

Myrmikan Update

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Higher Interest Rates Bullish for Gold Prices

The month of January was challenging for gold and gold investments. As prices fell, bearish voices grow louder. On January 24, famed market strategist Doug Kass called for \$1050/oz this year, reasoning that interest rates will go higher increasing the opportunity cost of holding gold. Kass argues that emerging markets such as China, Brazil, and India have been raising rates to contain inflation, and soon the Fed will need to follow suit.

All bull markets correct, and Kass's price target certainly could be met, but his analysis is flawed for at least three reasons. First, although nominal rates in emerging markets are rising, real rates are still negative. For example, rates in China are around 6%, while food is increasing at a 10% rate. In fact, a National Bureau of Statistics report released today showed food prices increasing 4.6% in the past ten days alone. The interest rate in Brazil is now 11.5% while the unofficial inflation index (FGV IGP-M) stands at 11.32% (as opposed to the official rate of 5.63%). And India's central bank has rates below 7% while even India's official inflation rate is over 8%.

In fact, the unwillingness of BRIC countries to make real rates positive is evidenced by the introduction of price controls in China and now Russia. They have no choice. With U.S. rates negative, developing economies cannot have positive real rates without choking off exports.

A second problem with Kass's view is revealed by the horrible data released by Britain on January 25: UK GDP shrank by 0.5% in the fourth quarter even while inflation soared to an 8-month high. With Cameron's government set to introduce a "fiscal squeeze" (meaning increasing nominal state spending at a slower pace), the central bank dares not tighten monetary policy.

Hayek's best-selling book on inflation was titled "A Tiger by the Tail," which is exactly where the British central bank finds itself: keeping rates low will cause inflation to accelerate, but raising them would cause the economy to collapse. As elucidated in other Myrmikan materials, the former action would cause gold's purchasing power to rise, whereas the later will cause gold's nominal price to increase.

Given the far greater size of the United States, and its continuing ability to export inflation to the emerging market through the mechanism of the reserve currency, the U.S. does not yet appear to be caught in the same stagflationary bind as the U.K. But the principles at work are exactly the same, and the momentum will be far greater.

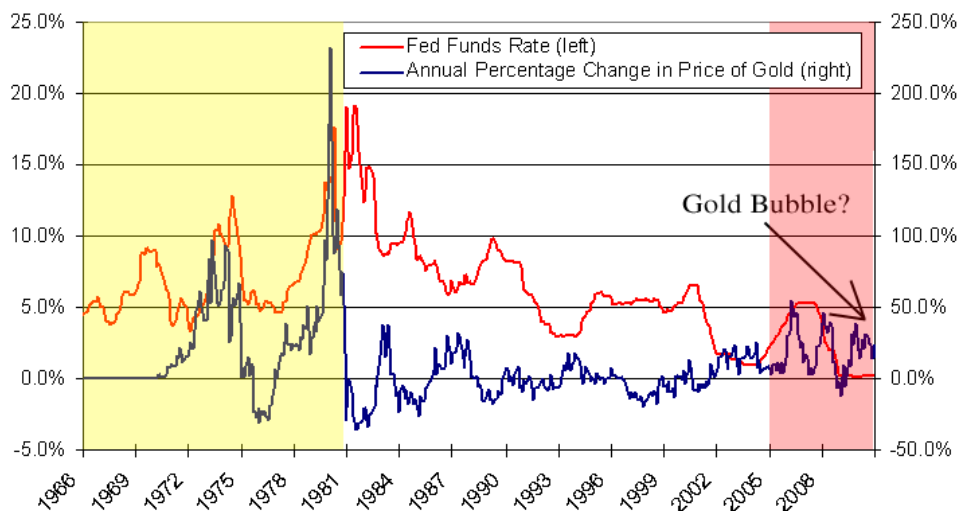
There is a third, deeper reason why Kass's argument is not only incorrect, but exactly backwards. Under a gold standard, currency and gold are interchangeable at a fixed price. The greater the demand for gold, the higher interest rates must rise to entice gold to remain in bank vaults. In other words, high interest rates are a symptom of, but also reduce, high demand for gold.

In the current fiat system, dollars are not redeemable for gold, but they are convertible – anyone can trade dollars for gold at the local coin shop. Therefore, rising demand for gold does not raise interest rates, which are set by the Fed, but instead puts upwards pressure on gold prices. So, in the first level analysis, Kass is right. Higher real interest rates would entice gold holders back into currency to buy bonds, and put pressure on gold prices.

But there's a problem. The dollar, instead of being defined as a unit of gold, is now defined as a liability on the Fed's balance sheet that is backed by the assets on the other side of the balance sheet. These assets currently consist of around \$2.3 trillion of bonds and \$11 billion of gold (261 million ounces valued by the Fed at \$42.22 per ounce). As every Econ 101 student knows, when interest rates rise, bond values fall. Since the number of dollars on the liability side would stay the same if rates were to rise, the gold price must increase in dollar terms to keep the balance sheet balanced, by definition.

