Myrmikan Research

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The Final Pop

January offered a dramatic display of what the Fed has done to financial markets: liquidity flows, not value, determine prices. Packs of retail investors, for example, discovered they could launch a stock higher squeezing short sellers.

GameStop Corp, a dying brick-and-mortar gaming store, had over 100% of its stock sold short. The higher the retail crowd pushed the shares, the more margin calls went out to funds short the stock, but there were no shares available with which to cover. The stock zoomed from $17/share at the beginning of the year to nearly $500 a few weeks later: the underlying value of the company was irrelevant.

The problem with short squeezes is defection. When Cornelius Vanderbilt squeezed Hudson Railroad in 1864, he purchased more than 100% of the stock personally, allowing him to dictate terms to the short-sellers. With Gamestop, it turns out there was a hedge fund (which may have used social media to instigate the retail frenzy) that sold out for $700 million near the top. These shares thrown onto the market, along with other sellers, allowed short-sellers an exit, albeit a very expensive one (don't cry for Gabe Plotkin, manager of Melvin Capital, which lost over $6 billion in the squeeze, or 53% of its capital; he is apparently pushing forward with plans to build a $12 million tennis court in Miami). Many retail holders were left with stiff losses as the stock careened back into the double digits.

And it isn't just GameStop: the most shorted Russell 3000 stocks have surged 98% over the past three months. Like Melvin Half-Capital (as social media has renamed it), the funds that are short these stocks are being forced to sell their longs in order to cover marginal calls on their losses, and the declines in these names started producing margin calls for other longs. Goldman Sachs warned last week that if the short squeeze continued, these dynamics could lead to a market crash.

There are, in fact, many examples of market crashes being prompted by over-levered speculators. In October 1907, for example, a speculator named Otto Heinze thought he had discovered a discrepancy in the market for United Copper Company: he calculated there were twenty-five thousand more shares trading in the market than actually existed, indicating a sizable short position. This was of particular interest because Heinze and his brother owned a majority of the shares. He attempted a corner: he bought a huge number of shares on margin, forcing the price up from $37 to $59 per share, and then had the corporation "call in" its shares, forcing physical delivery. Heinze assumed the shorts would not be able to find shares (since more were owned than actually existed), and then he could dictate terms.

Heinze got his math wrong: he did not own enough shares to pull off the corner. As the price of United Copper rose, other shareholders began to dump the overvalued stock, providing shares for the shorts to cover. Unlike Vanderbilt, Heinze lacked the capital to buy them all up. He was overwhelmed by sell orders. As the price fell, the banks that had lent him money against his shares issued margin calls, but he had already exhausted his capital. Over two days, the stock traded down from $59 to $10. Heinze's brokerage firm failed; the banks that had lent to that firm collapsed; a run on the entire system ensued. Interest rates on margin loans hit 100%. Stock prices crashed to half their peak value.

Market historians are well aware of this episode because the Panic of 1907 created the impetus to form America's third central bank, the Federal Reserve. Few, however, are conversant with the conditions that led to a situation in which the banks could be toppled by the failure of a single speculator.

The National Banking Acts, passed during the Civil War to centralize monetary power in Washington, allowed banks to deploy demand deposits into long-term assets and operate on a fractionally reserved basis. Even the minimal restrictions on mortgages and stock loans were easily avoided. The attending panics were, like today, dismissed as market failures and not as features of an unsound banking system.

The only element of pre-Civil War banking that had endured was the restriction that government deposits be kept at the U.S. Treasury independent of the national banking system. But starting in 1898, the Treasury Department began allowing government balances to accumulate in banks as reserves, which served as inflationary fuel. In 1903, Treasury Secretary Shaw announced that he would transfer balances from the Treasury to the banks to the extent needed to prevent any stringency in the money market. "No statement," noted a contemporary economist, "could have made more explicit his notion that it was the function of the government treasury to guard and protect the money market, to keep interest rates down and to prevent credit contraction": the same program as John Law and Keynes and Bernanke and now Yellen and Powell.

