# Myrmikan Research

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## Almost Inconceivable

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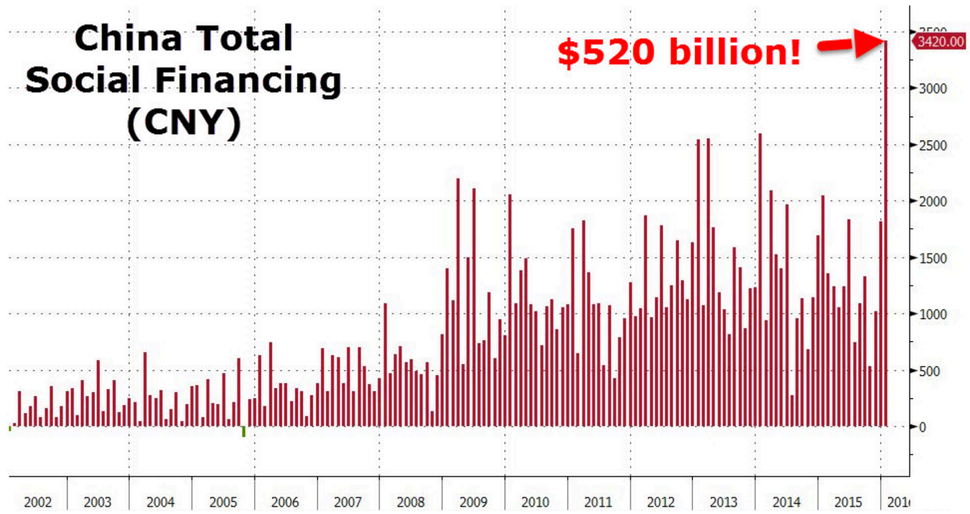
> When a wave breaks, it is the top that crashes first. Watch a great roller surging in upon a shelving shoal. It may seem to be about to break several times before it really does; several times its crest may gleam with white, and yet the wall of water will maintain its balance and sweep on undiminished. But at last the wall becomes precariously narrow. The shoal trips it. The crest, crumbling over more, topples down, and what was a serenely moving mass of water becomes a thundering welter of foam.
>
> When the American economic system broke, it was likewise the top that broke first: the crazily inflated structure of common-stock values which had been built up in the speculative madness of the Bull Market. Several times this structure had toppled—just as the crest of a roller curls over—in the successive stock-market breaks of June, 1928, of December, 1928, and of March, 1929; prices had cascaded down and thousands of speculators had been caught in the spate; yet each time the structure had recovered its balance and had lifted itself higher and yet higher. When, in the early autumn of 1929, another cascade of prices began, most observers supposed that, at the worst, these earlier episodes would ounce more be repeated. There would be a brief storm of selling, prices would drop thirty or forty or fifty points, a few thousand insecurely margined traders would lose everything, but the wave of values and of stock-market credit would catch its balance again and move forward. That the whole wave would go crashing down seemed almost inconceivable.

Frederick Lewis Allen wrote these lines in 1935 about the Great Depression, but they could apply to any one of the countless credit bubbles before and since. The credit wave that began in 1981 looked ready to crash on the shallow shoal of the 2008 housing bubble, when the crazily inflated structure of securitized housing debt derivatives toppled, but extraordinary actions by the Fed—suspension of mark-to-market accounting rules, \$1.5 trillion in direct loans, an additional \$6.3 trillion in guarantees,[1] trillions of dollars in quantitative easing—supported it safely into the deep water between the shoal and shore, where the wave recovered its balance and the crest disappeared from view. Yet the wave lifted itself higher and still higher. From the end of 2007 to mid-2014 the sum of global debt increased by 40%, 50% by 2015, and has since increased further.

1 http://www.bloomberg.com/news/articles/2011-12-23/fed-s-once-secret-data-compiled-by-bloomberg-released-to-public

In some quarters, debt growth is actually accelerating. See the chart below—the Chinese, desperate to keep their credit bubble alive have ramped up debt creation (mostly by banks). Not shown on the chart: February's current pace exceeds even that of January.




Let us recall that banks lend against assets (except when they are financing "vacation loans" and such). Loan *growth*, therefore, should be a rough measure of new assets. The Chinese banking system grew from $4 trillion in 2004 to $30 trillion today. The last thing China needs is more assets—they can't even use the assets they have—ghost cities, bridges to nowhere, the $n^{th}$ ring-road around the same city, not to mention steel plants, cement factories, ship yards, the industrial productive capacity Mao coveted and for which millions died in the Great Leap Forward.

The problem is that all of this still-expanding overcapacity of fixed capital is driving down the prices of that which it produces, which then devalues the capital itself, the collateral behind the bank loans that back deposits.

This analysis is no longer confined to fringe blogs—from the *Wall Street Journal*:

> SUIZHOU, China—Even in China's remotest places, relentless overproduction—here it is mushrooms and cement trucks—is clouding the country's path to prosperity and jolting the global economy.
>
> . . .
>
> Beyond the glut of steel and apartments that weighed down growth in recent years, China's economy is also saturated with surplus goods from farms and factories. Numerous small and midsize cities such as Suizhou, which boomed on easy credit and government support for agribusiness and construction, were supposed to provide the second wave in China's growth story. Instead they are now sputtering, wearing down prices, profits and job opportunities.[2]

That the Chinese banking system will collapse is not in question. More interesting are the second and third order effects. Already, the complete demise of commodity prices has put pressure on Western banks. It is hard to imagine the enormity of an iron ore mine, or the amount of capital imprisoned in a mid-sea oil platform. These projects generally

2 http://www.wsj.com/articles/overcapacity-swamps-smaller-chinese-cities-revealing-depth-of-crisis-1455738108

have a small equity tranche at the top of the capital structure, the remainder financed by debt. And they all rely on Chinese demand: "The Chinese must urbanize a billion people" went the refrain—they will buy our raw materials. No one thought to question how and with what—wealth does not spring forth *deus ex machina*; it must earned and saved and invested—wisely—not directed by and for the benefit of a politburo. There is a reason why a billion Chinese remained in poverty in the first place.

