

# Myrmikan Research Report

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## Launch Sequence Initiated

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Austrian economic theory holds that free markets will allocate scarce economic resources efficiently. Savers and entrepreneurs supply and demand capital in the financial markets, which determines interest rates, which determines the cost of capital, which reveals which economic projects are viable and which are not.

The fractional reserve banking system upsets this delicate interaction by creating funds *ex nihilo* through credit (debt) creation. These artificial funds enter the financial markets and lower the rate of interest, reducing the perceived cost of capital, giving the illusion that submarginal projects are viable. Entrepreneurs enter the market with these newly created funds and bid the price of scarce resources higher until the submarginal projects fail because of soaring input costs: the submarginal projects, in aggregate, can never be completed because of the lack of necessary real resources.

One of the most important economic costs is labor, so it should not surprise that during a boom caused by credit creation, unemployment should fall while prices rise. The data demonstrating this relationship between inflation and unemployment was first exhibited by William Phillips in a 1958 paper, and became known as the Phillips curve.

The late 1950s corresponded with the ascendancy of Keynesianism, and leftist economists enamored of state power drew exactly the wrong lesson. Presented with the data, they reasoned that it was the higher inflation that caused unemployment to fall, confounding cause and effect. If a politician wanted to increase employment, the simple expedient was to have the central bank dial up the printing press, and Federal Reserve obliged.

The flaw in the Phillips curve as policy as opposed to data relationship is that over the long run there is no trade off between inflation and employment. Any added employment during a credit boom is compensated by higher unemployment during the bust, as long term data studies demonstrate. Worse, printing money does not always lead to credit expansion. The process described above relates to credit creation by the banks. When governments run the printing press, the money can sometimes head directly into goods, which is what happened in the 1970s. During these monetary inflations, chaotic price signals reduce economic coordination, shrinking the demand for economic inputs even as the cost of living soars. Inflation and unemployment rise together creating deadweight loss.

In 1968, as the credit inflation of the 1960s was morphing into the monetary inflation of the 1970s, Milton Friedman predicted a Keynesian heresy that inflation and unemployment would rise simultaneously, rejecting the Phillips curve as policy. A mere three years later, Federal Reserve Chairman Arthur Burns admitted: “The

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rules of economics are not working in quite the way they used to. Despite extensive unemployment in our country, wage rate increases have not moderated. Despite much idle industrial capacity, commodity prices continue to rise rapidly.”

By 1978 the Federal Reserve Bank of Boston had to hold a conference titled: *After the Phillips Curve*, and by the 1980s the Phillips curve had been completely discredited as one more, sorry, failed statist attempt to control the wants and desires of individuals.

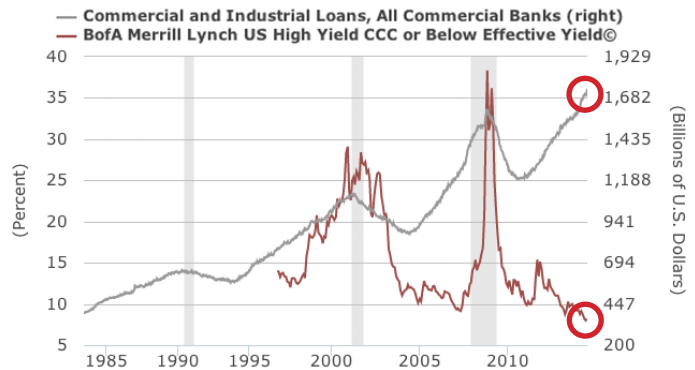
Given this context, it is shocking that in 2007 Federal Reserve Chair-to-be Janet Yellen would proclaim in a speech public and on the record:

The Phillips curve is a core component of every realistic macroeconomic model. It plays a critical role in policy determination, because its characteristics importantly influence the short and long-run tradeoffs that central banks face as they strive to achieve price stability and, in the Federal Reserve’s case, maximum sustainable employment.

