Myrmikan Update

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Taunted a Second Time

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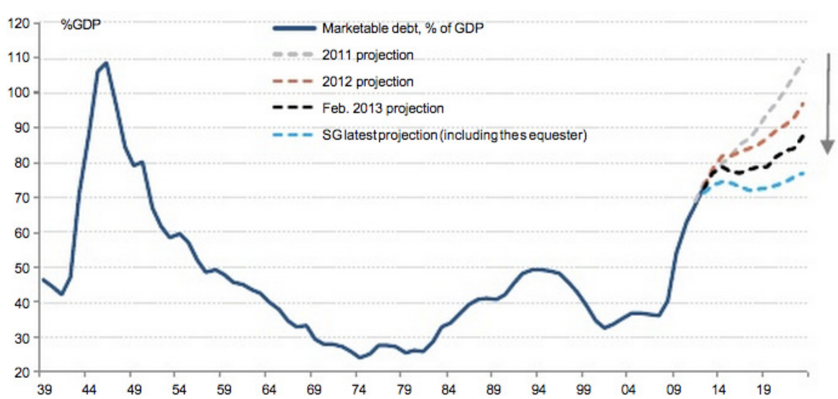
On April 2 Société Générale pronounced "the end of the gold era," calling the gold market a bubble and predicting gold will crash. The analysts reason: 1) improving economic conditions will prompt the Fed to stop printing money and raise interest rates, 2) the recent hike in taxes will stabilize the deficit, and 3) the dollar will strengthen.

Since they made their call, the rate on the 10-year Treasury has fallen from 1.88% to 1.71%, the dollar index has weakened from 83.1 to 82.2, and gold has plunged from $1600 to below $1400: it's better to be lucky than good. Readers of Myrmikan may recall the February 14, 2011 Update which discussed famed market strategist Doug Kass's prediction that gold would fall to $1050 by year end. Kass employed a similar rationale as the French bank: interest rates could only go up, and when they did the opportunity cost of holding gold would increase prompting investors to dump it. In fact, interest rates did not rise, have not risen, and, when they finally do, gold will surge to unbelievable heights for reasons explained in that piece and numerous since.

Société Générale repeats Kass's errors. An understanding of Austrian economics explains and a casual acquaintance with history reveals that once an economy becomes reliant on money printing the presses can't be stopped without economic collapse and won't be stopped until total destruction of the currency. The Fed cannot allow rates to rise.

Nor will tax hikes cause deficits to decline, the second prong to their thesis. In the 1960s there was a theory that raising taxes increased economic activity: higher taxes force people to work harder to maintain their lifestyles, improving economic growth and funding the government with the surplus. The 1970s revealed the absurdity of this concept. And yet, echoes of it are heard in vapid economic chatter, such as Société Générale's report.



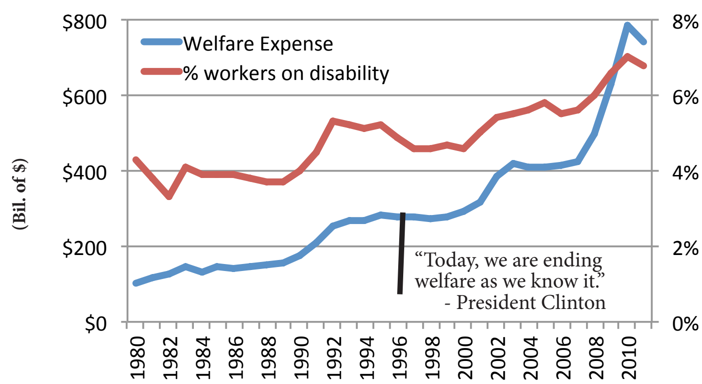
The French bank believes that U.S. debt can be put on a "sustainable trajectory" through "a 'grand bargain' with Democrats agreeing on entitlement reform and Republicans agreeing on additional tax revenue." The chart from the Congressional Budget Office shows how the tax hike earlier in the year lowered the trajectory from the orange line to the black line, and how a further agreement would lower it still further to the blue line.