Artificially low rates safeguarded by the state and levered by a fractional-reserve banking system powered economic growth at a blistering annual pace of 7.8% from 1896 to 1906. The twenty leading railroad stocks increased by 228% over that time, and the twelve leading industrials rose by 268%, enormous gains in a gold standard world. "Security prices," a contemporary reflected, "had been carried upward beyond all reason, and beyond all proportion with their earning capacity."

The tenuous credit that empowers such frenetic activity unravels at the first interruption of cash flows—in this case it was the 1906 earthquake in San Francisco, which leveled 80% of the city. Depositors required immediate funds to rebuild and began withdrawing their cash from the base of the inverted credit pyramid.

London remained the financial center of the world; the reference point for global interest rates was determined by gold flowing in and out of the Bank of England.

Huge insurance claims were submitted to British insurance companies, and 14% of Britain's gold stock had sailed across the Atlantic within months of the quake. The Bank of England responded as required: it raised the rate of interest it paid depositors to stem the outflow of gold.

This was precisely how the gold standard was supposed to work. The destruction of a major city caused the loss of considerable capital; high rates attract capital and favor investment in necessities over luxuries. When the senior bank raised its interest rate to stem the outflow of gold, all subsidiary banks had to as well to preserve their own reserves.

But a rising natural discount rate devalued the long-term assets in which the banks had invested their demand deposits just at the moment depositors were demanding the return of their ready funds. Banks had no choice but to try to sell their assets, but who would buy them?

The adjustment was at first retarded by the government, which reacted as soon as stocks began to slide. First, Treasury Secretary Shaw allowed banks to count as reserves gold in transit from Britain. Then he deposited federal funds into importing banks so that they could lend out the gold still on the seas. Finally, he transferred government funds wholesale into the banks. The banks deployed these new deposits by lending them into the call money market, sending stocks shooting higher when they should have been falling. As is so often the case, despite state intervention, or, rather, because of it, a wrong-footed speculator became all that was necessary to topple the credit structure.

When the panic came, the government sprang into more action. A contemporary recorded:

> [Treasury Secretary] Cortelyou found himself swept along by the precedents of Mr. Shaw, now extending to the banks' relief in the form of more government deposits, now offering again to accept railway bonds as security for such deposits, then offering to anticipate interest payments and also to redeem bonds in advance of their maturity.…
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> The power of the federal treasury to support the tottering edifice of credit had, however, at last reached its limit. The props snapped under the overwhelming weight. The financial frame-work collapsed, and on Monday, October 28th, the vast majority of the banks in the country suspended payments. Of the efforts of the secretary in subsequent weeks to reërect the fallen structure, of his increase of the government deposits to two hundred and forty-two millions, and of his preposterous plan to borrow one hundred and fifty millions additional in order to turn them over to the banks, nothing need be said, except that they proved futile, and that the latter plan was generally condemned as ill adapted to afford either immediate relief or future safety.
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> *Such is the story of the treasury's decade of paternalism.*

Today, of course, the Federal Reserve wields far more power than the nineteenth century Treasury Department. It has engineered a century of paternalism through its ability to ignore gold flows and print up reserves to save banks whenever their speculations (or the speculators to which they lend) go bad.

This power convinced early Fed proponents that they had solved panics forever. "Under the Federal Reserve System we shall have no more financial panics," declared Charles Hamlin, the first head of the Federal Reserve in 1915. The Democratic Party took full credit for setting up the central bank in its 1920 campaign literature: "Panics—the recurring phenomena of disaster which the Republican party could neither control or explain—are now but a memory.… Under this law such financial panics as we had in 1873, 1893 and 1907 are impossible."

