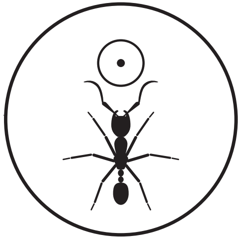

Myrmikan Research

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Credit Cycle Singularity

November was another frustrating month in the gold mining sector. The GDXJ junior gold mining ETF was up 12% mid-month only to finish down 1.3%. The broader markets behaved similarly, with the S&P 500 jumping 3% by mid-month but finishing down 2%. Gold stocks tend to trade in sympathy with broader markets in the very short term—such as in March of 2020—but over longer periods trade in opposition.

This long-term, anti-correlated relationship may explain why this whole year has been challenging for gold mining performance. The S&P 500 has surged 23% year-to-date; and after substantial increases in 2019 and 2020, gold stocks were perhaps due for some consolidation.

Gold mining investors are depressed that gold remains mired below $1,800, having traded above $2,050 in August of 2020, but they may forget that gold was stuck below $1,300 as recently as May of 2019, only two-and-a-half years ago. Current gold and silver prices are plenty rich for most mines to make good profits, even in the face of rising costs.

There has also been a spate of M&A activity in the sector over the past month, suggesting the larger players see value in the smaller companies: Newcrest Mining acquired Pretium Resources at a 22% premium to market. Kinross acquired Great Bear Resources at a 40% premium to Great Bear's 20-day VWAP. Hochschild Mining acquired Amarillo Gold at an 80% premium.

Amarillo had developed a shovel-ready project in Brazil with an after-tax capital payback of 18 months and an after-tax NPV 5% of $360 million, assuming gold at $1,730. It was resilient to lower prices—the NPV at $1,400 gold was still a respectable $183 million—and had operational leverage to higher prices, the reason why it was included in Myrmikan's portfolio.

The company had raised the equity component of the construction costs. And yet the shares sank and sank, falling 35% just in the past five months to an enterprise value of just $45 million, perhaps because of the accurate perception that debt financing for the sector had become challenging. Unable to obtain construction financing at decent terms, the company sold itself to Hochschild for a large premium. While we are disappointed at the acquisition, given that the company was far more valuable had it been able to finance construction on its own, we are happy to have the cash to redistribute to other names with similarly depressed share prices.

Part of the frustration of 2021 has been watching companies such as Amarillo trade to valuations that make no sense operationally, though they may make sense in terms of liquidity: either the liquidity of other shareholders or in terms of companies' ability to raise capital. Our expectation is investing in quality companies means that

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either we will see substantial gains when gold regains momentum and financing conditions improve or that acquirers will be forced to become more aggressive both in terms of the targets they pursue and the prices they pay as more projects disappear into larger companies.

Meanwhile, the macro-economic case for owning gold miners is as strong as it has ever been. As discussed in previous letters, the Federal Reserve finds itself out-of-sync with the credit cycle. Supply chains continue to get more snarled: the average wait-time for a ship to get a berth at Los Angeles has jumped from seven days in August to twenty-one days as of the end of November. Rising prices are suppressing consumer demand: retail sales in November actually fell when adjusted for inflation. Waning COVID transfer payments are also suppressing demand. Rising interest rates are pressuring corporate access to capital: the BBB corporate bond yield has jumped from 2.15% this summer to 2.57%, and the CCC yield from 6.52% to 8.00%. Treasury yields, meanwhile are barely changed from the summer, meaning corporate spreads are widening, a bearish sign.

Meanwhile, the broader markets look sick. China's $55 trillion property market (twice the size of that of the U.S.) is a slow-motion train wreck. The S&P 500 has not begun a sustained downtrend, but volatility has increased significantly, often a sign of the top. Market breadth is terrible: even though the Nasdaq remains near all-time highs, for example, 60% of Nasdaq stocks are below their 200-day moving average. Many bubble markets have already popped: Cathy Woods' ARK Innovation ETF is 42% off of its 2021 high. Tesla is down 22% and Bitcoin 31% just in the past month.

The Fed has signaled that it thinks asset prices are too high, warning "asset prices may be vulnerable to significant declines should risk appetite fall" in its bi-annual "Financial Stability Report." That was back in May. The S&P 500 would have to fall 10% to return to May's price level. Presumably, the market will have to fall well past that level to seek out the current strike price of the Fed put.

That expedition may occur much faster than market participants expect. We credit Jim Rickards with the line that the Fed thinks it is operating a thermostat when in fact it is at the controls of a nuclear reactor. It thinks it can nudge financial conditions warmer or cooler. In fact, in a world of margin and margin calls, asset prices gain their own momentum; and if they travel downward beyond a critical threshold, the insane quantity of global debt will implode, forcing either the unwind of the banking system or additional interventions that will be heretofore unthinkable.

Ludwig von Mises penned what has been the guiding philosophy of Myrmikan's strategy since inception: "There is no means of avoiding the final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as the result of voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the currency system involved."

The vise between deflationary collapse and hyperinflation is growing ever tighter. Previously it took years for the Fed to bounce back and forth between boom and bust: Internet bubble in the late-90s, bust in early 2000s, housing bubble in mid-2000s, bust in late 2000s, everything bubble in the 2010s, China bust in the mid-2010s and repo market crisis in 2019, then COVID stimulus bubble.