The analysts must be based in New York or Washington because anyone living in Europe would have witnessed that the two-sided fiscal tightening imposed by the Troika on several European countries has resulted in higher deficits, not lower. In an expansion, deficit spending stokes economic growth, which augments tax receipts, which allows more deficit spending. Once the government bubble pops, the dynamic runs in reverse: austerity shrinks demand, lowering tax revenue, forcing more austerity.

The CBO cannot consider these dynamics because the law requires it to use static analysis, assuming that taxpayers have no reaction to changes in policy. To illustrate *ad absurdum*, the CBO is required to assume that as taxes rise toward 100% taxpayers will continue working the same hours, cheerfully handing over their income while they starve, an assumption Société Générale apparently shares.

Société Générale had been predicting a March non-farm payroll increase of 230,000, which would have brought the six-month average payroll growth to 200,000, a threshold some FOMC members have cited for the minimum required to taper QE. Instead, three days later, in a direct rebuke to Société Générale's thesis, the figure printed at 88,000. Meanwhile, March retail sales fell 0.4% against analysts' expectations that sales would be flat. If nothing else, economists should at least be able to project that higher taxes combined with spiraling health costs and the chaos of implementing Obamacare should not stoke economic growth. France provides the model.

AMERICAN DEPENDENCY IS GROWING



Source: U.S. Social Security Administration

As far as a grand bargain, the team has it backwards. Most Americans have almost no savings. According to the Health and Retirement Study, the average monthly Social Security benefit of $1,230 for retired workers provides more income than any other source for over 60% of those households, with one-third of households ending up entirely dependent on Social Security. The chart shows that ever more non-retired Americans are also dependent upon government largess. The Democrats will not allow cuts to entitlements that harm their constituents.

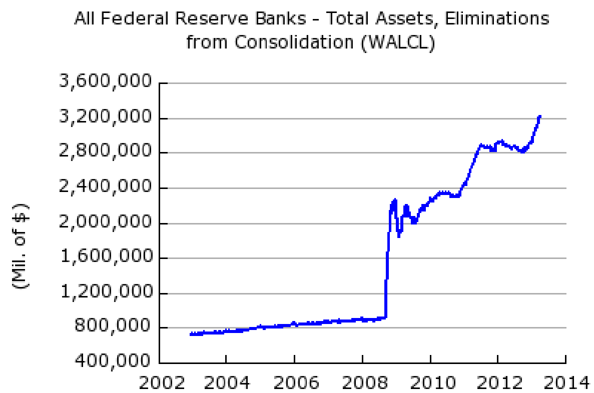
Assuming a deal on entitlements, it will hit only the affluent, and the reduction in income for the non-poor will force them either to shrink their economic demand or consume their capital to maintain their lifestyles. In fact, the Washington Post reports that last year more than a quarter of workers are already doing this, withdrawing money early from their retirement accounts despite the associated penalties. Consumption of capital cannot create economic growth, whatever Keynesian models may imagine.

Faced with intransigence from Democrats on real cuts, Republicans will not agree to additional tax increases. As the mid-term elections approach, politicians in the opposition must decide whether to compromise with a popular president, running as pragmatic accomplishers, or whether to use an unpopular president as a foil for principled opposition. Especially given gerrymandered districts, Republicans will choose the later option. The only bargain available, then, is to agree to kick the can down the road

– again – and rely upon Bernanke's printing press to supply the difference between spending and receipts.

Even assuming an improbable bargain to raise taxes and actually lower spending – when was the last time such an agreement occurred in Washington? – that has no economic effect, the Société Générale "grand bargain" forecast for debt-to-GDP remains upward sloping! It appears wishful thinking can but slow the accumulation rate of the debt burden.

