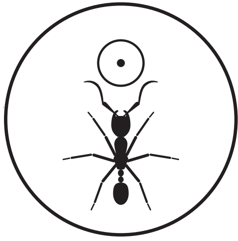

Myrmikan Research

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Timing the Crash

The S&P 500 rallied another 1.9% in July, bringing its year-to-date performance to a blistering 10.3%, an annualized return of 19.8%, and this in the eighth year of a bull market!

The beginning of the post-crash bull was easy to explain—the Federal Reserve guaranteed the debts of all of the Wall Street banks, and the QEs showered the most aggressive financial actors with free funds while driving rates down to zero. It is not correlation but an axiom that the net present value of a discounted cash flow must rise when discount rates fall (especially when that cash flow is guaranteed by the central bank).

But that axiom works in reverse as well, and more subtlety than most realize. It isn't just that rising rates lower the raw calculation of net present value of every firm, but every debt-laden customer in the economy finds his purchasing power reduced: his mortgage payments increase, and auto payments, student loan payments, credit card payments—he finds his cash flow squeezed ever tighter. Even if he's been clever and taken out fixed-rate debt, all this does is shift the burden of higher payments to someone else, a pension fund perhaps.

What, then, can explain the current market? The Fed began raising rates in December of 2015, twenty months ago. The Fed Funds Rate has increased from an absurd 0.12% to 1.16%, during which time the S&P 500 has soared by 25%. Earnings have also increased, it's true, but how can that continue if the consumer is forced to stop spending?

The current retail Armageddon partially reflects the mad drive for scale engendered by our banking system—in which everyday low prices reflects the quality of the products—but also a consumer being forced to retrench. Payless has closed 800 stores so far in 2017, RadioShack 550, Rue 21 400, The Limited 250, Family Christian 240, along with Macy's, JC Pennny, Sears, Micheal Kors, Sports Authority, Ralph Lauren—the list goes on.

The weakness is not just in retail. According to a July report by CNN:

> U.S. vehicle sales have lagged behind 2016 levels every month this year. If that performance continues, this year will mark the first since 2009 that industrywide sales declined.

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> General Motors (GM) reported a 5% drop in sales last month, as did Ford Motor (F), which recently replaced its CEO. Sales at Fiat Chrysler (FCAU) were off 7%.

Or consider the real estate market. Kiplinger reports:

> Housing starts rose to a seasonally adjusted annual rate of 1.215 million in June, a rise of 8.3% from May. . . . Sales fell 1.8% in June and were 0.7% above a year ago.

The cheer-leading article dismisses the glaring incongruity to conclude that sales fell only because there isn't enough inventory, meaning "more folks will ultimately have to rent instead of buy." Why, then, are rental prices falling as well?

According to an article by Doug French at the Mises Institute, "346,000 new rental apartments in buildings with 50+ units are expected to hit the market" in 2017, 17% higher than in 2016 and 63% higher than the 1997-2016 average. But, a housing analyst reveals:

> [T]he prices of apartment buildings nationally, after seven dizzying boom years, peaked last summer and have declined 3% since. Transaction volume of apartment buildings has plunged. And asking rents, the crux because they pay for the whole construct, have now flattened.

An anecdotal look at rents in New York using Trulia reveals that the large, ugly buildings are offering 1-2 months free rent upon signing. So rents are, in fact, falling, even if the mechanism by which they are falling allows the companies to tell their analysts and shareholders that "asking rents" are flat.

When cash flow disappears, assets become worthless along with the financial assets backed by them. According to UBS, for example, 20-25% of the 1,100 shopping malls in the U.S. will close within the next five years. And the bubble has not yet even burst! It will be much worse. And what will happen to all the owners of REITs? And subprime auto loans? And equities?

Everywhere ones looks, one sees the classic signs of a maturing credit bubble: massive overcapacity being added despite falling cash flows. Overall, pre-tax, corporate margins in Q1 2017 fell to 15.6% from a cycle high of 17.9% in Q3 2014.

Let us pause here to reprise, again, the words that Republican Senator Elihu Root delivered in opposition to the Federal Reserve Act, words the *Wall Street Journal* ought to publish daily in its masthead:

> With the exhaustless reservoir of the government of the United States furnishing easy money, the sales increase, the businesses enlarge, more new enterprises are started, the spirit of optimism pervades the community. Bankers are not free from it. They are human. The members of the Federal Reserve Board will not be free of it. They are human. All the world moves along upon a growing tide of optimism. Everyone is making money. Everyone is growing rich. It goes up and up, *the margin between costs and sales continually growing smaller as a result of the operation of inevitable laws* [emphasis added], until

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> finally someone whose judgment was bad, someone whose capacity for business was small, breaks; and as he falls he hits the next brick in the row, and then another, and then another, and down comes the whole structure.

The question, remains, however, why asset prices keep increasing in the face of rising rates and a maturing bubble. It has been always thus, in fact. Few remember that the Fed began raising its target discount rate in June of 2004, from 1% to 5.25% by July 2006. The economy began to fray a year later and didn't crash for another year after that, four years after the initial hike.

In the previous cycle, the Fed began raising its target rate in 1994 after lowering it to 3% in response to the savings and loan crisis. Its rate reached 6% by 1995, but the market didn't care. Greenspan then *lowered* the Fed's rate to 4.75% through 1999 stoking the Clinton internet bubble until finally, in a panic, he spiked it to 6.5% in 2000, at which point the market collapsed forthwith.