The next century was littered with panics as Fed paternalism allowed bubbles to grew much, much larger than ever before. As Fed power expanded, so did the virulence of the bubbles. And the Fed's commitment to credit expansion cannot forever prevent bubbles from popping because of the real world effects that bubbles create: overinvestment in capital-intense industries, enormous wealth disparity, leftwing governments that implement socialism to undo the effects of bubbles but instead make them worse, economic and political (and sometimes military) collapse.

It is somewhat extraordinary that as these effects intensify in our own time, the U.S. dollar maintains its purchasing power, as exhibited by the now six months' correction in gold. Myrmikan maintains that the U.S. dollar is a giant GameStop. Like the dying game company, the dollar is backed by dying assets: the Fed holds Treasury bonds that are increasingly long-term (magnifying interest rate risk) and issued by an entity (the U.S. Congress) that is increasingly insolvent.

Yet, like GameStop, the short position against the dollar is enormous. In August 2019, $76 trillion of dollar denominated debt had to bid on just $3.7 trillion of base money. When the COVID virus from Wuhan arrived in February, and the government locked down the economy in March, income fell for most entities. But debt persisted (as occurs in all recession/depressions). A dollar short squeeze (similar to what happened in 2008) prompted debtors to throw assets onto the market in a desperate attempt to get dollars to avoid default.

Unlike in gold standard times, there is an all-too-easy remedy to a currency squeeze in a fiat world: the Fed printed up another $3.7 trillion of base dollars to lessen the force of the squeeze. They may have been too successful.

Credit card debt, for example, with interest rates of around 15%, is useful to keep the plebeians in line: they have to scramble at low wage jobs just to make their interest payments. But consumers took the stimulus and began repaying credit card debt, which has fallen from $854 billion outstanding to $735 billion in the past year. This trend should continue as Congress lurches further toward universal basic income. Mortgage debt, on the hand, with an average interest below 3%, has soared. This is basically just free money pouring into the economy.

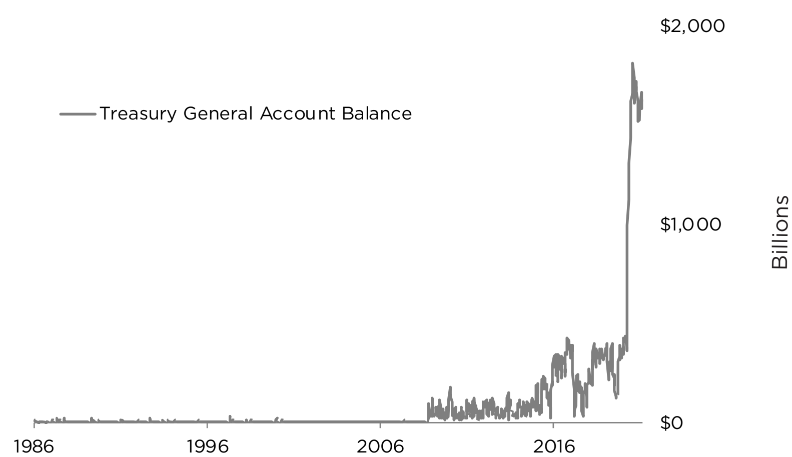
More free money is coming, and not just from the continuing Fed support of the repo market and quantitative easing. It turns out that, as in the nineteenth century, there still is a Treasury Department cash balance account, which is held directly at the Fed and thus does not act as reserves for the banking system.

To understand the flow: banks have a certain amount of cash. They use that cash to buy Treasury bonds at government auctions, which moves cash to the Treasury General Account (TGA) and creates a Treasury bond, which also acts as a reserve asset. Two things then happen: First, the Fed buys this new Treasury bond with newly printed money at a higher price, which creates a free profit and returns cash to the banks' reserve accounts at the Fed, with which they can buy new bonds. Second, the Treasury spends the cash it raised, drawing down the TGA, and this cash ends up back at the banks!

