidence suggests the smaller gold mining companies rose much higher, but with more volatility.

For example, a Wall Street Journal article dated April 10, 1934, two months after gold had been revalued, related:

> Boom conditions continue to prevail in West African gold mining shares. Carryover shook out many weak bulls . . . . Shares are mostly in small denominations of from 1 shilling to 5 shillings . . . A few months ago, many of these shares could have been picked up for 2 or 3 pence a share [there were 12 pence to a shilling].

Two years later, on May 19, 1936, the Wall Street Journal records that the gold mining boom was still in full force:

> Recent price and activity in Canadian gold mining stocks have attracted substantial amounts of speculative money from New York to these securities. For several weeks, prices of gold mining stocks generally have been moving upward, and advances in some securities have been sensational. As heavy trading has shifted to the penny stocks, volume of trading on Canadian exchanges has been lifted to above the combined volume of trading on the New York securities exchanges.

Gold and Barron's Gold Mining Index (1960=1)

The gold boom of the 1970s differed from the 1930s in that it was driven by inflation, and not by a collapsing credit bubble. In those circumstances, one would not expect the mining shares to necessarily outperform gold itself. The shares did outperform, but not to the extent of the 1930s. The chart at right shows gold and the Barrons Gold Mining Index, consisting mostly of large companies.

In this, inflationary, boom the lower chart clearly shows that the higher gold and gold stocks went, the more volatile they became. In fact, the larger the drawdown, the sharper the subsequent rise. Those who bought and held made 30 times their money at the peak. Even after the market peaked, with Reagan and Volcker changing the conditions by reining in inflation, investors had a second chance to get out with a 25 fold increase – provided they hadn't sold into the 73% drawdown trough between peaks.

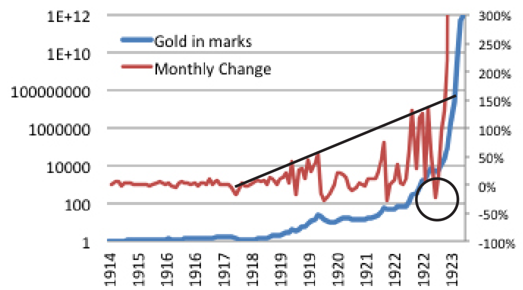
In fact, as discussed in other Myrmikan materials, it is the nature of gold bull markets to become ever more volatile the higher they go. The volatility is not necessary in gold, but in the currency in which gold is denominated. The cause is worth reexamining.

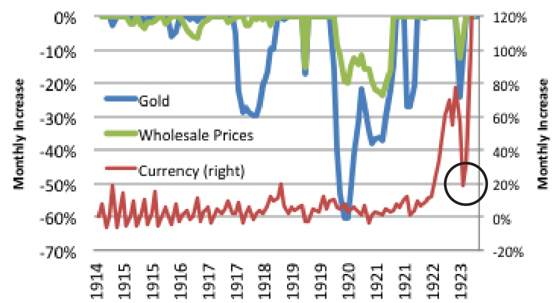
As often repeated in these updates, once an economy becomes dependent on money printing, it must receive accelerating doses to just to remain stable. The central bank must print money faster than market participants expect in order to fool businesses into mistakenly believing that additional savings exist, ready to be deployed.

As market participants become aware of the dynamics, expectations of future money printing become embedded in prices. First order expectations would mean that market agents expect a certain nominal increase every year. Second order expectations would mean anticipations of a certain percentage increase each year. Third order would imply that each year the percentage increase increases. For example, one might expect prices to increase 5% next year, then 10%, then 15%, etc. Then the degree of expected increase increases, etc.

Markets operate to create a net present value of all of the expected increases discounted back to the present. And, of course, the increasing price expectations must be supported by a central bank printing enough money. If more money than the market expects is printed, then prices rise, and vice-versa. The further into the inflationary spiral, the more degrees are being calculated by the market, and the more sensitive prices become to changes in how much money is actually printed.

