Myrmikan Research Report

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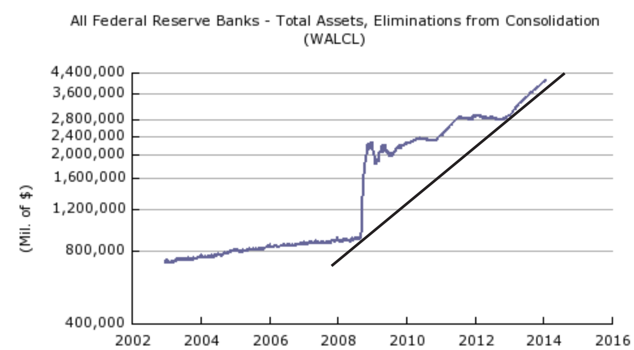
Tapering Euphoria

Myrmikan has consistently argued that printing money has opposing short term and long term effects. In the short run, shaky debt markets absorb the printed money, improving balance sheets and squelching inflation. Improved financial conditions prompts businesses and consumers to resume spending, creating an economic boom.

In the long run, however, rescuing reckless investors with funny-money encourages additional reckless malinvestment of resources. And the money eventually leaches out of the capital markets into the goods markets, boosting prices in chaotic fashion, which degrades the price signals necessary for economic coordination.

As long as the money printing accelerates, the short run effects can continually overcome the long term effects, delaying the inevitable consequences, though it requires printing at an accelerating pace.



The chart at right shows the face value of assets on the Federal Reserve's balance sheet on a logarithmic scale. A straight line on a logarithmic scale indicates constant percentage growth, with the slope of the line representing the rate of percentage growth. The fact that the blue line currently has a steeper slope than the black trend line indicates that the Federal Reserve is currently accelerating the pace of printing as measured from the start of quantitative easing in 2008. As discussed previously in these pages, the monetization of assets of ever longer duration is not captured in the above graph, and has the effect of accelerating the printing still further.

The taper will decelerate the printing and shift the market's focus from forecasted economic euphoria to a critical examination of balance sheets. It should be no surprise, then, that the taper precipitated the end of the liquidity induced stock market rally and brought stress to the weakest credits: emerging markets. Just the mention of taper last summer began a rout in emerging market currencies, which has accelerated since the taper began.

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The charts below of major emerging market currencies all show similar features: during the 2008 panic when conditions tightened, these currencies collapsed against the dollar. Through 2011, they stabilized or even strengthened. At the mention of taper, emerging market currency weakness has again begun to accelerate: a harbinger of the next economic crisis.

BRAZIL

RUSSIA

INDIA

SOUTH AFRICA

MEXICO

TURKEY

Source: XE.com

There is not yet any signs of panic amongst mainstream economists and investors. They trust the ability of the central banks to micromanage the aggregate decisions of billions of individuals. Nowhere is the confidence of these central planners better illustrated than former Fed Chairman Bernanke's response when asked: "Can you act quickly enough to prevent inflation from getting out of control?"

> BERNANKE: "We could raise interest rates in 15 minutes if we have to. So, there really is no problem with raising rates, tightening monetary policy, slowing the economy, reducing inflation, at the appropriate time. Now, that time is not now."
>
> 60 MINUTES: "You have what degree of confidence in your ability to control this?"
>
> BERNANKE: "One hundred percent."

Turkey's central bank presumably had 100% confidence that they could strengthen the lira within 15 minutes by spiking rates higher, which they did last Wednesday by 4.25% to 12%. Benoit Anne of Société Générale crowed: "Governor Basci, you have avoided a domino crisis in EM. . . . The TRY crisis is over."

It turns out that 15 minutes encompassed the total positive effect of the intervention. The lira is marginally weaker, and the higher rates will cut off credit to the domestic economy – it should not take long before credit stress results in additional currency weakness and more inflation.

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Turkish Prime Minister Erdoğan explained to reporters that higher interest rates would lead to inflation, leading the New York Times to sneer: “an argument that contravenes accepted economic logic.” It is accepted, Keynesian economic logic that got the world into the debt trap, from which there is no escape. The higher rates will reveal the misallocation of capital – a boom generated by shopping malls, skyscrapers, airport construction, and other capital spending based on excessive debt. Tax revenues will plummet, government bonds yields will soar transmitting losses to the central bank, weakening the currency further. Erdoğan may not understand the full causality, but at least he is correct about the effects of higher rates.

Erdoğan threatened he would only support the central bank if increased rates revived the lira, boosted the stock market, and then caused rates to fall again, adding, darkly, that rates: “aren’t the only instrument” to control policy. Mr. Erdoğan’s economic adviser confirmed pending executive action that would be “very positive for the markets.” It seems central planning will attempt to solve the failures of central planning.