The Western banks that financed commodity production are insolvent, though few yet realize it. Like the flawed analysis of the CDO market in 2007, the conventional view is that the subordinated lenders may be in trouble, but the senior banks with the senior debt are safe. Deloitte has just punctured this myth with a report stating the obvious: "Not Even a Wave of Oil Bankruptcies Will Shrink Crude Production." This is because oil companies go bankrupt not when the price of oil falls below the cost of production—they file much sooner: when the cash flow is no longer sufficient to pay the debts. After bankruptcy, the creditors become the equity holders and get any remaining cash flow—they certainly don't turn the well off. Not until the price sinks below the raw cost of production—and then for a time necessary to exhaust any capital reserves—does the well actually close. In other words, the oil spigot will not turn off until all residue of the debt is completely erased, and the same dynamic applies to the other commodity sectors.

The market is already re-rating the banks most exposed to the commodities sector—exposure measured not by the percentage of loans to the sector, but the ratio of such loans to bank equity. Deutsche Bank ($11^{th}$ largest in the world) is in the cross-hairs—its equity price has fallen below where it was during the panic of 2008. Equity doesn't get paid until creditors are satisfied, so a sinking equity price (not to mention soaring credit default swamps) signals debt distress.

John Mack, former CEO of Morgan Stanley, recently opined: "this idea that I heard yesterday, the possibility of [Deutsche Bank's] not making their interest payments, it's just absurd. The government will not let that happen . . . The bank's name is Deutsche Bank. It's the German bank. Politically, they will stand up, if they need a safety net, and give it to them." He should know: his bank had to get bailed out by the authorities on his watch.

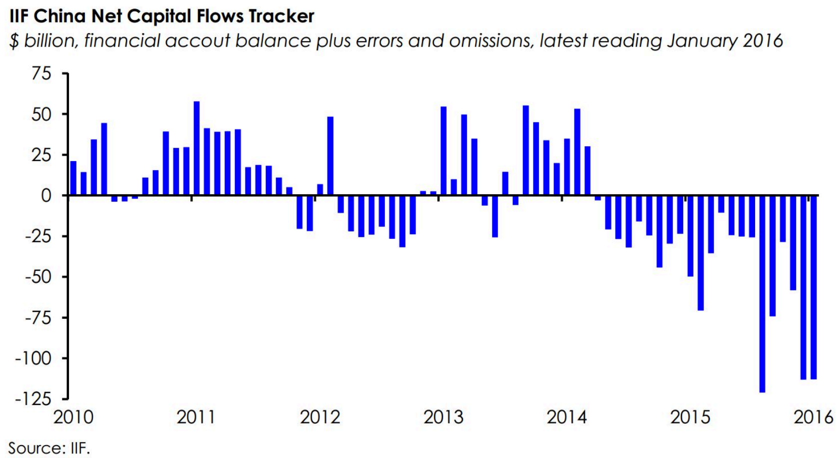
Mack is correct, of course, if for no other reason than the fact that Deutsche Bank holds $64 *trillion* in derivative bets, compared with Eurozone GDP of $13 trillion. Yes, the derivatives figure is notional not net, but if the derivatives daisy-chain breaks, even a tiny fraction of the figure would consume the entire economy. A bailout is coming, and it's going to be big, and it's not going to be good for fiat currencies.

But bailing out the banks does not the solve the problem of overcapacity—in fact, it makes it worse. As the *Journal* article continued:

> And with Chinese demand at risk, its industrial giants with idle capacity are looking to capture market share abroad. . . .

Deng Xiaoping famously said: "To get rich is glorious!" but he added: "We should let some people get rich first." There is a reason why the Communist Party adopted the Western, Keynesian program: in the upswing of a credit bubble, those who control capital become fabulously rich, a lesson the communists no doubt learned from the

Western elite. It only works, though, if you get your loot out of the country before it collapses, which is why capital has been fleeing China for safer quarters (this chart will be harder to maintain now that the Chinese have suddenly stopped reporting key data).




The capital outflows make tighter capital controls and devaluation a near-certainty, even if policy-makers didn't want them—but they do. Devaluation is the only way to keep the overcapacity competitive and maintain employment, which is the measure of legitimacy of the Communist Party. The result will be a deflationary wave that swamps developed markets, driving prices still lower, undermining whatever banks are still standing. This is precisely what happened in the 1930s.

Myrmikan has pounded the table since August that history is not rhyming but repeating nearly perfectly the 1929 model—first overcapacity drives deflation, then market collapse, which brings more deflation, then a banking collapse, then more deflation, until finally a dramatic devaluation of the currency to resolve unpayable debts. The value of capital falls to levels that seem almost inconceivable. This pattern has repeated without fail since the time of Solon, in 594 B.C. Athens, and it is doing so again now.