Gold in Weimar Marks



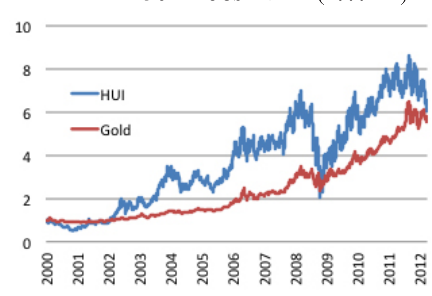


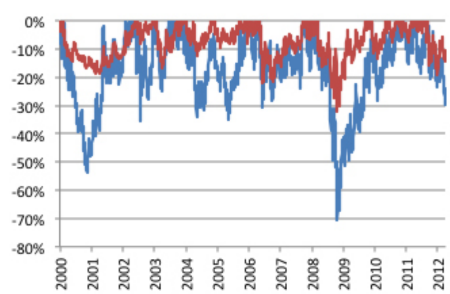
Looking at one of the most violent of all gold bull markets illustrates the point. The chart at right shows gold in terms of Weimar marks: a nearly perfect parabola on a logarithmic scale. Of course, gold was not rising in other currencies. The chart measures the mark's fall, not gold's rise.

The chart below shows that the trip to hyperinflation was hardly a smooth one. Holders of gold had to experience nominal drawdowns that were far greater than the fall in prices, representing serious losses of purchasing power. Gold holders were underwater for nearly two years after 1919. Even post-1920, when the rise in prices was obvious to all, gold suffered 25% losses at moments when the Reichsbank failed to meet market expectations of money printing.

It is also interesting to note that the most violent drop in the monthly change of gold occurred in the month before it goes completely vertical. The top chart ends prematurely: in October 1923 gold increased by 25,857%.

Amex Goldbugs Index (2000 = 1)





This history lesson has current application in that Bernanke's Federal Reserve has signaled that it has no plans to print more money. It will not be long before the economy will show signs of strain, and the gold market, the most sensitive area for symptoms of money mismanagement, is already reeling.

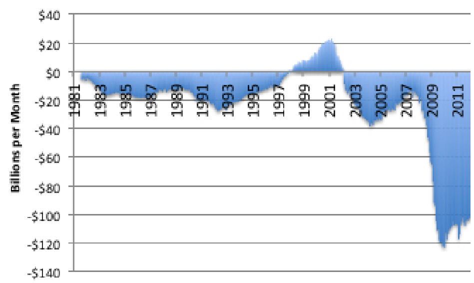
As of April, the Amex Gold Bugs Index has returned to levels first seen in November 2007, experiencing its sixth >30% correction since 2000. As discussed above, the correction in the smaller issues is even more severe.

There is no way to know how deep the current correction will go. Those trying to time these markets likely will be left behind. For example, legendary trader Dennis Gartman, having sold into the December decline and re-entered the trade at higher levels in January, has once again declared the end of the gold bull market and again sold into weakness. But, the evidence would suggest that as long as the gold bull market does remain intact, large drawdowns are harbingers of even sharper rises.

Therefore, the criteria for investors in judging the value of gold shares cannot be how they have performed recently, but rather whether the macro conditions that have driven the gold market thus far have ended. The main drivers of the gold markets are state and societal debt levels, the two factors that put pressure on the state to debase the currency.

Looking at government debt, the chart below left shows the 12-month moving average of federal government deficits. It is clear that the deficits of the past four years are unprecedented, and are now getting worse again. February had the largest deficit on record, and the deficit in March was the largest ever for that month. The chart at right is the same graph, only measured in ounces of gold instead of dollars. The market simply will not continue to advance credit to a profligate debtor. The government will find that it gets ever less purchasing power for each dollar it borrows.

Federal Surplus (12-month Moving Average)



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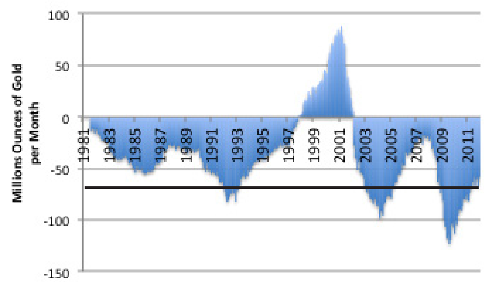
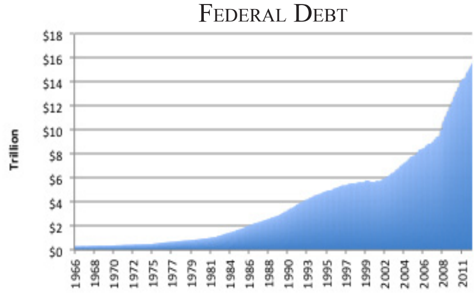
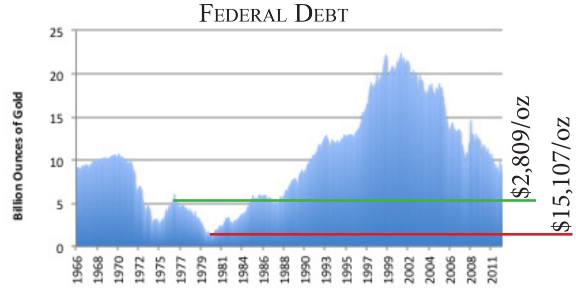


