Myrmikan Update

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On the Precipice

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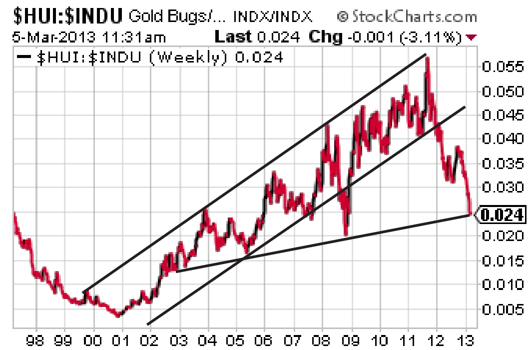
On May 15, 2012, the GDXJ mid-cap gold ETF plunged over 7% in one day on high volume, down 23% from the beginning of the month. This collapse was the culmination of a decline that had begun a year earlier in April of 2011 that resulted in a total loss of 57%. No one rings a bell at the top or bottom of a market, the old Wall Street adage goes, but the obvious capitulation was as close as it comes. After retesting the May low in July, gold stocks took off with the anticipation of further quantitative easing.

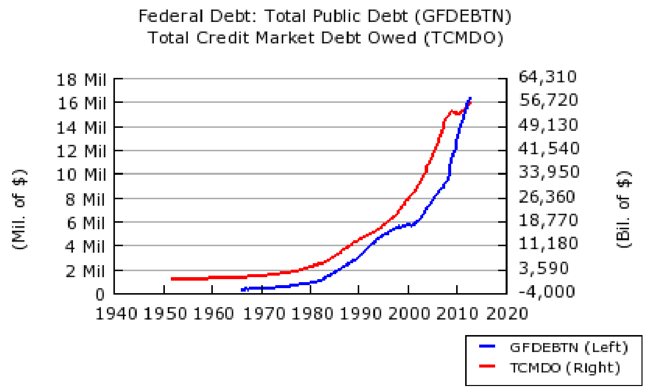
The re-election of Obama implying the reappointment of Ben Bernanke – or his replacement by someone even more dovish – seemed to herald a new beginning for the gold market. The real power of the Fed lies in Washington with the presidential appointees, and, in any case, the regional governors are dominated by the New York Fed, itself controlled by Goldman Sachs alumnus William Dudley. The triangle trade of Fed money issued to Wall Street banks to lend back to the Federal Government to distribute to its favored constituents will continue, despite the murmurings of lesser regional Fed governors.

But, shortly after the launch of QE3 – money printing without limit – gold prices began to soften and have now reacted down to the rising trend line as defined by the 2008 crash. As the top chart shows, gold stocks have breached the May 2012 bottom in a crash longer and now steeper than the one experienced in 2008.

Reports of large redemptions in gold funds continue to proliferate. And, as the broader indices power to new highs, gold investors must also suffer the mockery of mainstream investors. Indeed, the Dow-to-gold ratio has staged a powerful rally since gold's peak in 2011.

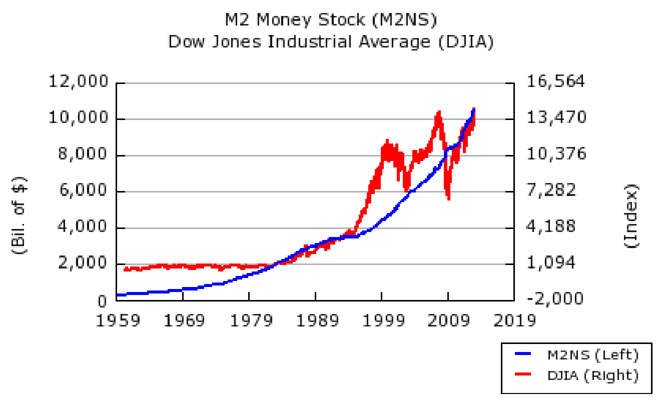


Moreover, the ratio of the Dow to senior gold stocks has collapsed back to 2008 panic levels, giving up half of the decade's gains, the junior gold stocks faring even worse. Such poor performance requires the gold investor to decide whether to salvage the remainder of his capital or stand his ground by reexamining the reasons he entered into the position in the first place.

