Myrmikan Research

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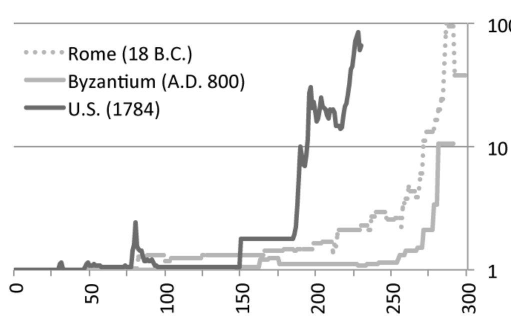
Bubble Watch

April is not the worst month, which best describes January or February, but said to be the cruelest, since it most defies expectations of improvement. Thus far, September has been the cruelest month for gold investors, since gold usually performs the best, driven by the Indian wedding season. After December's test of the bottom made in June of 2013, gold had been running higher on a collapsing world order, a toppy stock market, inflation fears, and renewed European and emerging market debt woes. Twice gold seemed poised to run at $1400, but then was violently beaten down and has now breached its rising trendline.

This softness is all the more galling after three years of nominal declines. Gold may not always be the most lucrative investment. In fact, gold itself is not an investment at all; it is the ultimate currency. Its supreme preservation of purchasing power compensates for lower returns. But, neither should gold decline in nominal price over any length of time.

The surest financial bet in human affairs must be that currency will decline in value. Small countries illustrate this constantly: in Latin America, Africa, central Europe, and Asia, countries hyperinflate with regularity. But, as the chart shows, even the most powerful of civilizations cannot resist the temptation to debase their money, driven by the luxury or necessity of war, the growth of bureaucracy, or the avarice of their rulers.

Nominal Amount Needed to buy Original Coin



Of course, an investor must worry about timing, and the graph above is unfair. Rome set the standard for the denarius in 211 B.C, and kept it firm for 250 years. The Byzantine Empire kept its money relatively solid from A.D. 312 into the 10th century. That is a long time to wait for nominal gains. But, what the graph does accurately depict is that once debasement starts, it always accelerates, which suggests that the longer and more severe the current correction in dollar terms, the steeper the next surge in the gold price shall be.

There is little doubt as to what has caused the pause in gold's inevitable ascent. Banks, as originally created, increase liquidity. They accept current assets, such as gold coin, and issue standardized notes against these assets. The very definition of a credit bubble is the distortion that occurs when banks issue current notes and create purchasing power against future liabilities. The frail promise to pay in the future becomes overvalued as against current assets in the hand, directing capital toward all sorts of absurd adventures: taming the Mississippi in John Law's time; developing Latin America in the South Sea Bubble; canals to nowhere in the 1830s; railroads to nowhere in the 1860s; providing houses, cars and appliances to those who couldn't afford them in the 1920s; showering billions on teenage entrepreneurs in the 1990s; providing houses to those who couldn't afford them in the 2000s; providing cars and student loans to those who can't afford them in the 2010s.

The higher real debt levels go, the more undervalued gold should be compared to everything else. And, right now, real debt levels are still rising. Consider this September 3 exchange on Bloomberg TV:[1]

> Host: Tell us about [auto] financing rates right now – I keep seeing advertisements of everything from zero to one percent financing, but you've got to hold on to the car for 60 to 72 months.
>
> Auto Analyst: . . . A lot of [interest] is being drive by the fact that [buyers] can get the vehicle that they really want, they're aspirational for. They might not have been able to afford the payment previously, but when the terms get extended out, it open up a whole new array of vehicles that people can look at and get into; the effects, of course, longer term, we have yet to see . . .
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> Host: What about a whole array of potential problems: if you're leasing or buying a car with a 60 month or a 72 month term, that may sound good right now, but fast-forward to that month 50, what does it look like?
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> Auto Analyst 2: . . . you do hope that there's not going to be this problem with people having these long loans and then having any kind of default situation or shifts in their own circumstance, and suddenly 6 or 7 years seems like a long time.
>
> Host: Or negative equity in the automobile, right?
>
> Auto Analyst 2: Well, that's the unfortunate thing, that initially, of course, all that money is going to interest, so you are going to be upside-down in a car when you have a seven year loan for at least the first half of that loan period.

