Myrmikan Research

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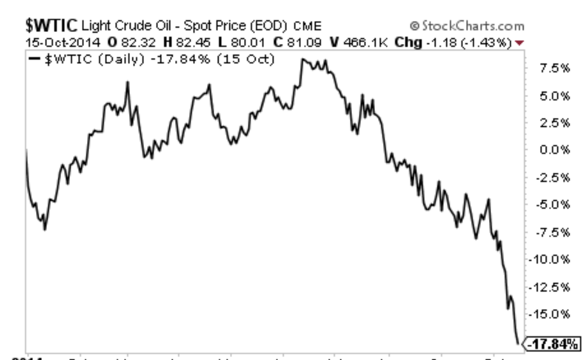
During the month of September, gold fell from $1285 to $1216, near the soft boundary of $1200 where many gold companies turn from profitable to unprofitable. On October 5, gold dipped to $1182. Most mines themselves have far lower operating costs than this figure, but debt financing, corporate overhead, and sustaining capital expenditure requires gold to be near these levels for the equities to retain value.

As gold has lost all of its gains for the year, so have the gold equities, with September producing the worst performance since the big smash in April 2013. Myrmikan's thesis has been and remains to gain exposure to marginal (but well managed and financed) gold properties to gain maximum operational leverage to gold, and that did not fare well in September.

However, there remains much room for optimism about performance going forward. First, many gold stocks clearly retain their leverage to gold. When a company dies through default or the issuance of huge numbers of shares, the equity loses its leverage to the underlying economics of the assets – it stops responding to gold price changes. Performance this year demonstrates that this is not the case with the better run companies. If and when gold rises again, these companies should see their margins explode in percentage terms, along with their share prices, as earlier in the year.

Second, much of the gold weakness has been driven by dollar strength. In countries like Mexico and Canada, where many small gold companies are based, gold has been far stronger in local terms, keeping a lid on labor costs (top chart two year gold, Canada in blue, Mexico in red).

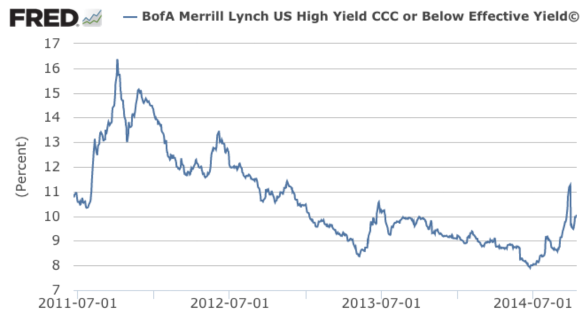
Third, oil is collapsing. In the past four months, West Texas crude has crashed from $107 to $82 a barrel. Falling oil prices can be good or bad, depending on whether the price decline is driven by demand or supply. If there is a supply glut, then falling prices acts like a tax cut. Individuals and industry can do more with less. If, however, supply remains



constant and price declines are driven by falling demand, then it serves as a signal of weakening economic conditions.

Whichever the reason for oil's decline, it will have a dramatic affect on the cost side of gold mining. Thanks in large part to oil, the gold / commodity ratio is now rising quite sharply, which will improve gold mining margins.

Finally, the credit bubble that has sustained stock prices and corporate bond prices is rolling over. Yields on junk bonds are rising, even as Treasury yields are falling, widening the spread between the two.



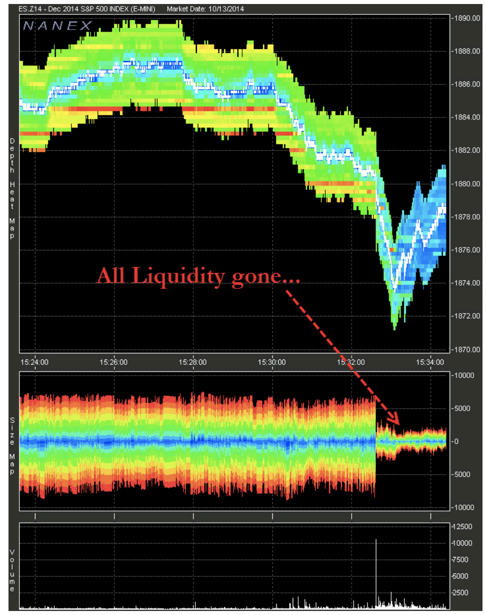
The bellwether of all emerging market credit, Greece, is collapsing in more spectacular fashion, as the graphs below show.

10-Year Greek Government Bonds

Source: Financial Times

This has prompted the S&P 500 to lose all of its year-to-date gains. The absolute drop is not of concern – it is the angle of descent combined with the realization that bubble dynamics demand prices not just advance but accelerate higher that should worry those in the traditional markets.

Ominously, the computers are beginning to take an interest. On Columbus Day, when U.S. equity markets were open, someone dropped $750 million of S&P futures over the space of 28 milliseconds, removing all liquidity sending the index down 9 points. Zerohedge.com helpfully posted the Nanex chart.



Gold investors will recall this is the kind of action that was seen right before the April 2013 smash: computers probing futures market liquidity. No doubt, since liquidity was found wanting, the computers have redoubled their efforts.