At least a dramatic weakening of currency should results in nominal gains in asset markets: as the numeraire weakens, the price should increase to compensate.

Sadly, this is actually not the case. As the chart below shows, since mid-2013 when the weakness in the lira began to accelerate, the value of the Turkey Titans 20 Index has plummeted even in nominal terms (in red). Going back to 2008, the index is up only 14%, and when adjusted for dollars (in blue), it is down over 40%.

Worse, as Bernanke reminded during a press conference, the value of a dollar today is much less than its value in 2008, so in purchasing power terms, the Turkish market has fallen even more than 40%. What foreigner would want to own Turkish assets given the context? And without a continual inflow of foreign capital, Turkey cannot finance its current account deficit. Rates will have to go much higher to entice capital to stay and/or avoid capital controls.

The day after the failure of Turkey’s intervention, South Africa similarly attempted to support their currency with a surprise increase in rates. The results were exactly the same, with currency weakness causing the market to fall even in nominal terms.

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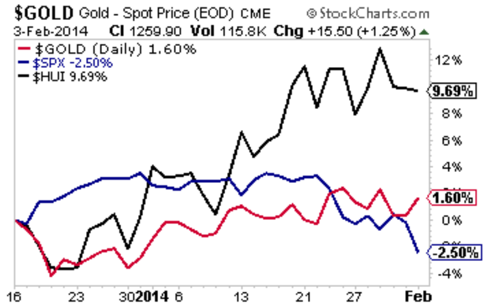

Even members of the FOMC have admitted that tapering is tightening, and the results of financial tightening in the United States will be no different. The dollar will fall in value – not against other currencies, but against goods – but financial markets will fall even in nominal terms. The seeds of this new trend have been evident since the first taper. Gold was supposed to be a "slam dunk sell," according to Goldman Sachs's Jeffrey Currie. But instead, since December 17, the day before the first taper was announced, the market is down, gold is up, and gold stocks have roared higher. This trend should continue, probably dramatically.

Gold stocks have had a outsized reaction to a modest increase in the price of gold, and there a few reasons why this should be so. First, gold and gold stocks were suppressed at the end of 2013 because of tax loss selling and hedge fund manipulation.

Second, gold stocks are real options on the gold price. The Black-Scholes options model disallows market momentum as a factor in option valuation, since market returns are assumed by statisticians to be normally distributed. However, a 2002 paper titled "Index Option Prices and Stock Market Momentum" by researches from the University of Michigan, Harvard University and Lehman Brothers concludes that momentum does indeed influence options pricing.

Assuming this to be the case, the mere fact the gold has stopped declining should have increase the valuation of gold stocks, since through December gold's momentum was sharply downwards and the general consensus was that gold was heading much lower.

The other reason why gold stocks have rallied so hard is the weakness in the commodity currencies, which notably have the same features as emerging market currencies.

CANADA

AUSTRALIA

Most commodity investors fail to understand that all commodity producers are spread trades on the differences between their input costs and revenue. For base commodity producers, the inputs are also base commodities, making the calculation very complex. If commodity prices increase in such as way as to increase the costs relative to output, then producers must close.

It may seem odd that commodity producers could go bankrupt in the context of rising prices, since rises prices should signal increasing demand for their output. But, this can

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occur when the rising prices are an artifact of monetary mismanagement as opposed to increased demand, when inflation is cost-push instead of demand-pull. When commodity production suffers, the Australian and Canadian dollar weaken.

This weakening results in an immediate pay cut for mining labor, improving margins for the surviving producers. Put another way, while the current gold price of $1260 is barely enough for producers to survive, in Canada the price is already back to $1400, and it is $1435 in Australia, providing plenty of margin.

Relative commodity prices don't care in which currency they are denominated, and costs will eventually adjust wherever the producer. But, currency fluctuations can make these adjustments very rapid, as they have for Canadian and Australian gold miners.

Gold investors have suffered over the past two years by looking too deeply into the future, underestimating the strength to which the short run effects of quantitative easing would delay the long-term consequences of a collapsing credit structure. The taper accelerates the arrival of the next stage of the credit crisis, the reason why gold instruments have responded so favorably.

Markets during crises become discontinuous, defying the assumed normal distribution of price movements upon which Value-At-Risk models are based. With the derivatives positions of the banks larger now than it was in 2008, small miscalculations could accelerate into enormous, sudden movements in markets. Moreover, with the memory of 2008 still fresh in mind, market participants will react to the return of such conditions with much greater speed than before. When Yellen is forced to deploy the Fed market put – though who knows what the strike price of the put is – gold's rise will be much steeper and more violent than its last run from 2009 to 2011.

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