Myrmikan Update

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Bottom Fishing

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If the most commonly known traders' adage is "the trend is your friend," its corollary is more colorful: "don't try to catch a falling piano." Those involved in the gold mining sector can testify to the results of disregarding this advice. After a year of falling prices, gold shares were routed in May. The mid-cap gold share ETF GDXJ fell 16.7% in the first ten trading sessions, and then fell an additional 7% on the eleventh, bottoming at negative 23.26%.

But, traders are not the only creatures to inhabit the financial markets: investors and speculators have different adages to live by. The investor desires not change, and attempts to find stable companies that will pay dividends over the long-term. The speculator considers the world as it is and positions his risk capital to profit from chances in circumstances he deduces should occur. This latter perspective requires action before market developments become obvious: falling pianos become opportunities to load up at cheaper prices, assuming the underlying thesis to be correct.

On June 1, the market suddenly realized that the economy is not recovering and more easing will be required, sending stocks down and gold soaring. As economic news darkened, Australia slashed interest rates by half a percent, and China followed, dropping rates for the first time since the 2008 crisis. The ECB cannot be far behind: the clear and present danger to Spain's finances cannot be solved with higher taxes on a non-working population. Monetary solutions will be necessary.

In fact, the news out of Europe is turning positively sinister. On Tuesday, reports emerged that the EU has contingency plans to limit ATM withdrawals and impose border controls should Greece leave the euro. Demonstrating verbal acrobatics achievable only by a professional bureaucrat, EU Commissioner Bailly stated: "I've not said that I'm not aware of any discussions, I've said I'm not aware about any plans, which is a slight difference."

Greeks, understandably, are not making this distinction between plans and discussions: outflows from Greek banks have been running between 500 and 800 million euros per day, according to Kathimerini, a daily Greek news source. Reports indicate that the funds are heading into German banks, euro or dollar denominated funds, and canned goods. Supporting this report, German Target2 balances grew another 8.4% in May, continuing its parabolic uptrend to reach a total of €699 billion. As a reminder, this is money owed to the Bundesbank by the ECB, secured by banking liabilities in the peripheral countries.

Greek elections are this Sunday. Because of a polling blackout, it is unclear who has the momentum, but events seem to favor Syriza, which is a Greek acronym for: Coalition of the Radical Left. Since the bailout terms announced for Spain are significantly better than those for Greece, Syriza argues that they can renegotiate the deal and remain in the eurozone. This position is a risky proposition: the main reason Germany cared about Greece was to prevent the contagion from spreading to Spain and Italy. The crisis having spread, Greece loses its leverage.

If EU commissioners are discussing methods to detach Greece from the EU, no doubt there are also discussions on the other side of the border. Greece would do well to consider Argentina, which has been an innovator in many aspects of finance. On January 6, 2002, Argentina forcibly converted dollar deposits into peso deposits at a ratio of 1:1.4. Perhaps more importantly, dollar loans were converted to pesos at a 1:1 ratio, while interest rates were frozen. On Monday, twelve and a half years later, the Wall Street Journal reported that Argentine President Cristina Kirchner has submitted a bill to allow dollar contracts to be repaid in pesos, once again proving the applicability of PT Barnum's observation to finance. What amazes is not €800 million of outflows per day from Greece, but that there remains around €170 billion in total deposits.

However, before sending their money to Germany, Greek depositors should consider the events surrounding the forcible breakup of the currency union of the Habsburg empire in 1919. Each country set short time frames during which holders of Austrian crowns had to have them officially stamped to retain their legal tender status. The purpose was to exclude foreigners, who would be unable to get their notes stamped in time. The point is, a deposit account is a liability of a bank, and there is no reason Germany could not legislate the deletion or diminution of liabilities to Greeks or other citizens of defecting nations. Alternatively, if Greece defaults on its Target2 liabilities and Germany honors its own liabilities, then its banks are threatened and will not provide safe haven. Canned goods may well be a better bet than any deposit account.

But, Greece is now a sideshow. The real developments are in Spain, where a bank bailout was announced with great fanfare over the weekend. Bond markets even rallied for a few hours before the realization that bailout money is supposed to come from the European Stability Mechanism – which Germany has yet to ratify – 30% of which is to be funded by Italy and Spain, and is also to be secured by a claim on Spain itself. So far, the proposal has had the following effects: a) the market now knows that the state of Spanish banks is dire, accelerating capital flight, b) private creditors to Spanish banks know they are about to be subordinated and so will continue to lend money only at usurious rates, c) since these same Spanish banks passed the recent stress test, the market will question other European banks, and d) yields on Spanish and Italian sovereign debt has reached new highs placing sovereign funding itself in jeopardy.

This has all happened before. In the late 1920s Austria forced a group of weaker banks to merge into the larger Creditanstalt, just as Spain forced the insolvent cajas into Bankia, among other institutions. The merger papered over the losses for awhile, but soon Austria was forced to guarantee the debts of Creditanstalt. By 1931, it was clear the bank was in serious trouble, impacting the creditworthiness of Austria and other banks. The French were prepared to act, but were overly aggressive in their political demands. Germany and Austria preferred the abyss. The failure of Creditanstalt precipitated the 1931 bond market collapse that forced devaluations across Europe and was the true beginning of the Great Depression.

Reprising the role of France, Germany is prepared to act, but there are conditions. As Chancellor Merkel said on Tuesday: "We must be prepared to give up national sovereignty to the EU" – presumably she was not using the royal plural, but was being inclusive of all the European states. She added: "it must always be ensured that joint liability and joint control lie within one hand" – the hand being the iron fist of Germany.

