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Profit from the Approaching Financial Deluge

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Before I begin I must confess that my formal study of economics never advanced beyond Econ 101, which I took three times – in college, law school, and business school, and did worse each time.

That was when I thought economics was a science, like physics, requiring decades of rote learning to understand. Like most people, I had followed the Fed's advice: leave economics to the experts. Years later I discovered that economics is, in fact, a humanity, a moral science, like politics, in which everyone ought to participate. After all, an agrarian minuteman may not be able to write a treatise on liberty, but he knows when to fetch his gun.

My interest in economic theory and, more specifically, the nature of money began during the panic of 2008. Right before the crisis I had been recruited to move to Buenos Aires to speculate in commodities. Timing is everything, particularly in speculation, and mine was bad. But worse was the later realization that I had been gambling, not speculating, a distinction I'd like to explore with you tonight.

In its simplest form, to speculate is to take a position, long or short, in hopes that a price moves your way. In this sense, speculation is the height of arrogance. If markets are the aggregate expression of each individual's knowledge, then taking a contrary position would be, as the Efficient Market Hypothesis tells us, a futile and non-profitable gesture. True, prices are always changing, and the speculator may win some and may lose some. But ultimately the activity adds no value.

Witnessing the chaos of financial markets in the 1920's and 30's, Keynes recommended investments be made semi-permanent, like marriage. In our own time, looking at the faces of speculation, the disgraced bankers still in their Hamptons mansions hedged from view, collecting bonuses, and still unable to answer the old question – where are the customers' yachts? – one empathizes with Keynes.

But there is another sense of speculation, one that conceives of the speculator as entrepreneur, rather than gambler. Ludwig von Mises wrote in his tome, Human Action:

> Like every acting man, the entrepreneur is always a speculator. He deals with the uncertain conditions of the future. His success or failure depends on the correctness of his anticipation of uncertain events. If he fails in his understanding of things to come, he is doomed. The only source from which an entrepreneur's profits stem is his ability to anticipate better than other people the future demand of the consumers.

Unlike the Keynesian view of speculation, the gambling view, where sometimes the roulette ball lands on 17 and sometimes on double zero, Mises see the speculator as the man who *acts* to create and safeguard wealth. Every loss and gain is simultaneously both private and public. Entrepreneurs and speculators are the fingertips in Adam Smith's invisible hand.

I would suggest to you that most investment decisions are not speculations at all, but gambles, driven by inductive, not deductive, reasoning. For example, consider this inductive argument:

1) Americans are getting older.
2) Older people like the beach.
3) Florida has beaches.
Therefore, invest in Florida real estate.

The premises are sound, the argument reasonable and, indeed, much capital was expended on the basis of its validity. But, as any amateur logician knows, truth and validity are distinct attributes. Older people may like the beach, but perhaps they prefer the mountains or being near their grandchildren. Or perhaps the price level of Florida homes has more to do with interest rates than with the elderly. It's not that inductive reasoning isn't a useful tool – Florida was a great trade for years – but the conclusions are never strong. Buying Florida real estate on the basis of this argument is really a gamble.

Contrast the Florida argument with the following example:

1) In 1942 FDR imposes price controls on many items, including meat.
2) The below-market price of meat causes demand to rise and drives high-cost producers out of business, creating a shortage.
3) Four year later, the mid-term elections are weeks away; Truman's popularity is 32%; and, the Republicans, running on the slogan "To err is Truman," are poised to win and end the meat controls.
Therefore, buy marginal cattle land.

There are no certainties in life, and this speculation can certainly go awry: what if the Republicans don't win; what if they win and chicken out, as they so often do. What if the herd you buy succumbs to foot and mouth disease? But, at least we know, as a matter of economic law – as a matter of deduction, not induction – that, all else being equal, if price controls end, then the price for cattle must soar to entice high-cost producers back into the market, which is exactly what happens.

Today there is another good that, similar to meat in the 1940s, has been held below market for decades. This too has driven out high cost producers. The price control is poised to end. When it does, the good will surge in price and the high cost producers will go from being worthless to worth . . . well, something, a nearly infinite percentage increase.