There is no solution. As the debt rises inexorably, the Fed will be expected to print – rising interest rates compounding debt growth will force the Fed to print faster. Those who question this proposition must explain why Bernanke's promises to shrink the Fed's balance sheet, maintained in speeches and meeting minutes since late 2008, have resulted with the chart at right.



The big news last month was not Wall Street prognostications, designed mainly to move client money to the house account, but Cyprus where said transfer was accomplished with much greater efficiency. One might have thought that it would have been liberals who should be furious, since the very premise of the Left is to have the benevolent state protect the people from their own folly, especially in commercial transactions. Similarly, conservatives and libertarians should applaud the removal of the state guarantee of banks, protecting the public finances and forcing upon depositors the responsibility of evaluating the health of their counterparties.

Instead, silence from the Left exhibits that it has metastasized to complete statism: since private property exists only as a grant from the state, and since the state will grant such only to the extent it is wealth-maximizing or otherwise benefits the state, there is no philosophical basis to object when state authority reassigns property from one party to another. See Orwell for a more detailed exposition of this view.

For the Right, the principles of limited government may allow objections to the socialization of losses from the two largest banks to the healthy banks (to the extent there are any), but not to the final resolution of letting the losses fall where they lie. As for capital controls, banks have been *de facto* and *de jure* creatures of the state since the advent of the great global fiat currency experiment in 1933. Depositors should have known, and now do know, that the true counterparties to their fiat currency bank deposits are the ignorance, pettiness, corruption, and malice of national and now transnational politicians.

The Cypriot "bail-in" was surprising in that it so clearly broadcast the true nature of government and banking for so small a target. Devaluations and confiscations only work by stealth. Dutch Finance Minister and President of the Eurogroup of euro zone finance ministers Jeroen Dijsselbloem is correct when he opined that the "bail-in" strategy will cause "all financial institutions, as well as investors, to think about the risks they are taking on because they will now have to realize that it may also hurt them," precisely the reason it was so foolish to impose the treatment on little Cyprus as opposed to waiting for a larger target.

From now on, any banking system under the least suspicion will prompt a mass exodus to escape before the doors close. As Dennis Gartman has commented:

> we are certain that the meetings of money managers, family-office managers, family members, company treasurers and their associates et al have been and shall be in the future taking place around the world to discern whether what has happened in Cyprus can happen in Paris, or Athens, or Buenos Aires or Toronto or New York… and if so, what can be done to mitigate against the damage possible.

Banks are the business of borrowing short and lending long – that is, the funds they borrow from depositors are due whenever the depositor calls for them, but they lend loans at term, money that cannot be recalled early. Loans can be sold for immediate cash, but only assuming there is a party with an interest and the liquidity to buy them. Since euro area banks are levered up at least 25-to-1, depending on how the figure is calculated, a withdrawal of less than 4% of deposits would cause the banking system to become illiquid and close. It is this realization that Euro action in Cyprus has forced upon the participants of the meetings Gartman describes.

It is not obvious to where capital will flee. All modern banks are fractionally reserved, making them susceptible to runs and confiscation by the state. As market participants work through the prisoner dilemma analysis, a growing number will conclude that the only means to hold financial wealth beyond the government's stated and legitimized sphere of influence is to defect and hold physical gold. Moreover, applying the logic reveals that this escape route is available only to the first movers.

It is, thus, surprising that gold did not react higher in price. Indeed, George Soros has opined that gold's safe haven status is "destroyed" because:

> when the euro was close to collapsing in the last year, actually gold went down, because if people needed to sell something, they could sell gold. Therefore they sold gold. So gold went down together with everything else. Gold was destroyed as a safe haven, proved to be unsafe.

But the very reason gold is money is that it is the most liquid good, the good one can sell when everything else is illiquid. Looking at gold in terms of the euro and German DAX, it is not clear exactly where gold failed to deliver.

