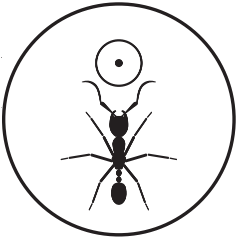

# Myrmikan Strategic Update

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Daniel Oliver
Myrmikan Capital, LLC
doliver@myrmikan.com
(646) 797-3134

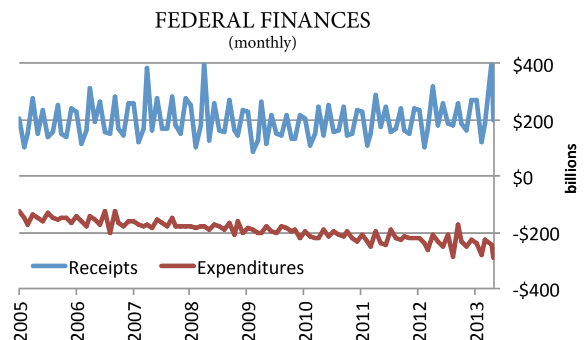
## Consolidation

Myrmikan prematurely called the end of the gold correction in November of 2012. The reasoning was simple: Obama's victory meant government spending could only increase: it requires new laws to reduce spending or even keep it constant (the so-called "sequester" merely reduces the rate of growth). Obama would veto any such bill. A Republican victory in the House implied there could be no new taxes. Republican congressional representatives, safely gerrymandered, need not worry about the population at large, merely their own constituents at home. Therefore, the deficit could but widen.

If the deficit widens, then the Treasury must sell additional Treasury bonds to finance expenditures. Through simple supply and demand, an additional supply of Treasuries would lower their price, increasing interest rates. Rising interest rates have three immediate effects: first, they cause federal interest payments to increase, increasing the deficit still further, causing even more Treasuries to be issued; second, higher rates make financing both consumption and investment more expensive, reducing economic activity and tax revenues, producing higher deficits and more Treasuries; third, higher rates lower the value of the bonds on the Federal Reserve's balance sheet, which back the dollar. As the value of the asset side of a balance sheet falls, so must the value of that same balance sheet's liabilities. Therefore, when rates rise, the dollar must fall, and gold must rise.

The Fed can delay the dynamic above by buying up any additional Treasury bond supply by expanding quantitative easing still further, keeping prices elevated and rates low. But, by making its balance sheet ever more sensitive to rates, it would ensure the ultimate value of the dollar would be that much lower and the equilibrium gold price that much higher.

The analysis failed because the Republicans folded. They agreed to a payroll tax hike on all working Americans. This tax increase, combined with a flurry of capital planning activity at the end of 2012 to avoid rising rates, caused a surge in tax revenue for the first five months of the year, each of which brought record revenue into government coffers. This ran the logic described above into reverse. One would expect the dollar to

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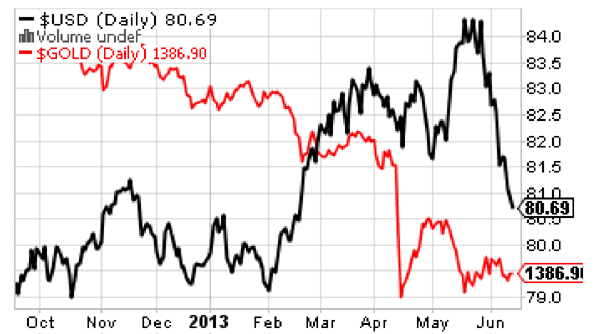
strengthen and gold to weaken when Federal deficits shrink. And this is exactly what happened. Especially from February through the end of May, the dollar ran to its highest level since 2010, and gold collapsed.

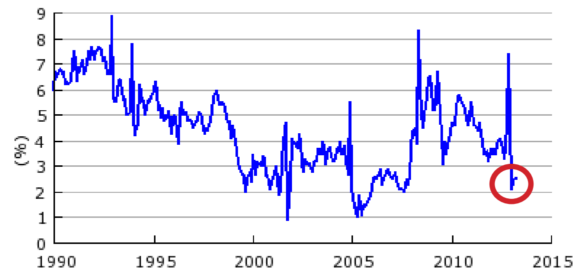
US DOLLAR INDEX VERSUS GOLD




But, things are not as rosy as they may appear. A large part of the Treasury's intake comes from remittances by Fannie Mae and Freddie Mac as well as from the Federal Reserve. The Fed is required to hand back to the Treasury its interest proceeds, so the more Treasuries it buys, the smaller the official deficit becomes. Of course, this is direct monetization, not an improvement in the finances of the government.