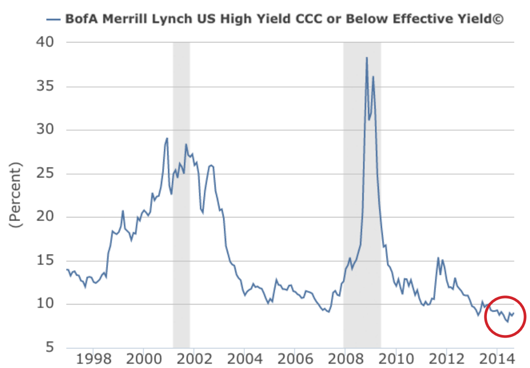
At least in the housing bubble, buyers presumably put some equity down (even if not enough), and then, at least in theory, the equity was supposed to expand. With autos, buyers leave the shop, by design, with negative equity on a rapidly depreciating asset. And, of course, with student loans, there is no hard asset at all backing the debt, only the prospect of debt servitude.

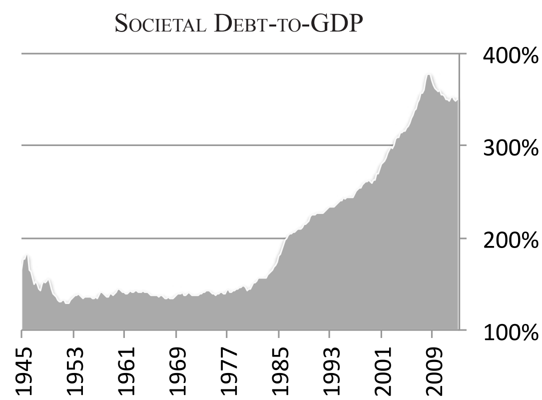
What goes unsaid in discussions such as the above is why the wave of a central planner's hand lowering rates can allow everyone to drive a much fancier car. Where does the extra savings come from that enables this boost in living standards?

1 http://www.bloomberg.com/video/u-s-auto-sales-shift-into-high-gear-y~WKN4UJQsqoDH_7N_OW9Q.html

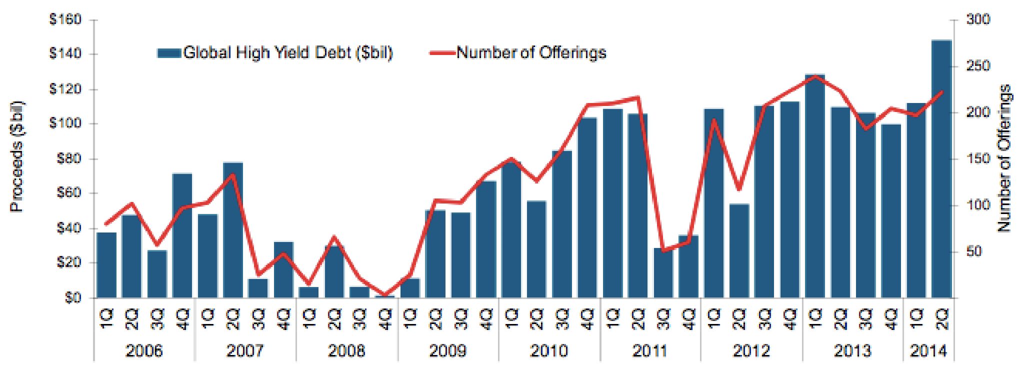
In fact, the reason subprime rates are so cheap is that the Fed has driven the rates for investment grade debt so low that pension funds have no choice but to reach for yield in the swamp of subprime auto paper. Car buyers are, in effect, borrowing and consuming their own retirement savings, and they don't even know it. Even if they did, it wouldn't matter because pension funds are pooled: going to a restaurant Dutch with 20 people does not encourage parsimony.

