



Myrmikan Research

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The New Bancor

Gold shares have skidded sharply in recent months: the GDXJ gold miners ETF and HUI Gold Bugs index both fell 41% from mid-April to mid-June. The TSX/S&P500 Global Gold Index of larger miners fell 39%. Gold shares have rebounded by roughly 15% in the past three weeks as gold seems finally to have found a bottom. Myrmikan maintains that gold shares remain efficient (and now cheap) vehicles to guard against the collapse of the central banks' monetary experiments and to hedge against the global chaos being fomented by the ebbing power of the American empire.

We see that power vacuum in many divergent spheres, from U.S. internal politics, where the rule of man usurps the rule of law, where the establishment left encourages violence (against Supreme Court justices, for example), where the ruling regime politicizes law enforcement, both in terms of who it prosecutes (republicans and those defending themselves against violence) and who it doesn't (the violent and friends and family of the regime), from the corruption and humiliation of the Afghanistan occupation, to the ongoing implosion of America's European allies, and the spectacular failure of America's surgical strike against the Russian Ruble.

The ruble began 2022 at 75 to the dollar. U.S. financial sanctions following the outbreak of hostilities in Ukraine sent the ruble down 46% within three weeks. Ejected from the Western banking system and with U.S. financial players freezing local operations, Russia was supposed to default, hyperinflate, collapse economically, and have a swift change in leadership.

Six week later, however, the ruble had regained all of its losses. Then-White House Press Secretary Psaki dismissed the ruble's recovery as manipulation: "it's important to note that the Russian Central Bank is making extreme policy decisions to artificially prop up the ruble," like raising the overnight interest rate to 20%, for example. "So it's not actually on the rise," Psaki continued.¹ Except that it was, and that the ruble kept on rising. And now, four months later, the overnight rate stands at only 8%, and the ruble has increased to 60 rubles to the dollar, a year-to-date gain of 25%.

The ruble's resilience is the harbinger of a new international monetary order emerging from the wreckage of U.S. dollar management. Most international operators likely do not want a new monetary order: networks effects and the comfort of understanding how to navigate the existing order, however flawed, are forms of capital not eagerly abandoned. But, as with money itself, which Aristotle tells was formed of "necessity" and not by design, necessity will drive countries into a new order.²

¹ <https://www.whitehouse.gov/briefing-room/press-briefings/2022/04/06/press-briefing-by-press-secretary-jen-psaki-april-6-2022/>

² "Many barbarous tribes now subsist by barter, for these merely exchange one useful thing for another, as, for example, giving and receiving wine for grain, and other things in like manner. From this it came about logically that as the machinery for bringing in what was wanted, and of sending out a surplus, was inconvenient,

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Perhaps the most prominent narrator on the coming order is ex-Fed insider Zoltan Pozsar. His recent commentary tells us that from a central bank perspective, money has four attributes: par, interest, foreign exchange, and price level.¹

Par means ensuring that nominal claims on money remain equal to the money available: i.e., money market funds and banks retain the ability to meet any and all withdrawals demands at face value. In March 2020, for example, when Fed governor Neel Kashkari was asked: “Will the Fed ensure that banks have all the cash they need to satisfy whatever withdraws may be coming,” he responded: “Yes. This is the fundamental reason the Federal Reserve exists. We call it lender of last resort.”²

The second attribute of money, interest, is the relationship between present and future money. Central banks control interest rates by buying and selling (mostly buying) bonds: the more bonds they buy, the higher bond prices go. Since bonds have an interest payment fixed as a percentage of face value, a higher bond price with a constant interest payment means a lower yield. And, since bonds are fungible, a lower yield on existing bonds means newly issued bonds will reflect that same lower yield. Returning to Kashkari, who is foolishly blunt, when asked during the COVID panic: “What’s it gonna take to get the bond markets working again? ... Can you characterize everything that the Fed has done this past week as essentially flooding the system with money?” He responded: “Yes. Exactly.” “And there’s no end to your ability to do that?” “There is no end to our ability to do that.”³

Pozsar’s third attribute, foreign exchange, may also be managed by central banks, but only when they act in concert, such as the Plaza Accord in 1985 and the Louvre Accord in 1987. Such agreements are moderately effective when joined with political power, such as repeated U.S. threats to withdraw military support for Western Europe during the Cold War.

