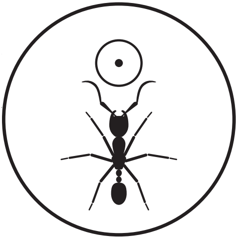

Myrmikan Research Note

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The Beginning of the End?

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Credit Suisse has a new 2013 target for gold: $1100. Ric Deverall, the analyst who set the target, proclaimed:

> Gold is going to get crushed. The need to buy gold for wealth preservation fell down and the probability of inflation on a one- to three-year horizon is significantly diminished. When gold is going up, it looks like a great idea to buy more gold. And when it's going down, do you really think risk-averse central bankers are going to try and catch the knife? No.

As explained in other Myrmikan reports, Wall Street analysis is not just notoriously inaccurate, but generally involves nothing more than projecting forward the current trend, a methodology Mr. Deverall practically admits to using. In fact, the falling knife that central bankers are going to avoid is not gold but U.S. Treasury bonds.

Few have noticed the sharp rise in Treasury yields over the past month, representing major losses for holders of Treasury bonds. Yields are still absurdly low, but the direction of yields matters more than the level.

Austrian Business Cycle theory, developed by Ludwig von Mises, holds that yields must continually fall to maintain an economic boom caused by credit creation. Assuming that view to be correct, yields will either have to fall significantly – presumably through greatly expanded Fed action – or else the economy and market will revert to much lower levels. The Japanese bond market, the second-largest after the U.S. Treasury market, is similarly seeing a surge in yields, which also has the potential to disrupt capital flows.

Gold, properly understood, is a short on the Federal Reserve's balance sheet. As explained in the Myrmikan update from February 2011:

> When interest rates rise, the bond portfolio at the Fed will immediately lose value, and all of its bonds – even the Treasuries – will face vastly increased default risk, further reducing their value. The higher interest rates will not shrink the number of dollars on the liability side of the balance sheet, so the dollar price of gold will have to increase

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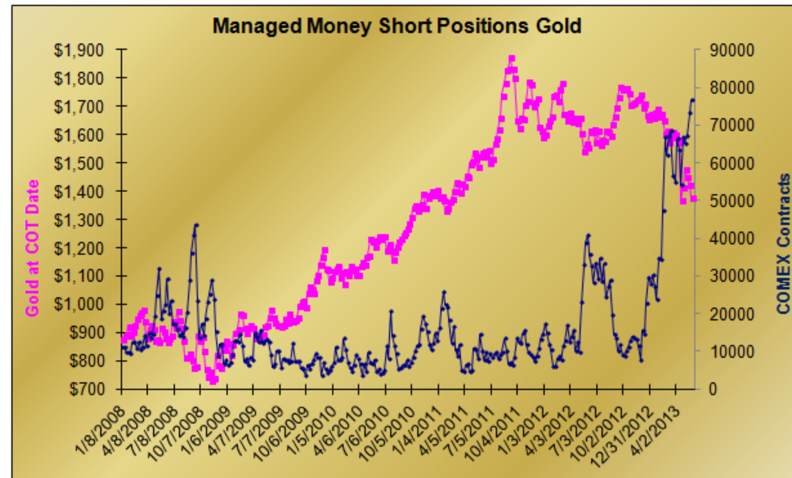
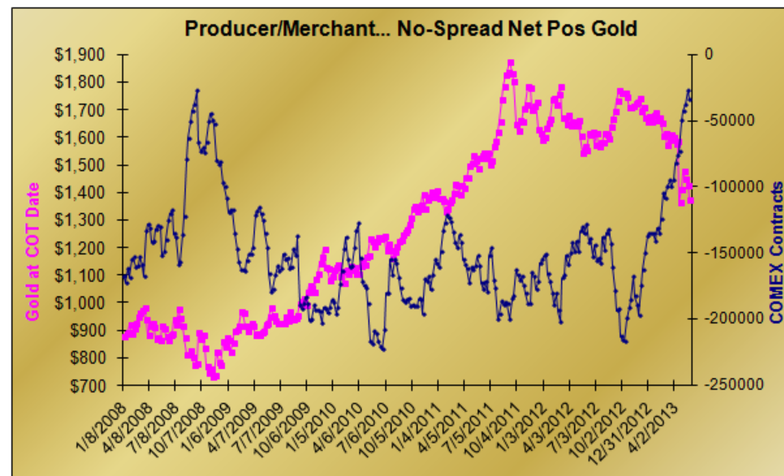
> dramatically, by definition . . . the computer models running trillions of credit dollars, have it backwards. To be sure, when rates first rise, high frequency trading algorithms may well tank gold in the short term due to faulty models. But in the end economic reality always wins.

This is exactly what has occurred. The charts below are from Gene Arensberg's Got Gold report, as reproduced by the Gartman Letter. The top chart shows that managed money, funds taking speculative bets, have built the largest short position on record in the gold futures market, helping to knock the gold price below its various price supports.



Meanwhile, the next chart shows the commercial traders in the gold futures market are the least short since the bottom in 2008.



It is to be remembered that producers are nearly always short in the futures market to balance their exposure to physical long positions. The fact that the commercial operators have covered their shorts indicates that the traders closest to the physical flows do not think the price is going lower, as in 2008.

Moreover, when the physical operators are short, they have the ability to deliver newly mined gold against their shorts to liquidate their positions. When speculative funds are short, they have no choice but to buy back their positions in the open market at some point. With continuing reports of high premiums and physical shortages in Asia

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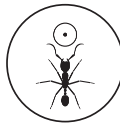
despite large shipments from the West, short covering may need to occur chaotically in a rising price environment.

Myrmikan has argued for years that the real fireworks in the gold market would not occur until the Treasury market peaked and began its inevitable decline. Contra Credit Suisse, this is when cash balance preference will decline and velocity will increase ushering in severe inflation. The conditions are ripe for the fun to begin.



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