Myrmikan Research

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

China Wobbles

Despite gold's four thousand year monetary history, during which its every attribute has been explored to the minutest detail *ad nauseum*, confusion continues to reign over the proper price for gold. In fact, as I had to explain on a recent panel at the Mines & Money conference in New York, the price of gold does not change—it is the price of other things that change in terms of gold. Gold has the most stable value of any substance, the reason the market has chosen it as money over thousands of years. As Karl Marx himself wrote:

> The truth of the proposition that, 'although gold and silver are not by Nature money, money is by Nature gold and silver,' is shown by the fitness of the physical properties of these metals for the functions of money.

It is true that retail prices are more stable in dollar terms than in gold terms, given the disruption of constantly altering them. But the prices of spot commodities—which sit at the beginning of every chain of production and therefore ultimately determine retail prices—are far more stable in terms of gold than in terms of dollars. The annual change of oil priced in gold (considered monthly), for example, has had a standard deviation of 40 percent since mid-1971. Over the same period, the annual standard deviation of oil priced in dollars has been 64 percent.

Gold is the most stable store of value and the safest depository of wealth—all other assets are mere speculations. Speculations can pay off, of course. Those holding gold were left behind in the NASDAQ bubble, the housing bubble, and now the everything bubble. All these bubbles have had as their foundation the global paper currency bubble. But gold always wins in the end. Empires rise and fall, but it is the gold coins of the preceding republican period that retain value.

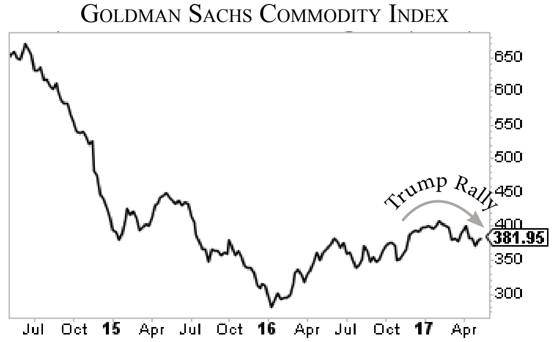
To determine where the "price" of gold is going in dollar terms, therefore, requires an examination not of gold but the of dollar, which is now defined as a unit of liability of the Federal Reserve's balance sheet. As discussed frequently in these pages, the assets backing that liability are long-term bonds, which will collapse when interest rates finally rise in earnest.

For investors in gold mining stocks, however, the more interesting question is how commodities are priced in gold, since gold mining is really just a spread trade between industrial commodities (mining inputs) and gold. To answer that question requires looking at China, which remains the primary consumer of industrial commodities. China consumes nearly half of the world's iron ore, copper, zinc, nickel, and aluminium, among other things. It may be true that China re-exports about one third of the commodities it "consumes," but that still leaves an enormous quantity in the country as raw materials for ghost cities and high-speed railroads to nowhere. And, commodities are priced on the margin, so a relatively small drop in demand can result in an enormous fall in price.

In the summer of 2015, it looked as though the China bubble was popping, and commodities reacted as one would expect. China saved itself through an enormous injection of credit. Yet overcapacity continued to weigh on prices, and now that credit injection is wearing off. In fact, Kyle Bass, one of the most well-spoken of the China bears, argued in a recent interview that China's financial collapse has already begun:

https://www.bloomberg.com/news/videos/2017-05-02/hayman-s-kyle-bass-on-china-s-economy-global-risks-video

Goldman Sachs Commodity Index



China is obviously listening to the markets—according to *The Wall Street Journal*, this week:

> the central bank made its biggest one-day cash injection into the country's fragile financial markets in nearly four months. . . . The huge provision of cash follows comments from Chinese officials in recent days that suggest they are concerned that recent moves to tighten market regulation have caused too much disruption. . . . Chinese Premier Li Keqiang stressed at a cabinet meeting the importance of "striking a balance" between maintaining financial stability, "gradual deleveraging" and stabilizing economic growth.

But there is no way to delever an overindebted economy without a painful restructuring. As Hayek lamented in 1979:

> I had preached for forty years that the time to prevent the coming of a depression is during the boom. During the boom nobody listened to me. Now people again turn to me and ask how we can avoid the consequences of a policy about which I had constantly warned. I must

> witness the heads of governments of all Western industrial countries promising their people that they will stop the inflation and preserve full employment. But I know that they cannot do this. I even fear that attempts to postpone the inevitable crises by new inflationary path may temporarily succeed and make the eventual breakdown even worse....

The Chinese leadership is determined to keep their markets stable through the 19th National Congress of the Communist Party of China this Autumn. As Bass points out, however, it will be difficult to ensure that none of the spinning plates that are the Chinese financial system fall and shatter in the meantime.

China imports a great deal of gold as well, of course, which opens the question as to how gold will fare once the credit system really starts to unravel. Again, gold's value changes very little—rather it is currency that becomes scarce in a credit crunch, and assets are dumped indiscriminately to meet margin calls. Levered entities getting the squeeze generally sell their most liquid assets first, not what they want to, and enormous selling of paper gold can indeed shift gold's value temporarily. In 2008, for example, gold's paper price collapsed, briefly, while the premium on physical coins surged, demonstrating it was not gold that was in trouble but the paper markets. Something similar may be happening in silver right now, in fact: this Zerohedge post makes an interesting case that the recent plunge in silver prices is due to the suspected implosion of Noble Group, Asia's largest commodity trader:

http://www.zerohedge.com/news/2017-05-15/was-asias-largest-commodity-trader-big-silver-seller

Any short squeeze on currency that prompts levered selling of gold, however, will be short-lived: we already know that central banks will print all the paper that is required to steady the financial system . . . and it will require a lot. Gold returned to its all-time high in nominal terms within four months of the bottom in November 2008, whereas it took stocks nearly four years to recover their record-highs.

Investors learn, of course, and it is likely that the next round of crash/print/recovery will occur at a much faster pace, making it difficult to time any draw-down in gold stocks if, indeed, one happens at all. Just because a hit on gold and the miners is what usually happens at the beginning of a credit crisis does not mean it *must* happen. In 2008, many hedge funds were levered long the miners when the margin clerk came calling. It is unclear the extend to which this is so today: generalist funds have avoided the sector since the 2013 bloodbath.

Either way, the very reason to play the end of the credit cycle in the gold mining stocks is that the companies have their own, embedded operational leverage, yet can survive short, sharp drawdowns in gold with little damage to the assets or the ownership of those assets. The equity prices may have violent short-term swings, but the insurance value persists. Gold stocks are still digesting the extraordinary gains of last year, but conditions seemed to be cumulating for the next step higher.