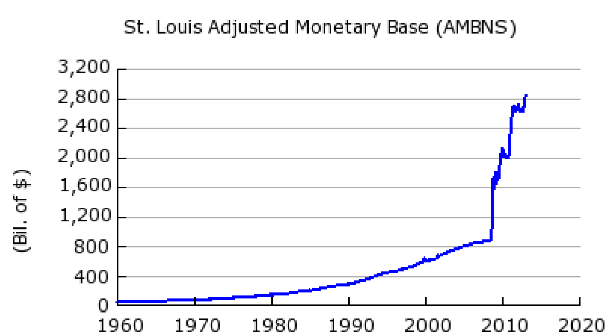


From 1981 to 2008, only professional investors were interested in the inner workings of the Federal Reserve. The Fed appeared deus ex machina during times of crisis, such as the 1987 crash and the collapse of Long Term Capital Management, cobbling together financial rescues in secret meetings, but otherwise it quietly did its job of containing inflation and lowering rates to mitigate recessions.

Indeed, any graph of any monetary measure of any importance showed nice, smooth parabolas. Even the stock market, if a little more jagged, had a nice parabolic trendline.



Then, in 2008, the world nearly ended. Not only did the broader markets plunge 50%, but the core banking institutions nearly collapsed. The meetings of banking titans were no longer secret: television broadcasted the worried faces shuffling in and out. Worse, the spectacle of characters such as John Thain holding his firm and the economy hostage for one more pay package, or Dick Fuld keeping his fortune while the other stake holders lost theirs, exhibited a sociopathy at the top echelons of power of which few were aware.



The shock of touring the monetary sausage factory evolved to fear upon realization that financial wealth depended upon structures the workings of which wealth-holders were only dimly aware. Over the past decades, many have grown wealthy because of free markets, the reason the capitalist West buried the communist East. Yet few had considered the incongruity that the free market had to be managed by the philosopher kings at the Federal Reserve. And, the method of salvation was wholesale money printing. Through 2005, the chart of the monetary base was also a nice, smooth parabola. In 2008, the smooth curve broke, with a vertical move higher. Fed actions have been headline news since.

The Fed Chairman assured us on December 1, 2008, even before quantitative easing began:

> To avoid inflation in the long run and to allow short-term interest rates ultimately to return to normal levels, the Fed's balance sheet will eventually have to be brought back to a more sustainable level. The FOMC will ensure that is done in a timely way.

The chart on the previous page tells the story. The balance sheet was not brought back to normal and instead, nearly four years later, continues to lurch higher. And, so, investors reached the first-level analysis of why to buy gold: if the Fed prints money, then each unit of money is worth less. Moreover, far from reaching "normal" levels, interest rates have plumbed seemingly impossible depths: what rational person would lend their money for 10 years at less than a 2% nominal return, below the Fed's own inflation target? If bank deposits and Treasury bonds, heretofore the safest place to store wealth, create guaranteed losses, then a new depository must be found. And, as the television ad says: gold has never been worth nothing.

As the bull market in gold developed, unverifiable factoids began proliferating through the internet, such as comparing the cost in gold terms of a Savile Row suit versus high-end 12th-century chainmail or Wonder Bread against loaves in the time of Nebuchadnezzar. This is not serious analysis but does reflect the historical fact that gold has been money for thousands of years. Yet few stop to consider *why* gold has been money or, indeed, what "money" is exactly, so most find it impossible to argue convincingly that gold remains money after Nixon's official demonetization. After all, you can't use it at the 7-11.

And, even assuming gold to be money, how would one price it? "Traditional metrics" certainly do not work. As is oft repeated, gold has no earnings calls and no yield, so the financially sophisticated place it with other similar objects which change hands for cash such as Ming vases or Monets. Gold is worth what the next fool will pay for it according to fashion, according to Warren Buffett.

But, there is a critical distinction between the market for Ming vases and gold. Gold trades 23-hours per day, in massive quantity – estimated to be $240 billion per day in London alone, with a bid/ask spread of only 0.006%. As a consequence of this activity, owners of gold know the instantly realizable value of their holdings with extreme precision at all times. And, holders of other assets can similarly calculate their precise value in terms of gold. Indeed, this liquidity for gold is not new. For thousands of years sellers of goods, instead of hunting for a barter counter-party, would instead trade their goods for gold and silver coins, store the coins, and then use them to buy the goods they wanted.