We need not rely on anecdote. The data clearly shows the hyperfinancialization of the economy since 1980, which has begun to increase yet again. This debt increase is driven by falling rates, which allow companies, individuals, and government to take on enormous liabilities (NB: CCC is described as "extremely speculative," right above "default imminent with little prospect for recovery.")



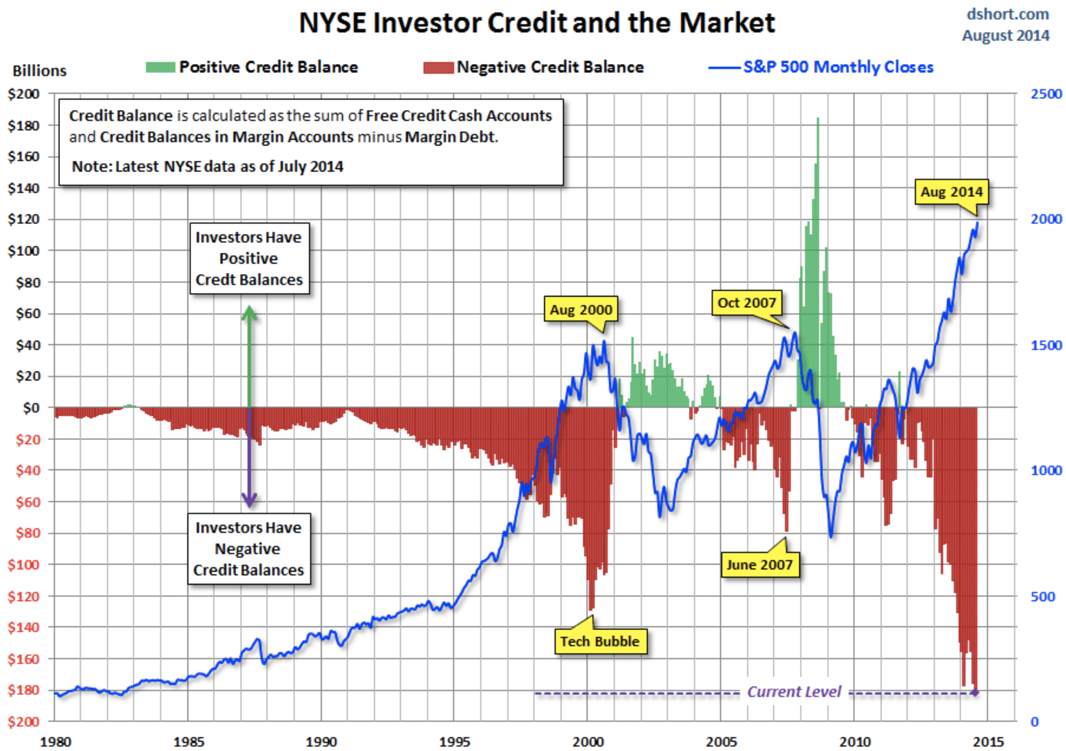


And, the hottest area of debt issuance is where there is the most cash flow, which, of course, also implies projects with the most dubiousness.

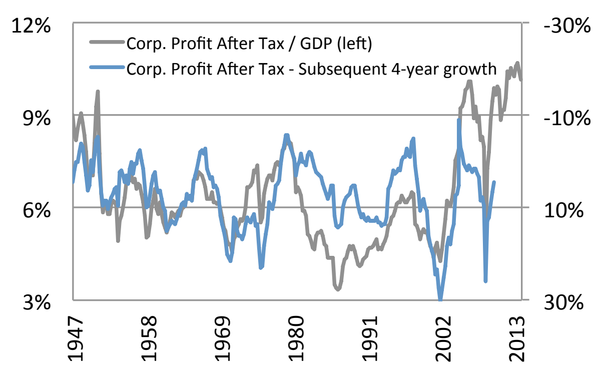


Falling rates also have the effect of boosting the value of future cash flows. Since an equity is, in theory, an infinite set of cash flows, discounting the future at zero causes valuations to go to infinity.

It's not just cars that are been bought with all this debt. The following chart published recently in the London Telegraph reveals what is driving stock prices higher.



