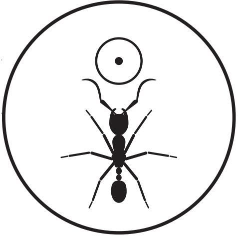

Myrmikan Research

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Inflation: Good and Hard

Last month's letter opined that it was still an open question whether gold was going to sink or soar when the global credit bubble first popped. Barely was the ink dry when the gold and gold mining markets went into free-fall. By March 13, the GDXJ gold mining ETF was down 39% (before recovering to close down 22%).

When the credit bubble popped in 2008, gold rose in terms of the major stock indices and commodities (the costs of mining), as it always does in a post-credit bubble contraction. Real operating margins increased, but the gold price declined in nominal terms, stressing debt obligations; and gold equities collapsed. It took several months of heavy Fed intervention to weaken the dollar and send gold and gold miners soaring higher.

There were reasons to believe gold might not dip this time and, in any case, Myrmikan was comfortable with its long-expressed agnosticism under the assumption that any deflationary impulse would be met by sudden and extreme Fed action. We were not disappointed.

To understand just how dramatic the Fed's moves have been, let us first review the policy innovations during the housing crisis. The Fed began cutting rates in September 2007 and followed up in December with the Term Auction Facility (TAF) through which any bank could borrow discretely from the Fed by posting a broad range of assets (as opposed to the normal process whereby the Fed adds and removes reserves to and from the banking system by buying and selling Treasury bonds strictly with a handful of primary dealers). On the same day that it announced TAF, the Fed also implemented currency swap lines to foreign central banks desperate for dollars.

By March 2008, financial conditions had deteriorated further. The Fed began lending directly to repo lenders and implemented the Term Securities Lending Facility (TSLF). Under this program, the Federal Reserve agreed to swap its Treasury bonds for illiquid AAA-rated mortgage-backed securities (MBSs). Then, on March 16, came the Primary Dealer Credit Facility (PDCF) under which the Federal Reserve would itself make overnight collateralized loans (in other words, the Federal Reserve would now act as a repo lender in the shadow banking system).

On May 2, the Fed increased the scale of the aforementioned programs, and the Treasury began sending nearly every American a $300 stimulus check. This influx of cash stabilized the market, at least until IndyMac Bank failed in July. Then Fannie

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and Freddie went down. The Treasury Department invested $200 billion of equity into these failed institutions, wiping out existing equity holders, and announced it would buy their bonds to support the housing market.

Despite these interventions, on September 15 Lehman Brothers filed for bankruptcy. There was an immediate run on the money market complex (the depositors in the shadow banking system who operate without FDIC insurance), which brought down AIG. Treasury Secretary Paulson then pilfered $50 billion from the Exchange Stabilization Fund (which had been set up in the 1930s to allow the Treasury Department to manipulate the dollar's international value) to create a temporary guaranty program for the U.S. money market fund industry.

None of these actions stemmed the panic, and on September 20, Paulson sent Congress a three-page memo requesting authority for the Treasury Department to purchase directly $700 billion of impaired assets, the Troubled Asset Relief Program (TARP), a theretofore stunning amount of money. But even that was not enough: on November 22, Citibank (the largest American bank in terms of assets) calculated that it would be out of money in just four days.

The Fed finally found its magic bullet: Citibank pooled $306 billion worth of MBSs and agreed that it would accept and could withstand the first $39.5 billion in losses. The government would absorb 90 percent of any additional losses (the first $15 billion in government losses to be paid by TARP and the FDIC and the remainder guaranteed by the Federal Reserve). The Fed was no longer supporting just asset prices but a particular institution: Citibank's stock price jumped 58% the day after the bailout announcement. The Fed made the same deal with Bank of America. By March 2009, the Federal Reserve had commitments in place to support or guarantee the value of $7.8 trillion worth of assets.

These specific interventions were combined with the Quantitative Easing program, implemented in late 2008, under which the Fed bought and held $1.7 trillion of MBSs and Treasury bonds. The stated reason for the program was that bidding up these instruments would lower interest rates and make borrowing less costly in order to stimulate the economy. The vast quantities of dollars issued by the Fed also helped decrease the dollar's value in real terms, which made it easier for debtors to pay their debts. QE would be followed by $600 billion of QE2, then Operation Twist, then $1.6 trillion of QE3.