Similarly, Freddie and Fannie are able to make large remittances because the housing market has improved. But, housing prices are supported by the Fed's buying $40 billion per month of mortgage-backed securities, making these agency payments indirect monetization.

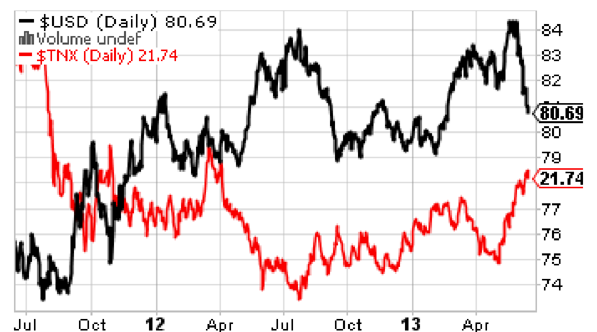
PERSONAL SAVINGS RATE




As far as taxes from the real economy, most Americans were hit unawares when they received their first paycheck in 2013. As the graph at right show, they reacted not by reducing consumption, but by reducing their savings rate. Given that most Americans still have excess debt they must repay, a 2.5% savings rate is not sustainable. At some point personal consumption will falter, with multiplier effects to the downside. The implementation of Obamacare seems similarly unlikely to boost the economy and real tax revenues.

Despite the newly printed money flowing into the Treasury, despite continuing consumption financed by savings, and despite the sequestration, the government still managed to run the fourth highest monthly deficit ever in May. Presumably, if the Fed stopped, or even slowed, its monetization program, the deficit would again explode, reinvigorating the logic for higher gold prices.

US DOLLAR INDEX VERSUS 10-YEAR YIELDS




Over the past month, as some data such as the employment numbers have suggested the economy is improving, the market began taking the Fed tapering threats seriously: the 10-year Treasury yield is surging. But, the dollar index is falling. Under conventional theory, yields and currency strength should correlate: when rates rise, hot money should be attracted, on the margin,

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to the currency to buy bonds at the new, higher rates, and the currency should strengthen. This is why Bernanke has stipulated that the Fed's plan to reign in inflation once it arrives is to strengthen the dollar by raising interest rates. But, the chart above clearly shows that yields and dollar strength have been in opposition for the past two years. A balance sheet view of the dollar explains this relationship, and why when the Fed eventually acts to restrain inflation the manoeuvre will backfire badly.

But, markets' expectations of Fed action may be premature. As veteran commodities analyst John Tumazos points out, declining prices across the commodities space do not suggest economic recovery. Spot lumber prices have fallen 30% from two months ago, aluminum orders fell 3.8% through April, while May steel shipments are down 3.2% from a year ago. Tumazos likens the current situation in commodities to the onset of severe recession in late-1981 and 2008 and warns that the policy makers, far from withdrawing stimulus, may have to "overstimulate" leading to a "hyper-gold" scenario.

Conflicting economic data renders forecasts extremely difficult. For example, despite lumber prices collapsing, the June survey of home builder confidence surged above 50 for the first time since 2006. Despite the June Empire Fed Manufacturing Survey leaping from -1.43 to 7.84, the sub-index for number of employees dropped to zero, the average workweek sub-index retreated ten points to -11.3, and capital expenditure expectations plunged at its fastest rate on record and printed at its lowest since the collapse in 2008.

Whatever the data says, it is sure that monetizing $85 billion of debt monthly is not normal or stable. The two possible outcomes are, first, a crack-up boom, in which prices spike higher from demand, causing rates to rise, igniting the monetary reserves printed over the past five years; or, second, a relapse into depression caused by a failure to expand the printing fast enough to head off the deflationary shrinkage of the shadow banking system and emerging market debt.

Doug Noland of The Prudent Bear closely follows this latter threat and points out that in the past four years alone, international reserve assets have ballooned from $6.6 trillion to $11.1 trillion. Domestic banking assets are pyramided upon these reserves, and shadow banking assets pyramid on top of the banking assets. As Ambrose Evans-Pritchard reports in the Daily Telegraph, capital inflows into China have slowed sharply and may even be reversing, which would cause these fragile credit structures to unwind. Already there has been a shock in the short-term interbank lending market with rates spiking after two mid-sized Chinese banks recently failed to meet their repayment obligations.