Not only is the market not allowing the government to borrow at the pace it wishes, but it automatically adjusts to write off bad debt. Already the debt level in terms of gold is only half what it was in 2000, even accounting for the massive deficits over the past decade.

Federal Debt



Federal Debt



Those who would argue that gold will plummet in value either do not understand gold's role of measuring value, or they implicitly believe that the sovereign credit of the United States will suddenly improve and deficits cease, an unlikely outcome. The debts and deficits in the graphs above are merely the on-balance sheet obligations. Including contingent liabilities such as the FDIC, the teetering student loan industry (27% of this federally backed $1 trillion market is at least 30 days past due) and, of course, Social Security and Medicare, the debt and deficits are vastly higher.

Gold acts as a store of purchasing power safe from the profligacy of politicians and speculations of bankers. The conservative can safely store a large percentage of wealth in the metal.

Gold stocks, especially junior gold stocks, are highly levered bets on gold which act as economic insurance: less capital exposure is required to protect the same amount of assets. As the economic news has turned positive over the past few months, with the broader markets rallying steeply, the perceived need for insurance has declined, sharply lowering its price. But, price and value are distinct concepts. It is precisely when insurance is priced the lowest that it has the most value, meaning now is the time to buy, not sell. And, the economic data is already starting to soften.

The 1936 Wall Street Journal article quoted above continued:

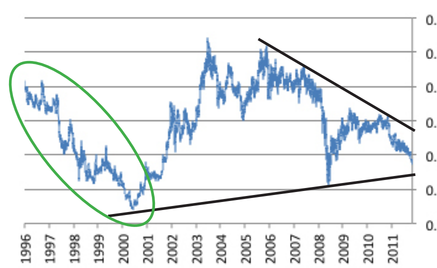
> Background for the little boom has been recent perplexing uncertainties in [the] world monetary situation. Uncertainties over [the] stability of the French franc, fears of inflation or further devaluation of the United States dollar have formed a basis for speculative activity in gold stocks.

Human nature does not change, and neither do the dynamics of credit bubbles and their collapse. By 1936 most of the necessary debt deflation had already occurred. The scares were mere aftershocks of the 1931 bond market collapse, an occurrence the world is still to experience in our credit bubble.

Gold spiked on Tuesday when the yield on Spanish 10-year sovereign debt crossed 6%, forcing European Central Bank executive board member Benoît Coeuré to reference the ECB's bond buying program. It is unclear which is more bullish for gold: a Spanish default or more money printing by the ECB, especially since the Fed and ECB are tied together with swap agreements.

The chart at right shows the depression gold stocks have been in as against gold since the peak in 2003. Gold executives of the senior companies are understandably embarrassed that their stocks' performance have returned sharply negative risk-adjusted returns in comparison with gold for the past nine years.

AMEX GOLD BUGS INDEX / GOLD



The lower chart shows that the gold-to-commodities ratio continues its long term rise, which will ultimately fuel the outperformance of the gold shares as against gold. It is difficult to imagine that the top chart will continue to fall while the bottom chart continues to rise. In fact, at a reading of 0.3, this ratio has now reached levels seen only in 2008 and before the gold bull began in 2001. A cheap asset can always get cheaper, but rarely has there been equivalent value in gold shares.

GOLDMAN SACHS COMMODITIES INDEX / GOLD

The drawdowns are certainly frustrating, but the returns should be worth waiting for. Senior shares will have to double against gold just to reach historically normal levels. As the gold-to-commodities ratio continues higher, driven by debt deflation, the senior stocks will rise still further. The smaller, more leveraged stocks will rise additional multiples.

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