Truly, the failed history of economic planning has made no impact on senior policy makers. It is said that those who are ignorant of history are condemned to repeat it, but who knew so precisely? The U.S. stands more or less where it stood in the late 1960s: a credit boom begins to fade into monetary inflation, and the Fed finds itself with a chairman who, no less than Arthur Burns, believes that a politburo of policy makers can control human action. The results will be the same.

Since the credit crisis in 2008, the Federal Reserve has acted as guarantor of last resort of credit instruments of all sorts. By backstopping the banks and supporting the credit markets, credit participants were free to speculate, driving asset prices higher and interest rates lower, which enabled the refunding of many business enterprises abandoned during the crisis. Indeed, this was the very purpose for Fed policy.

But, now, debt levels have reached absurd levels: the Bank of International Settlements estimates that global debt from 2007 to 2013 grew 40% to \$100 trillion. Rates have plunged to record lows, as the chart shows. It is as if 2008 never happened, the lessons unlearned.



There are two ways the excess debt can be written off, and written off it must be because the projects it represents has no real economic value: cascading defaults in a deflationary crash or inflation. The Fed has left no doubt as to which it will choose, should it have the choice.

There were those after 2008 who held that once the cascading margin calls begin, there is nothing the Fed can do. The Fed can make credit available, but if no one borrows it, it has no effect on markets. In this total melt-down scenario, the fractional reserve banking system would have gone into reverse: every dollar withdrawn from the system requires the banks to destroy at least ten dollars. The scarcity of dollars would

have caused rates to spike. The Federal government would have had no choice but to default on the national debt as tax revenue collapsed and the interest burden soared.

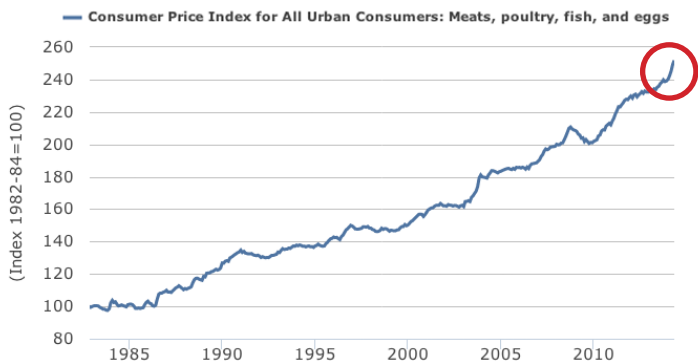
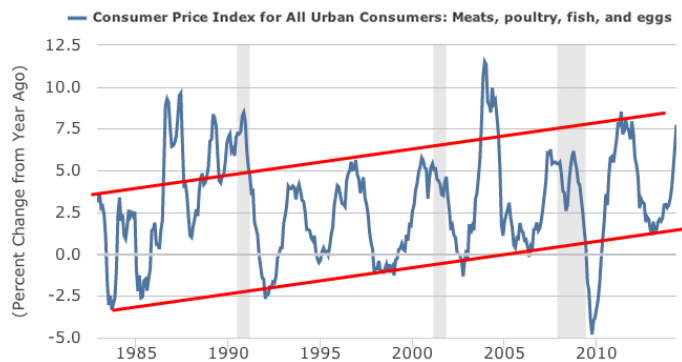
But, the Fed didn't wait for borrowers to use the funds it made available. Quantitative Easing allowed it to go into the market to buy directly with freshly printed dollars the valueless mortgage bonds no one wanted and long-term Treasuries. Forcing the prices of these instruments up disconnected the phone lines of Mr. Margin. A new, more hyperactive credit cycle began.

Wall Streeters were the first to enjoy the new money being printed, and the first receiver of new funds gets to spend the new money at the old prices, doubling the fun. The crisis in 2008 taught those in the finance a lesson that had been too subtle in earlier cycles: new money can push markets up even in the absence of economic growth. The funds were used to speculate, not invest, increasing the wealth disparity between those within finance and those without. Even within finance itself wealth disparity has become acute as those on top realized they didn't need all those expensive bodies judging projects: much easier to borrow from the Fed at 0% and just buy corporate bonds.