Japan’s current predicament illustrates the limits on currency coordination, however: The Bank of Japan has purchased more than half of Japanese government bonds to enforce yield curve control in its effort to manage the economy, setting a hard limit of a 0.25% yield for the 10-year government bond. As global inflation pushes up rates everywhere, the BOJ has had to accelerate its bond buying to keep yields from rising. But this has now caused the yen to fall 15% since March (with corresponding increases in the costs of imports such as energy). Japan has reportedly requested the U.S. to help support the yen, but that would mean driving down the dollar and importing part of Japan’s inflation, for which there is no appetite. All Japan received from the U.S. Treasury was the bland statement: “We will continue to consult closely on exchange markets and cooperate as appropriate on currency issues, in line with our G7 and G20 commitments.”⁴

The fourth element of central bank management, the price level, is not under their direct control. Central banks can heavily influence nominal prices of domestic assets to the extent they are driven by investment demand: the nominal prices of stocks, bonds, and real estate. The Fed can also influence commodity prices, but only through very round-about ways. The real estate bubble of the 2000s, for example, was driven by the private banks backstopped by the Fed. The bubble created extraordinary demand for

the use of money was devised as a matter of necessity. For not all the necessities of life are easy of carriage; wherefore, to effect their exchanges, men contrived something to give and take among themselves, that which being valuable in itself, had the advantage of being easily passed from hand to hand for the needs of life; such as iron or silver, or something else of that kind.” Aristotle, *Politics, I, 9*.

1 <https://www.opiniopro.com/2022/03/credit-suisse/bretton-woods-iii/>

2 <https://www.cbsnews.com/news/transcript-neel-kashkari-on-face-the-nation-april-12-2020/>

3 <https://www.cbsnews.com/news/coronavirus-and-economy-best-and-worst-case-scenarios-60-minutes-2020-03-22/>

4 <https://home.treasury.gov/news/press-releases/jy0858>

commodities, sending prices soaring, which then created a supply response, a glut, a crash, and then money printing. So, in fact, we see that the Fed's influence on commodity prices is opposite to the outcome they want: which would be lower prices during the boom and higher prices during the bust.

Repeated interventions to maintain the bubble economy must eventually weaken the currency, which means that the more the Fed exerts control over the first attributes of central bank money, par and rates, the less it can control the price level. This principle applies even more strongly to other countries, such as Japan, that do not issue the world's reserve currency and lose control of their foreign exchange value as well.

Central banks have little ability to reduce commodity prices (and therefore the price level of goods) when they are driven higher because of bad regulation (as in the U.S.), military destruction (as in the Ukraine), or political sanctions (as against Russia). Raising interest rates to inhibit demand to match lower supply makes financing commodity projects harder, reducing future supply, and, therefore, increases the costs of living still further. Only an act of desperation, such as throwing the economy into a depression to lower demand more than reduced supply can lower prices. But low prices also inhibit supply growth, meaning any recovery will send prices higher than before.

Poszar points out that the current situation with regard to the price level is worse than the framework above implies because commodities no longer have a unified price: Russian-sourced commodities collapsed in price after hostilities commenced while non-Russian commodity prices soared. Russian oil began 2022 at \$76/bbl versus \$77/bbl for Brent oil. By late April, Russian oil had fallen to \$68/bbl whereas Brent had jumped to \$101/bbl. Bottlenecks in U.S. natural gas exports, such as the explosion at the Freeport LNG Terminal in Texas, have similarly sent U.S. natural gas prices down while causing European natural gas prices to explode higher. Trading houses, such as Glencore and Trafigura, have been hit with margin calls on both sides of their trades.

Firms like Trafigura contract with producers to receive commodities over multi-year terms. They sell futures short on the commodity exchanges to hedge their physical long exposure and then settle the short positions with deliveries of physical commodities as the short positions expire. Their positions in the futures markets are not speculations on price direction but hedges of their contracted physical supply.

