

# Myrmikan Research

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## Dollar Short Squeeze

Markets have finally decided that quantitative easing is bad for gold—perversely, every time the Fed threatens to print, gold tanks, at least until recently. The first level analysis is that QE increases the number of dollars, which reduces the value of each and boosts the value of hard assets—simple supply and demand. This view relies on the seemingly obvious but hopelessly flawed quantity theory of money.

Back in 2008, when the Fed doubled the monetary base, some observers thought prices would double. They didn't. Money, it was explained, is broader than M0—it includes M1 and M2, so prices should still rise, but less. And so they did. Yet how to calculate the magnitude? Is it proper to include M3 or M4 in the calculation? And what about the “money” created by the shadow banking system?

Walter Bagehot, who penned what many still consider the definitive text on banking, wrote in 1857: “Men of business in England do not . . . like the currency question. They are perplexed to define accurately what money is: how to count they know, but what to count they do not know.” The Bank of Canada has examined forty-six different ways of determining the money supply. Milton Friedman himself concluded: “There is no unique way to express the real quantity of money,” yet nearly all academics and policy makers continue to use the quantity theory of money as their foundation.

What QE does, in fact, is add reserves to the banking system, and that allows banks to produce more credit. Banks lend this new “money” principally against assets, so asset values go up, overvaluing long-term cash flows, which is another way of saying that it lowers the discount rate. A lower discount rate sends a false signal that more savings exist, ready to be deployed. A boom develops, especially in projects with cash flows furthest into the future, such as base metal mines, which are most affected by discount rates. Gold has no cash flows and is not demanded by industry, so it falls in relative terms. Gold mining becomes a terrible business as margins compress.

But then the artificial stimulation produces overcapacity and prices start to fall despite the fact that there is more “money” in circulation. Soon the malinvestments can no longer make their interest payments. Industrial commodities collapse and gold mining margins soar. In fact, even if overcapacity weren't an issue, there would still be no way to extinguish the debts, as Aristotle explained over twenty-three hundred years ago.

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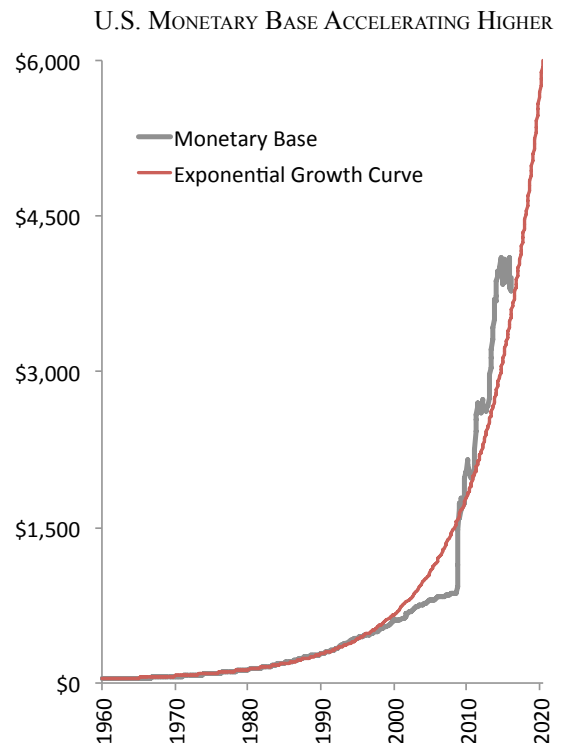
Imagine a simple economy in which there is 100 drachmas, all owned by the nobles, who then lend them to the peasants at 10% interest. A year later, the peasants owe the nobles 110 drachmas—but where do the 10 extra drachmas come from to pay the interest? Mining and minting may have only increased the supply to 102 drachmas (and the nobles own these 2 new ones anyway). When the debts come due, borrowers must sell goods to obtain scarce drachma, but no matter how much they sell, it is impossible for them all to perform. It doesn't matter how productive they have been with the borrowed capital—there are 8 drachmas missing: the money to pay simply does not exist. Prices collapse in the mad scramble for cash. If lenders forebear collection, their seeming charity only strengthens the imbalance: the following year creditors demand 121 drachma against only 104 in existence—now there are 17 missing drachmas.

This dynamic is why Aristotle (along with the Bible) condemned usury, the taking of interest:

The most hated sort [of gaining wealth], and with the greatest reason, is usury, which makes a gain out of money itself, *and not from the natural object of it*. For money was intended to be used in exchange, but not to increase at interest. And this term interest, which means the birth of money from money, is applied to the breeding of money because the offspring resembles the parent. Wherefore of all modes of getting wealth this is the most unnatural.