To encourage new debt, on March 3, 2009, the Fed introduced the Term Asset–Backed Securities Loan Facility (TALF) under which the Federal Reserve pledged to lend up $200 billion against AAA-rated tranches of securitized loans. The idea was that lenders would advance money to borrowers, contribute the new loans to new CLOs, pledge the AAA-rated assets (typically 80 percent or more of assets-by-value) to the Federal Reserve for cash, and then withdraw the cash to make new loans, in a standard fractional reserve process.

With the Federal Reserve pumping cash into the banking system through QE and into the shadow banking system through its other programs, there was little chance that senior mortgages would experience mass defaults or become illiquid. Falling interest rates soon returned asset prices to and even above where banks had modeled them, as opposed to where the free market had set them.

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And thus the key insight into the 2008 panic: since Bretton Woods, private banks, back-stopped by the central bank, have blown bubbles of ever larger size. The recurring panics of increasing severity are not evidence that "market participants can be bipolar—prone to fads, manias, myopia, panics, and depression; driven by short-term gain; and easily caught up in the madness of crowds," as Janet Yellen charged. They are, instead, the free market attempting to liquidate the greed and arrogance and power of the elite. As the bubbles grow larger, so too does the scale of intervention required to keep them from popping.

The first sign that the global credit bubble was once again in trouble came on September 16, 2019 with "repocalypse," when the overnight secured lending rate surged to a 7% premium over the fed funds rate. The way the repo market works is that repo lenders (such as money market funds) lend very short-term funds to repo borrowers (such as investment funds, mortgage REITs, etc.), who offer AAA-rated Treasuries and MBSs as collateral. The Fed simply could not allow the repo market to price Treasuries at a 9% yield when the fed funds market was set at 2%.

The Fed had been slowly reducing the size of its balance sheet, which was draining reserves from the banking system. Repocalypse persuaded the Fed that it had drained too much cash because, *QED*, there was not enough cash to bid on AAA-rated, riskless securities. No thought was given to the alternate explanation that exploding federal deficits and a new bubble in housing had created excessive quantities of Treasuries and MBS paper.

The Fed jumped back into the repo lending business to reassert control over interest rates, and within two weeks its repo lending balance stood at $181 billion. This was called colloquially LE (Liquidity Expansion) instead of QE. It represented loans injected directly into the shadow banking system, which has become the primary funding mechanism for the housing market and the state.

Policy makers assured the market that this was merely a temporary measure, first to cover corporate tax payments due September 15, then quarter-end rebalancing on September 30, then annual rebalancing. But, funnily enough, the Fed was never able to exit from the program. In reality, the Fed had become the marginal lender for both markets.

By late February 2020, the Fed's repo balance was still $143 billion, and the overall size of its balance sheet had increased from $3.76 trillion at the beginning of September to $4.16 trillion by the end of February. In other words, the market was already flashing yellow before the Communist China virus struck (better known at the Wuhan virus).

The spread of Wuhan virus into the U.S., the putsch by the medical profession, and the ensuing lockdowns gave the Fed the perfect excuse to do that which it had to do anyway (and that which Trump had been demanding): flood the market with cash. And there was no hesitation: the Fed had its housing crisis playbook ready to execute—and so much more. On March 3 and 4, the Fed cut interest rates and reduced capital requirements for banks. Then, from March 15th to the 23rd, the Fed:

- reduced the fed funds rate to 0%;
- reestablished the PDCF;
- reestablished the TALF;
- reestablished the swap lines with foreign central banks;