However, when futures prices spike higher suddenly, making the short positions have large mark-to-market losses, banks demand more collateral even though the ability to deliver physical commodities against the short as it matures is never in question.¹ Commodity trading houses have been trying to raise billions in additional capital but have been rebuffed by banks and even private equity firms. They have even demanded central bank bailouts, which have not been forthcoming.

Apart from margin call problems, trading firms and markets face balance sheet capacity issues. Commodity markets generally operate on large volumes and thin profit margins. Producers and purchasers of raw commodities need large amounts of working capital relative to their profits to finance shipment and processing, capital that is typically borrowed from trading firms. If the nominal value of a ship full of a commodity has doubled, for example, then a trading firm needs lend twice the capital to finance the shipment of the same physical quantity of commodities. If their balance sheets are unchanged (or smaller because of margin calls), trading firms can finance only half (or less) the previous physical movement. This dearth of capital has allowed trading firms to increase their margins substantially, which has the effect of increasing the prices buyers

¹ See a recent report by the Dallas Fed: <https://www.dallasfed.org/research/economics/2022/0414>

pay for commodities while decreasing the prices that sellers get for them. Lower prices to suppliers translates into falling supply and even higher wholesale prices.

The intensity of commodity trade turmoil has prompted many food and energy exporters to hoard supply to ensure that domestic demand is satisfied at existing prices. India, for example, has banned the export of wheat and limited exports of sugar to ensure sufficient domestic supplies.¹ Argentina has limited exports of beef² and soy products.³ Hungary has banned exports of grain.⁴ Malaysia banned the export of chicken products (though softened the ban for neighboring Singapore).⁵ Indonesia lifted its export ban of palm oil only after imposing a local sales requirement to keep domestic prices low.⁶ Norway is planning to ban the export of electricity from its hydroelectric plants: “we must secure enough power for our national consumption,” explained the energy minister.⁷

This emerging distinction between international market prices and politically-driven domestic prices will lead naturally to a new financial order in which commodity producers will trade directly in terms of commodities themselves—or currencies representing commodities—bypassing the dollar and international markets.

Private and public actors hold dollars (as opposed to pesos or lira) because of the expectation that the dollar’s purchasing power is relatively stable. The higher and more volatile and more divergent commodity prices become, however, the more the market will seek alternative vehicles to store purchasing power. For example, Malaysia may become willing to trade its chickens for Indian wheat but not for dollars from a place like Egypt, which can no longer bid on Indian wheat. Pozsar thus answers those who argue that the dollar will remain strong because there is no other prospective reserve currency by concluding that the U.S. dollar will fail not against the euro or the yen (which the dollar index measures) or the yuan but against commodities or, more broadly, against the price level of goods.

Putin’s recent speech demonstrates that Russia is self-consciously encouraging this shift away from currencies and towards commodities:

So, they printed more money, and then what? Where did all that money go? It was obviously used to pay for goods and services outside Western countries—this is where the newly-printed money flowed. They literally began to clean out, to wipe out global markets. Naturally, no one thought about the interests of other states, including the poorest ones. They were left with scraps, as they say, and even that at exorbitant prices....

Under the cloud of inflation, many developing nations are asking a good question: why exchange goods for dollars and euros that are losing value right before our eyes? The conclusion suggests itself: the economy of mythical entities is inevitably being replaced by the economy of real values and assets.⁸

1 <https://www.voanews.com/a/india-defends-wheat-export-ban-/6590477.html>
2 <https://www.euomeatnews.com/Article-Argentina-sets-new-rules-for-beef-exporters/5360>
3 <https://www.reuters.com/world/americas/argentina-halts-export-registration-soy-oil-meal-2022-03-14/>
4 <https://www.reuters.com/article/ukraine-crisis-hungary-grains-idAFL5N2V75IT>
5 <https://www.bloomberg.com/news/articles/2022-06-01/malaysia-reaffirms-live-chicken-export-ban-in-blow-to-singapore?sref=lsNUbNMA>
6 <https://www.reuters.com/markets/commodities/indonesia-ministry-hold-briefing-lifting-palm-oil-export-ban-2022-05-20/>
7 <https://www.montelnews.com/news/1340275/norway-to-curb-power-exports-on-hydro-dearth--minister>
8 <http://en.kremlin.ru/events/president/news/68669>