The good, of course, is gold, and the industry ripe for speculation is the junior gold mining sector. When I say that gold has been priced below market, many of you may think I am referring to the work GATA has done or, perhaps, to reported massive short positions of the large banks. But, actually, the price fixing goes much deeper than that.

Casting your mind back to the days of yore in Medieval England, rich people had a problem: where to keep their gold. Home was out, as it was hard to get good help in those days. And, after a few hundred years, they'd figured out that lending it to the king was a raw deal – he'd spend it on castles and war, invariably default, and if you complained you'd end up in the tower … at best.

So, as libertarian author Garet Garrett told the story, goldsmiths fill the void. In return for safe-keeping gold, they issue gold receipts, paper gold, that pass from hand to hand as money. Observing that few ever come to collect their gold, goldsmiths start issuing additional gold receipts. Now, they aren't exactly Medieval Madoffs – they don't spend the money on frock coats and jesters. No, they lend it out at interest secured by collateral. The theory is that if there are too many gold withdrawals they can always sell the claim on the collateral and repay the note. No harm no foul.

The problem is, the more receipts they lend, the greater the money supply. The greater the money supply, the higher prices go; and the more secure they seem in their loans; and, therefore, the more lending capacity they have; and the more they do lend to enhance their profits.

Everyone feels rich, until one day, when a band of foreigners show up, who don't want domestic warehouse receipts, and demand the gold. Now there's a problem. Our goldsmith must sell some collateral, thereby pushing prices down, which puts neighboring goldsmiths underwater. So they have to sell. Soon there's a panic, prices are in free-fall. Using Garrett's own words:

> The faith is lost. All with one impulse people rush to seize the gold itself as the only reality left—not only people as individuals; banks, also, and the great banking systems and governments do it, in competition with people. This is the financial crisis.

It is important to note that at the panic stage, prices collapse in terms of gold, but the paper claims on gold are revealed to be worthless – demand for them goes to zero, so prices in terms of these currencies go to infinity.

The irony is that even the goldsmiths didn't know what they were causing. They thought they were secure in their collateral – when the panic comes they are as confused as everyone else.

This parable gives us a simple but deep perspective into the fractional reserve banking system. Mises, of course, develops a much more sophisticated version known as Austrian Business Cycle Theory. But, the point is, as long as fractional reserve banking exists, the story will repeat again and again. The inverse debt pyramid climbs ever higher and, as it climbs, all prices rise in terms of gold, making gold a terrible speculation. But, as soon as someone asks to be repaid, for example, Charles de Gaulle in 1971, the edifice collapses and gold surges.

The collapse is not caused by inflation *per se*. After all, the inflation rate in August 1971 when Nixon closed the gold window was declining, from 4.6% to 2.9% a year later. Instead, confidence is the key. De Gaulle wanted to claim France's gold because, since Bretton Woods, despite the $35/oz fixed price, U.S. gold reserves had diminished by half even while the monetary base had nearly doubled. De Gaulle wasn't worried about what had happened as much as he was concerned about what he could deduce was going to happen. Namely, that once the U.S. defaulted on its gold obligations, which was inevitable, then confidence would be lost: interest rates and currency inflation would rise together, a deadly combination for government bonds.

In a way, the 1970s was only a dress-rehearsal for the next step in our current crisis. Although the government had abused its monetary privilege, the banks, in fact, had not. The societal debt-to-GDP ratio stayed below 150% the entire decade. This low debt level allowed Volcker to raise rates to 21%, offer a real return on dollars, and soak up all the extra cash. And, when gold passed $600 an ounce in 1980, the Federal Reserve was solvent – at that price the gold hoard completely backed the monetary base. The Fed had been discredited, but the sovereign promises of Congress were still sound.

Unfortunately, the cycle began again almost immediately. Only this time the government's credit expansion was complemented by the fractional reserve banking system operating on a global scale. The monetary base has grown 18 fold since 1980, while societal debt has surpassed 350% of GDP, not including off-balance sheet obligations, both private and public, that are a multiple of that number. Now, all of a sudden, people are nervously asking to be paid back. This will have an unhappy ending.