It was from this curious phenomenon, that "every economic unit in a nation should be ready to exchange his goods for little metal disks apparently useless as such" that Carl Menger developed his liquidity theory of money. Menger deduced that a party who must accept an intermediate good when trading one good for another will choose that good which offers the least transaction costs. Moreover, the more stable the intermediate good's value, the longer the trader can wait to perfect his transaction, and the more flexibility he has. Gold is money because it is the element with the most spatial and temporal liquidity. Money was not constructed self-consciously, it emerged as a necessary convention to facilitate trade. Gold was not designated as money by committee and cannot be unchosen: gold best fits the need for the mediate good that enhances trade.

Critics of Menger point out that there have been constructed currencies. The euro, for example, or the iron money of Sparta. But Sparta was the original communist community. The iron tokens served for distribution of the goods produced by the Helot slaves, not for trade. As Plutarch tells us:

> for, [the money] being of iron, it was scarcely portable, neither, if they should take the pains to export it, would it pass amongst the other Greeks, who ridiculed it. So there was now no more means of purchasing foreign goods and small wares; merchants sent no shiploads into Laconian ports; no rhetoric-master, no itinerant fortune-teller, no harlot-monger or gold or silversmith, engraver, or jeweler, set foot in a country which had no money.

The Spartan system of distribution persists in such claims as food stamps, which are a growing part of the modern political economy. But, Menger's theory does not imply the state lacks the power to abolish or control money, merely that to the extent it does so trade will whither. Meanwhile, the euro, constructed by committee, has disrupted the trade and the capital markets of Europe. As the turmoil grows, increasing taxes and emerging capital controls are transforming the currency into distribution tokens, harming trade and capital allocation further.

Menger's theory implies that for gold to be money it must have the most stable value of any other good. In fact, though gold may not be very stable in terms of dollars, it is extremely stable when compared to commodities over the short term and general purchasing power over the long term. The instability of the price of gold in dollars reflects problems with the dollar, not gold. And, the parabolic increase in the price of gold over the past thirteen years reflects an exponentially decaying dollar.

Yet, it is, perhaps, surprising that the dollar has lost so little value over the past four years. While the monetary base has nearly quadrupled since the financial crisis began, neither gold nor the general price level have kept pace, even after correcting for the absurd CPI index. This relative strength of the dollar seems to contradict the proposition that twice as many dollars should halve their value and undermines the first-level argument to buy gold. More sophisticated analysts point out that the true "money supply" in an economy consists of not just the monetary base, but the credit money issued by banks as well, dramatically increasing the monetary denominator. Throw in a monetary velocity chart and the amateur monetary theorist is hopelessly lost, the simple relationship replaced by dynamics too complex to analyze. Calculating a fair price for gold becomes impossible.

There is, in fact, a clearer perspective. Attempting to determine a fair gold price or predict changes in the general price level by examining the changing quantities of dollars assumes a quantity theory of money. That is, it is the number of bank notes outstanding that determine their value through an interplay of supply and demand. Menger's liquidity theory suggests this is not how bank notes are valued in the market.

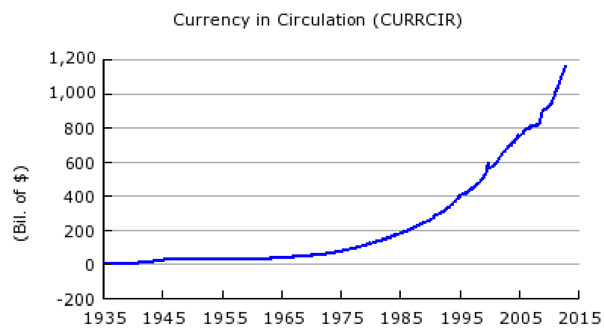
Instead, as presented more completely in the Myrmikan Report: *Liquidity*, it is the assets backing bank notes that determine their value. Briefly revisiting the argument: the first banks were private organizations that issued notes against deposits of gold and silver. When the notes returned to the bank, the specie was refunded. Merchants preferred bank notes because they were more liquid than gold coin and could always be redeemed on demand because the bank held 100% reserves. The notes behaved as mere warehouse receipts for the gold.

