

Myrmikan Research

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The American System

“The biggest political upset in American history” muttered Clintonite George Stephanopoulos repeatedly as the election returns came in. The pundits and the polls had dismissed Trump’s presidential aspirations as a publicity stunt. In July of 2015, the betting markets gave Trump a 5% chance of winning the *nomination*, much less the presidency.

Yet it was around this time that Myrmikan began arguing that Trump’s victory was historically inevitable. The American Constitution was modeled on the Roman Republic, and we all know (or should know) what happened to Rome. As the republic turned to empire, credit levels exploded, widening the gap between rich and poor. A citizenry composed of small landowners was transformed into a plantation system, more efficient but less flexible, able to sustain the populace through government hand-outs, but destructive of civic virtue: *latifundis perdidere Italiam*.

Similarly, credit growth in our own time has replaced a *bourgeois* society, comprised of small capitalists, into an employee society, where the mass of people owe their existence to large institutions, be they big business or big government. Indeed, aware of the corrupting influence of credit, in 1785 Congress declined to renew the Bank of North America’s charter on the basis that “they had no banks in Rome during the Republic.”

Meanwhile, the elites who controlled the two major political parties, the *Popularis* and the *Optimates*, the Democrats and Republicans of their day, battled over who could extract more wealth from their positions of power, which generally involved alliances with the large landowners, crony capitalists. The plebeians, crushed under the weight of debt and graft, yearned for a champion. They got it in the emperors.

The emperors drew their power from the little people and were thus hated by the intelligentsia, the reason the famous historians made them out to be crass, obscene, belligerent, and insane, more or less the attitude of the press towards Donald Trump. Even if these exaggerated characterizations contained some truth (for commoners like to think of the emperor as one of their own), it didn’t matter: it turned out that monopoly in graft is self-limiting, since it is in the interest of the single emperor to keep the host alive and strong; whereas competitive plundering focuses on extracting as much as possible before the host dies.

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This may be the reason why the Romans, a most practical people, accepted the demise of political freedom in exchange for economic stability, but it does not explain why they chose it—for *ex ante* the benefits were unknown. They chose it because the *status quo* of oligarchic oppression had become intolerable, as it has in our own time. The George Soros's, and Lloyd Blankfeins, and Janet Yellens, the Davos Crowd and big businesses pushing corporate welfare under the guise of free trade, the Ford, MacArthur, Clinton Foundations, big media—who could oppose them, but one of their own who had even larger ambitions and audacity. Trump's argument to the black community was the same as to blue collar workers in the rust belt: what do you have to lose? It worked: the latter showed up at the polls and the former didn't, confounding the press and handing Trump victory.

And now what? The establishment Trump attacked confidently predicted gold \$100 higher and a crashing market, the unraveling of the current order, both of which occurred the election evening. But then an extraordinary thing happened: by morning the market had regained its loses and gold had collapsed, and everyone is wondering why.

The financial media has settled on three reasons. First, Trump has proposed lowering tax rates on individuals and dramatic cuts to the corporate tax rate. The value of business cash flows will increase, boosting corporate valuations, the stock market, capital investment, and future growth.

Second, Trump has proposed \$1 trillion of infrastructure spending over the next 10 years, in addition to a military build-up. Why not put all those unemployed people and all that overcapacity to work? especially when they can be financed with interest rates around zero? Copper absolutely loves the idea, and much of the 24% rally since late October has occurred since the election. This stimulus-by-another-name will happen: Democrats love to talk “government investment,” and the Republican Party is always willing increase government spending as long as its done on their watch.

Third, Trump has promised to dismantle the Dodd-Frank Act, which prohibits banks from engaged in proprietary trading, among other things (though the exact details of his plan remain murky). Perhaps even more revealing are rumors Trump's finalists for Treasury Secretary include 17-year Goldman Sachs veteran Steven Mnuchin, JPMorgan Chase CEO Jamie Dimon, and billionaire Jon Gray from the Blackstone Group, putting a fox in charge of the hen house.

Capital markets are understandably ecstatic about these priorities, for they are likely to pass the Republican-controlled Congress without too much dilution (a few bridges in sensitive districts will do the trick). They are all fuel for credit expansion—the KBW Nasdaq Bank Index has surged 18% since the election—and, as Myrmikan continually points out, gold hates the upside of a credit expansion, which may explain the collapse in gold prices since the election.