Gold need not rise in nominal terms to fulfil its purpose, which is less about making money than preserving it. In the banking collapse of the 1930s, the dollar held most of its value making dollar denominated bonds a fantastic investment . . . provided the counterparty didn't default. The trick was picking a counterparty that could remain solvent, and owning gold avoided that risky analysis. Any Cypriot holding gold hasn't made gains in nominal terms, but retains his capital, unlike his neighbors. Today the risk is both default and devaluation.

Perhaps gold just needs some time: it was four long months between the collapse of Credit Anstalt in May of 1931 and the devaluation of the British pound in September, corresponding with the collapse of the global bond market.

The modern bond market would have itself collapsed following the 2008 panic but for the extraordinary efforts by central banks, yet these cannot continue indefinitely. Faulty interest rate signals guarantee the miscoordination of capital and economic decline, requiring ever more intervention. Japan may be nearing the end-point of this logic. Shorting Japanese bonds has been known as the "widower maker" for years because against all logic and analysis yields continued to fall to ridiculously low levels. But, as Kyle Bass notes:

> when you do the quantitative analysis here, you know they're insolvent; everyone that owns the bonds knows they're insolvent, it's a question of how long can they hang on. When you see things like Argentina, Greece, Cyprus, Ireland, Italy - you see how fast things can go from perfectly stable to completely unstable: it happened very quickly. In this case I think it will happen even more quickly.

The yen has lost 20% against the dollar since the beginning of the year. Yields on Japanese bonds are near zero, meaning holders of the $14 trillion Japanese bond market have lost 20% in dollar terms in three months. At some point this money will abandon its position and panic out of Japan into other assets, just as European money is also searching for a safe haven.

Sophisticated money is betting that these funds will flow into the dollar, strengthening the dollar and weakening gold, the third prong of Société Générale's thesis. But, since everyone knows Japan is insolvent, the extreme easing may pass a tipping point, causing cascading losses. The challenge would immediately flip to how to support the yen. Since the government bonds of the senior economies are fungible, and since Japan owns $1.1 trillion in Treasury bonds (after the Fed and China), an unwind of the Japanese financial system would have direct consequences for the dollar. All currencies would become immediately suspect.

In 2011, as gold spiked towards its all-time high in nominal terms, the various banks were busy increasing their price estimates. Now that gold is in a correction, the banks have all lowered their targets, and not just Société Générale. Earlier this week Citibank told its private clients:

> As economic recovery gains traction, we expect to see interest rate and inflation expectations gradually rise. . . . We remain heavily underweight in government bonds. . . . With global growth solidifying, demand for gold as protection against systemic risk has dissipated. We therefore remove our position in this asset class.

They are correct that as the government bonds that function as the global monetary base lose value, there will be inflation – and a lot of it – making it a curious time to sell gold.

Not to be outdone, on April 10 Goldman Sachs also lowered its gold forecast, now expecting gold to sink toward its $1200 target even faster. This is the same firm that forecast oil was going to $200 in May of 2008 when oil was rising, but six months later was forecasting oil at $45 when oil was falling. One wonders if the methodology incorporates more than a pencil and ruler. As noted in November's update, banks are very good at predicting short-term policy decisions – they help design them – but are terrible at economic forecasting.

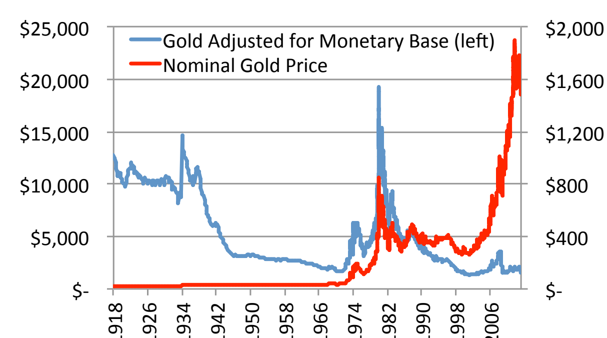
Nevertheless, in the current era, financial players operating with huge leverage can peg a price nearly anywhere. On Friday morning traders were greeted to the chart below, showing $1522 as two year support:

According to Ross Norman of Sharps Pixley, a cabal led by SAC Capital dumped 100 tons of gold to test the waters and then shorted a further 300 tons, for a total short sale of 13 million ounces or 15% of annual global gold production. The selling broke support and gold collapsed, losing $83 on Friday alone as longs abandoned their positions and shorts pressed their advantage.

