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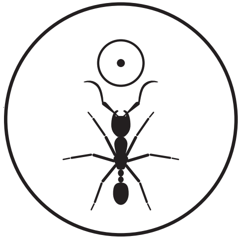

Myrmikan Performance

June 2018

Yield Curve Inversion

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Myrmikan's April letter discussed how the financial industry—banks and the shadow banking system—is based on the prestidigitation of borrowing short-term funds to lend against long-term assets. The business model "works" because short term rates are nearly always less than long-term rates. The generally accepted explanation for this phenomenon is that the longer one lends one's funds, the riskier it is, and so the more compensation the market demands.

Banks are not the only ones who play the curve: corporations are always tempted to shorten the duration of their debt, to reduce costs, and lengthen duration of their assets, to increase return.

As a result, steep yield curves encourage the banks to create credit and ought to produce large financial and corporate profits for new projects, which accelerates economic growth. Keep in mind that growth is not always good: expanding malinvestments juices GDP for a certain period but results in overcapacity and eventually financial distress. When distress approaches, the scramble for ready cash sends short term rates sharply higher so that they exceed long term rates, a so-called "inverted yield curve." An inverted curve is deadly to banks and the shadow banking system because the cost of capital comes to exceed the expected return on investment, which means the financial system ceases creating credit for new enterprises.

The whole yield curve can rise without inverting, but, as the following video shows, inversion always occurs in the context of rising short-term rates (notice also how slight the inversion had to be in December of 2000 to pop the internet bubble and in March of 2007 to pop the housing bubble):

https://www.youtube.com/watch?v=SdAuHSKtpmk

If inversion threatens the viability of new projects, rising rates threaten the solvency of existing projects. For example, let's assume that a bank were to fund a 10-year loan by rolling debt taken out at 3-month LIBOR: to get a sense of the economics, in April 2015, the 10-year high-quality corporate bond par yield was paying 3.16% and 3-month LIBOR was only 0.275%, earning a spread of 2.89%. Today, 3-month LIBOR is 2.35%. Even though a new investment would still yield 1.69% (because the 10-year corporate bond rate has risen to 4.04%), the one already entered into is fixed at 3.16%, so the yield on that has shrunk to a paltry 0.81%, and falling, and there remains 6.75 years of duration left.

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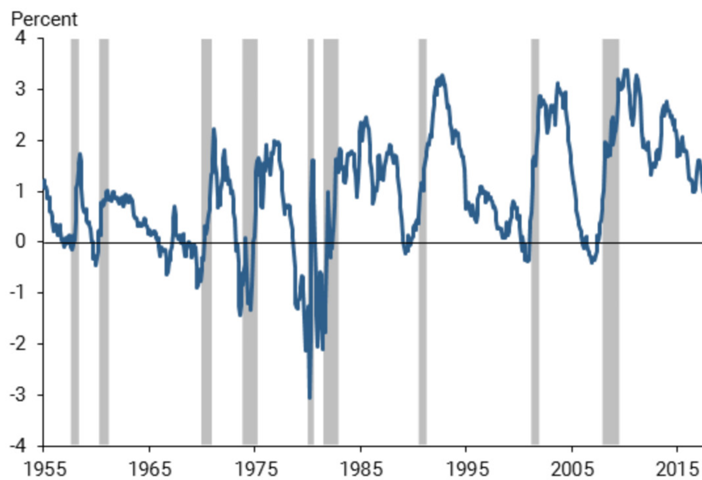
We must quickly qualify this hypothetical in a few ways. First, corporate bank debt typically has a floating rate, though this does not matter since many debt agreements require the borrower to enter into a swap agreement with a money center bank, keeping rate risk within the banking system (and the ones that do not simply swap interest rate risk for solvency risk). Second, banks tend not to sit on fixed rate long-term loans and instead securitize them into the market—all this does is shift liquidity risk from the banks themselves to actors such as insurance companies and pension funds. Third, corporate bond yields (used here because the Fed publishes them over time at different maturities) are generally marginally lower than bank interest rates, so bank margins are slightly richer than presented above.