Until recently inflation had remained low but, just as in 1971, it is not difficult to deduce what must inevitably come next. Countries like Russia, China, and now even Mexico, are quietly trading in their dollars – their claims on gold – for real gold. Giant institutions like the University of Texas are joining. As the credit collapse intensifies, this process will accelerate. Gold will increase in value as a matter of deduction, just as it has in every other credit collapse throughout history.

So gold is a great speculation. It will preserve and increase your purchasing power. It's not a sure thing, no speculation is. But if our model is right and our logic sound, gold must go up and the value of currencies down.

There's a second, related speculation I'd like to share that has a lot more leverage. The thesis is simple: as gold increases in value as against everything else, gold mining revenue must increase in terms of cost, expanding profit. And, it's the most marginal gold miner that receives the greatest benefit on a percentage basis. Therefore, speculate in the junior gold mining sector.

While there are good deductive reasons for this speculation currently, we can use inductive reasoning to suggest the likelihood that, in the future, gold mining shares will form the basis of a mania, where the serious returns are.

Manias require three elements: easy money, a focal point, and a theory to convince the top buyers. For example, sales catalog companies of the late 1910s were the hot new thing, representing a low-cost way to expand markets. The easy money from World War I went flooding into sales catalog equities and, as the market rose, financial papers ran articles claiming, for example, that in 20 years there would be no more retail stores. In this new world, companies were valued not on profit or even revenue, but on how many catalogs they sent out. The theory was if you send it out they will buy. This mania collapsed in 1921 when credit conditions tightened.

I assume this story sounds familiar, since it was repeated almost exactly 80 years later in the internet bubble. In that bubble, Wall Street valued companies with metrics like eyeballs and clicks per site. In theory, rising revenue with 100% profit margins create infinite profits, enticing so-called investors to buy at the top.

Turning back to gold mining, we know that the credit conditions of the 1930s caused a gold mania. We know that the monetary conditions of the 1970s also caused a gold mania. Today we have a confluence of both conditions, suggesting fertile ground. So let me suggest two reasons why valuations might go beyond all bounds.

First, right now, the sector is inhabited mostly by experts, who understand the difference between oxide ore and sulfide deposits, narrow vein versus open pit, etc. When the public shows up, they won't appreciate these distinctions.

A popular newspaper contest from the 1930s illustrates this point. The paper would publish 100 pictures of pretty women. The contestant who picked the six most popular pictures won. This forced participants to pick not the women they thought were the prettiest, but the women they thought others thought were the prettiest. This was Keynes's interpretation of the stock market, where investors pick not the best stocks, but the ones they think others are going to pick.

The contest we played tonight is the mathematical version of this Keynesian Beauty Contest. You were asked to pick a number between 0 and 100. The winner is the person who chooses the number that is 2/3rds the average entry.

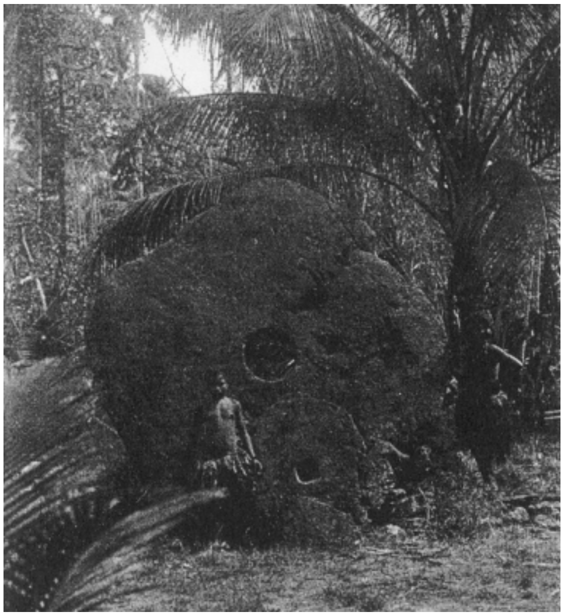
The reader should feel free to consider what his entry would have been.