Clearly $1522 held much psychological importance, but it is not clear why: though the support line on the chart is flat, $1522 dollars in April of 2011 meant something very different than $1522 dollars in April of 2013. In fact, Chairman Bernanke himself made this very point at his last press conference when asked if there was "still time to get in" to the stock market even though it has reached all-time highs:

> In particular, you should remember, of course, that while the Dow may be hitting a high, it's in nominal terms, it's not in real terms. And if you adjust for inflation and for the growth of the economy, you know, we're still some distance from the high.

Similarly, gold trading at $1483 today is significantly cheaper than when it first closed above that level on April 18, 2011. Adjusting for the monetary base, which was then $2.53 trillion, $1483 today is the same as $1243 two years ago. Put another way, $1483 two years ago is worth $1780 today, so gold is really $297 dollars cheaper now than it was then.



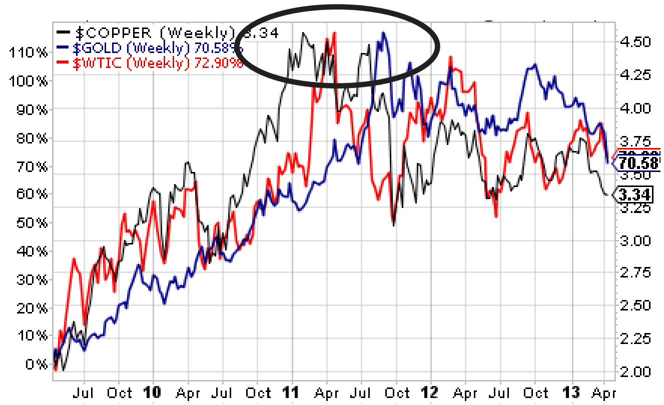
The chart at right shows that even while the nominal price of gold in red has a parabolic shape, adjusting for the monetary base reveals that it is near its all-time low of $1260 (in 2013 dollars, reached on January 4, 2002). And, this adjusted low keeps rising as the Fed prints more dollars. When

Goldman Sachs forecasts a gold price of $1200, they are predicting that gold will fall below the adjusted all-time low, despite continuous QE from multiple countries with no end in sight. By the time the monetary base reaches $4 trillion, that 2001 adjusted low will be $1667 in current dollars against an adjusted all-time high of $25,482 on January 21, 1980.

Of course, analyzing the monetary base is more complex than just considering its size – the nature of the assets on the Federal Reserves balance sheet, against which the monetary base is a liability, also determines the value of the dollar. As discussed elsewhere, these assets, long-term Treasuries, are ultimately both illiquid and worthless: the Fed cannot sell them without destroying the market, and Congress cannot raise taxes high enough to retire them with good money. As with Japan, everyone that owns the bonds knows they're insolvent, it's a question of how long can they can hang on.

Monetary inflation will not manifest until the Treasury market seeks true value, but when it does the Fed will face a dual problem: there are too many dollars, and the assets backing them will be impaired. The only options will be massive devaluation, involving capital controls and rationalization of the state, or hyperinflation if current policies are maintained.

Even though financial speculators were responsible for the severity of gold's recent decline, as opposed to fundamentals, many articles have declared the end of the gold bull market. But, those articles tend not mention other commodities markets, such as copper and oil, which are also weakening.