It should be obvious that the quantity of notes issued by these banks should have no effect on prices. For every note added to the money supply an equal amount of gold was withdrawn, and vice-versa. As long as the backing is maintained at 100%, there could be no inflation. This is why the quantity theory of money as applied to dollars is flawed.

Imagine, however, that the banks collectively were suddenly to double the number of outstanding notes without increasing the amount of gold backing them: the value of the notes would halve, and the general price level in terms of their notes would eventually double. Or, similarly, if the banks were to lose half their gold, the effect would be the same *even though the number of notes outstanding remained constant*. In other words, it is the quality of the assets backing the notes determines their value, not the quantity of the notes.

This, currently archaic, liquidity view of money received unlikely support from Chairman Bernanke during his *60 Minutes* interview in 2010:

> Well, this fear of inflation, I think is way overstated. We've looked at it very, very carefully. We've analyzed it every which way. One myth that's out there is that what we're doing is printing money. We're not printing money. The amount of currency in circulation is not changing. The money supply is not changing in any significant way. What we're doing is lowing interest rates by buying Treasury securities. And by lowering interest rates, we hope to stimulate the economy to grow faster.

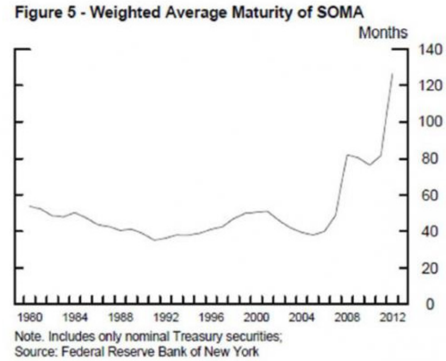


Beyond the obvious falsehood, as revealed by the Fed's own data on "currency in circulation" at right, the Chairman's point is actually a good one. The Fed isn't actually printing dollars and dropping them from helicopters, yet, it is swapping new Fed liabilities (known as dollars) for newly acquired assets. Per the argument above, if it were acquiring gold with the new dollars, there should not be any inflation. Instead they are buying 30-year Treasury bonds at market. As long as these bonds have a value similar to what the Fed paid for them, there should not be much inflation, and there hasn't been.

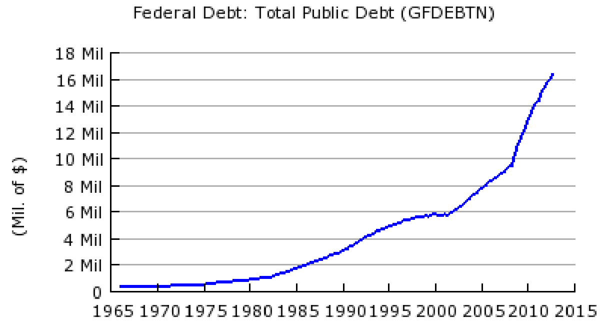
But, what would happen if, like the example above where the banks lost half their gold, the bonds were to lose half their value? Then, presumably, the notes' value should fall and prices should rise. Thus, according to Menger's theory, the inflation from the Fed's actions should manifest not when they print the money, but instead if and when the bonds they are buying fall in value: it is the quality of the bonds that must be analyzed to predict the future value of the dollar and the equilibrium price for gold.

Bonds can lose value in two distinct ways: if default risk rises or if interest rates increase. These two risks are also related: if interest rates rise, and a debtor cannot pay off his debt upon maturity but must roll it, then the debt becomes harder to maintain, increasing default risk (which feeds back into the interest rate), a dynamic several European countries have recently discovered. In addition, the longer duration a bond, the more sensitive its value to interest rates.

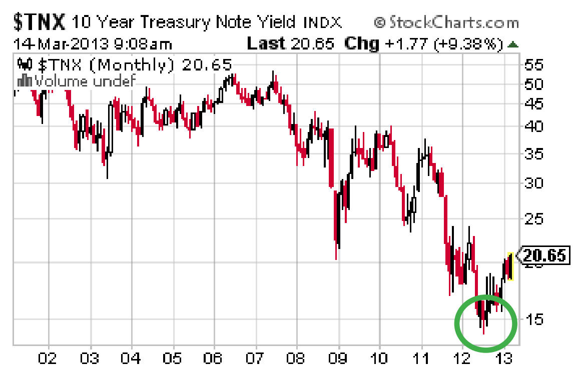
The Federal Reserve is currently buying long-term Treasury bonds, including 75% of the 30-year Treasury issuance, which currently yields just over 3%. The top chart shows how dramatically the Fed's duration risk has increased over the past decade. The next chart, the trajectory of the Federal debt, suggests the credit worthiness of this debtor is not good.



