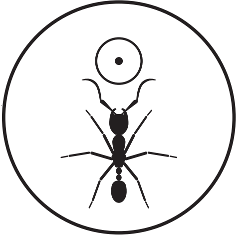

Myrmikan Research

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Waiting for Gono

Gold has been in a correction for two months—since peaking at $1370 on July 6, gold has fallen 4.4% to $1310. Over that time period, the GDXJ gold miners index has fallen nearly 12%, which is not surprising since gold stocks generally trade as operationally levered plays on the bullion price.

Performance has not been uniform, however. As predicted, the levered producers were the first beneficiaries of capital flows back into the sector as their suddenly increasing cash flows erased bankruptcy risk. Producers will still increase with gold, but with not nearly as much leverage to the upside; yet they retain their leverage to the downside. For this reason, Myrmikan has shifted its focus to the developers, which are receiving the second wave of capital flows. News flow from the developers had to wait until investors recapitalized their projects, the values of which depend more on the long-term expectations of the gold price. Participating in those recapitalizations has proved quite lucrative.

Even better, were gold prices to experience another deep dive, it is much easier for developers to hibernate than for operating companies, especially after they have been recapitalized. And, over the short-term, the developers are not in the main flow of liquidity, so the falling tide has had less influence on them.

If gold continues to rise, then the operating companies will put their cash flow to work through acquisitions. At some point in the cycle, once all of the good development companies have been swallowed up, focus will turn to the exploration companies; but in the medium-term development companies should have the best relative performance regardless of which gold trades.

Myrmikan does not claim insight into the short-term direction of gold—only traders at bullion banks, who see capital flows directly, have reliable insight into short-term movements—and they don't talk. But, the longer term movements are completely regular. Let us revisit Senator Root's extraordinary speech on December 13, 1913 opposing the Federal Reserve Act:

> With the exhaustless reservoir of the government of the United States furnishing easy money, the sales increase, the businesses enlarge, more new enterprises are started, the spirit of optimism pervades the community. Bankers are not free from it. They are human. The members

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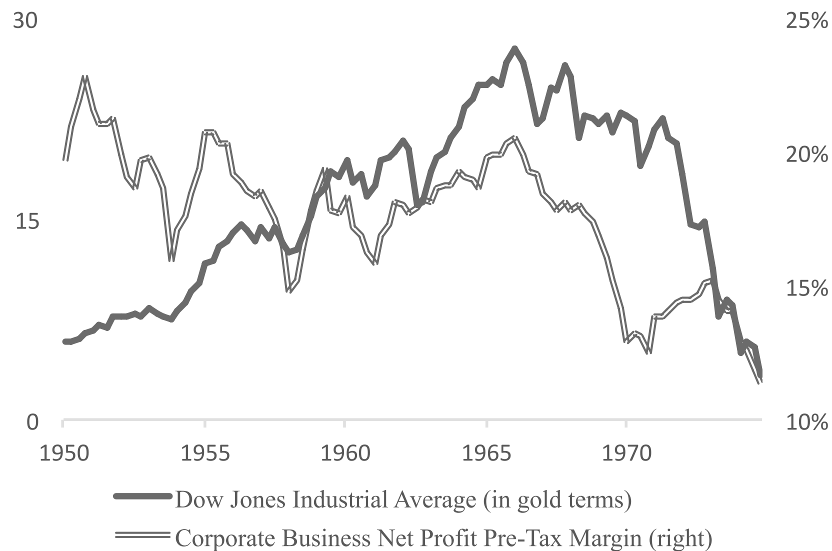
of the Federal Reserve Board will not be free of it. They are human. All the world moves along upon a growing tide of optimism. Everyone is making money. Everyone is growing rich. It goes up and up, *the margin between costs and sales continually growing smaller as a result of the operation of inevitable laws [emphasis added]*, until finally someone whose judgment was bad, someone whose capacity for business was small, breaks; and as he falls he hits the next brick in the row, and then another, and then another, and down comes the whole structure.

That, sir, is no dream. That is the history of every movement of inflation since the world's business began, and it is the history of many a period in our own country. That is what happened to greater or less degree before the panic of 1837, of 1857, of 1873, of 1893, and of 1907. The precise formula which the students of economic movements have evolved to describe the reason for the crash following this universal process is that when credit exceeds the legitimate demands of the country the currency becomes suspected and gold leaves the country.

Root's insight was that during a credit boom margins shrink. The mechanism has been discussed many times in these pages: a credit boom artificially lowers interest and discount rates; a falling discount rates increases the net present value of all future cash flows; the further into the future the cash flow, the more changes in the discount rates affects its present value—therefore, a falling discount rate over-stimulates production especially of higher orders of capital causing overcapacity; overcapacity lowers margins until the capital liquidates, bringing on a banking crisis.