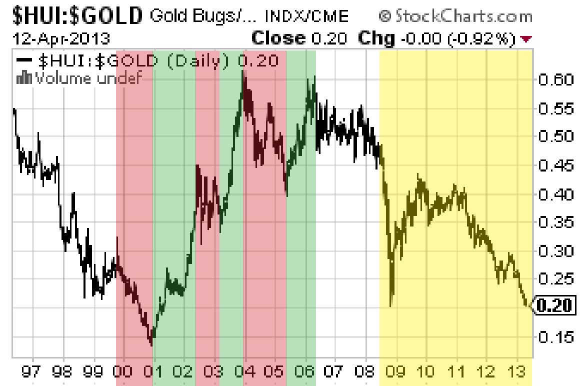
Oil is the most important commodity in an industrial economy, and traders call copper "Dr. Copper because it's the only metal with a PhD in economics." Economic growth adds to demand on commodities, so, one way or another, it is likely that the schadenfreude of mainstream investors towards commodities investors will be brief.

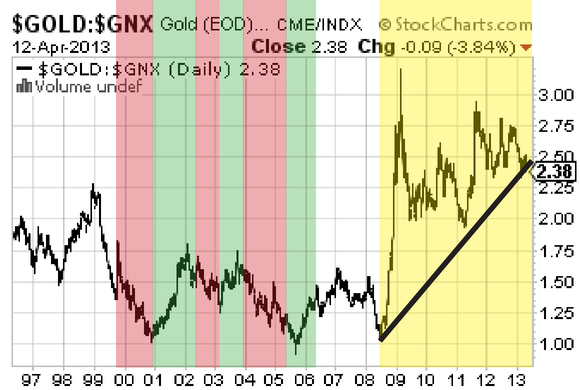
Those familiar with Austrian economics understand that not just money printing but accelerating money printing is required to keep a credit boom going. Commodities are signalling that even $85 billion per month is not enough to keep the deflationary forces at bay, which is why the next policy move will likely be additional easing, not tightening as predicted by the banks.

The hawks on the Federal Reserve do not object to quantitative easing on philosophical grounds, all applauding the action during 2008. The difference with the doves is they interpret the economic data is signalling a recovery is in place, and they are more averse to keeping easy policies in place for too long. If, however, the data rolls over, so will resistance to additional measures. In 2008 the economic forces that lowered gold from $1000 to $700 prompted the Fed to implement policies that drove it to $1929. It may well be that a decline of a similar magnitude, to $1350, will correspond with the actions necessary to drive gold to

$4000. As currencies gurgle down the drain, the spiral always accelerates, so $4000 gold could come sooner than most think.

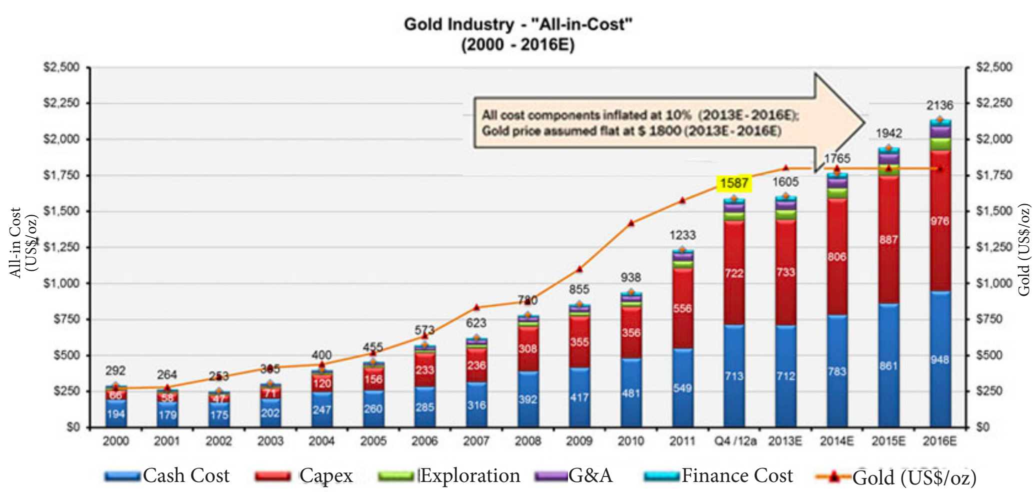
If the function of gold is to maintain wealth, the purpose of speculating in gold mining shares is to increase it by seeking operational leverage to gold. Instead the miners have offered negative leverage: as the upper chart shows, they have fallen in terms of gold for years and are now past the 2008 panic low. And yet, as the lower chart shows, the central investment thesis that gold would increase in terms of the costs of mining it has remained intact.