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- established the Commercial Paper Funding Facility (CPFF) to buy "commercial paper" (short term debt issued by large-enterprises) directly from issuers;
- established the Money Market Mutual Fund Liquidity Facility (MMMLF) to "assist money market funds in meeting demands for redemptions by households and other investors." Assets eligible as collateral include unsecured commercial paper, U.S. municipal debt with a maturities not exceeding twelve months, and bank certificates of deposit;
- established the Primary Market Corporate Credit Facility (PMCCF) to "serve as a funding backstop for corporate debt issued by eligible issuers." Eligible issuers include those with debt "rated at least BBB-/Baa3 as of March 22, 2020." BBB- is the lowest investment grade, one notch above junk;
- established the Secondary Market Corporate Credit Facility (SMCCF) to "purchase in the secondary market corporate bonds issued by investment grade U.S. companies." The SMCCF is also authorized to buy ETFs that have a similar objective. As with the PMCCF, issuers may be rated as low as BBB-;
- announced that it was removing previous guidance that it would buy $500 billion of Treasury securities and at least $200 billion of mortgage-backed securities and would instead "purchase Treasury securities and agency mortgage-backed securities in the amounts needed to support smooth market functioning and effective transmission of monetary policy to broader financial conditions and the economy." In other words: unlimited QE.

Whereas the housing crisis programs were developed and implemented over eighteen months (from September 2007 to March 2009), the programs listed above were deployed in *eight days*. In June 2017, Janet Yellen as Fed chair had opined: "Would I say there will never, ever be another financial crisis? You know probably that would be going too far but I do think we're much safer and I hope that it will not be in our lifetimes and I don't believe it will be." *Eight days*. No one knew Wuhan virus was coming, but there was obviously a *lot* of contingency planning going on inside the Fed counter to Yellen's base case.

In conjunction with the central bank's actions, Congress passed a $2 trillion stimulus bill, the "Coronavirus Aid, Relief, and Economic Security Act" (CARES Act). The CARES Act includes a $1,200 check for every adult and $500 per child (subject to an income cap), $350 billion in loans to small businesses (forgivable if used to meet payroll), and $500 billion in loans to big corporations. After certain specific industry carveouts, the Treasury was left with $454 billion to lend to big businesses. And, unlike with the loans to small businesses, the Treasury and the Fed colluded to distribute ten times that amount through special purpose vehicles.

Powell himself explained the strategy: "We're required to get full security for our loans so that we don't lose money—so the Treasury puts up money as we estimate what the losses might be.... Effectively one dollar of loss absorption from the Treasury is enough to support ten dollars worth of loans." In other words, the Fed will lend out up to $4.5 trillion, with Treasury funds absorbing the first 10% in losses and the Fed's printing press responsible for the rest (similar to the Citibank rescue).

Consider the insanity: the Treasury's equity, levered up ten times, will buy the obligations of irresponsible municipalities and corporate bonds rated one notch above junk. Consider further that $4.5 trillion is the precise amount of cumulative share buybacks by S&P 500 companies since 2012.

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Consider also that the Treasury has no equity: the federal budget was $1 trillion in deficit before the Wuhan virus lockdown hit, before revenues for many industries went to zero, before Keynesian automatic stabilizers deployed with historic magnitude. Goldman Sachs estimates that the federal deficit will hit $3.6 trillion in the fiscal year ending September 30 and $2.4 trillion the year after that. Since the Fed has pledged to buy Treasuries "in the amounts needed to support … effective transmission of monetary policy," and since monetary policy is to have interest rates set at zero, the Fed will be buying a lot of Treasuries: the Fed itself, through its printing press, will be supplying the Treasury's 10% equity for the loan various programs. There is no longer any real distinction between the Fed's balance sheet and the Treasury's.

One effect of these policies will be a sudden acceleration of the decades-long trend of concentrating economic power. Small businesses are getting $350 billion and big business is getting $4.5 trillion. The situation evokes lines from Upton Sinclair, who described in 1927:

> the Federal Reserve system at work; a device of the big Wall Street banks, a supposed-to-be government board, but really just a committee of bankers, who had the power to create unlimited paper money in times of crisis. This money was turned over to the big banks, and in turn loaned by them to the big industries whose securities they held and must protect. So, whenever a panic came, the big fellows were saved, while the little fellows went to the wall.

Some things never change.

It is, perhaps, not surprising that before running the central bank, Powell was managing partner of the Industrial Group within The Carlyle Group's U.S. Buyout Fund. In other words, he was a top conductor on the engine of economic and wealth concentration.

