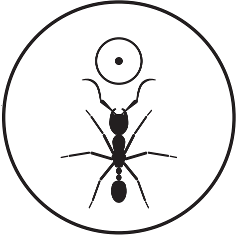

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The First Cockroach

Credit bubbles are all the same. Let us review the life cycle. A fractional reserve banking system (which is enabled solely by legal tender laws) creates an artificial supply of credit, which bids on real assets, thereby driving asset prices up and discount rates down. The longer term a prospective cash flow, the more affected its value is by discount rates, so the prices of long-term projects jump the most. High prices in a properly functioning market signal scarcity, so economic agents respond rationally by investing especially in the construction of new long-term projects, which tend to be capital intensive. The high prices are not, in fact, due to scarcity but are the result of a malfunctioning credit system: the new investments create overcapacity, which leads to falling margins, which puts pressure on their ability to repay debts. The banking system that financed the bubble becomes impaired, and the want of money causes interest rates to soar. Malinvestments cannot renew their debts, soon default, and are liquidated by creditors, throwing misappropriated capital and workers onto the market, stressing government support programs just as tax revenue plunges. This is when, according to both Keynesian and monetarist theory, the state should intervene directly, bailing out the banks, the government, and systematically important companies by printing money. The intervention might "work" in that it stems the panic, but the losses due to overinvestment are real and are ultimately born by those holding or having claims on currency. Bailing out the investment class transfers wealth from the prudent and conservative to the profligate and reckless, encouraging them to do it again on a larger scale.

Myrmikan never tires of reading Senator Root's 1913 speech opposing the Federal Reserve Act:

> 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, until 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.

This pattern of a small, wrong-footed speculator igniting a credit conflagration is set by the nature of bubbles. Those with the thinnest capital have the most to win and the least to lose by levering up marginal assets. Once the cycle turns, rising rates tip over these small players first. Sometimes their failure brings the system down

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immediately, if it is big enough to take down their lenders. Other times they are merely the first to drown in the incoming tide.

The first panic of the United States came, for example, when Alexander Hamilton's protege William Duer levered up his purchase of federal bonds with margin loans from state banks. When rates rose, Duer's failure took down his lenders as well, igniting the panic of 1792. In the panic of 1837, New Orleans cotton broker Hermann Briggs's collapse brought down its New York correspondent banks, and the rest of the money market forthwith. In 1857, the failure of the Ohio Life Insurance and Trust Company popped the railroad bubble. In 1907, it was Otto Heinze's failed corner of the United Copper Company that brought down his brokerage firm, its banks, and ignited the panic of that year. Some speculate that the Hatry fraud in London sparked the 1929 panic.

The "new economics" of Keynes argued that the state should bail out these speculators and those that aid and abet them to prevent the bubbles from popping: "Recessions are now considered to be fundamentally preventable, like airplane crashes and unlike hurricanes," boasted economist Arthur Okun in 1970.

Operating on Irving Fisher's theory that the Federal Reserve should impose price stability, the Fed raised rates in the late 1960s to control rising asset prices. Instead of a new equilibrium, the Fed got the Penn Central collapse, which threatened widespread panic. Peter L. Bernstein cautioned at the time:

> With all the narrow escapes we have had with railroads, airlines, and brokerage firms during 1970 [i.e., capital intensive industries], it is to be hoped that the monetary authorities keep in mind that policies designed to fit in with overall public policy with respect to the economy as a whole can ricochet dangerously onto the quality of the assets of the institutions that create and hold the nation's monetary assets.

The Federal Reserve got the message, printed the money to bail out the banks, the currency depreciated, and inflation soared. The Fed tried to instill discipline a second time, raising rates throughout 1973 until the Franklin National Bank collapsed in late 1974. Down went rates again to prevent contagion. The Fed did it again, raising rates to end the inflation of the 1970s—Mexico and the rest of Latin America defaulted, which would have taken down America's largest banks if the IMF and World Bank had not intervened.

The pattern continued: Greenspan bailed out the market in 1987 after the portfolio insurance scam burst, then again for the Savings & Loan crisis, the Long Term Capital Management failure, the Asian contagion, and the internet bubble. Then came Bernanke's turn.

