Myrmikan Research

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A Scent of 2013

Gold and gold shares had a dismal June. Gold lost 7.1%, the HUI Gold Bugs Index plunged 16.1%, and the GDXJ gold miner ETF fell 14.6%, putting it down 13.8% year-to-date. Sector chatter worries that we are reliving the events of 2013. Let us review. The housing market began teetering in mid-2007, and it took around eighteen months for the market and banks and GSEs to collapse. The Federal Reserve, reticent at first, unleashed the full power of Bernanke's monetary experiments in late 2008. The stock market bottomed a few months later but would not return to pre-panic highs until early 2013.

Bernanke's remedy was administered through many and varied impressive-sounding programs, creating an alphabet soup of acronyms. But they were all of them at essence the same: the guarantee of private speculations—that should never have been made and could not be settled—with government credit, supported by the printing press. The Federal Reserve's balance sheet quintupled, from $900 billion in mid-2008 to $4.5 trillion at the end of QE3 in 2014, partially to monetize exploding federal deficits.

Many commentators expected massive inflation. Bernanke himself alarmed the public when he declared in 2009 that the trillions of dollars used to fund purchases under QE were "not tax money. The banks have accounts with the Fed, much the same way that you have an account in a commercial bank. So, to lend to a bank, we simply use the computer to mark up the size of the account that they have with the Fed. It's much more akin to printing money than it is to borrowing." With speeches like this, it was no wonder that all and sundry raced to buy gold by whatever means possible, sending the yellow metal from below $700 per ounce at the 2008 panic low past $1,900 per ounce by late 2011.

Bernanke soon changed his tune. A year later he lectured on 60 Minutes: "This fear of inflation, I think, is way overstated.… One myth that's out there is that what we're doing is printing money. We're not printing money. The amount of currency in

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circulation is not changing. The money supply is not changing in any significant way. What we're doing is lowering interest rates by buying Treasury securities. And by lowering interest rates, we hope to stimulate the economy to grow faster."

On this Bernanke had it mostly right. As Myrmikan has discussed in more detail in previous letters, the 2008 panic was caused by the banks' overlending to the housing sector, which created overbuilding, which eventually lowered prices, blowing a giant hole in the balance sheet of the banking system, then panic and collapse—a cyclical process that has been ongoing since banking began.

The Fed flooded the banking system with fiat money reserves, thereby saving it from insolvency and lowering the prevailing interest rate. A lower interest rate made marginally uneconomic projects appear to be profitable. As Bernanke himself wrote: "Paul Samuelson taught me in graduate school at MIT, if the real interest rate were expected to be negative indefinitely, almost any investment is profitable. For example, at a negative (or even zero) interest rate, it would pay to level the Rocky Mountains to save even the small amount of fuel expended by trains and cars that currently must climb steep grades."[1]

Sure enough, because of Fed policies, companies became able to sell debt at tremendously low rates to investors starved for yield (such as pension funds), which enabled capital expenditure into projects with correspondingly low projected returns. Existing projects appeared all the more valuable as discount rates fell, which sent the stock market soaring. Meanwhile, the overcapacity being maintained and promoted served to *lower* consumer prices, at least in certain highly mechanized segments of the economy.

It was in this context that the Fed began phasing out QE in 2013. Gold is the anti-bubble, so with printing slowing down and a new credit cycle well underway, enabling federal deficits to lessen, and tame CPI inflation, the market lost its appetite for gold. From late 2012 to late 2015, gold plunged by 41%. Gold mining stocks fared much worse.

The current worry is that we are repeating this same set of circumstances. After China exported the virus from Wuhan (recall that China banned domestic travel in and out of Wuhan but encouraged international flights to continue)—and (now we know) the very same people at the NIH who had funded development of COVID-19 convinced Trump to lock down the economy—the banking system faced the prospect of sudden debt collapse: how can someone with no revenues continue to pay his debts? The cause may have been different than the 2008 panic, but the effects were the same: a giant hole in the balance sheets of the banks. The market plunged.