The game forces the knowledgeable player to focus on the rate of error. The theoretical winning number, the Nash equilibrium, is 0 – if everyone picks zero, then 2/3rds of 0 is 0. Everyone is a winner. But not everyone does. This game has been played often at business schools and investment conferences, and the winning answer usually ranges between 17 and 34.

Why? Often there are a few people who don't understand the directions and pick 100, an impossible result – if everyone picks 100, the winning answer is 67. Other people can't decide, so they split the difference by picking 50. The most popular response is usually zero, but this is always wrong. 1 is the next most popular answer: these are people who know the answer should be zero, and then account for mistakes. But they know too much – they can't conceive that so many people will get it so wrong.

As applied to junior mining companies, as the public arrives, driven by fear and enticed by greed, more and more errors will be made, and the experts will be left behind. Bill Gates and Warren Buffet made no money speculating in the internet bubble – they knew too much.

Notice that this kind of game cannot be won using logic. Only experience can guide the player to a reasonable answer. For this reason, speculating in gold and trading gold are completely distinct. The former is based on deduction, as described previously, the latter is based on gambling on the psychology of crowds.



Beyond the errors, I suggest that gold mining valuations might one day approach the mineral value in the ground. This may sound preposterous – after all, presumably, at some point someone has to pay to dig it up, and mining is a difficult and expensive business. But some of you will recall the story of the Island of Yap in Micronesia. The island having no metal, the inhabitants used large stones to represent wealth. Most stones were so large they couldn't be moved – the Yappians just kept track of who owned which. The largest stone, owned by the wealthiest family had, in fact, been discovered on a neighboring island, but fell off the canoe and sank under the waves as the intrepid discoverer tried to transport it to Yap. No one had ever seen it, but they traded it as if it were real.

I submit that owning a gold ETF is the same as owning a large stone no one has ever seen. You can't get the gold, you can't visit the gold, you don't even know where it is, and yet people trade it as if you could. Why? Because a banker, a modern goldsmith, says it's there, somewhere.

But what about the gold exploration company with a million ounce resource? You can't dig the gold the up, and they probably can't either. But there's a geologist who says the gold is there in the ground.

Who are you going to believe, the man in the pin-striped suit, who offers only downside risk? or the man in the white coat and safety goggles, who can scientifically prove the physical gold is there – and is charging only $10 an ounce? and says he'll find more?

As financial institutions get further discredited, and values shift from assets to goods, more and more people will choose the latter, driving the price higher.

Manias aren't sustainable, so don't get greedy and hang on too long. Signs of the end will be New York apartments selling for cash, a price of gold that makes the Fed's books balance – around $10,000 an ounce currently – and Morgan Stanley peddling crazy valuation theories, such as the aforementioned, to its retail customers. But we're in early days. Gold and mining stocks can still be bought as a deductive speculation, as opposed to an inductive gamble.

Much of what I've learned about economics, gold, and manias came from old books, mostly out-of-print. Commodities guru Jim Rogers said in an interview once that it's impossible to make a fortune reading history books, because otherwise all the librarians would be rich. But librarians don't act. And neither do most people.

Mises teaches us that views on the future without action are mere prognostication, not speculation. He was echoing Aristotle, who said: "It is not the most beautiful and the strongest that are crowned but those who compete (for it is some of these that are victorious), so those who act win, and rightly win, the noble and good things in life."

In 1944 Henry Hazlitt, an original member of this organization, wrote an editorial called "For World Inflation?" warning that the monetary framework being set up at Bretton Woods would lead to exactly that. He reiterated his warning in a 1968 article called "The Coming Monetary Collapse," where he predicted that large budget deficits would force the U.S. off the gold standard. He got these calls right not by chance, but because he knew how to deduce the inevitable results of policy by applying economic law.

Using the same economic framework, and observing that the forces at play are much greater than they were in 1944 or 1968, we can confidently anticipate the future. And it is bleak. Few institutions will withstand the credit and monetary storms that approach. But, if we have the courage to speculate, to act, we can salvage our capital and our wealth. And, if we're willing take a small gamble, we just might profit from the approaching financial deluge.