Perhaps this is why the Fed this week trotted out San Francisco Fed head John Williams to say: “If we really get a sustained, disinflationary forecast . . then I think moving back to additional asset purchases in a situation like that should be something we should seriously consider.” St. Louis Federal Reserve Bank President James Bullard joined his colleague on Thursday, saying: “Inflation expectations are declining in the U.S. That’s an important consideration for a central bank. And for that reason I think that a logical policy response at this juncture may be to delay the end of the QE.”

Anyone holding dollars should seriously consider the import of these statements. The Fed simply will not allow the stock market to fall below a certain level if it is within its power to prevent the drop. Its power consists of one trick: printing dollars and distributing them to Wall Street cronies to buy financial instruments.

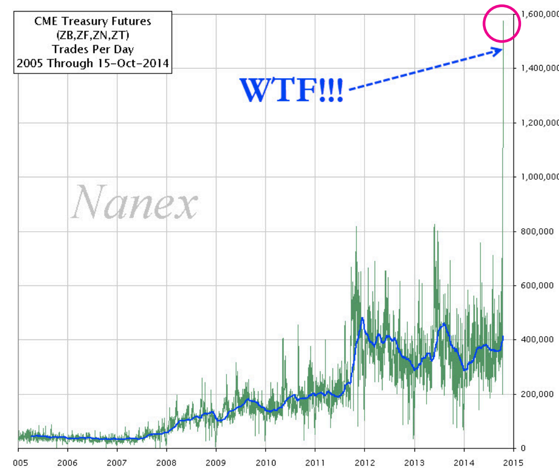
But, until the Fed starts printing again, the margin clerks are in command. As assets move lower, the credit financing those assets evaporates – the money literally disappears – forcing liquidation sales and lower prices still.

In 2008, gold fell along with the market in nominal terms, outperforming only in relative terms. The nagging question for gold investors whether that will repeat in the next crash, which looks like it may be already underway, or whether gold will break free and actually rise nominally during the implosion.

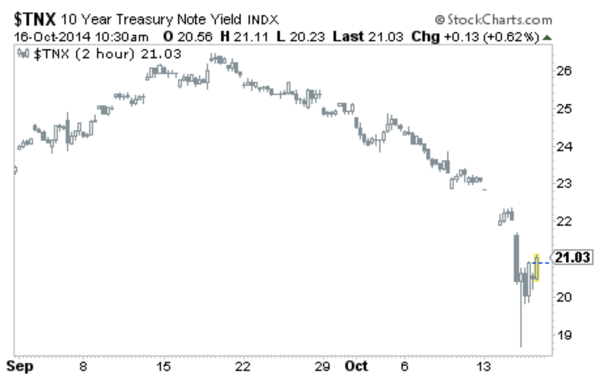
The reason markets crash is because of a sudden shortage of currency. There are over $100 trillion of debt contracts in the U.S., including the shadow banking system, and only $4 trillion of base money with which to make interest payments on that mountain of debt. If the Fed fails to print fast enough, there is a short squeeze on dollars. Dollars may not have any intrinsic value, but those indebted who run out lose their collateral, providing a strong incentive to keep dollar balances.

In 2008, the first big spike in the dollar index sent gold crashing as all assets were liquidated in a desperate bid for dollars. Four months later, even as the dollar hit a higher high, gold was back at its all-time high. When the biggest debtors of all start teetering, the banks and the government, no one wants fiat whatever the circumstances. The sharply rising dollar of the past several weeks suggests the short squeeze is underway, soon to be followed by stress moving from the periphery to the center.

A the key difference this cycle is that last time gold had risen in nominal terms along with the stock market. In this cycle, three years of nominal losses has created an indigenous short position by various players. When these funds get margin calls in other markets, they will be forced to buy in order to close their positions. This dynamic sets up a perfect storm for gold: spiking in the initial crash, rising more when core institutions start wobbling, and then a third time when the inevitable policy blitz arrives.



That crash point may not be far off. Wednesday saw some extraordinary trading. Zerohedge delivers again with this eye-popping chart from Nanex showing the combined Treasury futures trade Wednesday.



Someone bet badly. The second chart shows 2-hour bars of the 10-year Treasury bond yield, the most liquid market in existence. Moving the yield from 2.2% to 1.85% in just over two hours implies value dislocations of enormous scale. Recall that banks and funds hold ridiculously levered positions on a VAR ("value at risk") basis. The VAR models rely on historical data to generate risk parameters given assumptions of the limits markets can move in a day. Since it's all the same MIT scientists programming these models, whenever they blow up it's sure to spectacular. It has all happened before: portfolio insurance in 1987 and Long Term Capital Management are the two primary examples of mathematical models that nearly destroyed the financial system. The difference now is the forces are vastly greater, presenting the risk of a financial market sudden stop.

Physical gold is the only sure thing to survive. Presently, it looks like conditions are gathering for a perfect storm for gold stocks too. Margins are nearly flat currently, so any increase would generate stellar equity returns from current levels. Gold stocks have already started responding, moving contrary to the moves of the broader market. If gold is back at its all-time high in four months, with oil and stocks crashing, the move could be of epic proportions.