Corporate officers eschewed the investment risk of innovative projects, and bought back shares instead, juicing stock prices (bought on margin) and the value of management options. According to a July 8 Financial Times story:

US lending to businesses is reaching record levels but banks are privately warning that the activity should not be seen as evidence of an economic recovery . . . Much of the corporate lending is going to fund payouts to shareholders, finance acquisitions and fuel the domestic energy boom, bankers say, rather than to support companies' organic growth.

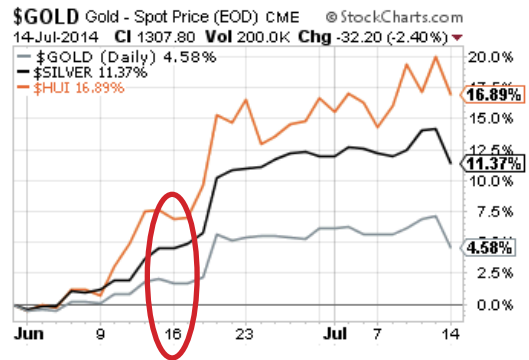
With markets blazing, all this credit money is beginning to leach into the real economy. For those not in Wall Street or Washington, the most important cost is food, and within food the most important is core proteins. The top chart may not look dramatic, but realize the rising channel is not increasing price, but an increase in the *rate of increase* in price. The lower chart is what the consumer sees. And this despite the technology that should be driving costs down and after all the adjustments made to the CPI to pretend prices are well behaved. Energy, airline tickets, even base commodities now are starting to surge as well.



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On June 18, Fed Chair Janet Yellen was asked whether the Fed was “behind the curve on inflation.” She acknowledged that recent CPI readings had been “a bit on the high side,” but explained that inflation is “evolving in line with the Committee’s expectations” and that “the recent evidence we have seen abstracting from the noise suggests that we are moving back gradually over time toward our 2% objective.” Per above, food is rising at 7.5%. But food is not counted in the core inflation numbers. Let them eat iPads.

Gold immediately began a significant rally which continues despite yesterday’s raid. Gold now senses that inflation, not deflation, is the risk to the debt markets and that the Fed is at best clueless and more likely complicit. Silver and the gold stocks, which are even more sensitive to inflation, have outpaced gold.



This shift from deflationary to inflationary fears has left some traders flatfooted. From 2008 to 2011 gold rose according to the perception of how much money the Fed was going to print. Good economic news was bad for gold and vice versa. In an inflationary environment, however, good news is great for gold. For example, on July 3 at 8:30 AM, the Bureau of Labor Statistics reported that non-farm payrolls had surged 288,000 in June, well above estimates. Traders instinctively sold gold hard – it recovered almost immediately.



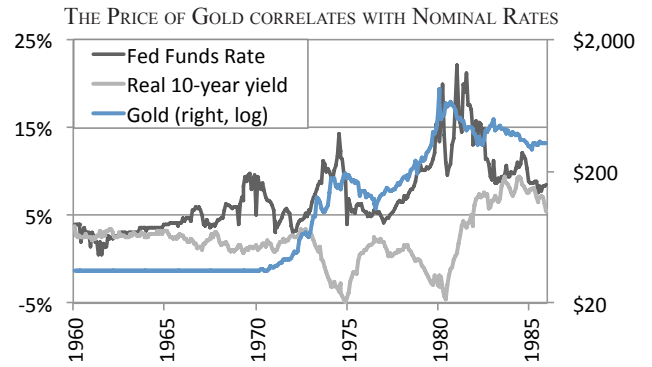
Then, on July 9, at 2:00, the Fed released the minutes from the previous FOMC meeting that stated QE will end by October and contained a discussion of the “liftoff of the federal funds rate.” The aggressive tone of the minutes, perhaps combined with Federal Reserve Bank of St. Louis President James Bullard’s recent comment that the Fed will commence liftoff in Q1 of 2015, convinced various banks to move forward their own launch sequences.