The other BRICS face similar problems. Brazil, South Africa and Russia have boomed, supplying the Chinese fixed asset bubble with commodities, but that trade is ending. Philippine equities lost 9.2% last week, Thailand 3.4%, and Brazil's market fell 4.4%, bringing the year-to-date loss to 19.1%. Meanwhile, Brazil's currency, which recently was so hot that authorities were intervening to prevent it from rising, has fallen to a four-year low against the dollar. The South African Rand has lost 15% against the dollar year-to-date, and the Indian Rupee has lost over 5% since the beginning of May. Nolan posits that just as the credit crisis began with "contained" troubles in the sub-prime real estate market, so the emerging market crisis will begin at the periphery and move to its core in China. He has history on his side.

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The boom then bust of emerging market debt has been a salient feature of senior market credit bubbles since the first Latin American Debt Crisis in 1826[1]. The Bank of England had left the gold standard during the early 1800s to help finance the Napoleonic Wars. Starting in 1815, the Bank adopted contractionary policies to bring the ratio of paper issued back in line with its gold reserves. But, it overshot, and in 1821 began following very loose monetary policies, lowering interest rates below market.

Inevitably, low rates cause a market boom and a search for yield. Country banks were permitted to issue paper without gold reserves, and pyramided their loan books on top of Bank of England notes, stoking financial speculation. With domestic assets wildly overpriced, British investors threw money at Latin American credit, most notably £600,000 of 6% bonds from "Poyais," a fictional country invented by Scottish adventurer "His Highness" Gregor MacGregor.

By 1825, the Bank of England began experiencing a rapid decline in its bullion reserves as holders of overvalued notes redeemed, leaving it with £19 million bank notes in circulation against £4 million in gold specie. It was forced to call in credit during the summer, the stock market crashed in October, and a banking panic arrived by December. Shortly thereafter, the crisis spread to Latin America. The Latin American bonds had made initial interest payments only because some capital had been reserved during the offerings. Cutoff from the ability to roll debt, and suffering from a contraction of trade, mass defaults began in late 1826. Gold became the only financial asset of merit along with, by extension, Bank of England banknotes, since the bank had acted in time to salvage its balance sheet to make good its commitments.

The histories of subsequent panics are remarkably similar. For example, in the 1920s the Federal Reserve kept rates too low and markets soared. In the search for yield, capital fled abroad to the most unlikely places. Writing in 1932, Garet Garrett captured the absurdity:

> Fancy telling that woman at the "Savings" window, who gets her money up in small bills from the deeps of an old satchel, that her dollars, multiplied ten times by the bank, will go to build ornaments for a grand boulevard in a little Latin-American country she never heard of, or to build work-men's houses in a German city better than the house she lives in. Fancy telling the man in overalls who comes next that his money, multiplied ten times by the bank, will go to a speculator on the New York Stock Exchange, or to mend a cathedral in Bavaria, or to a foreign bank that may lose it unless the matter of reparations is somehow settled in Europe, or that it may be loaned to Germany in order that Germany may pay reparations to the Allies in order that they may be willing to pay something on account of what they owe to the United States Treasury.

The Fed finally tightened, spooked by soaring markets. First the stock market collapsed in 1929. Only the speculators were hurt. Two years later the international bond market cracked ushering in the mass poverty of the Great Depression.

Contra the monetarist view of the Great Depression, the Fed did print, with its assets ballooning from $5.3 billion in September of 1929 to $18.8 billion by the end of 1939. But, due to gold revaluation and accumulation, its gold holdings multiplied from $2.7 billion to $15.2 billion, increasing the backing of the dollar from 52% to 81% gold.

1 The South Sea Bubble of 1720 concerned the bubble of the company given the royal monopoly to trade with South America, not the lending of actual capital to Latin American countries.

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No wonder that the dollar, like the pound before it, remained strong during the depression.

The current situation is very different from the 1820s, the 1930s, or innumerable other deflationary depressions. Instead of revaluating and accumulating gold, the Fed has been accumulating near-worthless bonds. In fact, at the current price of $1385, the 8,133 tons of gold held by the U.S. provides 10% backing for the Fed's $3.4 trillion of liabilities. The only time this percentage backing has ever been lower was at the end of 2008 when the Fed had already expanded its balance sheet and gold had yet to react. Within weeks, gold would begin its charge to $1900, an increase of 2.7 times. Even at that price, gold backed only 17% of the Fed's liabilities, well below the historical average.

Save for the crisis of 2008 and currently, the only other times the Fed's balance sheet has only been 10% backed by gold are 2001, the beginning of the current gold bull market, and 1969, at the beginning of the previous gold bull market. Looking further into history at the annual reports of the Bank of England from 1700, there have been only 4 other times that the bullion coverage ratio fell below 10% at the central bank of the senior currency.

