Myrmikan Research

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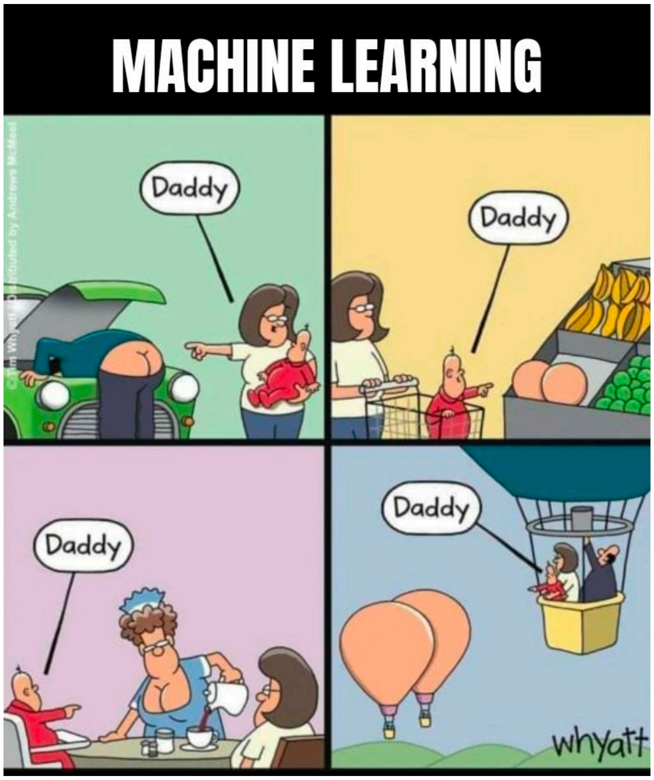
Gold Also Rises

Yesterday offered a microcosm of the markets. Inflation came in hot, printing at a 7.5% increase, higher than last month, higher than Wall Street estimates, the highest in forty years. Gold got slammed from $1,831/oz to $1,821/oz in the first minute after the announcement. The U.S. dollar index jumped 0.28%, a sizable move in currency land. Oil fell $1/bbl.

For the past few decades, inflation has been dollar positive and gold negative because higher inflation forces the Fed to tighten financial conditions, or so the thinking goes. For example, inflation was running hot in 2007, ending the year at 4.4%—Fed chairman Bernanke slammed on the financial brakes, ushering in the 2008 panic. By 2011, QE had sent inflation back to 3.8%—the ensuing halt of QE cut gold nearly in half, from a peak above $1,900/oz in 2011 to $1,050/oz by the end of 2015.

This pattern is, no doubt, how algorithms are trained, which is why the markets moved so fast and furiously after the inflation data release (humans can't trade that fast). But the machines are missing another pattern: rising nominal rates boost gold's nominal price.



Bernanke raised rates from mid-2004 to mid-2006, during which time gold surged from $400/oz to $700/oz, a 75% increase (a similar move today would put gold over $3,200/oz). Then again, the Fed raised rates from the end of 2015 to early 2019, and gold moved 24% higher, from $1,050/oz to $1,300/oz.

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This phenomenon is not confined to this credit cycle. From 1972 to 1974, the Fed raised the fed funds rate from 3.3% to 13%. Gold ran from $45/oz to $180/oz, a 300% increase. Then again, from 1977 to 1980, the Fed hiked from 4.5% to 20%. Gold (having fallen nearly in half peak to trough) surged from $130/oz to $850/oz, a 550% increase over three years. So it is a myth that rising nominal rates are gold negative.

The reason why gold is positively correlated to nominal rates was discussed in detail in Myrmikan's previous letter—in short, rising rates increase the need to hold dollars to make interest payments (strengthening the dollar) but also severely impair the value of the assets on the Fed's balance sheet that back the dollar. Rising rates also accelerate the next economic downturn, each successive episode of which demands progressively stronger monetary intervention to avoid economic and financial collapse.

Yesterday was a microcosm because shortly after the computers had made their algorithmic trades, gold rallied, the dollar fell, and oil popped—all this despite (or, rather, because of) nominal rates that continued to rise.