In fact, the Fed has created a bubble in Federal debt. For the past three decades, the Fed has expanded its balance sheet driving Treasury bonds higher in price and yields lower. Sophisticated bond traders learned to front run these uneconomic purchases to make risk-free profits. The opportunity to front run the Fed became an even surer bet since QE began, with the Fed announcing precisely when and what it would buy. As long as Wall Street players could get risk-free money from the Fed, there was little reason to engage in risky speculation.



But, there will be an inflection point when the dollar gains will generate purchasing power losses. The sophisticated money will then abandon bonds and turn to hard assets to preserve the profits they have made. This precipice may be at hand. Even though the Fed has been buying $85 billion worth of bonds every month, yields have made a powerful move higher. It would not be the first time yields moved higher only to find a lower bottom later. But, the absolute nadir in yield will be identifiable only in retrospect, the reason it is prudent to maintain some exposure to gold investments in any market condition. Because, when the Treasury market cracks, interest rates, inflation, and gold will surge simultaneously in a non-linear fashion.



If rates were to jump a mere 4%, the market value of the Fed's holdings would decline by about 35%, meaning prices in dollars would jump 50%. This is the static view. The actual situation would be much worse. First, a disorderly decline in the dollar would cause rates to surge much higher as bonds were dumped on the market from levered, distressed holders. Second, the higher rates go, the harder it will be for the government to roll its $16 trillion of debt and the more pressure on private debtors with floating debt, adding default risk to the Fed's bonds. Third, the Fed recently began paying interest on reserves to entice the banks to keep the excess reserves sterile under the theory that it would be irrational to lend to a private buyer at a similar to rate to what the Fed would pay. Bernanke has stated that as rates rise, the Fed will increase its payments to the banks, meaning the faster the value of its assets shrink, the faster its liabilities will grow, and the more they will lose value.

Fed officials deny there is any risk to its balance sheet or the dollar if interest rates rise. The Fed receives a constant income stream from its bond portfolio. It keeps enough to fund its expenses ($4.2 billion in 2011) and pay a 6% dividend to its shareholders. The balance is sent to the Treasury ($89 billion in 2012, or 8% of the federal deficit). Yes, under this cozy arrangement, the Treasury gets to spend the money from its bond sales and then receive back the interest it pays on the very same bonds.

Under Fed accounting conventions, bonds held by the Fed are marked to par value, so losses occur only if the Fed sells a bond for less than it paid for it. If losses exceed its income, then the Fed creates a negative liability and makes no remittance to the Treasury until income has been sufficient to cover the losses.

A recent Financial Times article pointed out that the banks currently hold $1.5 trillion in excess reserves at the Fed, so 4% interest rates would provide them risk-free income of $60 billion per year even while the Fed's payments to Treasury shrank to zero, exacerbating the deficit. As James Bullard, president of the St. Louis Fed, told the paper: "Well that's more than the entire profits of the largest banks." But, he added: "I think it's more just a question of the optics, and how you're going to play the optics. . . . it shouldn't matter in a monetary policy sense."

The "optics" of having the Fed paying tens of billions to private banks and nothing to Treasury are so bad that at his recent Congressional testimony Bernanke now suggests that the Fed could avoid all capital losses by simply holding its bonds to maturity. And, because there would be no realized losses, the Fed could keep remitting its interest income to the Treasury, payments that would keep growing in proportion to the Fed's balance sheet.

His position is, of course, technically true. But, it is a curious development for a man who said only three months ago:

> We've been very clear that this is a temporary measure . . . We've been equally clear that we will normalize the balance sheet and reduce the size of our holdings . . . so again this is only a temporary step. It would be a quite different matter if we were buying these assets and holding them indefinitely. That would be a monetization. We're not doing that.