Now the Fed is staring down a deflationary collapse of asset prices and higher consumer inflation simultaneously. When these two forces converge, in the not-

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distant future, the credit cycle will reach a singularity that will demand a final choice: print or die. And not the QE kind of printing—cautious, hidden in the plumbing of the financial system, limited in scope—but public, no-limits, dump-currency-in-people's-front-lawns kind of printing.

Central banks print like this not because they are insane but because the path to hyperinflation is paved with deflationary scares and cries about the scarcity of money. In the greatest example, Germany of 1923, central bank chief Rudolph Havenstein announced—publicly—an extraordinary effort to meet the "rapidly increasing demand for additional currency":

> The Reichsbank today issues 20,000 milliard [billion] marks of new money daily, of which 5,000 milliards are in large denominations. In the next week the bank will have increased this to 46,000 milliards daily, of which 18,000 milliards will be in large denominations. The total issue at present amounts to 63,000 milliards. In a few days we shall therefore be able to issue in one day two-thirds of the total circulation.

Even with sixty-three trillion marks issued, the authorities' foremost concern was how to address the "scarcity" of money.

One need not look to such an extreme example of how money printing paradoxically leads to a scarcity of money: the same phenomenon occurred in American's own history. In 1690, Massachusetts sent a raiding party to Quebec. Soldiers were normally paid out of the plunder—this raid was repulsed, but the soldiers demanded pay anyway. So Massachusetts issued £40,000 in bills of credit to make the payment and made the bills receivable for taxes at face value. The issuance was so successful that the colony began issuing a series of notes. "This was a fatal experiment," wrote nineteenth-century banking historian Horace White: "Its apparent success as a means of postponing taxes led to disorders far worse than the commodity currency of the earlier period. It spread to the other colonies like an epidemic."

As note issuances by the colonies exploded, tax revenue ceased to be sufficient to back the bills, and the notes began to sink in value. Ever more stringent methods were employed to enforce the legal tender laws. Thomas Hutchinson, the last royal governor of the Massachusetts Bay Colony, observed that by 1713, "so many bills had been issued for the charges of the war, particularly the large sum of forty thousand pounds, issued for the Canada expedition, that they were become the sole instrument and measure of commerce, and silver and gold were entirely banished," as they are in our own time.

By 1719 the boom had turn to bust. "People of estates cannot raise money, unless they dispose of them at half their value," complained one supporter of paper money. He urged fiscal stimulus: "Fifty thousand pounds ought to be laid out for making a bridge over Charles River, so that workmen might be employed and currency enlarged, as well as the public accommodated; and ruin will come unless more bills of credit are emitted." Economists today study math and ignore history, but all of the policies implemented today have antecedents for those willing to look.

The bust persisted and Hutchison recorded that in 1720, "the trade of the province declined. There was a general cry for want of money, and yet the bills of credit, which were the only money, were daily depreciating." At the same moment that business could not find ready commercial credit, funds for speculation were rife: "Waste lands

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have an imaginary value set upon them, sometimes higher, sometimes lower, and continually afford subject for bubbles among ourselves."

Who can read these lines and fail to see the parallel with current affairs? Industrial activity in the United States is less today than it was in 2007; yet Wall Street makes huge profits directing capital toward assets of imaginary value.

Over the objection of the governor, in 1721 Massachusetts issued another £100,000 in bills of credit to stimulate trade—as if a sparse, rugged population in a new country with vast resources should need stimulating. Seven years later, Hutchinson recorded:

> The trade of the province being in a bad state, and there being a general complaint of scarcity of money the old spirit revived for increasing the currency by a further emission of bills of credit.... Some of the leading men among the representatives, were debtors and a depreciating currency was convenient for them.

And, again, five years after that, Hutchison wrote: "there was a general complaint throughout the four governments of New-England of the unusual scarcity of money. There was as large a sum current in bills of credit as ever, but the bills having depreciated they answered the purposes of money so much less in proportion."

In 1751, Parliament outlawed the issuance of any further bills. However, the first thing the American patriots did when they formed their revolutionary government was, of course, to print more money: "Do you think, gentlemen," charged one congressman "that I will consent to load my constituents with taxes, when we can send to our printer, and get a waggon load of money, one quire of which will pay for the whole!" more or less the attitude of establishment Republicans. The Continental Congress issued $240 million continentals into an economy that had previously made due with $10 million in gold and silver. The value of the continental sank by 99.7%. No wonder that the delegates to the Constitutional Convention added to Section 10: "No state shall ... make any thing but gold and silver coin a tender in payment of debts" (the tenth amendment disallowed Federal legal tender laws until the prohibition was abolished by judicial fiat because of the funding necessities of the Civil War).

The alternative to final and total catastrophe of the dollar is the Cyprus solution: drain the system of excess liquidity by canceling financial claims on assets through banking and shadow-banking bail-ins. Instead of gold running into the $10,000s per ounce, nominal asset prices would collapse (and the prices of goods as well, though less so). All of modern economic theory rejects this option, but it remains a possible policy choice.

The pattern that Mises identified has played out over the centuries across innumerable countries. Contemporary America will not be immune. Myrmikan invests in gold mining companies not because it hopes to slowly compound capital over time but because the central banks are going to fail, global currencies are going to collapse (or be canceled), much value will be revealed to be imaginary, gold will reestablish itself as *de jure* currency and not just *de facto* money. When the credit cycle singularity hits, the world will be suddenly and forever changed.

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