Then, in the afternoon, St. Louis Fed President James Bullard (a voting member of the FOMC in 2022) announced that the morning's inflation print had made him: "dramatically" more hawkish: "I'd like to see 100 basis points [a 1% increase in the fed funds rate] in the bag by July 1." Bullard also suggested an inter-meeting rate hike would be appropriate. Shortly thereafter, the Fed posted to its website that this Monday it will be holding an "expedited" meeting for "review and determination by the Board of Governors of the advance and discount rates to be charged by the Federal Reserve Banks." In other words, a rate hike may come as early as Monday.

Yields climbed sharply again, with the 10-year hitting 2.05%. Gold got hit again, the S&P 500 lurched lower, and the dollar higher. Twenty-four hours later, despite the large jump in rates, the S&P 500 was down 2.4%, the dollar index was unchanged, and … the price of gold was higher (and that was before deep-state-leaked rumors of impending war with Russia sent gold dramatically higher).

The Fed's problem is that, while a 1% increase in the fed funds rate is an earthquake in bond land, the jump in inflation from 7% in December to 7.5% means that real rates just sank by half a percent (NB: gold loves negative real rates). This means that half of Bullard's shocking 1% increase is needed just to combat the past month's increase in inflation.

Remember that this financial tightening is only prospective. The Fed, at the moment, is still printing. Just as Bernanke had to switch the monetary engine into reverse violently in 2008, the Fed is again threatening to tighten into economic weakness. The Atlanta Fed's GDP Now engine estimates Q1 real economic growth at only 0.7% annualized. This is when the Fed is supposed to be loosening, not tightening.

Tightening will crush Treasury holders, corporate debt investors, and equity speculators. The 10-year benchmark lost 0.9% yesterday (6.5% since August, which is around four years of interest), the yield on BBB corporate debt has surged from 2.6% to 3.3% just since the year began, and the Nasdaq has lost 12% year-to-date (including 5% since the inflation print yesterday).

Raising rates may not, however, solve the inflation problem. While other markets have been melting down, commodities are strong. Since yesterday morning, the energy-heavy Goldman Sachs Commodity Index has increased 2.3%, the CRB index is up 1.3%, and the industrial metals LME index has surged 3.5%.

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The previous time commodities were this hot was in 2008, when dogs and cats were getting mortgage applications and goldfish credit cards. Banks created credit against everything that moved and even more so against things that didn't. Malinvestors the world over bid on commodities to complete their projects. When the Fed removed reserves from the banking system, the credit tower collapsed, commodities and all.

Today is very different. Banks are careful: they lend mostly to those who do not actually need the credit, except when the government guarantees the debt, as in the housing market. The increase in commodity prices appears to be supply-driven, a result of misguided and destructive lock-down policies. But, in fact, as discussed in Myrmikan's October letter, price increases are driven not by credit creation but by money printing disguised as supply-chain issues.

Raising rates will exacerbate commodity scarcity in the short term. The authorities will tell us that we must become contented with lower living standards (as has already occurred in the U.K.), and the World Economic Forum will continue to push bugs as the answer to rising food prices.

As we asked last month, what will the Fed do when rising interest rates destroy the financial markets and the economy, but prices keep rising anyway. We expect the movements seen in miniature since yesterday to develop into an ongoing trend over the medium term: interest rate and market shocks will pull gold lower at first, but as the market digests information, stocks and the dollar will be weak, commodities strong. As in the 1970s (and even more so in 1920s Germany), falling asset prices conjoined with rising costs of living make people poor fast.

We'll look back to Garet Garrett's 1932 masterpiece, The Bubble that Broke the World, to describe what come afterwards:

> For a while this difficulty of not knowing what anything is worth but inflames the ecstasy. Everything will be priced higher and higher to make sure it is high enough; there will be the illusion that things are becoming dear and scarce. They seem to be dear because the value of the money and credit in which they are priced is falling; they will seem to be scarce because people are buying in the expectation that prices will go higher and higher still. Suddenly doubt, then coming awake and panic. The spirit of gold has been debased by senseless inflation. The faith is lost. All with one impulse people rush to seize the gold itself as the only reality left—not only people as individuals; banks, also, and the great banking systems and governments do it, in competition with people. This is the financial crisis.

And it is approaching fast.

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