Perhaps to defray criticism that the Fed is massively favoring the large, connected companies over the little guy, on April 9 the Fed announced that it would direct $600 billion of its $4.5 trillion bazooka toward to small and mid-sized businesses through the Main Street Lending Program. And how does the Fed define "small and mid-sized businesses"? Those with "up to 10,000 workers or with revenues of less than $2.5 billion." We're not talking about the local diner.

The Main Street Lending Program will be loans made by commercial banks who will "retain a 5 percent share, selling the remaining 95 percent to the Main Street facility." Banks always find it easier (and safer) to lend $100 million to a single giant company than to process a thousand loans of $100 thousand each to small firms. It has always been thus with asset-backed banking systems. And few politicians care if a petty bourgeois fires his four employees and is himself demoted to the proletariat. Whereas when a big firm fails, it throws thousands out of work.

Except that usually it doesn't. As billionaire investor Chamath Palihapitiya tried to explain to a shocked CNBC host, when a large company such as an airline fails, "it does not fire its employees … it goes through a packaged bankruptcy.… If anything, what happens is the employees end up owning more of the company. The people who get wiped out are the people who own the unsecured debt and the equity.… And if a bunch of hedge funds get wiped out—what's the big deal? Let them fail. So they don't get to summer in the Hamptons—who cares."

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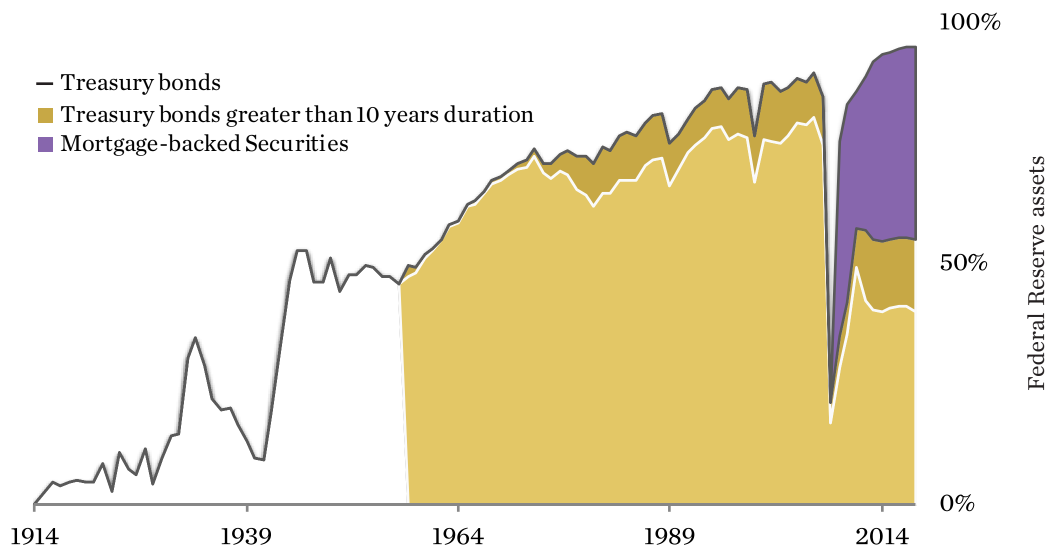
In other words, the Main Street Lending Program will benefit not small businesses (using a conventional definition of small) nor even the activities and employees of big businesses; the money will flow primarily to financial speculators, just as it did in 2008. In fact, it turns out the whole Main Street Lending Program is a stealth bailout of the private equity industry.

Private equity sponsored companies were frozen out of the $300 billion small business portion of the CARES Act because of a 500 employee limit that applies to small business loans includes affiliates, not just individual companies (i.e., the private equity firm has to sum up all of the employees of all its portfolio companies). The industry lobbied intensely and failed to have the definition of affiliate changed in the CARES Act. By redefining small and medium business to include those with up to 10,000 workers, Powell overrode Congress.