Modern economists have a simple solution to the usury problem. When lenders demand that 121 drachma be repaid out of the 104 that exist, and the market and economy begin to crash, the central bank simply prints up the missing 17 to “stabilize” asset prices. They don't actually “print” the money, of course; central banks lend it into existence (to the lenders!), but then the next year the 17 new drachmas require interest payments, on top of the interest on the unpaid balance of 121. Now the hole is even larger, and the printing must accelerate.

Behold the chart of the U.S. dollar monetary base—since 1960 (when the Keynesians took control) it has been following an exponential growth curve, which is becoming frighteningly vertical. Note the anomaly after 2000, when the Fed tried to hop off the curve—“Helicopter Ben” actually began his career as Fed Chairman by *reducing* the rate of monetary growth. As long as the banks were happy to roll debts, to allow interest to be paid with more credit, the market didn't need the raw dollars: this was a time of hyperleverage. But, when someone finally asked to be paid, the credit structure collapsed, and the Fed got back on the curve in a hurry.



Debts outstanding in dollar terms equal 90 trillion. The monetary base today—the raw money available to maintain these debts—is just shy of \$4 trillion. Where does the money come from to pay the interest? To be fair, the 90 trillion is a gross, not net figure: some of the debts are in the form of A owes B who owes C who owes A, which debts cancel out, along with interest. It is net debts—old to young, rich to poor, powerful to weak, capital to labor, government to students—that generate unpayable obligations and create a short squeeze on currency.

In 2008 with the banks collapsing, the Fed's quantitative easing program eased the short-squeeze on dollars, lowering their value, seemingly supporting the quantity theory of money by sending all prices higher, especially gold. The second and third rounds were different—their purpose was to lower interest rates further to stimulate the demand for all the overcapacity built during the bubble. This was decidedly bad for gold as the Fed managed to reignite the boom in risk assets. The tendency for gold to fall (at least in relative terms) during a credit expansion made it an ideal asset for speculators to short in order to enhance their returns on economically sensitive assets.

With the puncturing of China's credit bubble last summer, all of these trends have now reversed. Debts are becoming unpayable again, starting at periphery of credit: the BRIC countries and high yield debt such as energy and sub-prime auto loans. Margin calls on risk assets forced the unwinding of short positions in gold, boosting its price despite a building short squeeze in dollars. Overcapacity aggravates the problem: Fitch Ratings expects \$40 billion in U.S. energy defaults in the next six months—and the fractional reserve banking system magnifies greatly the effects of such losses.

These trends are set to accelerate. The South China Morning Post, Hong Kong's semi-official newspaper (and owned by quasi-state company Alibaba), recently ran article warning:

All indications are that China wants to export the overcapacity. And why not? China overinvested to bail out the global economy. It shouldn't pay the whole price for the mistake. China's strategy would lead to de-industrialisation in most of the world.<sup>1</sup>

Attributing China's actions to altruism is merely propaganda to justify what internal politics demanded. China's only alternative would have been and is to bulldoze the excess capacity and fire tens of millions of workers, breaking the covenant that Communist Party would make the people rich in return for the people consenting to their power. This, obviously, will not happen, and so a deflationary wave will swamp the world, just as in the 1930s.

Politics will demand a response, of course. A President Trump will not stand idly by while blue collar American workers are "de-industrialized." He will label China a currency manipulator and build a tariff wall in a replay of Smoot-Hawley. That's when the real banking crisis will begin. Banks will demand a ban on cash, or at least the Cyprus solution, and they will get it—the intellectual groundwork has already been prepared the same way QE was discussed in academic circles years before it was implemented. It's what they did in 1933 with gold—this time will be the same with cash, only worse since the imbalances are larger.

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<sup>1</sup> The whole article is required reading: <http://www.scmp.com/comment/insight-opinion/article/1919092/dont-listen-ruling-elite-world-economy-real-trouble>

The Federal Reserve entered the Great Depression in 1929 with 51% of its liabilities backed by gold. The other assets on the Fed's balance sheet were solid: short-term sovereign debt of a country that had run a surplus every year for the previous decade and had government debt totaling 16% of GDP. Today, by contrast, gold backs Fed liabilities by just 7.1%, and the other assets are long-term government bonds of an improvident Congress that has racked up total debt of 75% of GDP and continues to run large annual deficits.