The chart below shows Root's analysis in action. The data set begins right after the inflationary Bretton Woods agreement, which initially sent margins shooting higher, only to see them decay rapidly as the boom turned to bust in 1966. Note that the market's plunge occurs only well after margins have rolled over[1] and that in gold terms the market ended the cycle below where it had begun.



1 The chart of the market is artificially stable: until 1971 gold was pegged to $35 an ounce, and a rising gold price expressed itself as gold leaving the Federal Reserve—in fact, from 1949 to 1968 the U.S. hemorrhaged 58 percent of its gold reserves (even as the Federal Reserve increased the monetary base by 117 percent to accommodate federal deficits). Nevertheless, stock prices in nominal and CPI terms did not begin to fall until late 1968.

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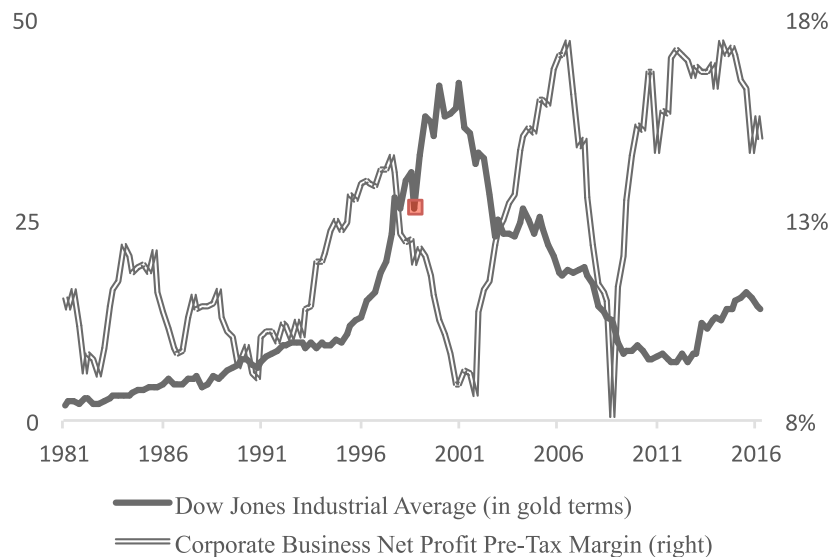
Recent data is messier, but reveals the same dynamic. In the mid-1990s, Greenspan juiced the economy for the Clintons, resulting in an initial spike for profit margins. The market followed margins higher—but then something strange happened: the "inevitable laws" did bring down profit margin, but the stock market kept soaring in gold terms. The red dot is October 1998, the month after the Federal Reserve bailed out Long Term Capital Management. Greenspan testified to Congress on October 1, "This agreement was not a government bailout, in that Federal Reserve funds were neither provided nor ever even suggested . . . and had no implications for Federal Reserve resources or policies," except, of course, that Greenspan had lowered the Fed Funds Target rate by 25 bps three days before his testimony, and he would lower by another 25 bps fourteen days after. Note, however, that while Greenspan's "coup de whiskey" drove the market into its final frenzy, his action did nothing for profit margins, which continued to plummet—the overcapacity was simply too great.



The Dow Jones index peaked in nominal terms on January 14, 2000. On January 3, 2001, less than a year later, with the Dow Jones down only 6.6% in nominal terms (less than 1% in gold terms), Greenspan began easing. In the span of less than a year, he brought the Fed Funds Target rate from 6.5% to 1.75%. He did it to bail out tech investors—the NASDAQ was cut in half during 2000. The result was a bubble more virulent than that which had proceeded it. Note, however, that the stimulus was not powerful enough to ignite a market rally in the senior shares. Yes, the Dow Jones soared in nominal terms, but the chart shows it continued falling in terms of real money.

The chart above shows that the QE stimuli were the biggest yet, in terms of height and duration. In fact, they were so huge that even the deflating market bubble responded, and the DOW Jones actually rose in gold terms. But, now, the *inevitable laws* have taken hold. This credit cycle is ending, as margins roll over from overcapacity. We near the moment when *someone whose judgment is bad, someone whose capacity for business is small, breaks*—perhaps Deutsche Bank or China—and the vertical lurch down in margins brings a market crash (at least in gold terms).