The most disgusting part of the speculator bailout is that the little guy pays for the whole thing. Say's law tells us that buyers do not purchase products with their money but with their own productions: first someone produces something, then he obtains money by selling his productions, and then he buys someone else's production with that money. The printing press interrupts this process by granting purchasing power to those who have not produced anything. And, since there are a finite number of goods in the economy, printing money can only transfer purchasing power from one party to another, in this case from currency holders to the private equity industry. *The big fellows were saved, while the little fellows went to the wall*. Let us not forget: Powell was a partner at The Carlyle Group.

The more important effect of recent Fed actions concerns the Fed's balance sheet. Myrmikan's January 14 letter explained that it is not primarily the quantity of dollars that determines the dollar's value but rather the quality of the assets that backs them (the definition of a dollar is and has been for some time a unit of liability of the Fed). In 1923, for example, the Fed's assets were comprised of 61% gold, 22% commercial invoices, and 3% government bonds. The graph below demonstrates the deterioration of asset quality backing the dollar over the past century.



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If adding long-term government bonds and mortgage-backed securities degraded the quality of the Fed's assets, imagine what municipal bonds and BBB- corporate bonds will do to it.

Myrmikan's January letter pointed out that the average gold backing for Bank of England liabilities from 1720 to 1900 was 33% and that private banks in the U.K. maintained a similar percentage of gold backing during this time period. Looking at American history, the average gold backing of the Fed through 1933 was 54%. The market controlled this ratio, not central bankers, because pounds and dollars were freely exchangeable for gold at the central bank (and vice-versa).

When Myrmikan published its January letter, gold prices of $5,266/oz and $8,600/oz would have been required to grant Fed liabilities 33% and 54% gold backing, respectively.[1] But, as Myrmikan's letter also pointed out, that these ratios existed historically when the non-gold assets were mostly commercial invoices with maturities of ninety days or less, not long-term government bonds and mortgages.

Already, with the Fed's balance sheet at $6.1 trillion, the gold price required to back the Fed's liabilities by 33% and 54% has soared to $7,676 and $12,516, respectively. And, more importantly, Fed asset quality is worsening at a dramatic pace with introduction of municipal bonds and corporate bonds near junk, giving an upwards bias to the percentage of gold backing the market will demand once it decides to stage a run on global central banks.

The worsening quality of assets applies to the Treasuries as well. In January 2020, the Congressional Budget Office estimated total revenues of $3.6 trillion and total outlays of $4.6 trillion for a deficit of $1 trillion. The panic of 2008 saw government revenues decline by 20%, and the Wuhan virus lockdown is far more severe. If we assume a 30% decline in revenues and accept Goldman's $3.6 trillion deficit, it would imply that deficit spending will be supplying 59% of government expenditures. Assuming 2021 revenues return to projected 2020 levels and Goldman's $2.4 trillion deficit, the government will still be relying on borrowing to supply 40% of its expenditure. Deficits of such levels are typically associated with currency crises.

And let no one imagine that these programs can be unwound. When Bernanke first launched QE, he argued that the money printing was not dangerous because QE was to be a temporary measure:

> To avoid inflation in the long run and to allow short-term interest rates ultimately to return to normal levels, the Fed's balance sheet will eventually have to be brought back to a more sustainable level. The FOMC will ensure that that is done in a timely way. However, that is an issue for the future; for now, the goal of policy must be to support financial markets and the economy.

As Myrmikan has explained in previous letters, there is a vast difference between credit inflation and monetary debasement. The QEs stoked the former by adding reserves to the banking system, which were then multiplied through the fractional reserve process, and lent (mostly) to refinance or construct new assets. Overcapacity

1 Some noted commentators have criticized this point, arguing that the Fed's gold certificates are, in fact, empty claims on gold confiscated by the Treasury Department in 1933. Myrmikan's response has been: first, it if true that the Fed has no gold, then the possibilities for where gold price can go are vastly higher than the numbers here suggest, but second, more practically, the dollar is more sensibly viewed as government script without any real difference between the balance sheets of the Treasury and Fed. Recent events have supported the reality that the two balance sheets are, in fact, one.

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in capital assets puts downward pressure on consumer prices, hence the perceived absence of high inflation (even while asset prices were going vertical).