Nevertheless, as rates rise, and the short-term rate goes above the rate at which long-term loans were made in the past, the nodes of finance (banks, pension funds, insurance companies, private equity firms, money market funds, etc.) start making current losses. The scramble for funds sends short term rates higher again causing mounting losses until the system implodes. This is more or less what happened to the S&L industry in the 1970s and the entire economy in 2001 and 2008.

This discussion is timely because the yield curve is set to invert. The widely-followed spread between the 10-year Treasury yield and the 2-year has fallen from 2.9% in 2011 to just 0.29% today. Current market expectations are that the Fed will keep raising rates and the curve will invert by year-end. Some at the Fed understand the danger. In late June, Fed governor Bullard warned: "I would see the yield curve inversion as a key near-term risk for the Fed." And not just the Fed: even while the S&P 500 has risen 3.7% year-to-date, the XLF financial sector ETF has fallen 2.4%.

10-year Treasury yield minus the 1-year yield as of March 2018
(bars indicate recessions)



Myrmikan has tried to remain agnostic on the question as to what gold will do when the curve inverts and liquidity evaporates. On one hand, there will be an enormous short squeeze on dollars: assets will be tossed at any price in the mad scramble for dollar liquidity, the same reason gold fell over 30% from March to October of 2008. Then, as the system teetered, within four months gold was back near its then all-time highs before doubling again. This scenario could certainly play out again.

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But, there is an important difference: gold had quadrupled over the previous eight years, attracting levered momentum players. There is no equivalent momentum play in gold right now, and everyone knows what will inevitably come during the next liquidity crunch: massive money printing. So it may just be that gold rockets higher when the system starts to implode.

The way Myrmikan has remained agnostic is by investing in gold mining companies that have great convexity to gold on the upside (to pursue its mandate of providing credit bubble insurance) and also financial resilience on the downside: producers that have little or no debt and can defer sustaining capital expenditures, developers and explorers who can furlough employees and wait for better times. The share prices may turn ugly in a liquidity crunch, depending on what gold does in the initial crash, but as long as the equity is able to retain its claim on the assets (escaping the twin risks of default and dilution), they should bounce back with gold as they did in 2009 and 2016. Being clever and trying to side-step possible weakness, on the other hand, risks being out of the market when the shares take off.

Gold mining share prices recently have been more resilient than one might have expected, in fact. Gold sank by 4.1% in June—a large move for gold—and Myrmikan's portfolio of sensitive gold equities fell by only 3.9%. Gold has fallen further since the end of the month, but Myrmikan has risen marginally higher. The broader gold mining indices have shown similar resilience to the recent drop in gold prices. Since gold mining equities generally lead the gold price, it is a hopeful sign that gold's seven-month correction may finally be nearing its end just as the broader market becomes ever more vulnerable.

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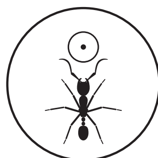


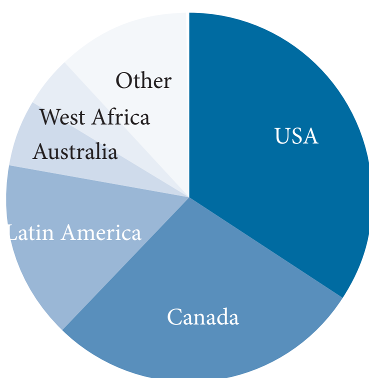
MYRMIKAN CAPITAL LLC

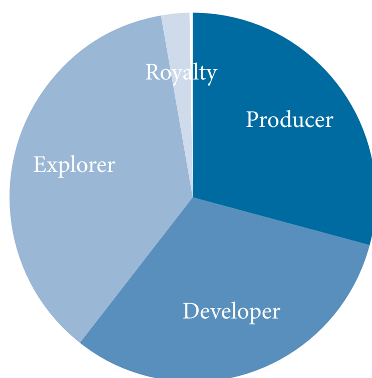
Investment Purpose

Myrmikan Gold Fund is designed to provide insurance against a global credit collapse through speculations in the equity of operationally levered gold mining companies. Any investment should be considered a premium, the value of which decays over time until and unless the insured event occurs. Investors should be prepared to lose substantially all of their investment should the insured event not occur. Please see the Confidential Offering Memorandum for additional details.