The Federal Reserve began raising interest rates in June of 2004 to "stabilize" housing prices. The first sign something was not right in the financial industry was the May 4, 2007 failure of Dillon Read, an internal UBS hedge fund, which had invested heavily in subprime mortgages. With losses totalling only $125 million, the failure barely registered in the financial press. In mid-June, two internal hedge funds at Bear Stearns required an injection of $3.2 billion to meet margin calls. The next month, a fund within IKB, a small German bank, found it could not roll its asset-backed commercial paper—the parent bank lacked the resources to bail it out, prompting a

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€3.5 billion rescue from other banks. Spooked investors began dumping asset-backed commercial paper, the market for which shrank by a third in the second half of 2007.

In the nineteenth century, these failures would have led swiftly to a thorough market cleansing. By August, however, the ECB and the Fed were injecting funds into the overnight funds market and slashing interest rates, the Keynesian prescription. The market soared, peaking in October of 2007. The Lehman panic was coming anyway—all they did was delay it by a year and make it worse.

When the panic arrived, the Fed rolled out the policy it has pursued since 1921: it printed on a massive scale. Gold ran from $700 to $1,900, measuring the devaluation of the dollar. The rescue encouraged the speculator class to do it again on a larger scale, and gold then unperformed during the boom, as it always does.

The Fed began raising rates in 2015 to constrain various asset bubbles, as it has throughout its history. It is an axiom of Austrian theory, confirmed by history, that rising interest rates pop credit bubbles—the current one will be no exception. Myrmikan has been waiting for some small bank to roll over, or reports of a rouge trader at a large bank, or a pension fund to collapse, for the first cockroach, in whatever form it may take.

It looks like this time, as with the Latin American crisis of the 1980s and the Asian Crisis of 1997, the culprit may be second-world countries, most notably Turkey. The problem is not just that Turkey has a lot of debt; the problem is that the debt is denominated in dollars and euros. This means that the debt becomes more onerous as the local currency collapses. To illustrate, the lira has lost half its value against the dollar in the past year, meaning that dollar debts in local terms have suddenly doubled in size: they are unpayable.

Many of these dollar denominated corporate debts are owed to Turkish banks, which thus feel the effects of the devaluation first. The Turkish lira has moved from 3.8 to the dollar at the beginning of the year to 7.0 on Monday. Goldman Sachs estimates Turkish bank capital will be completely exhausted when it hits 7.1, terminating the flow of credit, accelerating the economic crash. How, then, will Turkey pay the $429 billion it owes to foreigners ($224 billion of which is held by international banks)? As

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Charles Gave of GaveKal noted: “When it comes to major defaults in Turkey, it takes little imagination to predict new banking turmoil in Europe.”

Most market commentators are as yet unconcerned, pointing out, for example, that Spanish banks have €229 billion in shareholder equity and only €74 billion in exposure to Turkey (already shaky Italian banks have €16 billion of exposure and French banks €31 billion). Such analysis mistakes Turkey as an idiosyncratic problem as opposed to a symptom of a cracking global credit bubble. What will happen to Spain’s own domestic asset values as rates rise? What will happen to European sovereign debt markets, the reserve base of European banks, when Erdogan unleashes a flood of Turkish and Syrian migrants onto European shores?

Already the contagion is spreading. On Monday, Argentina’s currency dropped another 3%, bringing its 1-year decline to 42%, and Argentina owes $250 billion to foreign creditors. So far this year the Brazilian real is down 19% (external debt $545 billion), the Russian ruble is down 17% (external debt $451 billion), the Indian rupee is down 9% (external debt $483 billion), the Chinese yuan is down 6.5% (external debt $1.6 trillion), and the South African rand is down 14% (external debt $144 billion, all of which will be reneged on as the country goes full-Zimbabwe). These countries, the BRICS, were the darlings of this credit cycle. With the Turkish situation, the emerging market bank jog is turning into a run. Asia will follow, with $2.1 trillion in dollar debt, not counting China.

The last couple of days has brought some market respite due to maneuverings by the Turkish banking authorities: they suspended mark-to-market accounting for capital adequacy ratios, encouraged banks to extend maturities, and limited banks’ ability to lend lira to offshore funds for the purpose of shorting it. The pause in the panic will be limited. Turkey used its foreign credit to finance the construction of shopping malls and office towers, and overcapacity makes the true value of this collateral much lower than what is carried on bank balance sheets. Speculators help accelerate a collapse—the market, left to its own devices, will always swiftly liquidate malinvestment—which means that neutering speculators can merely prolong the agony. It is falling cash flows that ultimately pops a bubble.