The Fed responded more or less the same way it had in 2008, flooding the banks with fiat reserves, funding extraordinary federal deficits, lowering rates to make ever more sub-marginal investments look profitable, igniting a new credit bubble sustained by the banking sector, and now promising to taper the extraordinary interventions (though it is probably post time to stop calling them "extraordinary").

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1 This is because with a discount rate at zero, cash flows an infinite distance into the future would be worth the same as in the present, and so there would be an infinite amount of time to make back a less-than-infinite capital expenditure.

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Under the analogy, gold should soon be reaching the same kind of peak and crash it experienced in 2013, which would explain the recent price action. Indeed, observe the chart below, which overlays the recent surge in gold against the one in 2011. Spooky.

GOLD PRICE PER OUNCE

There are, however, reasons why gold investors should not despair. First is one of time scale. Whereas Bernanke's housing panic programs were developed over eighteen months (from September 2007 to March 2009), these very same policies were redeployed in 2020 over only eight days. Whereas it took five-and-a-half years for the stock market to recover its 2007 all-time high, the February 20, 2020 record high was recaptured in only six months. Whereas Bernanke announced the beginning of the end of QE five-and-a-half years after beginning the program (it wouldn't actually end for an additional seventeen months), Powell has already announced that the Fed is "talking-about-talking-about" tapering QE, only fifteen months after the interventions began. Any bear market in gold is likely to be only a fraction of the four-year bear market experienced after the top in 2011.

A conventional Keynesian/monetarist would reject this analogy, claiming that the virus was a temporary externality as opposed to a structural problem like the housing bubble. But peering more deeply into economic theory and Fed policy thinking reveals that this latest episode is simply a continuation of the boom/bust cycle endemic to an asset-backed banking system and that such cycles by their nature become compressed in time and greater in amplitude.

As adherents to Austrian economics understand (but Keynesians and monetarists do not), a credit boom can be only temporary because it misleads economic actors into investing in capital-destroying projects, such as trying to flatten the Rockies. As ever more capital is expended into sub-marginal projects, the pool of real savings is depleted as is the ability to make interest payments: a crisis occurs. The more the central bank

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intervenes, the more it has to intervene, and faster, to keep the whole economic system from collapse.

This is no mere theory: consider recent times. Greenspan dropped the Fed funds rate from 9.8% in 1989 to 3% to stimulate the economy after the S&L crisis. Then he raised rates to 6.25% in 2000 to constrain the internet bubble. Then he lowered rates to 1% in 2001 to stimulate the economy after the bubble popped. Then Bernanke raised rates to 5.5% by 2007 to constrain the housing bubble. The shaky mortgages defaulted, bringing the global credit pyramid came tumbling down, so Bernanke sent real rates past zero with QE, creating the everything bubble. Concerned with soaring asset prices, the Fed began tightening again in 2016.

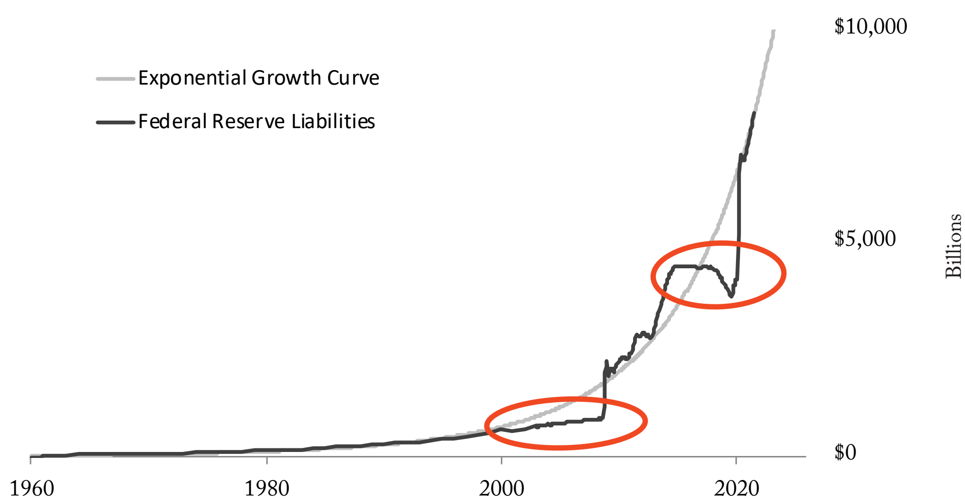
In 2017, Fed Chairman Janet Yellen told reporters that allowing the Fed's balance sheet to shrink "will be like watching paint dry." She added: "Look, of course, if it turns out that there is a surprise and a substantial reaction, that is something we would have to take into account in deciding on the appropriate stance of policy." Austrian economists knew that having substantial reaction would be a certainty, not a surprise.

