Myrmikan Update

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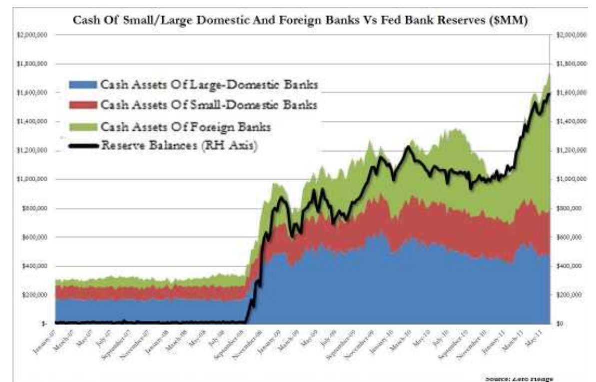
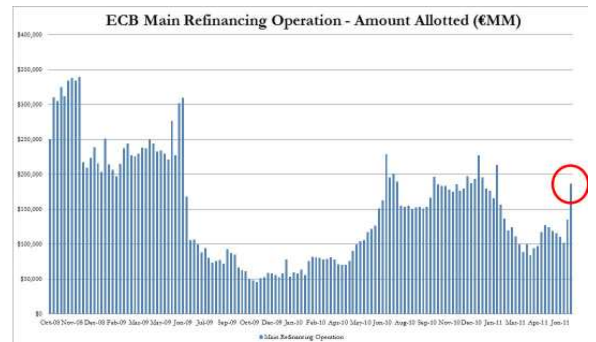
Summer Squeeze

On June 22, Fed Chairman Bernanke announced that the Federal Reserve would complete the QEII bond buying purchase program at the end of the month, on schedule. By the next morning the S&P 500 was down 2.7%, oil had plunged over 4%, and gold was down over 3%. Gold stocks, which have higher betas than gold itself, fell even further.

In fact, the global debt markets have anticipated a deceleration of money printing for some time. As first analyzed by Zerohedge, European banks started hoarding cash last October, their cumulative cash balance rising by approximately $600 billion. Curiously, this is the exact number of dollars printed by the Fed since the beginning of QEII (top chart).



Despite all of this extra cash, credit conditions are tight, with the ECB being forced to provide additional liquidity to the banking sector (middle chart).



Even in China, with its massive foreign reserves, liquidity is threatened as the Bank of China is being forced to raises rates to constrain inflation (bottom chart).

As the liquidity scramble intensifies, treasuries are being pushed to record lows, and on June 23rd the 1-month Treasury was bid so high it resulted in a negative yield: investors are so spooked they are paying the Treasury for the privilege of lending it money.

It should be no surprise that with the Fed suspending its monetary easing program, and the ECB accelerating its, the trade-weighted dollar should rise in value. But this will likely be a temporary phenomenon. Last week the Fed again quietly extended its swap line with the ECB, essentially merging the two balance sheets.

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A core tenet of the Myrmikan investment thesis is that, as described in other materials, the path to hyperinflation occurs on the cusp of hyperdeflation. Inflationary dynamics demand accelerating money printing to keep a credit boom alive. As soon as additions to monetary media slow, insolvencies are revealed and liquidity plummets. The central bank prints not unaware of the dangers, but through greater fear of the consequences of inaction.

True to theory, the economy began to roll over even before the cessation of QEII. Last week the Dallas Fed's general business activity index plunged from -7.4 to -17.5, personal income and spending slowed (even while the PCE Deflator jumped from 2.2% to 2.5%), and unemployment remains stubbornly high above 9%. Even Friday's surprisingly strong ISM number was mostly the result of a surge in inventories. Incredibly, Bernanke admitted at the FOMC press conference: "We don't have a precise read on why this slower pace of growth is persisting." If he hasn't figured it out by now, there is little chance the Fed will change its models or outlook.

Predictably, the economic downturn has spurred calls for action from semi-official voices. Former Obama economic advisor Larry Summers wrote in a recent Financial Times article:

> The central irony of financial crisis [sic] is that while it is caused by too much confidence, borrowing and lending, and spending, it is only resolved by increases in confidence, borrowing and lending, and spending…. Stimulus should be continued and indeed expanded by providing the payroll tax cut to employers as well as employees.