Any stock market weakness will be the "shift in circumstances" that will cause borrowers to default on their student loan payments, mortgage payments, auto loan payments, etc. Most everyone needs a car to get to work, but no one needs an aspirational car, just as everyone has to live somewhere, but the reaching for the aspirational house destroyed the banking system.. The problem is not that people have cars, but that the Fed has created the illusion they can buy a car greatly beyond what their productivity can support.

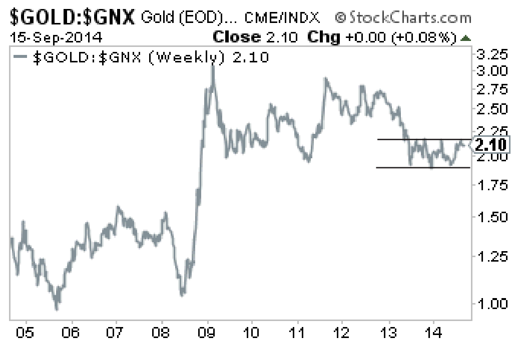


Companies can always squeeze cash flow out of current operations, for example, by levering their capital structures, entering subprime markets (see Myrmikan's previous update on Carmax), or cutting investment, but this growth comes at the expense of future profits. As the chart shows, when corporate profits as a percentage of GDP spikes, subsequent 4-year growth stalls. Right now this relationship is suggesting that corporate profits will shrink by roughly 18% over the next four years.

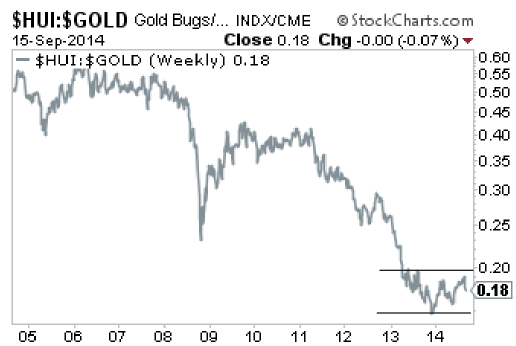
In December of 2013, nearly a year ago, the Federal Reserve began tapering its bond purchases, in effect tightening financial conditions. The ridiculous amount of debt outstanding in society is payable only when rates are sharply negative. Any increase in corporate rates, especially in the subprime market, will cause the entire financial system to implode, unless the Fed were to intervene at a scale as unthinkable now as the 2008 interventions would have seemed in 2007. It is difficult to construct the scenario in which gold fails to responds in proportion.

In the meantime, gold continues to provide the antidote to the collapse of the hyperfinancialized economy, and it is the one financial asset that remains undervalued, persisting near 300 years lows in terms of the monetary base. The gold mining stocks have suffered in the latest drawdown, but things are not as dire as they may first appear.

First, the prospect of a washout collapse, while possible, is low. Crashes generally occur not because of a widespread, sudden, simultaneous urge to sell, but because leverage forces cascading margin calls once downward momentum builds. After the plunge in 2013 and price action since, it seems unlikely that there are many weak players operating on margin in the gold sector (unlike in nearly every other financial sector currently).



Second, a gold mine is properly viewed as a spread-trade between the input costs, which are mostly correlated with industrial commodities, and the revenue, as determined by the gold price. The top chart shows that this metric is trading near the upper end of the trading range established since the big smash in 2013.



Indeed, this metric may explain why the ratio of gold to gold stocks is also trading near the upper end of its trading range since the April 2013 crash, as shown the lower chart.

None of this means that gold and gold stocks can't crash lower from here. When the broader markets collapse, which they must without support from the Fed, who knows exactly how collateral chains are wrapped around the banking system and what will happen to prices – though it is just as likely that gold shorts will get margin calls, forcing wholesale buying, as that gold longs will dump to raise collateral for margin calls from other markets. But those who hold gold and gold shares unlevered and as insurance have the ability to wait out any short-term noise. Consolidation has provided most gold mining companies with cushions to the downside for the short term, and in the long term the proposition that gold rises in a credit collapse is so well established by history that no theory is needed to justify it.