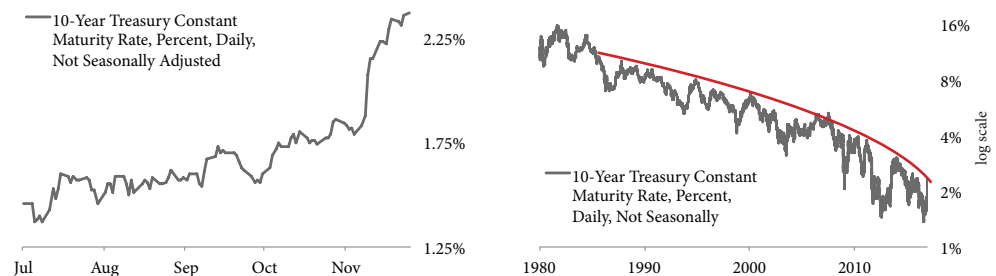
Financial news chatter has it that Trump's program is the same as Reagan's, who revitalized the economy by slashing taxes and regulations, spending on the military, nor, like Trump, did he care about the deficits: “I am not worried about the deficit. It is big enough to take care of itself,” he quipped. Reagan's policies ushered in a generation of rising stock prices, declining inflation, and a falling gold price.

If only it were so easy to achieve national greatness! Reagan’s program came at a particular moment in time: the trough of a credit cycle. Interest rates were at cycle highs, exceeding 20%, and the sum of government and private debt added to only 150% of GDP. The Federal Reserve’s hoard of gold backed its liabilities by 92%. These were ideal conditions to commence on a credit expansion, the longest and largest history has ever known.

President-elect Trump faces very different conditions. Rates are at cycle lows and the total debt-to-GDP ratio is recorded at 338% (likely a good deal higher). Medicare, Medicaid, and Social Security alone consume 10.4% of GDP—compared to 5.4% in 1980—and are projected to grow to 13.5% by the time Trump finishes his first term. Add military spending at the lowest levels since World War II and interest on the debt at historically low interest rates, and expenditures already exceed current revenues, even at Obama’s tax rates, leaving nothing for anything else. Unless he’s going to somehow slash entitlements, which he promised not to do, Trump has no revenue to redirect. Any spending above military, interest, and entitlements must come from borrowed money. And any increase in interest rates widens the deficits, requiring the issuance of more Treasuries, which will increase rates even further, in a positive feedback loop.

The U.S. Treasury market has had an enormous reaction to the prospect of large new issuances from deficit spending, wiping out well over \$1 trillion in the bond market since the election.

INTEREST RATES MUST CONTINUALLY FALL TO MAINTAIN A CREDIT BUBBLE



The chart above right puts this surge in yields in perspective—they have merely returned to where they were at the beginning of the year. But, as Ludwig von Mises and Hayek pointed out, a boom brought about by credit expansion can continue only as long as interest rates keep falling. If interest rates break their 35-year trend lower, watch as the entire financial system implodes. Higher rates immediately translate into rising monthly payment for anyone with floating rate debt—student loans, mortgages, consumer loans, auto loans—the whole country—even for those with fixed rate debt, someone else is on the hook. There are currently \$418 trillion in interest rate derivatives swaps. These start to sour immediately.

Trump understands this: “She is a low interest rate person,” he said of Federal Reserve Chairman Janet Yellen:

she’s always been a low-interest-rate person, and let’s be honest, I’m a low-interest-rate person. If we raise interest rates and if the dollar starts getting too strong, we’re going to have some very major problems . . .

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Now, if inflation starts coming in—and we don't see any signs of that, but—if inflation starts coming in, that's a different story. Then you have to go up and you have to slow things down. But right now I am for low interest rates, and I think we keep them low, and we have to compete.

In other words, the stimulus has to happen first, before the rise in rates. And is the bond market so stupid that it will lend a trillion at low rates, knowing it's going to get slaughtered by higher rates and inflation? The strategy might work if the Fed embarks on another bond buying program that traders would front-run, but instead the market is predicting with near certainty that the Fed will raise rates in December. Trump is facing the prospect of having his program defunded before it is even passed—Yellen's revenge. Worse, even existing government spending becomes untenable at higher rates.

If the Reagan analog is no good, there may be others we can consider. Herbert Hoover, for example, came to office at the peak of a credit bubble, which cracked only seven months after he became president. He increased federal spending by 49% even as tax receipts plunged 50%. He acquiesced to two Republicans, Senator Smoot and Congressman Hawley, who led the charge to protect American workers through the highest tariff the nation had ever seen:

We met the situation with proposals to private business and to Congress of the most gigantic program of economic defense and counterattack ever evolved in the history of the Republic.

So much for Laissez-Faire capitalism. The result was the most gigantic depression in the history of the nation.