The money currently being pumped into the system will not be used to construct new assets and overcapacity: its purpose is to allow companies to pay current bills (both real and financial) on existing fixed capital that has no cashflow because of the Wuhan virus lockdown. It is straight debasement.

Again, Say's law tells us that granting purchasing power to those who are not productive (in this case because the government has locked them in their homes) can only be the transfer of purchasing power from someone else. Since the transfer is being executed through deficits and credit, not taxes, the someone else is those holding dollars or claims on dollars.

Powell's April 9 comments at the Brookings Institute demonstrate that he does not understand this distinction between credit inflation and debasement and would not care even if he did:

> Back 12 years ago, when the financial crisis was getting going and the Fed was doing quantitative easing, many people feared that the increases in the money supply, as a result of quantitative easing asset purchases, would result in high inflation. Not only did it not happen, the challenge has become that inflation has been below our target. So that is—globally the challenge has been inflation below target. Honestly, it is not a first-order concern for us today that too high inflation might be coming our way in the near-term. Far from it.

Economic consensus has been evolving toward advocating a burst of high inflation anyway. Paul Krugman recommended the policy way back in 2011: "a period of modestly higher inflation would help reduce that private debt overhang, which would help promote economic recovery, which would in turn raise revenues and help the fiscal situation." The Fed is about to get its inflation, good and hard.

Myrmikan see three possible outcomes: First, the magnitude of the dollar debt overhang is so large—tens of trillions—that policy makers cannot practically prevent the inverted credit pyramid from tipping over. The result is a panic more intense by magnitudes than 2008 or 1929. Gold does well on a relative basis, but falls in nominal terms. Project debt destroys the equity values of the major mining firms, which reduces investment into the sector despite rising real margins. Dollar cash is the best performing asset, but capital controls impair dollars held in the financial system and suitcases full of cash become subject to confiscation (as they already are under asset forfeiture policies because, as Ken Rogoff argues, only criminals use cash).

Though this scenario is within the logical space of possibilities, the foundation of economic thinking since Keynes is to prevent this outcome, making this possibility the least likely. The Fed has already said there are no limits. And, don't forget, if this happens, the Fed will experience massive losses from its new lending programs, and an insolvent central bank is a prerequisite for hyperinflation.

Second, the lockdowns end in short order because the economic effects are simply too painful. The trillions of dollars distributed through the Fed's new lending programs does little to help local businesses and the working class; Wall Street speculators, however, are not just saved but lever up the bailout largess to create truly spectacular increases in asset prices. Gold bullion soars in nominal terms as it did from

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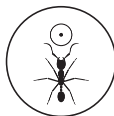
2009 to 2011 under similar conditions. Gold mining equities soar despite falling real margins partially because the real burden of project debt erodes and partially because speculators with too much credit money buy anything quoted on an exchange. The accelerating divide between rich and poor dramatically increases social tensions and strengthens the Bernie Sanders wing of the Democratic Party.

Third, the Fed's helicopter drop of dollars precipitates a currency crisis. Gold bullion rockets toward $10,000 per ounce. Gold miners (especially marginal players) have breath-taking increases, last experienced from 1978 to 1981. The destruction of economic activity means that government credit granted to companies has little effect: If the middle class is wiped out, no one will be able to afford to go to Disneyland, regardless of the rate at which Disney can refinance its debt; demand destruction will mean that Boeing will have no orders for passenger airplanes, regardless of how much debt the government lends the company; smart phone companies will see their orders collapse and will not invest in next generation technology and factories, whatever the financing costs; and so on. The Fed takes massive losses on its loans. The broader markets and real estate decline by at least 90% as against gold bullion. It won't be Weimar but the 1970s plus. In this third scenario, gold will increase in terms of both commodities and nominal price, the ideal environment for gold miners.

Those who have lived through currency crises know that they are swift, brutal, and irreversible. The lucky who have income or saving in a non-local currency see a sudden, dramatic increase in their purchasing power. Most see their living standards collapse. When the dollar fails, so will nearly all of the other global currencies, since most central banks use dollars as their core reserve asset. Gold will prove to be the only non-local currency.



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