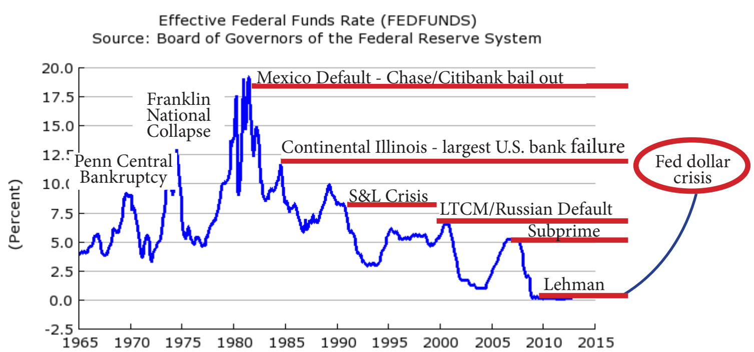
Now it seems they *would* do that if enough political pressure were exerted. But, Bernanke's intentions are irrelevant as are the technicalities of how the Fed chooses to report its balance sheet. The Fed currently reports the gold on its balance sheet at $42 an ounce, but that doesn't mean gold is worth $42 an ounce. The Fed can choose to report its bonds at par, but that does not make them worth par value.

When the liabilities of a company or bank decline suddenly in value and the institution is liquid, it can buy back its liabilities in the market earning a free profit and support their value. If the liabilities of the Federal Reserve, collectively known as the dollar, were to lose value suddenly, the Fed has nothing it can sell to buy back its dollars in the market. The mantra of bond traders is "Don't fight the Fed." For decades that has meant buying bonds when the Fed is buying. If the Fed starts selling, so will every bond trader, and the bonds will collapse in value.

The inflation implied by a quadrupling of the Fed's balance sheet is latent and will be released when the Treasury market breaks. The minutes of the most recent Fed meeting admitted: "Some participants mentioned the potential for a sharp increase in longer-term interest rates to adversely affect financial stability and indicated their interest in further work on this topic." That concern should be read in conjunction with the following, disturbing resolution:

> By unanimous vote, the Authorization for Domestic Open Market Operations was approved with two amendments. The first broadened the actions that the Open Market Desk may take, at the Chairman's instruction during an intermeeting period, to include transactions to address temporary disruptions of an operational or highly unusual nature in U.S. dollar funding markets. For example, if secured funding rates were to increase to high levels in the wake of a natural disaster, the risk of a broader, more systemic disruption to the functioning of asset markets could result. In this case, the prospect that repurchase operations could potentially alleviate some of the market strains might warrant immediate action. Consistent with Committee practice, the Chairman, if feasible, would consult with the Committee before making any such instruction.

In plain language, if the dollar faces a disorderly decline with interest rates shooting up, instead of selling assets to defend the dollar, the Chairman, personally, will buy every Treasury offered for sale. This resolution may be intended as a warning to bond speculators, but also reveals the Fed will choose hyperinflation over a deflationary systemic collapse.

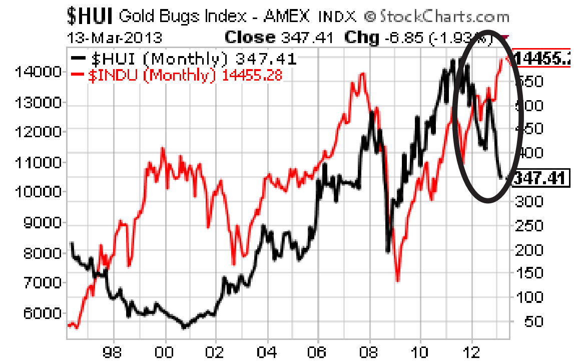


For decades, every time interest rates rose, a financial crisis appeared that required Fed action. The Fed's balance sheet is now full of illiquid, long-term assets. It will be unable to absorb the liabilities it has issued when they face a disorderly decline in value. It is impossible to determine precisely how far the dollar will fall when rates finally rise, nor is it clear what effects rising rates will have on the $500 trillion of interest rate derivatives held by the major banks. But, it is certain that gold will retain its role as the most liquid asset and, hence, money and act as a store of value through the collapse of the dollar and the banks.

Armchair philosophical musings on monetary policy have not yet helped investors following the precepts of Austrian economics grow their wealth. As shown above, gold has been a terrible relative investment for eighteen months, and gold mining shares have been a horrible investment from any perspective. Speculators want to know when the shift of wealth from paper to gold will take place. Ironically, the shift may be happening presently, even as most are abandoning or being forced out of their positions.