Modern economists place the blame on the Fed, telling us it didn't do enough. In October of 1929, Federal Reserve liabilities were backed over 50% by gold, and government bonds made up a paltry 3% of its assets, the remainder mostly short-term commercial bills. The dollar was solid, which is precisely what modern economists don't like. Contrary to the narrative, the Fed did act forcefully: it increased its holdings of government securities by eleven times from 1929 to 1933, and the monetary base increased by 16%, but deposits in the banking system still crashed by 45%. Economists would have had the Fed print enough *money* to balance the decline in *credit* Bernanke-style.

Let us move on, then, to an analogue in which the Fed had more freedom of action. Richard Nixon, another Republican, also arrived near the peak of a credit bubble in the context of the inflationary architecture of Bretton Woods, designed by Keynes himself. Kennedy and Johnson had increased federal spending by 65%, and half the resulting deficit was financed directly by the Federal Reserve under a policy formulated by Roosevelt's Federal Reserve Chairman Marriner Eccles:

Congress appropriates the money; they levy the taxes; they determine whether or not there should be deficit financing. The Treasury then is charged with the responsibility of raising whatever funds the Government needs to meet its requirements.... I do not believe it is consistent to have an agent so independent that it can undertake, if it chooses, to defeat the financing of a large deficit [by raising interest rates], which is a policy of the Congress.

By the time Nixon took office, profit margins were crashing and gold was fleeing the Federal Reserve as panicky foreign governments redeemed their still convertible dollars. As a result, the Fed's liabilities were backed only 12% by gold and 68% of its assets were government bonds valued in terms of a 10-year nominal yield of 7%.

Nixon slammed shut the gold window "temporarily" in a move he called "highly technical." He admitted: "If you want to buy a foreign car or take a trip abroad, market conditions may cause your dollar to buy slightly less." In other words, the devaluation was in part a protectionist measure. Just to make sure, he boosted the tariff on imported goods by 10%.

And, like Trump and Hoover, Nixon thought stimulus would help—in his six years in office he managed to surpass Kennedy and Johnson combined, increasing federal spending by 72%. Nixon told his Federal Reserve Chairman Arthur Burns: "I don't want to go out of town fast," so the Fed did its part by purchasing 40% of the resulting deficit. As Nixon explained to his Treasury Secretary: "[we] can't afford to risk a downturn, no matter how much inflation."

But even with the Fed buying every bond in sight, the enormous deficits caused the dollar to buckle and the yield on the 10-year bond surged to 15% as investors demanded inflation protection. Gold would soar twenty-five *times* from 1970 to 1980, wiping out debt in real terms, and setting the stage for Reagan.

Hoover and Nixon: both Republicans, both came to office right as a credit bubble began to sour, both turned to fiscal stimulus, monetary easing, and protectionism: America first. The antecedents of these policies go much deeper, in fact. Following the Panic of 1819, Henry Clay devised what he called the "American System": a tariff to protect American industry from British goods, which would fund a system of internal improvements, all coordinated by an active central bank. Its implementation in 1824 nearly caused South Carolina to secede. Tariffs faded with the Clay's Whig Party, but reemerged after the Panic of 1857 as a platform of the new Republican Party. "My politics can be briefly stated," announced the first Republican president, Abraham Lincoln, "I am in favor of the internal improvement system, and a high protective tariff."

Not only is Trump's personality timely for the shift from republic to empire, but his program reflects the original, core principles of the Republican Party that reemerge every time a credit bubble cracks. Of course Trump was going to win. Yet he has been handed a poisoned chalice. Clay and Lincoln had the luxury of implementing their poisonous "American System" well after the fall, at the trough of a credit cycle. It is Hoover and Nixon we must look to as guides, since they arrived at the peak.

The current credit cycle is already rolling over, as detailed extensively in these pages, and each new cycle requires vastly more intervention to produce. Only policies an order of magnitude larger than the QE and TARP programs of 2008 can reignite the bubble. A few bridges and a wall aren't going to solve the Chinese overcapacity problem, or the European banking problem, or Latin American commodity overinvestment, or mis-pricing in American stocks and bonds.