If less printing and higher rates were bad for gold, as the bank analysts tell us, gold should have sold off vigorously. It surged instead. As tirelessly explained in these pages, higher interest rates are very bullish for gold for at least two reasons.



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For those who take a liquidity view of money, a dollar is nothing more than a unit of liability of the Fed's balance sheet. Liabilities of a balance sheet cannot remain worth more than the assets backing them. Since the Fed now holds mostly long term bonds, and since long bonds are extremely sensitive to rates, even modestly higher rates would result in huge losses in the value of the assets of the Fed and, therefore, the value of the dollar as well. The chart above shows how this dynamic played out in the 1970s when the bond portfolio at the Fed had a much shorter maturity profile: higher nominal yields resulted in negative real yields and higher gold prices.



On September 14, 1976, the Fed Funds rate stood at 5.89% and gold at \$111/oz. By April 1979, the Fed Funds rate had nearly doubled to 10%, and gold had more than doubled to \$240. On January 21, 1980, the Fed Funds Rate broke 14% and gold more than tripled to a generational high of \$850. After this blow-off high, gold retreated back to the \$500s by March before taking another run into the \$700s by September. Rates peaked at 22% on January 1, 1981 and began to decline, with gold, for decades.

The lesson is simple: high rates may be good the dollar and gold negative, but *rising* rates are what power gold higher, whatever Mark Hulbert may write in the Wall Street Journal or Jeffrey Currie in Goldman Sachs research pieces.

There is another, more conventional way to think about the effect that rising interest rates have the purchasing power of the dollar. The quantity theory of money holds that money is demanded for various reasons, and supply therefore directly affects value. If supply doubles, all things being equal, then value falls in half.

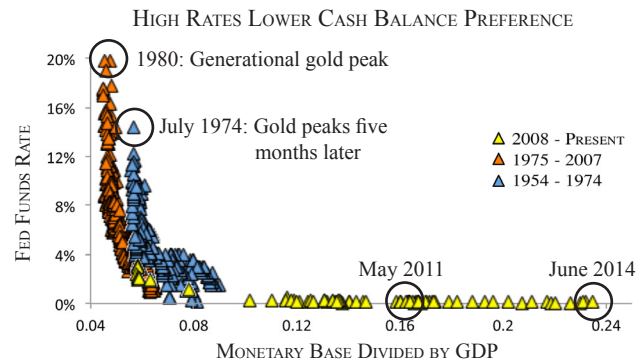
But, what about the demand side? It is relatively easy to calculate the supply of dollars, but less so demand. The theory is that everyone in the dollar economy holds enough cash dollars for, let's say, four weeks of expenditures. Posit that, for whatever, reason, society at large shifts its preference so that everyone only wants two weeks' supply of dollars. Everyone would attempt to spend half his dollars to go from four weeks supply to only two. But, spending dollars merely transfers them to someone else, who most now spend not only his original hoard, but the newly acquired dollars as well. Dollars would race around the economy until prices had doubled. Once prices have doubled, then the same amount of money would command only two weeks spending instead of four. In highly inflationary environments, like Weimar Germany, cash balance preference can shrink to minutes, propelling prices toward infinitely.

As discussed in a Myrmikan Update in May 2011, economist and investor John Hussman developed a clever way of measuring dollar demand: he divides the monetary base by GDP, i.e., the amount of money society at large is holding in comparison to the turnover in the economy. In normal times, for any unit of



economic activity, people hold a certain amount of cash. If the risk-free rate rises, they will use the cash to buy short-term government bonds in search of yield, lowering cash preference, which raises nominal prices (making the return on the bond actually negative, which demands still higher rates). If the risk-free rate falls, they become less eager to get out of cash, and cash balances rise, lowering nominal prices, all other things being equal.