It is unlikely that safe-have global capital will flow into gold mining shares any time soon, given their volatile nature and recent performance. The Canadian promotional model is dead. The market ignores large gold assets that cannot be financed. But, a new model based on cash flow – really the original model – is slowly emerging.

The chart below has been discussed in gold circles, questioning the cash generating potential of the miners, or even their viability in the context of falling prices.



There are lots of problems with this graph. First, it incorporates only the top 13 gold companies. The largest gold producers tend to mine large copper/gold deposits, reporting copper by-product revenues not as revenue but as a credit against gold production costs.

This means as copper has fallen over the past two years, reported costs have risen, even if actual mining costs remain stable – a dynamic that does not affect pure gold producers. And, as gold has increased in price, miners have been able to mine lower grade ore, increasing costs but expanding throughput.

Second, the high capex figures result from the fact that the high gold price causes many previously sub-marginal deposits to become highly profitable, and gold companies are naturally investing in highly positive NAV projects. It is true that if gold were to fall precipitously and stay down, the capital already expended on these projects would be lost, which is what the market seems to be anticipating. On the other hand, if gold eventually runs higher, these prospective investments will turn out to be highly profitable.

Third, the graph assumes that gold prices remain stable while costs rise 10% per year. In fact, the recent earnings statements of gold companies indicates mining costs are falling, as competitive demand from base metal mining operations wanes. As the bottom chart on the previous page shows, the gold-to-commodity ratio is rising, not falling, and it will rise further as the global credit bubble continues to deflate.

On the downside, the chart seems to indicate that gold below $1600 would cause the mining sector losses. This, also, is not correct. First, according to GFMS Ltd, average all-in costs of the industry (including cash operating costs, general & administrative costs, and sustaining capex) was $1150/oz in 2012, much lower than the previous chart suggests. Second, it is important to remember that capex is investment, not an expense. It represents additional book value being added to a company. In a negative price environment, gold miners first halt exploration, then capex on new projects, and then sustaining capex on existing projects (e.g., mine life extension).

If the price keeps falling, miners start focusing on the high grade portions of the mine, lowering cash costs. Although the market is pricing many of the junior producers for bankruptcy, cash flow can be maintained at much lower gold prices. They won't thrive, but the inherent call option on gold inherent in the operations would not expire until the gold price were to remain low enough for long enough to force them to ruin their capital structure. This has not happened yet, and should not for some time if at all.

Investors should remember that the performance of gold stocks in the deflationary 1930s surpassed even the performance gold stocks in the inflationary 1970s. Falling prices are bullish for gold mining, as long as the costs of mining fall faster than gold. But any deflationary move is temporary. Either the Fed will print faster to save the banks, or they won't print fast enough, banks will fold, businesses will close, tax revenue will decline, and government bonds will default, destroying the backing of the dollar. Long-term, those are the only two outcomes and the end result is the same.

Gold mining stocks should always be viewed as economic insurance, not a place to invest a large percentage of net worth. Monetary risks have only increased given the actions of central bankers, and yet the insurance has become much cheaper as weak hands are squeezed out, just as in past cycles, even though the sector as a whole is in a much better position than in 2008 to withstand a deflationary impulse move. Moreover, mining companies get no credit for the book value they've added to their companies in recent years. When gold runs and that capital is put to work, cash flow will explode. The value in the sector remains, even if it is not recognized.