As in 1969, the dollar is sick: Federal Reserve liabilities are backed only 7% by gold, the remainder by long-term bonds with enormous duration risk. As rates rise—

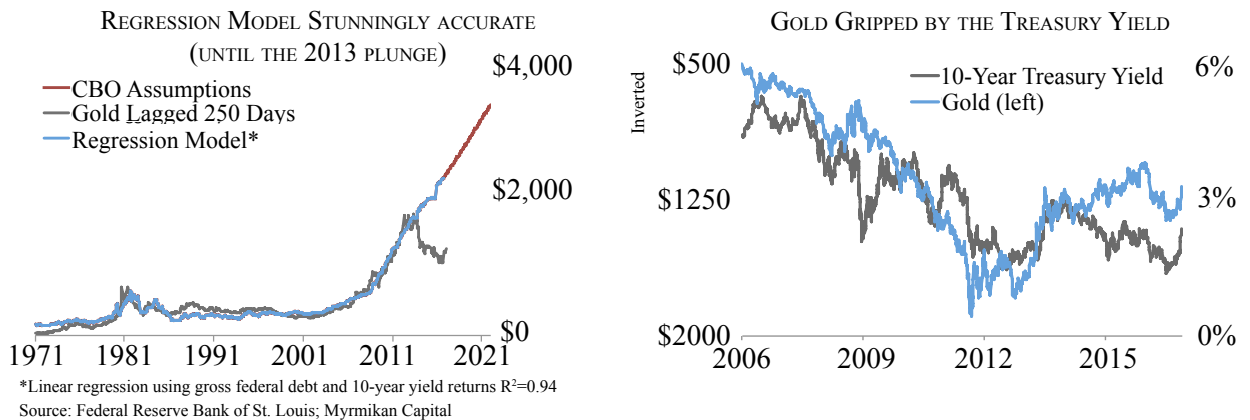
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not from 7% as with Nixon, but from 1.5%—the bonds will get crushed and the dollar along with it. Gold will soar as in the 1970s, only more so.

But not yet, as the head researcher at the Bank of International Settlements (BIS) recently explained:

As interest rates have fallen to historically low and even to negative levels in some regions, investors searching for yield have sought higher-yielding assets. In practice, given the global role of the dollar as the borrowing currency of choice, such higher-yielding assets have been denominated in US dollars, even if the borrowers are non-US residents.... When so many borrowers have borrowed so much in dollars, whether for hedging or speculative purposes, dollar appreciation exposes borrowers and lenders to valuation changes and in turn impacts their balance sheets....

In other words, the world is massively short dollars, so when rates rise, the foreign demand for dollars intensifies, strengthening the dollar instead of weakening it. Indeed, it is this phenomenon that may explain the breakdown of the relationship noted in Myrmikan's previous letter. For forty-two years after Nixon floated the dollar against gold, gold prices behaved exactly as one would expect: rising with nominal interest rates and government debt (chart below left). Since 2006, however, the relationship with interest rates has inverted. As the Treasury bond weakens and rates rise, gold falls, and it is completely ignoring the growth in government debt (chart below right).



This dynamic, if it continues, will lead to a trade war 1930s-style, as alluded to by the BIS:

Crucially, the financial channel of exchange rate fluctuations often operates in the opposite direction relative to the net exports channel. For net exports, it is when the domestic currency depreciates that real economic activity picks up. By contrast, the financial channel operates through the liabilities side of the balance sheet of borrowers, so that it is when the domestic currency appreciates that balance sheets strengthen and economic activity picks up. The impact of exchange rates is back-to-front compared with the textbook stories....

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As rates and the dollar rise, emerging market economies slow due to rising financial stress, which makes it harder to pay dollar debts, which lowers emerging market currencies still further, in a positive feedback loop. This is why the MSCI Emerging Market Index is down 5% since the election and why the dollar keeps soaring in value, especially against emerging market currencies. It was a similar, intensifying dynamic that led to the Panic of 2008, the only difference being that credit levels are far more elevated currently.

Falling emerging market currencies not only stresses emerging market corporate balance sheets but also amplify trade imbalances. Foreign goods become cheaper because of currency movements, and distressed companies slash prices to juice volume in a desperate bid for solvency. As noted by Myrmikan last April, *The South China Morning Post* ran an editorial warning of this very dynamic:

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.

Much of what Trump said campaigning may have been rhetoric, but is he really going to let a deflationary wave destroy what is left of the rust-belt? Or will he be forced into a replay of Smoot-Haley to protect his core constituents and unravel the international banking system, as happened in the 1930s? Will he allow market forces to bring the big banks down, or do his Treasury Secretary finalists broadcast that he will continue the Bush/Obama/Clinton policy that what is good for Goldman Sachs is good for the nation?

Trump's cunning should not be underestimated, but whatever the answers to these questions, the dollar is not strong. It will collapse, and the only question is when and how. Once the short squeeze on dollars burns itself out—and who knows how long that might take, and what will be left standing—then the Nixon dynamic may begin, with rising deficits driving higher nominal rates, destroying the Fed's balance sheet, sending gold into the stratosphere, absent draconian capital controls, for which our democracy is ill prepared. For gold investors, the key is to survive until that inflection point, which will likely arrive with little warning.



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