This pattern is not an artifact of modernity. The Fed began raising its discount rate from 3.5% in February of 1928 with the specific goal of reining in asset markets. Asset prices not only ignored the Fed, but taunted it, accelerating their rate of increase. Determined to prove its authority, the Fed chased the market higher, increasing its discount rate again in the summer of 1928 to 5%. When this proved useless, the Fed increased it again, peaking in September of 1929 at 6%. Within six weeks, the market stood 40% lower—the bubble was so large, it had taken only eighteen months to puncture it.

Unlike modern episodes, in 1928 the Fed wasn't just trying to prevent prices from rising too fast, it actually wanted to lowered them, as it had in the previous cycle. The Fed had lowered rates to finance World War I, but inflation became so virulent that the central bank began increasing its discount rate a full year before the end of hostilities, from 3.75% in November of 1917 to 4.56% by May. There it held it, reluctant to crash the economy after the war boom. But the market kept roaring higher, so the Fed began hiking again in November of 1919. The market peaked that month and fell 24% by February. But then it rallied back nearly to the high, so the Fed raised again: by June of 1920, its discount rate stood at 7%. This last hike corresponded with peak oil prices, which had soared more than fourfold since 1915. A year later, the market stood 47% below its high, three-and-a-half years after the Fed's initial efforts.

We can, in fact, take this analysis back into the nineteenth century, when the Bank of England controlled global credit flows. Interest rates, then, were much better behaved, prices being tied to a gold standard. Nevertheless, the pattern is clear. In August of 1905, for example, the bank's discount rate stood at 2.5%. The bank began raising its rate, which reached 4% in January of 1906 right as the market peaked. By October 1906, with the market still near its high, the bank had increased its rate to 6%. Eventually, however, the high rates kicked the legs out from under the bubble and stocks crashed nearly in half from January of 1907 to November, an event that, ironically, prompted the formation of the Federal Reserve.

Going back further still, the Bank of England raised rates steadily from 2% in 1852 to 10% in 1857, prompting the Panic of 1857. And let us not forget the double-panics

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of 1837 and 1839. The initial episode was a cleansing caused by Andrew Jackson's 1836 Specie Circular. Up until that time, near-worthless state bank notes could be used at face value to buy land from the federal government, against which additional funds could then be borrowed—more or less the same system that legal tender laws enforce today. The Specie Circular required that payments be made in terms of gold, the proper way to restore a currency and credit system (which, *nota bene*, Daniel Webster had implemented in 1817, though the effort was undone by the founding of the Second Bank of the United States). Woodrow Wilson described the result:

> The volume of paper currency which had gone West for the purchase of lands was thrown back upon the East for redemption, or to add still further to the plethora of circulation already existing there. Credit had received a stunning blow, under which it first staggered, and then fell.

It did not help that the Bank of England faced its own troubles and had increased rates from 4% to 5% at the same time. The Panic of 1837 abated in 1838 when the bank lowered its rate back to 4%, and the Federal government distributed a dividend to the states, Jackson having retired the national debt. In 1839, however, the Bank of England again increased its discount rate, this time to 6%. Daily turnover at the New York Stock Exchange fell from over seven thousand shares to fifteen hundred, market interest rates leapt to 24 percent, and real estate prices collapsed, with some marginal properties selling for one twentieth their former value.

In the age of classical liberalism, the sovereign saver controlled capital flows and banks had to react: when the Bank of England started losing gold deposits it had no choice but to raise rates to preserve its capital. Under the Federal Reserve, by contrast, Keynesian apparatchiki mandate rates using government power. But whatever the cause of higher rates, the effect is the same: the toppling of credit pyramids throughout the globe, though with a considerable lag.

History suggests that we are entering prime zone for a market crash. While the Fed has not raised rates that much, the bubble is enormous, the largest in history, and 18-48 months seems to be the sweet spot for private credit pyramids to react to changes in government-sponsored rates. This general timing may be combined with the specific observation that most market crashes occur in the Autumn, and for good reason. In an agrarian era, cash requirements for the harvest often provided the final thrust of rates higher that brought the end. In our time, it is credit requirements for manufacturers placing Christmas orders that can stress a super-saturated system.

The big question for gold investors, however, is: will gold crash along with the market first before the moonshot. The initial market crash is always brought by a short-squeeze in currency, and investors must sells assets to raise cash to forestall foreclosure—they sell what they can, not what they want to. This is why gold plunged 30% from March 2008 to October, before the Fed's reaction drove it back near its all-time high within five months on its way to nearly tripling.

It is always dangerous to expect things to be different in markets, but there are reasons to think gold may avoid its 2008 swoon. First, physical gold has spent the past nine years moving to strong hands in the Far East. Second, unlike in 2008, there is no indication that managed money is levered long gold. It may well be short, which

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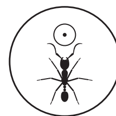
would require massive buy orders when margin calls go out. Third, even if gold does dip, market participates learn—everyone knows what the Fed's reaction will be and its effect on gold. It won't take five months for gold to recover its highs—perhaps five weeks or five days.

If markets merely follow the same script, we should expect gold to run to $3000 in the aftermath of the next credit implosion. Credit levels are much higher than they were in 2007, however, so that target is conservative, and gold's rise will be much steeper than in the previous cycle. Imagine the effect on junior gold miner equities.

Gold will ultimately reach prices much higher even than that when the market forces the Fed's balance sheet to balance, upwards of $10,000 per ounce, higher depending on how the Fed reacts. Even if we are not yet at the end of the credit supercycle that began in 1948, cyclical highs should grant enormous gains to gold investors over the coming few years. If the supercycle should end, the gains will much greater, but so will the mandate be to protect the gains from a jealous state. This will be a high-class problem—at least gold investors will have something to protect.



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