India's biggest cement producer, UltraTech Cement (ULTC.NS), is importing a cargo of Russian coal and paying using Chinese yuan.¹ Turkey is in discussions with Russia to switch trade settlement from dollars to ruble and lira.² The ruble's strength against the dollar, and the dollar's soaring value, means that Russia now faces the problem that its currency is too strong, and it has announced it may start buying currencies of friendly countries, essentially trading its oil for imports.³

The import of this shift is not so much with regard to the present exchange of current goods: converting one currency to another to execute a trade and then back again is a trivial matter, nearing eliminating the need to hold cash balances. The importance is that if trade takes hold in alternate currencies, then it becomes more sensible to denominate debt in those currencies, and it is through dollar debt markets that American exerts its power.

Pozsar concludes that the global monetary system is moving: "from the Bretton Woods era backed by gold bullion, to Bretton Woods II backed by inside money (Treasuries with un-hedgeable confiscation risks), to Bretton Woods III backed by outside money (gold bullion and other commodities)." We see it already in the value of the ruble. No one is buying rubles because they want exposure to Russia, Inc. (even Putin has admitted that sanctions have materially damaged Russia's economy); countries are buying rubles because Russia now requires them in exchange for its energy and metals. It does not hurt that Russia has little debt and a lot of gold.

Bretton Woods III is not a positive development for global trade—it brings the world nearly back to the swamp, in fact. Contrary to popular myth, primitive societies did not subsist on barter: the primitive world had very little division of labor—everyone did everything, the reason such societies remained poor. Trade began as an inter-tribal ritual, as Aristotle described: when they weren't fighting, tribes on the coast with lots of fish might trade with the tribes inland with a surplus of coconuts—more or less the Bretton Woods III system that is emerging.

Pozsar's analysis is sound except that he truncates monetary developments at both ends. Before Bretton Woods was the gold-exchange standard, and pre-World War I there was simply the international gold standard: currencies were not *backed* by gold; currencies were *defined* as a certain mass of gold. Therefore, both domestic and international transactions in goods and for credit, though denominated in national currencies, were, in fact, accomplished in terms of gold directly.

As for Pozsar's Bretton Woods III, backing currencies with a basket of commodities is not a new idea. Stanley Jevons, for example, proposed in 1875 to make money more stable through the issuance of "a legal tender note which should be convertible, not into any one single commodity, but into an aggregate of small quantities of various commodities.... Thus a hundred pound note, would give the owners a right to demand one quarter of good wheat, one ton of ordinary merchant bar iron, one hundred pounds weight of middling cotton, twenty pounds of sugar, five pounds of tea, and other articles sufficient to make up the value."⁴ Irving Fisher and Keynes both proposed more sophisticated versions of a commodity monetary standard: Keynes's "bancor" was to be an international reserve

1 <https://www.reuters.com/business/exclusive-indias-top-cement-maker-paying-russian-coal-chinese-yuan-2022-06-29/>

2 https://www.bloomberg.com/news/articles/2022-07-19/turkey-looks-to-ditch-dollar-in-payments-for-russian-energy?utm_campaign=socialflow-organic&cmpid%3D=socialflow-twitter-energy&utm_source=twitter&utm_content=energy&utm_medium=social&sref=lsNUbNMA

3 <https://www.reuters.com/business/energy/russia-introduce-new-budget-rule-60-per-barrel-oil-vedomosti-2022-07-19/>

4 William Stanley Jevons, *Money and the Mechanism of Exchange* (New York: D. Appleton and Co. 1876). 4/19/2018. http://oll.libertyfund.org/titles/318#Jevons_019L_535

asset similar to the IMF's Special Drawing Rights and stabilized by using bancors to buy commodities when they were cheap and sell them when expensive.