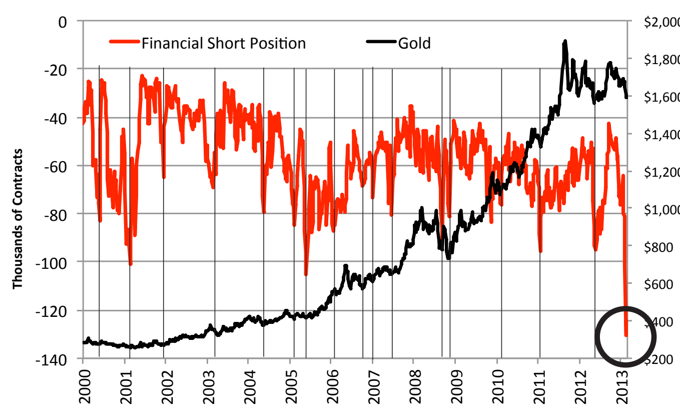
According to the prevailing facile logic, when rates rise so will the opportunity cost of holding gold, and so gold must decline. And so it has. But, the reasoning is faulty and there are several anomalous features about the latest rout in gold.

First, as the ratio chart on the second page shows, the HUI gold stock index has handily outperformed the Dow since 2000. The chart at right shows that since 2003, the two markets have moved in the same direction, the HUI's outperformance being driven by a larger amplitude with an upwards bias. This changed in mid-2011, reverting to the relationship last seen as the Dow went over the bubble peak in 2000.

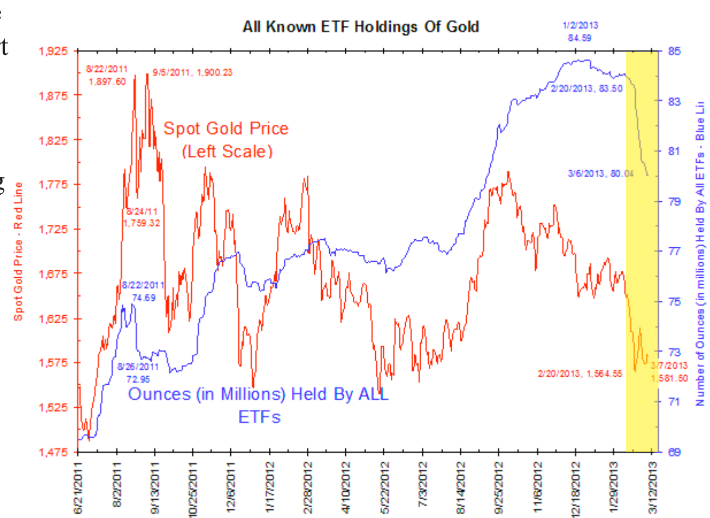


The futures market in gold is also showing a major anomaly. As a quick review, futures contracts are basically side bets on the price movement of a commodity. Commercial producers open up short contracts in anticipation of near-term physical delivery of their production. These short contracts must always be perfectly balanced by long contracts from speculators or other commercial users who intend to take delivery of the commodity for their businesses. Since there is little commercial use for gold, the long side is mostly speculators intending to take delivery. Speculators themselves may also open short positions if they believe prices will fall over the life of the contract, and these positions must be balanced by other speculators making the opposite bet.

The chart at right shows the price of gold and the total short position of the financial speculators. They nearly always get it wrong: large short positions from speculators correspond with bottoms in the gold price. Incredibly, the current short position is the largest since reporting began. These are speculators who think that rising interest rates will make gold go down. The gold chart shows how well the market has absorbed their selling. These speculators, who most likely have also been shorting the gold miners as well, are set to be caught in an epic short squeeze.