A week later, former vice chairman of the Federal Reserve Alan Blinder called for more stimulus in a Wall Street Journal article, arguing: "even building bridges to nowhere would create jobs, not destroy them, as the congressman from nowhere knows."

These trial balloons echo the initial voices raised for QEII last summer, when the market and the economy were similarly weak. But, similar to last summer, it will take a few months for current officials to exploit the cover that former officials are providing. When asked about additional asset purchases at the latest post-FOMC press conference Bernanke responded: "as of last August, we were essentially missing on both sides of our mandate. Inflation was too low and falling, and unemployment looked like it might be even beginning to rise again."

Here are the clear triggers necessary for QEIII: rising unemployment and low inflation. The first half of this equation is being provided free of charge by the market. The second half is being addressed with political solutions, such as the release of the strategic petroleum reserves and yet another redefinition of what inflation is. A recent DOW Jones story begins:

> Lawmakers are considering changing how the Consumer Price Index is calculated, a move that could save perhaps $220 billion and represent significant progress in the ongoing federal debt ceiling and deficit reduction talks.

It continues:

> It is a rare proposal in that it would likely lead to both lower benefits paid to seniors and higher taxes paid by most people who pay federal income tax. As such, it could allow Republicans to argue they are tackling federal entitlement programs such as Social Security, and permit Democrats to say they are increasing taxes as part of any budget deal that is reached.

The last time the CPI was redefined, in the Clinton administration, at least the stated purpose was to make it more accurate. For example, "hedonistic adjustments" were intended to capture the extra work that goes into developing more complex products. This time, the policy makers are self-consciously manipulating the figure to save money, a frightening development that brings the U.S. one step closer to Argentina.

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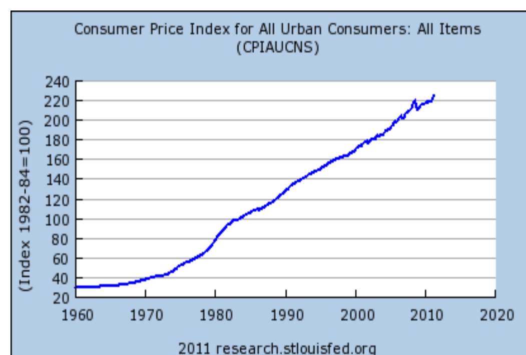
As a quick aside, it is worth noting that following the destruction of the Roman currency due to debasement in the third century A.D., the economy returned to barter, relying on weighing different commodities against bullion. But then even the definition of weights broke down, commerce ceased, and a thousand-year dark age ensued. In the absence of sound measurements, commerce cannot survive and autarky results.

The proposed change in the CPI would recognize that rising prices affect economic activity. For example, Americans drive less when gas prices increase. Therefore, the additional expenditure on gas is less than the percentage rise in price. Presumably, if prices go to infinity and economic activity plunges to zero, there would be no reported inflation.

But Bernanke will not have to wait for these political proposals to come to fruition. If starved of easy money, commodity and other markets will provide the transitory decline necessary to give the Fed cover to act.



Larry Summers can't even wait for the data to cooperate, stating in his article: "The underlying rate of inflation is still trending downwards." Considering the graph at right, which already embeds the statistical and hedonistic adjustments injected into the CPI in the 1990s, this is a remarkable statement. Notice the blip up to a record high at the tip of the graph.

Bernanke's bottom line is: "We'd be prepared to take additional action, obviously, if conditions warranted." Conditions will warrant, and therefore additional action will be taken. And, the current chatter is that instead of QEIII, the next monetary stimulus will be in the form of Operation Twist II (OPII).

Operation Twist was an effort in 1961 to lower long-term interest rates to spur the economy, since business investment and housing demand is priced on long term debt, but raise short term rates to protect the dollar, since currency traders look at short rates. In his now infamous 2002 speech on how to prevent deflation, Bernanke said: "Historical experience tends to support the proposition that a sufficiently determined Fed can peg or cap Treasury bond prices and yields at other than the shortest maturities. . . . I suspect that operating on rates on longer-term Treasuries would provide sufficient leverage for the Fed to achieve its goals in most plausible scenarios."