This kind of money is similar to that which Putin is proposing and which the Chinese have pondered since the first QE, when governor of the central bank of China wrote: "The creation of an international currency unit, based on the Keynesian proposal [of the bantor], is a bold initiative that requires extraordinary political vision and courage."¹

The problem is that commodities make very bad money. The essential attribute of money is that it measures value, *not that it has stable purchasing power*. The distinction is subtle but critical. In a bubble, for example, commodities, stocks, real estate, etc., get more expensive as a signal that they are either scarce or overpriced. If money were to adjust so as to stabilize prices, than those signals would be hidden from the market. As George Gilder points out: "A measuring stick cannot be part of what it measures."²

Raw commodities sit at the beginnings of every supply chain both for capital and for consumer goods—they are the most distant elements from consumption. Small changes in the discount rate, therefore, have great influence on their value, the reason their prices are so volatile. The only asset class with greater sensitivity to discount rates is real estate, which has cash flows infinite in duration. It was John Law's idea to base money on real estate and, indeed, that is more or less the system that the West adopted: half of the assets in the U.S. banking system (which backs dollar deposits) is real estate.

Gold, on the other hand, is the optimal foundation for money because it measures value. Gold fulfills this measuring function well not only because of its stable supply, durability, identifiability, high unit value to mass, and broad distribution, but also because it is not demanded in industry, making its value virtually immune to the credit cycle and, therefore, changes in discount rates.

Free markets, including the money market, are self-optimizing. This is why the gold standard became preeminent during the Laissez Faire nineteenth century—not because politicians willed it but through economic necessity. As Horace White noted in 1893:

The most impressive fact in the world of finance is the dominance of the gold standard. A year or two ago Roumania passed under its sway, today it is Austria, next year or soon it will be India, by and by it will be Russia, and meanwhile it has lost no ground that it has ever held. Three international conferences have been assembled to stay this conquering march, while none has been called to promote or assist it. Yet the movement has been as little impeded as that of an ocean steamer would be by the action of a debating society in its own cabin. Is all this due to human perversity, or has it a rational cause founded in the needs of mankind?³

It is possible, as Pozsar argues, that international trade will transition through some sort of Mad Max commodity barter world as U.S. dollar hegemony collapses. Assuming trade survives, the market will swiftly instruct economic actors that gold is the ultimate reserve asset.

But not yet. The U.S. will not willingly abandon the global reserve status of its currency, that which maintains its global hegemony. It did not when Saddam Hussein proposed

1 Xiaochuan, Zhou. Governor of the People's Bank of China. "Reform the international monetary system." 23 March 2009. <https://www.bis.org/review/r090402c.pdf>

2 Gilder, George. "The 21st Century Case for Gold: A New Information Theory of Money." American Principles Project: 11.

3 White, Horace. "The Gold Standard. How It Came into the World and Why It Will Stay. A Historical Sketch with Some Practical Reflections Thereon." *The Evening Post Pub. Co.*, 1893: 3.

selling oil in terms other than the dollar, nor when Muammar Gaddafi proposed setting up a gold-backed pan-African currency. American neocons publicly call for Putin to share a similar fate, but the methods used against Iraq and Libya are too risky against a nuclear armed Russia, the reason for aiding a proxy war to try to destabilize Russia without direct conflict. Another way to undermine the development of a competing, commodity-backed, BRIC currency is by targeting commodity prices: it is perhaps this political prerogative that is driving Fed policy, more than general management of the business cycle and inflation.

As discussed above, the Fed's control of the price level is tenuous at best: it cannot print commodities to respond to supply disruptions. But it can shock global demand by jacking up interest rates, creating dollar debt crises all around the world, forcing the foreclosure of third world assets by first world lenders.

Such a policy would have to be sharp and short-lived: sharp enough to put Russia and the BRICS on their backs but short enough not to endanger the U.S. financial system or the federal government. Russia demonstrated it could survive 20% interest rates because it has little debt and a lot of gold and in the context of strong commodity prices. The West does not have such resilience.

High interest rates not only destabilize the over-indebted consumer and punish companies who must roll their debts, and they do not just threaten to defund the government as rising interest payments force either cutbacks in spending or accelerating Treasury issuance, they also undermine the solvency of the Fed itself.