Another chart making the rounds in gold circles is a chart of all known ETF holdings produced by Bianco Research. The largest



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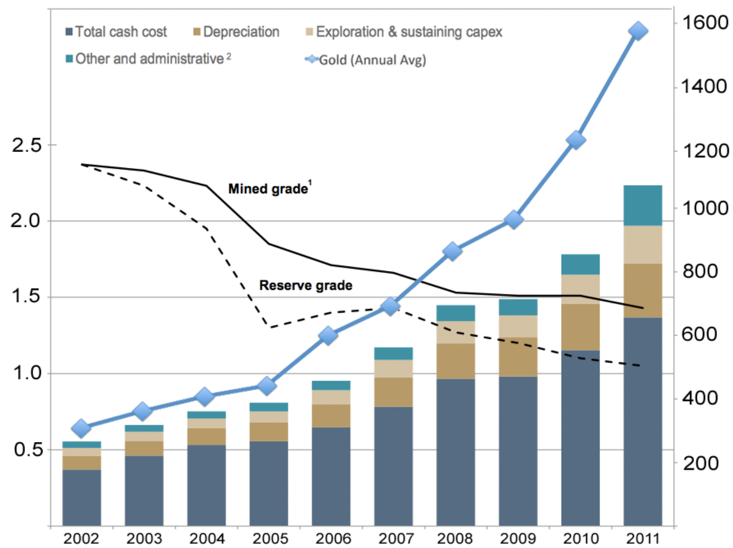
liquidation of gold ETFs since they began trading, a withdrawal of over 4 million ounces, has been well absorbed by the market, especially since the timing corresponded with futures traders piling on the shorts. There appears to be buyers with unlimited appetite at current levels We know at least one: South Korea announced that it bought 20 tons of gold in February, increasing its gold holdings by 24%. No doubt China and other banks are buying less publicly.

Sentiment in the gold mining sector is the worst ever by some metrics. As levered bets on the price of gold, gold stocks have been hammered by disgruntled longs and fervent shorts. The specter of rising costs have analysts downgrading price targets almost as fast as share prices fall.

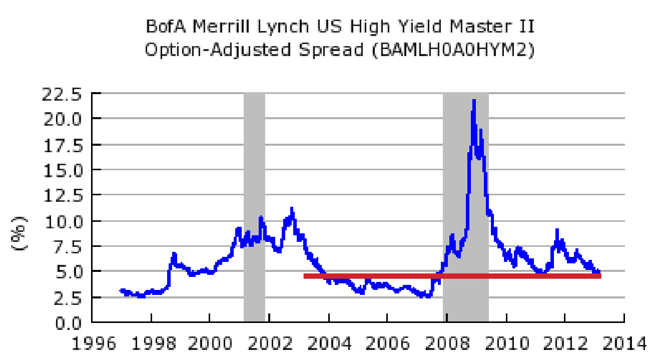


Source: GFMS Mine Economics, LBMA, World Gold Council
1) 2002-2004 data set includes primary Gold mines only, 2005 onwards, includes porphyry copper gold mines
2) Includes exceptional items

But, as the chart at right shows, while the general costs of mining have grown sharply over the past decade, the gold price has risen even faster. And, this frequency cited chart includes the operations of porphyry copper gold deposits, which are notoriously high cost and low grade.

Leverage works both ways, and the smaller gold stocks, perhaps fairly, have been particularly affected by the latest draw down in gold. Changes in mining costs have more momentum than changes in the gold price, which occur instantaneously on the exchange, so falling commodity prices can squish margins quickly. But, when the gold price finally turns, which appears immanent, gold shares could move chaotically to the upside from their currently depressed and oversold state.

The market is not currently distinguishing between strong and weak companies – funds must sell not their worst names but their liquid positions to meet redemptions – but those companies that avoid or minimize issuing equity will emerge better positioned to exploit gold prices that must rise as a mathematical function of the Fed's balance sheet.



Gold and gold investments function primarily to protect wealth against the collapse of traditional, economically sensitive assets. It should not amaze, then, that they have not performed well in an environment involving record highs in the traditional indices and the compression of spreads between junk bonds and

Treasuries to levels seen only during the bubble years. But, the return of bubbly credit phenomena, such as no money down mortgages and the bundling of personal loans with no collateral, should heighten concern, not lessen it.

When making a directional bet on markets, it is important consider what developments would falsify the investment thesis. If it were to become a reasonable prospect that the Federal Reserve could allow interest rates to rise back to "normal" levels, as promised by Bernanke in 2008, without destroying the economy, the banks, and the Fed's balance sheet, then the intellectual case for holding gold investments would diminish. There is currently no prospect of this occurrence, so gold remains an important hedge, and junior gold mining shares an efficient way to lever a small capital allocation.