Jacques Rueff's 1965 analogy of the Bretton Woods system may aid in understanding the flow: "If I had an agreement with my tailor that whatever money I pay him he returns to me the very same amount on the same day as a loan, I would have no objection at all to ordering more suits from him." In our case, the banks are the tailor, except they don't have to produce anything and the debtor is a sovereign. They lend money to the government through bond purchases and then find the money they lend arriving back as cash deposits. They can then use these deposits as reserves to pyramid loans to Wall Street speculators, just as they were doing in 1906.

What makes this story immediately relevant is that the second step in the process for the enormous liquidity created since March has not yet occurred. Behold the cash balance of the TGA in the chart below. The Treasury panicked in March and built up an enormous cash balance to fund all manner of stimulus. But since Nancy Pelosi held up stimulus negotiations for election-posturing, the Treasury was unable to spend the cash.[1]

Here is the fun part: the Treasury announced on February 1 that it intends to reduce its TGA balance to $800 billion by the end of March: in other words $825 billion of cash will come flooding into the economy (and make its way into banks) over the next seven weeks, over and on top of QE. To understand the scale of this injection of cash, consider that the monetary base is $5.2 trillion (up from $3.2 trillion last March).



And the fun doesn't end there. As financial news site Zerohedge observes, part of the debt ceiling law prohibits the Treasury from having a cash balance higher than it had the previous time that the debt ceiling was increased. This provision was added to prevent the Treasury from ramping up the TGA before the debt ceiling expires, which would allow the president to ignore Congressional oversight for an extended period. The debt ceiling deadline is August 1, and unless Congress passes a new one,

1 Dilbert-creator Scott Adams has pointed out the irony that Pelosi impeached Trump for purportedly withholding aid to Ukraine for political purposes while she herself withheld aid to Americans for political purposes.

the Treasury must shrink the TGA balance to $200 billion by that date, force feeding another $600 billion of high-powered money into the banking system.

The Treasury will have little need to borrow over the next six months as it spends down the TGA. The banks, which will be flush with cash from continuing QE and Treasury expenditures, will not want to keep the cash sitting idle, and deploying that cash into the money markets will send interest rates down even more: the BBB bond index is already yielding a mere 2.1%, 30-year fixed mortgages yield 2.7%, 1-month Treasuries yield 0.05% (down from 0.09% last month)′. How low can they go?

And how high can falling rates push prices? The median price of a single-family home surged 14.9% in the fourth quarter of 2020 compared to the previous year, according to the National Association of Realtors. Total margin debt balance has surged from $479 billion in March to $778 billion in December as money pours into the stock market.

It will all end in tears, of course. The real world economic and social effects can only intensify the more the Fed intervenes in the money market; the market and the economy (dominated by quasi-monopolies) will break. But not yet: it is hard to imagine a financial crash in the midst of this money-printing orgy.

These economic dynamics have direct implications for precious metals investors. Gold underperforms in real terms during credit growth, and credit it set to explode over the next few months. This does not mean that gold must decline in nominal price, however: it is also hard to imagine the dollar not weakening substantially as this flood of liquidity hits the market. It does mean that outperformance may have to wait until the back half of 2021.

One of the ironclad laws of credit inflation is that the more an economy has been subject to it, the more money printing is necessary to prevent collapse. Witness the Fed's ill-fated attempt to shrink its balance sheet in 2018: within 18 months the wheels were popping out of the repo market, forcing a swift about-face. Yes, the party may continue for the next few months, but imagine the scene by August. Any plans to halt QE will be quickly shelved, and the markets may demand a commitment of accelerating monetary expansion long before then.

The Fed had better be willing to accommodate. The Biden regime has announced plans for a $3.8 trillion deficit in 2021. With Bernie Sanders acting as Chair of the Budget Committee pushing through the spending using the filibuster-proof reconciliation process, deficits of that scale may happen and may not stop. There is no easier way to destroy a currency than have the central bank monetize deficits. If the Fed resists, however, the crash would leave little standing.

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