By law, the Fed must hand over interest payment income that exceed its operating budget back to the Treasury. The Fed is prohibited from buying debt directly from the Treasury so as to avoid Banana Republic-style money printing. But our system is little different in substance: the banks buy the bonds, the Fed buys them a short time later (providing a free profit the banks), and then it hands over the interest payments—so the reality is little different from the typical practices of our southern neighbors.

Fed policies through 2020 avoided high consumer inflation, and the stimulus-spike inflation is wearing off, but higher rates will perversely accelerate the money printing even as they harm private markets. Recall from the school textbook that banks must keep their reserves at the Fed, typically set at 10%. Prior to 2008, banks did not earn interest on these regulatory deposits. Following the 2008 crisis, the Fed flooded the banks with cash but then started paying interest on reserves to bribe banks to keep significant reserves at the Fed, thereby avoiding the possibility that all those trillions of base money would crash suddenly into the economy.

This policy worked pretty well when rates were near zero because the interest rate on reserves could similarly be very small. But now that rates are higher, the Fed must offer higher rates on reserves to keep the \$3.2 trillion in reserves bottled up (as well as the \$2.1 trillion parked at the Fed's overnight reverse repo facility): the interest rate the Fed offers on reserves has gone from 0.15% in March to 2.4% currently (2.3% for reverse repo) and will increase again in September.¹ The result, according to former New York Fed president Bill Dudley, is that: "higher interest rates will generate operating losses for the Fed, as the interest it pays on bank reserves far exceeds the return on its holdings of Treasury and mortgage securities."

In 2010, Bernanke argued that QE wasn't dangerous because when the Fed paid out dollars to buy Treasuries, it was merely swapping one asset (dollars) for a close substitute

1 <https://fred.stlouisfed.org/series/IORB>

(a Treasury bond is but an impeachable contract to deliver dollars in the future).¹ A Fed with an operating loss is completely different. It will have to pay out newly printed dollars to banks without receiving any balancing asset even as it stops making interest payments to the Treasury, forcing the Treasury to accelerate the issuance of Treasury bonds to fund spending. Alternatively, the Fed could stop bribing banks to keep their reserves and cash bottled up, but then watch as the trillions in already-printed money go crashing into the economy. The first path leads to galloping depreciation of the currency, the second to a massive credit bubble.

Economic signals continue to be awful. The yield curve becomes ever more inverted, with the 10-year minus 2-year Treasury yield the most negative since 1981, worse than in 2000, worse than in 2007.² Consumer confidence is the worst on record.³ The change in worker productivity (down 2.5% over the past year) is the worst since the series began in 1948, below the 1975 and 1981 recessions.⁴ Notwithstanding the establishment survey, which showed that the U.S. added 528,000 jobs in July, the household survey suggests that there has been no job growth at all since March (and even the establishment survey's job-growth figure reflects growth from workers with multiple jobs, whereas full time employment decreased).⁵ Initial jobless claims are increasing, with last week's reading 100,000 higher than in March.⁶ China's Producer Price Index fell 1.8% in July down 8.2% since October.⁷

The Fed is running out of time. Rising rates have hit commodities, but only back to previous, pre-COVID peaks, not low enough to knockout the BRICS. The U.S. economy is imploding. Continued aggressive rate hikes will usher in a depression, defund the state, and perhaps not even break the BRICS. A Powell pivot will lower the dollar and grant relief to risk assets, but will also empower America's geopolitical enemies. After the initial rate hikes shocked over-levered speculators, it is no wonder that gold has found a bottom and is again rallying.

1 "This fear of inflation, I think, is way overstated... 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 lowering interest rates by buying Treasury securities. And by lowering interest rates, we hope to stimulate the economy to grow faster." "Fed Chairman Ben Bernanke's Take On The Economy." *60 Minutes*. 05 Dec 2010.

2 <https://fred.stlouisfed.org/graph/?g=SDme>

3 <https://fred.stlouisfed.org/series/UMCSENT>

4 <https://fred.stlouisfed.org/graph/?g=SDSN>

5 <https://www.zerohedge.com/markets/something-snaps-job-market-multiple-jobholders-hit-all-time-high-unexplained-18-million>

6 <https://fred.stlouisfed.org/graph/?g=SHdP>

7 <https://www.economy.com/china/producer-price-index-ppi>



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