Normally this counter-intuitive interest rate effect is muted because traditionally the Fed has held only very short-term, secure bonds, and small changes in interest rates have very little influence on the value of short-term bonds. But if the changes are dramatic, and/or if the Fed is holding long term bonds, then the Fed's bond portfolio can have large swings in value, causing inverse changes in the price of gold.

The chart below shows this dynamic as it occurred in the 1970s. From the initial floating of gold through 1980 (yellow shaded region), each time the Fed was forced to raise nominal rates to ward off inflation the value of its bond portfolio would decrease, driving the price of gold higher to compensate.



In 1981, Volcker raised rates and held them high. The first effect was to destroy the value of the Fed's bond portfolio. Gold entered a super-spike. When it hit \$595, the 263 million ounces controlled by the Fed was worth \$156 billion, or equal to all of the Fed's liabilities. In other words, at that time, the Fed could have redeemed all issued dollars with its gold at the market rate: the bond portfolio was worthless.

But, since the Fed held the rates high, and since it was able to roll over its low yielding short-term bonds into high yielding ones, the market soon began to impute value to the Fed's bonds again. Gold ceased rising and stabilized at around \$350 over the ensuing ten years, ten times where it had been in 1970. Volcker may have saved the dollar, but he did so only after it had lost 90% of its value.

Once the system was stable, gold and interest rates returned to their historical and healthy inverse relationship, as the chart on the previous page shows. Rising interest rates would again cause holders of gold to substitute dollars to buy bonds. This happy state of affairs lasted until 2005, at which point, as the chart shows, gold began to again correlate with nominal interest rates, just like it did in the 1970s.

Unfortunately, the current situation is much worse than in the 1970s. In January of 1980, U.S. Treasuries comprised 72% of the assets on the Fed's balance sheet, of which 39% were Treasury bills (less than 1 year duration). This short-term orientation allowed the Fed to quickly roll over its bonds into higher yielding issues as rates increased. And, there was no question the Congress could pay its bills so default risk was negligible.

The current composition of Fed assets is oriented toward long-term bonds, the values of which are very interest rate sensitive. U.S. Treasuries comprise only 44% of the Fed's balance sheet, of which only 1.7% are Treasury bills. The non-Treasury debt is a toxic mixture of agency securities and mortgage-backed portfolios.

Therefore, when interest rates rise, the bond portfolio at the Fed will immediately lose value, and all of its bonds – even the Treasuries – will face vastly increased default risk, further reducing their value. The higher interest rates will not shrink the number of dollars on the liability side of the balance sheet, so the dollar price of gold will have to increase dramatically, by definition.

In fact, the market is already discounting the value of the bond portfolio. Whereas the Fed holds its gold at \$11 billion (\$42.22 an ounce), the market values it at around \$353 billion (\$1350 an ounce). This means the bond portfolio, nominally valued at around \$2.3 trillion, is already suffering a 15% discount. As rates rise, this discount will rise significantly.

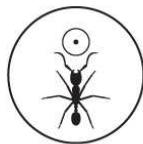
This is why Kass, and the computer models running trillions of credit dollars, have it backwards. To be sure, when rates first rise, high frequency trading algorithms may well tank gold in the short term due to faulty models. But in the end economic reality always wins.

The analysis above discusses only the asset side of the Fed's balance sheet, and the necessary effects of a market-driven rise in interest rates. If, instead, the Fed were to allow interest rates to rise by accepting (and thus destroying) dollars as bonds mature, then the dollar price of gold would not react because the diminution of assets would be balanced by the reduction of dollar liabilities. However, a rise in interest rates forced by the bond vigilantes, as opposed to allowed by Fed action, will reveal the Fed's impotence and accelerate the flight to hard assets.

Gold bulls are often accused of radicalism for arguing that gold prices always increase. For example, mainstream media often points out the perceived contradiction in the argument that gold should rise both in inflationary times or deflationary times. Of course, monetary inflation and asset deflation are not causes but symptoms of monetary mismanagement, which is the ultimate driver of gold prices and resolves the contradiction.

Similarly, the false prosperity created by the Fed the past ten years by propping up asset prices means real asset values must fall, either in nominal prices or in purchasing power. Conversely, the value of gold must rise. If the Fed keeps rates negative, then capital will continue to flee to hard assets. If the market forces rates higher, then the dollar's previous debasement will be revealed and gold will power higher. The only way to keep gold prices constant over the long term is through a gold standard system that allows the market to set interest rates, not a politburo of Keynesians.

The chart on the previous page not only shows the changing relationship between gold and interest rates, but also reveals the absurdity of thinking that gold prices are in a bubble. Higher nominal interest rates will correlate with the first super-spike of this already 10-year old gold bull market. Ironically, most of the managed money will miss it. It will be interesting to hear how pundits like Doug Kass explain the spike after the fact – no doubt the accused culprits will be “animal spirits” and “rank speculation.” In fact, it's just simple math.



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