What did not work for France in 1931 is unlikely to work for Germany in 2012. At some point the EU will have to decide whether to print or die. The model is Japan: massive purchases of assets by the central bank.

In fact, on Monday Bank of England policy maker Adam Posen declared: "[it is] time for the major central banks, including the Bank of England, to engage in purchases of assets other than government bonds . . . [taking] the form of private sector securities for the time being. This will allow more direct targeting of financial sector dysfunctions, and greater impact on liquidity preferring investors' portfolios, thereby leading to greater impacts on confidence and on the real economy than a similar unit of QE on government bonds."

Obviously, any such action by central banks would send gold vertically to the upside. But, gold will rise in any case. In 1931, central banks did not have the authority or the Keynsian intellectual edifice necessary to allow them to engage in wholesale printing, coming so soon after the hyperinflations of the 1920s. When Creditanstalt collapsed, the market forced currency devaluations of debtor nations, and politics forced devaluations of creditor nations: gold will rise whether the ECB prints or not.

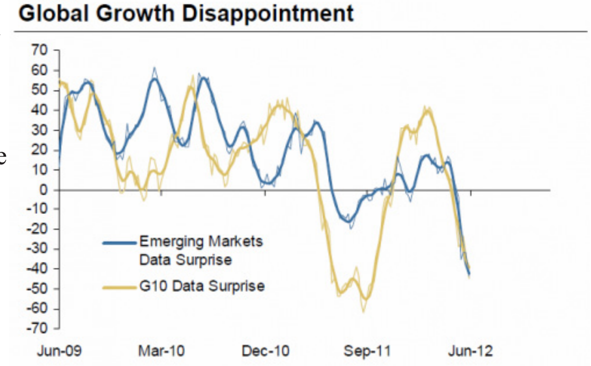
With Europe imploding and the U.S. election drawing near, the stakes grow ever higher for Bernanke. Obama is slipping in the polls and at fund raising, and there is, no doubt, intense political pressure for monetary accommodation (anyone who thinks that the Fed is truly independent should read Frederick Sheehan's *Panderer to Power* on Alan Greenspan's career).

The media's interpretation of Bernanke's recent prepared Congressional testimony was that he is resisting more easing. Once again, gold plunged during his testimony, briefly touching $1550. Gold stocks barely flinched. This suggests that all those who were inclined to sell have sold and that a bottom is firmly in place.

The more interesting part of the hearing occurred during the question period when Senator Casey directly asked if the Fed was considering more easing. Bernanke responded:

> That is the central question that we have to look at: will there be enough growth going forward to make material progress on the unemployment rate. My colleagues and I are still working on our own assessments, staff are working on their updated forecasts, and we will have a new round of economic projections by all the participants of the FOMC participants between now and the meeting [on June 19], and that's a key question.
>
> If we decide further action is required then, of course, we also have to decide what action is appropriate or what communication is appropriate. We have a range of options . . . The key question is: will economic growth be sufficient for continued progress in the labor market, and our mandate of maximum employment says we should be looking to achieve continued improvement.

Exhibit 1
Global Growth Disappointment



Source: Bloomberg, Citigroup, Morgan Stanley Research

Bernanke highlights that stability is not enough: there must be continued improvement to avoid additional money printing. The chart at right from Morgan Stanley shows the number of economic surprises, positive and negative.

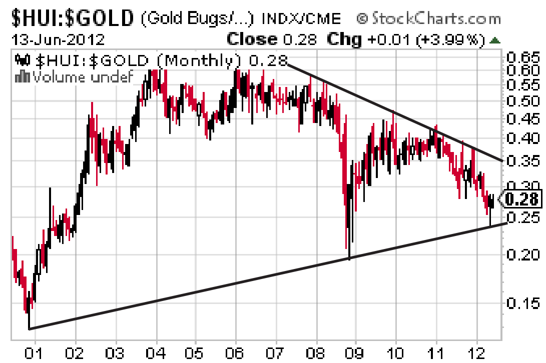
Bernanke is unlikely to print without the models in place to justify his actions, the reason the staff is hard at work. No doubt, charts similar to Morgan Stanley's are circulating. The fact that the employment numbers missed yet again on Thursday and that the CPI printed at negative 0.3% in May, the lowest reading since December 2008, can only help his case.

Whether Bernanke prints or not will dramatically affect all asset prices, especially gold. But, prices are a function of the value of the dollar, a construction of a bankrupt state. The economy, a field that comprises all human action, is larger then one man, no matter how powerful the central planning board he directs. Long term, gold must rise in purchasing power terms as surely as the U.S. debt burden can never be repaid.

Gold Over the Goldman Sachs Commodities Index

In fact, seeing through the dollar illusion, the gold-to-commodities ratio continues to creep inexorably higher, as the chart above demonstrates.

The chart at right shows that the ratio of gold to the senior gold stocks has touched its trendline and is bouncing higher. For this chart to return to 2006 highs, gold stocks would have to triple as against gold, and gold is unlikely to decline given the environment. Moreover, the chart above shows how much better the macro environment is for gold stocks, as compared to 2006.



It has been months of painful suffering for gold investors, but with events nearing a climax, the wait may soon be over. According to market historian Bob Hoye, 2012 has seen the sharpest decline in gold stocks since 1924, and all declines of similar magnitude have been followed by sharp, strong gains. The juniors have declined far more than the senior stocks, and should see an even more powerful bounce.

Even though gold at $1600 per ounce provides plenty of operational cash flow to production companies and substantial implied value for development properties, gold conferences are empty. Retail investors have left the sector. It is in such environments that bottoms are made.

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