The facts fit the theory, as shown by the graph. When interest rates are high, such as in the 1970s, no one wants to hold cash. Whereas, when interest rates are near zero, such as now, the opportunity cost of holding cash as against the risk-free rate is very low, and cash per unit of GDP is very high.



The Myrmikan Update in 2011 stated it would be bizarre if gold were to peak with cash balances at record levels. Since then, cash balance preference has exploded still higher, which may help explain gold's performance since then.

If the curve on the graph holds, an increase in rates to a mere 0.25% would suggest that monetary base divided by GDP should decline from its current level of 0.234 to less than 0.1. Mathematically, there are only two ways this can occur: either the monetary base must shrink by 63% or GDP must increase by 133% in nominal terms (or a combination). The former would have unthinkable consequences to the market, and the only way GDP can increase so much so suddenly is if the dollar devalues by near the 63%. "Liftoff" may involve a lot more g-forces than anyone at the Fed contemplates.

This scenario is more plausible than it may sound. An examination of past currency crisis in different places and different times show that they arrive suddenly and seemingly without warning, the causes having been present for years. On January 29, 1973 gold traded at \$65/oz. By June 5, gold was \$126, nearly doubling in six months. After retreating to \$90 by November 26, gold stood at \$177 on March 22, 1974, nearly doubling in just four months. Gold's moves have been even more dramatic in other currencies. It would be entirely precedented for gold to be above \$2500/oz by the end of the year with but a small increase in rates.

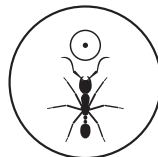
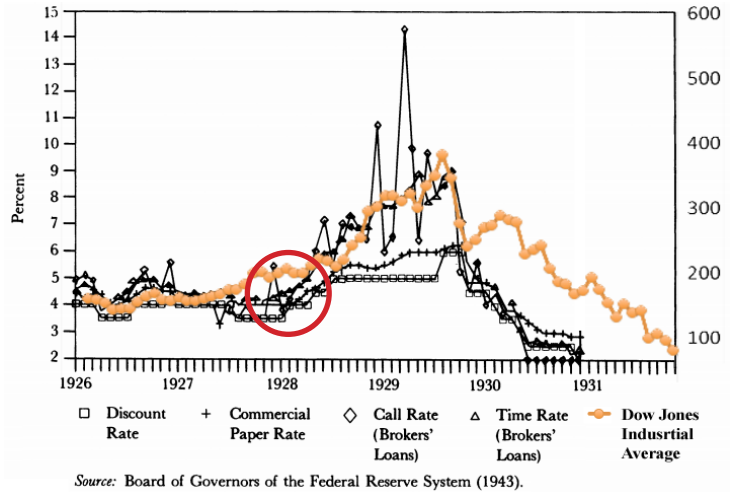
That is when the real fun would begin. Bernanke demonstrated the Fed's erroneous view of the relationship between rates and inflation when he said on 60 Minutes:

We've been very, very clear that we will not allow inflation to rise above 2 percent. 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.

How did that strategy work out in the 1970s per above? Or in 1928 per the chart at right? Or in 2005, when Bernanke himself took rates from 3% to 5.26% by mid-2007, powering the last rise in the real estate insanity.

Bernanke was supposed to be a student of the Great Depression, but now he, Yellen, and the Fed's Phillips curve models have imperiled America's status as a first world country. If there is a classic currency crisis in the dollar, the Fed will respond by raising rates, which will weaken the dollar further in a positive feedback loop until rates are so high they destroy the economy, tank the markets, and threaten the solvency of the Federal government.

In the analysis of day-to-day markets, it is easy to lose site of the fact that since 1720, gold has, on average, backed the dominant central bank's liabilities by 35% (by 29% since gold was "demonetized in 1971). With gold at \$1340, that figure stands at 8%. If gold were to quadruple it would be fairly priced for normal times – and times are highly abnormal. If the economy is indeed in inflationary launch mode, with Yellen captain of the dollar, gold could rise a lot higher a lot faster than most strategists think possible.



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