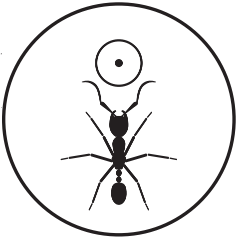

Myrmikan Update

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Gold Share Reflexivity

George Soros is famous for his theory of financial reflexivity: the idea that while values in a financial market begin as reflections of the economics of companies (or currencies), changes in market values influence the very economics the values are supposed to reflect, creating positive feedback loops.

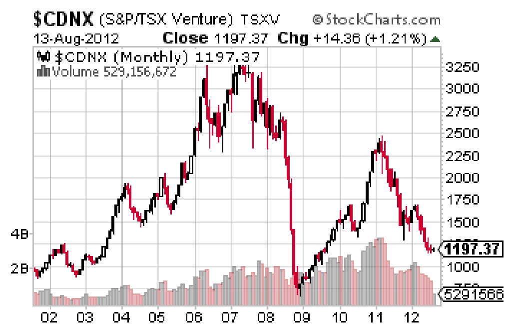
Consider his theory's application to gold development stocks: when a company with a gold project trades with a high equity value, potential buyers assign high values to the project and the company, confident that the company will be able to finance the project. In fact, the higher the stock goes, the easier it is to finance the project, and, therefore, the more value the project has to the company, and the more valuable the company.

However, if the market corrects lower and the value of the company shrinks, then financial observers will question how the company will finance the project, and therefore assign a lower value to the company, forcing the stock lower, reducing the value of the company, etc.

With the implosion of junior gold stocks, there is much chatter in the gold sector about the impossibility of financing the many NAV positive projects. With stocks so low, there is no reason to buy. What amazes is how short memories can be. The current situation is not worse than at the bottom in early 2009, when gold was 43% lower and capital was even scarcer, and that was an excellent time to enter the sector.

The chart at right shows the performance of the top 500 stocks on the Canadian Venture Exchange. While there are many gold companies in the index, it also includes base metal explorers, plus energy and biotech companies. A common characteristic is that most require external capital to execute their business plans.

S&P/TSX Venture Composite Index



The past year-and-a-half has been abysmal for companies in this position. Market participants wonder what will change the situation while they pine for central banks to intervene and re-ignite liquidity, replaying 2009.

So far, the authorities have failed to act. Despite clear signals from the ECB and Fed that they are philosophically inclined to print, larger political forces have stayed their hand. And, yet, despite the lack of fresh liquidity injections, the price of gold simply refuses to break down. The chart at right shows multiple attempts to break $1525, all rebuffed, and now the metal drifts higher.

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There is no lack of theories as to why this is so. Perhaps gold senses that the central banks will, in fact, resume printing in the Autumn. Perhaps the chart dusts the fingerprints of large purchases by Asian central banks, such as South Korea, which raised its gold reserves by 30% in July at $1582/oz setting a new floor for official buying. Perhaps the money already printed by central banks and bottled up in cash accounts and excess reserves is getting restless: if this reservoir were ever to pour into the market, prices would spike, no matter how the Fed were to react.

Unlike during QE1 & 2, the reasons for gold's recent rise are all speculative. But, prices trending without apparent fundamental reasons can herald growing subterranean forces that burst violently into view. The gold chart at any time could move chaotically to the upside.

The gold stocks have not yet inflected into rising, but have stabilized since mid-May: attempts to move lower are sharply rebuked by exploration and production companies alike. Meanwhile, the explorers continue to develop their projects with the cash hoards the more experienced or lucky management raised last year in more liquid circumstances, while the cashless have been discounted down to near zero. The producers continue to apply their cash flows to expanding their capital asset base.

There is nothing the companies can do themselves to alter the macroenvironment in which they are priced. However, those that continue development guarantee new highs when the positive feedback loop of higher prices reasserts itself in the next inflationary wave. Even the companies forced into hibernation probably represent good value at current prices – in fact, given their marginality, it is precisely the companies worst hit that should react the most when liquidity is reestablished.

The receding tide of liquidity has left gold projects stranded in the mud. But, admiring sea shells is a poor strategy when the animals are panicking to higher ground: the current sale prices on the gold miners is an opportunity that cannot last.

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