And, sure enough, by May 2019, with the Fed funds rate having reached just 2.4%, the Fed began easing financing conditions (as discussed in Myrmikan's May 2019 letter) and was officially cutting rates by July. Despite the easing, September 2019 saw the "re-pocalypse," the implosion of the shadow banking system, which has become the main source of funding for mortgages and the government. The Fed was already printing money again wholesale before China exported its virus.

Therefore, it would be wrong to think of the virus as a temporary externality—its arrival merely masked the termination of a credit cycle that was already underway. And now if the Fed does manage to extricate from continual QE—which is not at all certain—we can be sure that the next financial crisis will arrive sooner than the six years it took between 2013 and 2019.

Putting it in visual terms, the circles below indicate where the Fed attempted to jump off the monetary exponential growth curve, and its reaction when the economy began to fray. As that line heads more vertical, the time that the Fed will be able to spend below the curve will decrease at the same rate that needed scale of interventions will increase.

FEDERAL RESERVE BALANCE SHEET



Source: Federal Reserve Bank of St. Louis

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What is more: the Fed has all but admitted it is trapped. To see how first requires some background on the natural rate of interest: Consider Robinson Crusoe shipwrecked on his island barely subsisting on fish caught by hand. If he must spend all of his effort catching fish to survive, then he cannot save the resources necessary to invest in capital; he can never improve his condition. If, however, he has at least some surplus time, then he has a choice: he may spend it at leisure or he may continue to work and save the surplus. Once he has enough surplus fish, he may take time off from fishing to construct a fishing spear, which will greatly enhance his productive capacity and allow him time to perform the much more difficult task of building a hut.

Eugen von Böhm-Bawerk, a nineteenth-century finance minister of Austria, used this example to show that savings must come before capital investment. Furthermore, we can deduce that Crusoe will always choose to invest in the fishing spear before the hut because doing so accelerates his enjoyment of both.

The preference to receive goods sooner is innate and essential. There can be no exceptions. If man were immortal, he might give no care as to whether his investments matured in a day or in a century. If mortal man be due an apple presently, two apples must be offered to entice him to delay delivery.

Time preference determines the natural discount rate: the rate at which economic actors discount the value of an item due to arrive in the future as compared to the value of the same item in the present. Discounting is the core of economics and the foundation of all planning: investments in capital are evaluated not just on how much they will produce but by when.

In a complex economy under a gold standard, if the bank offered rate strays below the natural rate, then depositors will demand their deposits be redeemed into gold so that they can invest elsewhere; the banks, seeing their reserves being withdrawn, are forced to increase interest rates to attract new reserves. On the other hand, if the bank offered rate is above the natural rate, gold will be deposited at the bank, allowing the bank to reduce its interest rate, which is normally the banks' greatest expense. In such a system, therefore, the bank rate is a precise measure of the natural discount rate.

Legal tender laws distort this process, and it was abolished completely under Franklin Roosevelt when he made holding gold bullion a felony. Now when the bank offered rate goes below the natural discount rate, depositors are enticed to withdraw their funds and buy assets, creating a boom.

The Fed accepts the concept of a natural rate of interest. The staff presented this free-market idea to the Fed governors in the October 2015 FOMC meeting: "The interaction of desired saving and desired investment determines the equilibrium real interest rate," which in current economist language is designated r^*. The staff then stated a formal truth that: "a monetary policy strategy in which the real policy rate tracks the natural rate generally leads to beneficial economic outcomes." The problem is that r^* can no longer be observed directly, because of the abolition of the gold standard, so the staff continually makes what they admit to be "uncertain estimates of r^*."