In 1742, the Bank of England had to fight to renew its charter, leading to market stress. The bullion coverage ratio sank to 6%, but recovered to 36% the following year. The Dutch banking crisis of 1763 created a huge demand for bullion on the continent, leading to redemptions, lowering the Bank of England's coverage ratio to only 5%[2]. It returned to 23% the following year. The third time the coverage ratio fell below 10% was during the inflationary period of the Napoleonic Wars, and the other was in 1826; the ratio recovered to 33% the following year.

The reason that Bank of England coverage ratios recovered so quickly without devaluation is that most of the non-gold assets at the Bank of England were commercial bills due within 90 days. The bank would raise the interest rate at which it would discount bills, and within 90 days all of its bills would be paying at the new rate, enabling the bank to entice depositors to halt withdrawals. In the case of the Fed in 1933, it was able to revalue gold above the market price by fiat, enticing Europeans to deposit gold for undervalued dollars.

Contrast these measures with the scope of action for the Federal Reserve today. Unlike in these other episodes, there is no risk of a run, since federal reserve notes are no longer redeemable. But, how would it protect the value of the dollar in a panic? The average maturity of its bonds is now above 10 years and rising: if the Fed were to raise interest rates, it would take that long, not 90 days, to begin to receive the full income, the value of its bond portfolio collapsing in the meantime. Bernanke has discussed the idea of raising interest payments on excess reserves – that is, bribing the banks to hold their depreciating dollars by giving them more dollars. This idea is barely worth discussion, as it merely buys time by compounding the problem exponentially.

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2 William Roberds of the Federal Reserve Bank of Atlanta co-authored a 2012 paper entitled *Responding to a Shadow Banking Crisis: the Lessons of 1763* which attempts to defend current Federal Reserve policy by claiming its liquidity enhancing operations are similar to the successful response of the Bank of Amsterdam to the 1763 liquidity crisis. He observes that both banks increased liquidity by expanding the assets acceptable at the discount window. The only difference is that the Fed accepts near-worthless, interest-rate sensitive Treasuries and mortgage-backed securities to expand its balance sheet, whereas the Bank of Amsterdam temporarily allowed the deposit of trade coins and silver bullion. By drawing no distinction between the discounting of future assets versus current assets, Roberds demonstrates complete ignorance of basic banking principles, endemic at the Federal Reserve.

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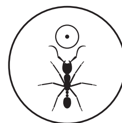
The prudent bears are correct that commodities and emerging market debt always collapse in the wake of a credit bubble, but collapse against what? Nolan points out that non-U.S. holdings of U.S. assets have surged from $1.9 trillion in the 1990s to over $20 trillion currently, $5.7 trillion of which are Treasuries, half of total issuance. Presumably, when the currencies of the various emerging countries begin to weaken noticeably, as is already happening, they will be tempted to sell their Treasuries to buy back their excess currency.

Indeed, the reason the 10-year Treasury yield has spiked so suddenly may not be due to clever macro-funds betting on the timing of Fed tapering, but instead reverberations from imploding debt pyramids in emerging markets. Nevertheless, rising interest rates will reestablish the logic for higher gold prices. History demonstrates that a central bank backed by less than 10% bullion is highly unstable. And, unlike central banks pre-1971, the only way the ratio can climb is by the gold price rising.

While gold investors wait for the titanic macro forces to engage, gold continues to wallow below $1400 putting pressure on the operations and balance sheets of gold mining companies. As discussed in the previous Myrmikan update, most gold operations have “cash costs” well below $1000 per ounce, although sustaining capital, some but not all of which is discretionary, can push the all-in costs closer to $1100 and corporate overhead higher still, thinning cash margins significantly.

While the performance of gold mining equities are disheartening to say the least, thus far there has been little capital structure damage to the better run companies. Some operations and exploration projects may have been mothballed, resulting in falling share prices, but the gold in the ground remains, waiting to be mined when prices recover. As long as the current slump does not materially worsen or last more than several months, the damage should be contained to mild asset and equity dilution in the healthy companies with good projects.

It is possible that a final wash-out decline lies ahead, but one main purpose for seeking operational leverage through the companies as opposed to financial leverage through financial instruments is the ability to avoid margin calls. Whatever volatility the market throws, and the Fed stokes, economic law demands that balance sheets eventually balance. In the case of the Federal Reserve, such a balancing will propel the dollar down, gold multiples higher, and the gold mining companies multiples higher still.



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