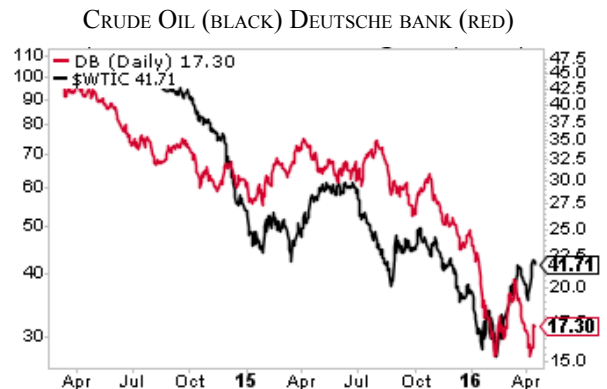
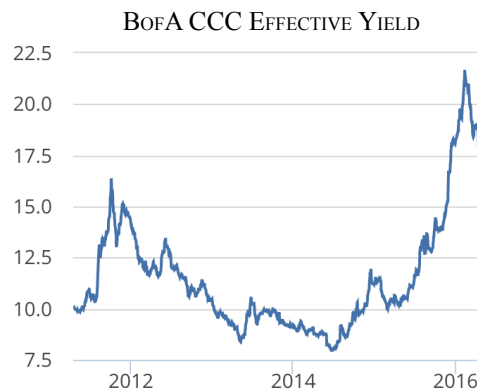
The return of Smoot-Hawley will eviscerate tax revenue and the value of the government bonds. Our depression is going to be so much worse than the Great Depression because we have so much more debt. As Freeman Tilden wrote in 1936:

The natural remedies, if the credit-sickness be far advanced, will always include a redistribution of wealth: the further it is postponed, the more violent it will be. Every collapse of a credit expansion is a bankruptcy, and the magnitude of the bankruptcy will be proportionate to the magnitude of the debt debauch.

Capitalists suffer most in credit collapses, and it will no different this time. The only sure safe-haven is gold.

By the end of the Great Depression, in 1941, the dollar was 84% backed by gold. Similarly, at the height of the Bretton Woods credit bubble in 1969 the ratio of Fed gold to Fed liabilities fell below 10%, but by 1981 (at the end of the inflationary credit collapse) the price of gold had risen to a level whereby the Fed's gold backed its liabilities by 135%. Given the current ratio of Fed gold to liabilities, the equivalent prices today are \$14,400 and \$23,200 per ounce (which numbers will increase if the Fed expands its balance sheet further). These figures are not equilibrium values; they are the limits of how far the dollar declined at the end of two massive credit bubbles. Our bubble is significantly larger, which is why when the market finally places a margin call on the Fed, gold will trade at these levels, perhaps higher, though only for a brief moment. The equilibrium price is anywhere from \$5,500 to \$9,000 per ounce.

The trends powering gold higher have, in fact, temporarily reversed. The chart bottom left shows the vertical spike in sub-prime corporate debt taking a pause at the same time that the chart bottom right shows oil prices and Deutsche Bank stock bouncing. Higher oil prices translate into less pressure on bank balance sheets, which mitigates the dollar margin call.



If markets were perfectly efficient, now would be a good time to withdraw from the gold trade and wait for a correction. Indeed, a correction may well happen, but trying to time the move higher is more likely to result in missing it, for the giant sucking sound that is credit being pulled into the abyss will not abate as a broad trend until the Fed acts and with 2008-style conviction. And, unlike the most recent QEs, the next one will have the effect of the first one, alleviating a short squeeze on dollars, sending all prices higher, especially gold. *Assuming QE4 works*, then we may repeat the cycle of the past eight years, except with more virulence from a higher price level, the focus shifting first to gold and then to risk assets with QE 5 and 6 until the following crisis.

The next QE may not work. It may be that when the Fed offers free money to lenders there is so few prospects for gain that they don't want it. It may be that when the Fed trots out its trillions of guarantees (as it did in 2008), they are triggered, forcing the Fed to hand over multiple trillions in cash. When the short-squeeze on dollars breaks, that will be the end of the mega-cycle that began in 1981—industrial commodities, interest rates, and gold will rise together as the sovereign debt bubble implodes. Commercial banks will fail not because prices are too low but because interest rates are too high: either they have financed long-term fixed debt with short-term floating deposits or they have financed floating debt that borrowers cannot possibly maintain at the higher rates. The Fed will fail because its assets, United States Treasury bonds, will have become nearly worthless. The dollar, now defined as a unit of liability of the Federal Reserve, will trade down to a level that reflects the only asset on Fed's balance sheet of remaining value: the gold. The price of gold in dollars will be at levels that today are intellectually assured yet emotionally unimaginable. Imagining where the miners will be makes trading them down here a fool's errand.



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