If the optimal policy for a central bank is to set rates to be equal to r^*, why not just let the market do it? Keynesians and monetarists would answer that the economy is

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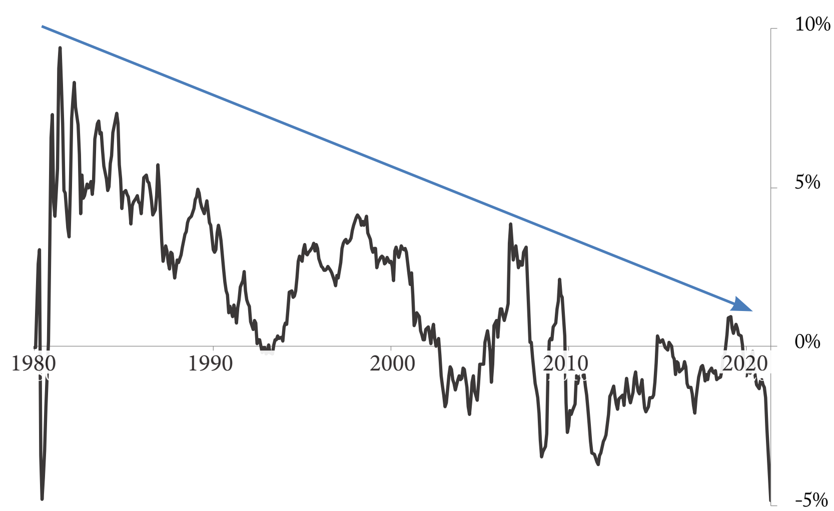
unstable over the short-run. Leaving that issue aside, even Yellen understands that over the long run "if you were to hold the nominal rate at zero, in spite of the fact that the equilibrium nominal rate would be higher, you would end up generating not lower but higher inflation. And, the higher inflation went, if you kept the nominal interest rate at zero, the lower the actual real rate would move over time, the gap would increase, and you would get accelerating inflation"—which is more or less what happened in Weimar Germany.

The problem the Fed faced in that October 2015 meeting was that the staff estimated *r** to be zero, yet the *real* Fed funds rate was negative 1.6% (the Fed funds rate was zero and CPI was 1.6%). In order to return policy to *r**, the governors determined they had to raise the nominal Fed funds rate to 1.6%, to make the real rate zero.

Before going any further, let us ponder that the natural rate of interest can never be zero! even for an instant! Returning to the Crusoe example, a zero discount rate would mean that all economic wants have been satiated and/or that Crusoe has become immortal: he has no care whether his future goods arrive in an hour or in a century. In a market economy, it would imply that every single person on earth had become completely satiated with economic goods.

However, what can be zero is, as the Fed staff put it: "the real policy rate [that] would be consistent with moving the economy to, or keeping it at, full employment ... [being] neither contractionary nor expansionary." In a debt saturated economy, the more debt there is, the lower the interest rate must be to avoid liquidating malinvestments and the employees who work for them (not to mention governments at all levels). As debt has grown apace, the real Fed funds rate must move continually lower in order to sustain the distorted economy; and this explains why the Fed is so confused about the natural rate of interest versus their alternate definition of *r**.