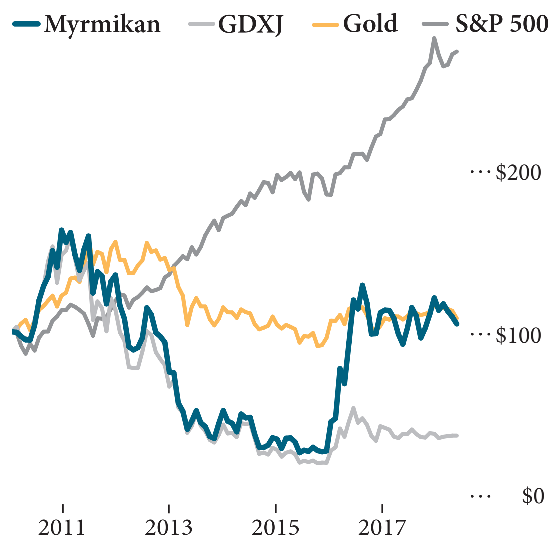
Annualized:	3-Year	5-Year	ITD	Alpha	(Annual)	Beta	Sharpe	Positions	Largest	Top 10
Myrmikan	58.1%	3.0%	0.6%	Benchmark			0.25	37	7.6%	48.4%
GDXJ	21.5%	-13.9%	-11.4%	1.58	20.7%	1.11		72	5.7%	40.7%
S&P 500	11.2%	17.4%	12.8%	0.48	6.0%	0.53		505	3.9%	21.2%

Portfolio Holdings





Net Return of $100



	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD	ITD
2010				-0.3%	-2.5%	-2.2%	-0.1%	9.5%	14.7%	7.1%	4.5%	11.8%	**49.3%**	**49.3%**
2011	-6.7%	16.2%	-4.6%	3.9%	-8.5%	-6.4%	9.2%	5.5%	-21.9%	10.5%	-1.9%	-12.7%	**-21.6%**	**17.1%**
2012	11.6%	2.3%	-13.8%	-6.7%	-15.8%	-2.1%	1.5%	6.4%	18.9%	-3.8%	-9.78%	-2.3%	**-16.7%**	**-2.8%**
2013	-3.7%	-19.2%	-0.7%	-24.5%	-8.6%	-21.2%	11.9%	13.8%	-14.1%	-5.1%	-14.1%	-3.42%	**-63.8%**	**-64.8%**
2014	25.6%	17.9%	-12.3%	-2.9%	-11.6%	27.5%	-4.6%	0.6%	-21.3%	-21.2%	6.5%	-2.2%	**-11.6%**	**-68.9%**
2015	14.4%	-2.6%	-15.9%	21.2%	0.5%	-7.2%	-19.6%	5.6%	-2.6%	9.3%	-12.8%	-2.4%	**-18.5%**	**-74.6%**
2016	1.9%	74.8%	9.1%	57.2%	-11.8%	36.6%	27.6%	-4.6%	12.6%	-8.4%	-16.0%	0.2%	**289.4%**	**-1.1%**
2017	13.0%	1.3%	-0.1%	-4.2%	-8.9%	-6.0%	10.2%	12.3%	-4.4%	-12.2%	6.3%	8.1%	**11.9%**	**10.7%**
2018	8.9%	-6.2%	3.4%	-3.7%	-3.1%	-3.9%							**-5.3%**	**4.8%**

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Performance data presented is as of June 30, 2018, is unaudited, is net of fees (with regards to Myrmikan), represents past performance, and does not guarantee future performance. The investment return and principal value of an investment will fluctuate and the member's interest, when withdrawn, may be worth more or less than original cost. The current performance may be lower or higher than the performance data quoted. The GDXJ represents the Market Vectors Junior Gold Miners ETF, which is marketed as a low-fee way for investors to gain exposure to junior gold mining equities. The S&P 500 acts as a benchmark for many investors.

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