The key words in the quotation above are "sufficiently determined." As market strategist David Rosenberg has pointed out, the Fed can target either the size of its balance sheet or interest rates; it cannot do both at the same time. Once committed to fixing 10-year rates at a certain level, the Fed would be committed to buying as much paper as may be offered above that rate.

The likely outcomes of this strategy are profound. One might think that holders of capital require a certain return and that if the Fed is going to print more dollars, then the interest rate must rise to compensate holders of capital for the expected dilution of dollars. One of the contributions of Austrian economics is the understanding that the first order effect of printing money is, in fact, lower interest rates. The new supply of dollars hits the existing demand driving down the price. These non-market rates then create all the distortions described in Austrian Business Cycle Theory. Malinvestments cause input prices, such as commodities, to rise until there is a recession. In the recession the new credit dollars either vanish through cascading defaults, or else the Fed prints even more money to keep the cycle going.

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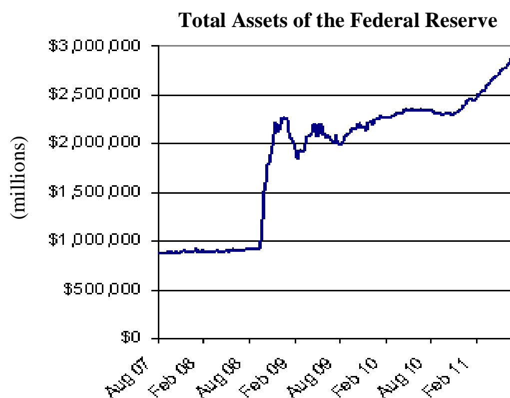
OPII would put the Fed in the curious position of having to print ever more money, creating ever more future inflation, to keep current interest rates low. Moreover, the real measure of interest rates is the nominal rate minus the rate of inflation. Therefore, if the Fed holds rates steady while inflation rises, it would have the effect of constantly falling negative rates, which would boost future inflation even more in a positive feedback loop. This is more or less what happened in Weimar Germany. Incidentally, the first Operation Twist was a failure since, in Bernanke's words: "[it] was rather small in scale, did not involve explicit announcement of target rates, and occurred when interest rates were not close to zero." OPII will be on a large scale.

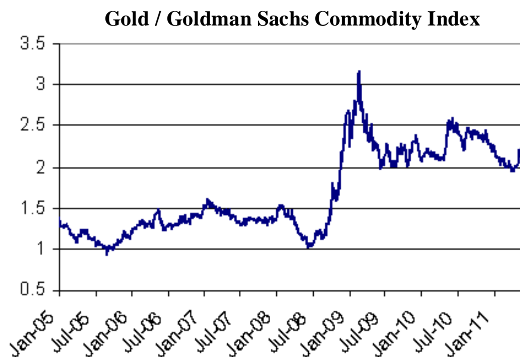
If the graph at left is what a controlled balance sheet looks like, one can only guess what it will look like once uncontrolled. In a panic, the Fed would be forced with the unpleasant prospect of massive expansion of its balance sheet. There would be a tipping point where the Fed would have to buy every bond on offer, or else abandon the peg, see interest rates spike, and watch the value of already purchased bonds decline to nothing.

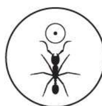


In short, some form of QEIII approaches, but will likely be even more confused and unconventional than the first two iterations.

The market, especially the gold market, is uncertain how to digest this framework. It would seem the trigger for OPII will be lower prices, but once triggered the result will be much high prices, since gold remains the principle defense against Federal Reserve balance sheet expansion. Thus volatility will likely increase until there is some form of resolution. This may present juicy opportunities for the trader, but the best course for the investor is to maintain his position despite the sickening lurches.

Gold stocks had a terrible second quarter, with the large cap index falling 13%, and the smaller stocks even further. But, as the chart below shows, they are merely retesting the breakout from Q4 of last year. With an elevated and rising gold-to-commodity ratio and the approach of some form of money printing, the stocks ought to hold support and rally from here.





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