Myrmikan Research

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'ALL WELL,' IS VIEW OF BUSINESS CHIEFS

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Last week's Myrmikan report probed the similarities between Fed policy in the 1920s and that since 2008. The only material difference is that the modern Federal Reserve (operating outside the gold exchange standard) has been able to push prices much further from market value and, therefore, the underlying economic imbalances are worse. The conclusion will be an unwind greater than the credit collapse that occurred between 1929 and 1932.

Monday morning's 6.6% crash of the Dow had many wondering whether a dramatic end to the credit bubble had arrived. The subsequent recovery has largely allayed those fears, but investors should not yet be sanguine. While it is unwise to push market analogies too far—every credit bubble has its own center and its own dynamics—the eerie similarities to 1929 continue to proliferate.

From its peak on May 18 leading up to Monday's crash, the Dow had bled 10%. Then the trap door opened, but by the middle of the session, nearly all of the losses had been erased. This stunning reversal was widely credited to an email sent by the CEO of Apple to financial commentator Jim Cramer (which, incidentally, violated SEC Regulation FD): "I can tell you that we have continued to experience strong growth for our business in China through July and August. Growth in iPhone activations has actually accelerated over the past few weeks, and we have had the best performance of the year for the App Store in China during the last 2 weeks." The Dow has continued higher, buoyed by recent news that GDP increased more than initially reported during the second quarter of 2015. Neither of these two pieces of news has any bearing on where stocks go next, as the example of 1929 illustrates.

On October 23, 1929, after a two-month, controlled market decline of 20%, Professor Irving Fisher repeated his claim that stocks had reached a "permanently high plateau." The next day, the market opened 11% lower. A coterie of bankers pooled funds and publicly placed large bids for blue chip stocks well above the market, instilling confidence. The market reversed and closed down only 2%. The following New York Times Headlines are a sampling of those published over the next three days.

> 'ALL WELL,' IS VIEW OF BUSINESS CHIEFS; Reassuring Statements From Leaders Help Wall St. to Regain Composure.
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> BUSINESS IS SOUND, STORE CHAINS SAY; Twenty-six Systems Reply to Inquiry as to Conditions in Their Territories. OTHER LINES QUESTIONED Twelve Industrial Companies Make Similar Statements --All Optimistic.

OFFICIALS ARE OPTIMISTIC Federal Summaries Say Trade Level Is Above 1928 Mark --Other Markets Recover

Investment Trusts Buy Stocks Heavily, Pour In Their Reserves as Market Drops

SAYS STOCK SLUMP IS ONLY TEMPORARY; Professor Fisher Tells Capital Bankers Market Rise Since War Has Been Justified.

Stocks remained flat on October 25, a Friday, the calm continuing into the Saturday session. It looked like the bankers' gambit had worked.

But, margin calls had already been sent out. On October 28, stocks finished down 13%. The next day is recorded by history as the day of the great crash. Stock were down less than the day before, falling 12%, but the volume smashed all records. Stocks would eventually sink 89% from their highs.

The storybook version of the great crash imagines that this devastating decline followed October 29 forthwith. In fact, October 30 and 31 saw stocks rally 19%, putting them only 10% below where they had been on October 23, higher than the open had been on October 24.

The point is threefold: first, stocks rarely simply head unwavering in one direction. That would make it too easy for short-sellers. Second, economists, brokers, and government officials have no clue about the market.

Third, major stock declines generally follow declines in commodities and basic industries, but lead declines in retail sales. As suggested in the last report, this is because the banking system take the current money, the ready funds of depositors and lends them to businesses at term to invest in long-term assets. This manufactured credit dries up first because overcapacity in higher level capital forces prices and asset values to decline. Meanwhile, depositors, who are as yet unaware their ready money has been malinvested and destroyed, continue to consume normally. Banks get squeezed because their assets (loans) fall in value while their liabilities (deposits) stay the same. When the banking system finally collapses, then retail sales plunge. Therefore, statements that all is well by those selling at retail are to be ignored.

There is a fundamental difference between 1929 and today, however. The proximate cause of the stock market crash then was the Fed had raised rates to from 3.5% to 6% over the previous 20 months. It lowered rates to 4.5% within a month of the crash and to 2% within a year. This plunge in rates allowed the banking system to function normally, at least until the European banking system collapsed two years later. Then the real liquidations began.

This time, rates are already at zero, and the Fed is vain enough to imagine that 25 basis points makes any difference. If the 1929 analogy holds, the Fed will very soon be forced to lower rates by several percentage points. The only way to do that with rates already at zero is wholesale money printing.

As part of the sick humor of markets, gold and gold stock have been crushed over the past few days, even while economic conditions for gold mining continue to improve dramatically.

GOLD IS SURGING IN TERM OF INDUSTRIAL COMMODITIES (WHICH DRIVE THE COSTS OF MINING)

Improving economics of gold mining means operating margins in gold terms are expanding. The main risk to the miners is that nearly all of them carry large debts in nominal terms. If a short-squeeze in dollars (there are $4 trillion base dollars against $90 trillion in dollar denominated debts) drives gold lower in nominal terms, companies will have trouble paying their debts whatever their margin in gold terms.

This outcome is a possibility in the short term, but a rising dollar crushes everyone with dollar debts, not just gold miners, and the most indebted institutions are government and banks. The Fed will intervene long before banks start to crash, so gold miners with debts of sufficient duration will survive the interim stress to prosper in its aftermath.

China's demise has put a hole in the credit bubble too large to mend. Only those with intimate knowledge of banking, capital flows, and liquidity dynamics can hope to play the nuances of the decline. Everyone else must be content with mitigating the consequences of a global credit collapse. That means a large position in gold bullion, judicious bets on the gold miners, and complete avoidance of higher levels of capital and credit-driven enterprises.

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