The emerging market rout may have already claimed its first financial victim. On July 31, the Zurich-based GAM Investments gated redemptions of a €9.5 billion bond fund after suspending the manager because “Mr. Haywood may have failed, in our judgement, to conduct or evidence sufficient due diligence on some of the investments that were made, or make accessible internal records of documents relating to these.” GAM assures its frozen clients: “To date, we have not concluded that there are any inaccuracies in the current NAVs of the relevant funds.” The problem is that over 10% of the capital tried to redeem: “The funds have the necessary liquidity to serve the redemption requests we have received, but such actions would lead to a disproportional shift in their portfolio composition, which could compromise the interests of remaining investors.”

According to the Financial Times:

> The ARBF strategies followed a so-called “go anywhere” approach, which gave portfolio managers freedom to choose securities from a wide range of structures and regions. The funds’ annual report includes

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> more than 150 pages dedicated to listing the assets they invest in, which vary from treasuries, corporate bonds and emerging market debt to more exotic assets such as mortgage-backed securities, collateralised loan obligations and credit default swaps.
>
> "The striking thing to me is how many swaps and derivatives there are," says a senior industry figure. "Unwinding all the hedges or outright derivative positions would take an absolute age. If you sold just the liquid stuff to meet the redemptions, you could be stuffing the remaining shareholders with all the illiquid 'toxic' stuff."

Let us recall how a model bank functions: it takes in demand deposits, keeps a small portion as actual cash reserves at the Federal Reserve, buys some Treasury bonds (which it gets to count as reserves), and loans the rest out at term, setting in motion the credit cycle described above. When depositors start asking for their money back, the reserves can be paid out immediately, but the remaining depositors get stuck with the long-term, illiquid assets. A run accelerates until the government suspends withdrawals, and the bank is required to liquidate its assets and distribute the recoveries, if any, to the depositors over time.

In other words, this unconstrained bond fund is not a fund at all but an unregulated, maturity transforming bank. Note the cleverly composed claim that there are no inaccuracies "in the current NAVs." What is current? Like a bank, as long as no one tries to leave, the fund can continue the fiction that its assets have value. Anyone invested in other "unconstrained" bond funds would be a fool not to start moving slowly toward the exit.

The Keynesian framework, completely dominant since 1922, would call for money printing now, before the problems get worse, before countries besides Turkey are forced into capital controls, before other bond funds and ETFs need to gate their investors due to liquidity mismatch. But the Fed has recently reiterated its tightening stance—it thinks it can enforce a new equilibrium, keep asset prices at a permanently high plateau. Combined with emerging market liquidation, Fed tightening will instead create a liquidity black hole.

Myrmikan has over the past several months expressed agnosticism over which way gold would lurch when liquidity dries up. The pattern established in 2008 was a quick plunge followed by a moon-shot when the Fed engages. Reasons to think that that would not happen this time included that everyone knows the pattern and would front-run it and that, unlike in 2008, there are no large momentum chasers in the sector. Reasons to think it would include the fact that emerging market borrowers, especially in Asia, often use gold and even other commodities such as copper as collateral. When a borrower defaults, the lender seizes and must sell the collateral in order to meet the demands of his own creditors. It it, perhaps, instructive that Turkish gold markets have been trading at a $30 discount to world prices.

It is in the nature of market panics that they accelerate. The Fed must respond soon or watch the whole post-2008 recovery crumble. If it does react, gold will bounce hard—already indicators such as sentiment and the positioning of traders on the COMEX are as bullish as they were at the bottom in late 2015. If it does, there is a chance the Fed can play the same game it has played since 1980, printing up another

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round of the credit cycle. If the general pattern holds, gold would likely run above $3,000 and then fall back as speculative juices take over.

If the Fed does not respond in time or forcefully enough, gold may take a deeper plunge, but it would open the door to a complete liquidation of the system, including the Fed itself. As discussed extensively in previous letters, gold on the Fed's balance sheet currently backs Fed assets by 7%, the rest by the long-term debt of an insolvent government and derivatives of real estate loans. In panics, the market makes the gold backing rise well above 50% ($8,300 currently)—it hit over 100% in 1980, which would imply a gold price of $16,600 per ounce. Those numbers are based on theory and confirmed by history. Imagine where the gold miners will be.

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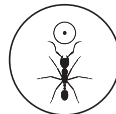

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