REAL FED FUNDS RATE



Source: Federal Reserve Bank of St. Louis

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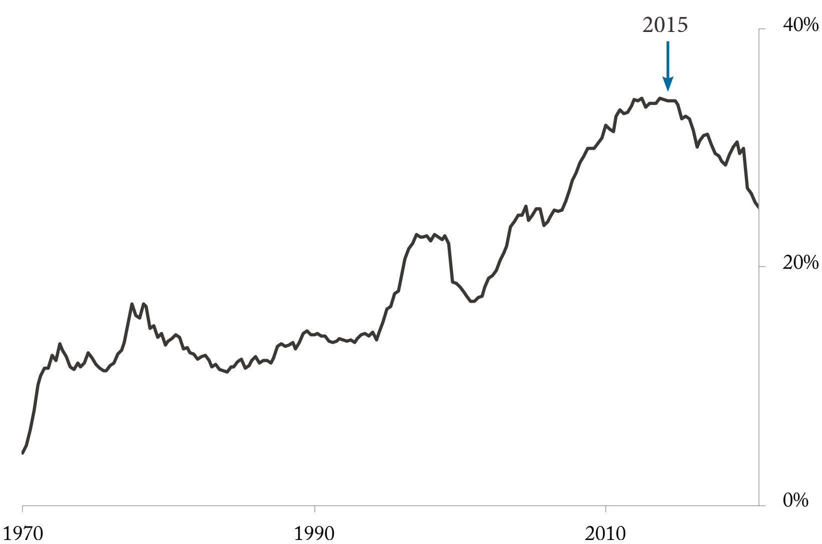
The point of all of this is the Fed itself has accepted the conclusions of Austrian economy theory. Of course they reject the Austrian framework: in the Fed staff's view, a falling r^* is explained by "the 'global savings glut' hypothesis put forth by then Governor Ben Bernanke in 2005." But in this case methodology doesn't matter. The Fed realized in 2015 that they could not increase real rates above zero. Low rates and stimulus since then have sent total public and private debt from $63.7 trillion to $84.6 trillion. Where does the Fed think r^* is now?

Probably not -4.9%, which is the current reading for the real Fed funds rate (accepting CPI as an accurate measure of inflation). But surely negative. This does give room for the Fed to stop QE and raise nominal rates (to make real rates less negative), which has the market spooked. But it also means that real rates can never again go positive without inducing complete financial and economic collapse. Even the Fed senses this.

U.S. citizens may be stuck with the dollar, but the rest of the globe isn't; and who would willingly hold an asset that had a guaranteed negative real return?

U.S. TREASURIES HELD BY NON-U.S. INVESTORS



Source: Federal Reserve Bank of St. Louis

French finance minister Jacques Rueff explained in 1972 why the U.S. was able to run such large deficits:

> What is the essence of the system, and what is its difference from the gold standard? It is that when a country with a key currency runs a balance-of-payments deficit—that is to say, the United States, for example—it pays the creditor country dollars, which end up with the latter's central bank. But the dollars are of no use in Bonn or in Tokyo or in Paris. The very same day, they are reloaned to the New York money market, so that they return to the place of origin. Thus the debtor country does not lose what the creditor country has gained. So the key-currency country never feels the effect of a deficit in its balance of payments. And the main consequence is that there is no reason whatever for the deficit to disappear, because it does not appear. . . . In this way, the [Bretton Woods

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> system] brought about an immense revolution and produced the secret of a deficit without tears.

But what if foreigners who obtain U.S. dollars simply dump them instead? and replace them with gold or rubles or renminbi? The dollar's standing in the world is not helped by waning U.S. economic power and a military focused more on race-based ideology than on fighting and winning wars.

The other main difference between now and 2013 is that there is emerging consumer inflation. It's not just that official CPI has increased to 4.9%, well above the Fed's 2% target, it's that everyone feels it, and everyone knows that real inflation is actually much, much higher. This is because, as discussed in previous letters, QE this time was not directed solely at refreshing bank reserves but served to monetize enormous deficits that funded transfer payments to consumers first prevented from working and now given incentives not to work.

It is certainly possible that the Fed will be able to engineer another hyper-bubble that would put gold on the defensive. In Myrmikan's view, such an outcome, if it were to happen, would be short-lived due to the intensifying dynamics of the natural credit cycle. It is also possible that the extraordinary dislocations in asset markets unwind suddenly, putting the Fed on the defensive, and forcing it to increase—not decrease—stimulus through the debasement of the dollar. Either way, the dollar is set to devalue sharply against real assets. And once the dollar finally breaks, there will be no recovery for the dollar or the stock market. The world will be forever changed.

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