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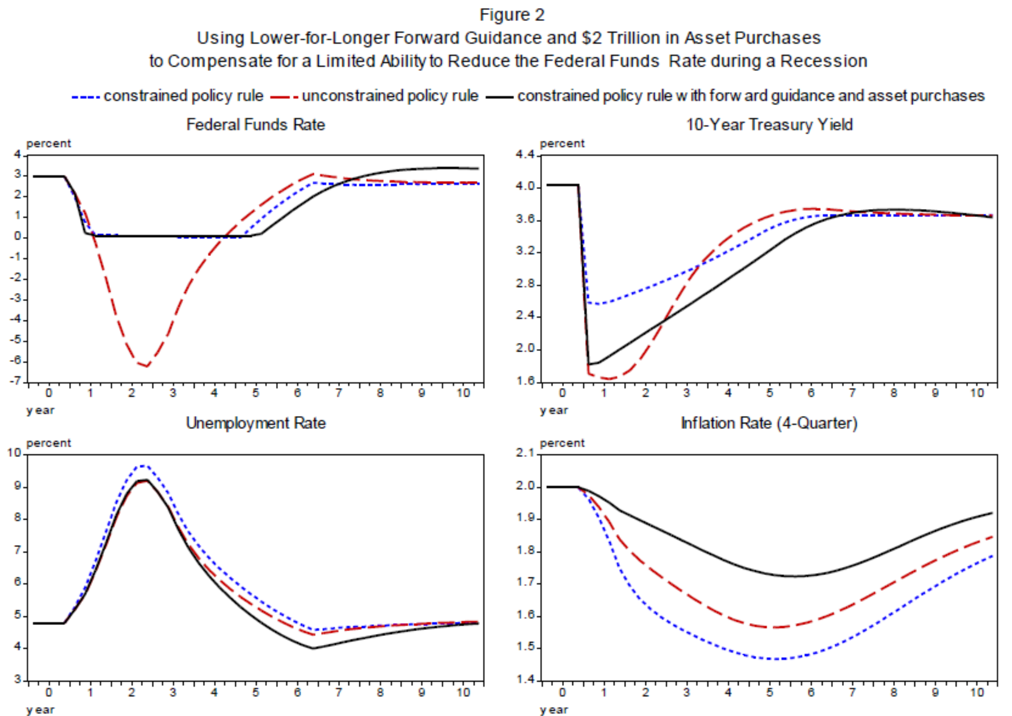
We already know what Janet Yellen's Fed will do. Fedologists have focused on Yellen's Jackson Hole Speech of August 26, 2016, which contained the following absurdist footnote:

> Consider the following policy rule: $R(t) = R^* + p(t) + 0.5[p(t)-p^*]-2.0[U(t)-U^*]$, where R is the federal funds rate, R^* is the longer-run normal value of the federal funds rate adjusted for inflation, p is the four-quarter moving average of core PCE inflation, p^* is the FOMC's target for inflation (2 percent), U is the unemployment rate, and U^* is the longer-run normal rate of unemployment. Based on the medians of FOMC participants' latest longer-run projections, R^* is approximately 1 percent and U^* is about 4.8 percent. Accordingly, with the unemployment rate climbing to 10 percent and core PCE inflation falling to 1 percent in 2009, this rule would have prescribed lowering the federal funds rate to minus 9 percent at the depths of the recession. In contrast, the standard Taylor rule, which is half as responsive to movements in resource utilization, would have prescribed lowering the federal funds rate to minus 3-3/4 percent using the same estimates for R^* and U^*. The more aggressive rule does a reasonably good job of accounting for movements in the federal funds rate in the decade prior to its falling to its effective lower bound in late 2008. . . .

Minus 9%! Absent from the model is the run on cash that would unwind the fractional reserve banking system and immediately usher in a crash far greater than 1933. Perhaps, though, the model may be forgiven because in any such situation the government would undoubtedly adopt Kenneth Rogoff's view that cash exists primarily for "the benefit of criminals and tax evaders everywhere. It is time, at last, to get rid of all those $100 bills."

Yet Yellen pulled back from Footnote 8 to propose instead using the Fed's "new tools—our authority to pay interest on excess reserves and our asset purchases." She even included a nifty chart to show that massively more QE would have a better outcome than the "unconstrained policy rule" detailed in Footnote 8.



Source: David Reifschneider (2016), "Gauging the Ability of the FOMC to Respond to Future Recessions," Finance and Economics Discussion Series 2016-068 (Washington: Board of Governors of the Federal Reserve System, August), www.federalreserve.gov/econresdata/feds/2016/files/2016068pap.pdf

Gold, of course, will go crazy when that happens, at least in nominal terms. If the policy "works," then we should see another business bubble and a correction for gold from a much higher level. But it may not work. An essential part of the Fed's 2008 strategy was to guarantee $6.8 trillion of assets (Source: Treasury Department's Special Inspector General for the Troubled Asset Relief Program). What if, as in other places in other times, the next crisis sees the guarantees triggered? Gideon Gono, former Governor of the Reserve Bank of Zimbabwe, may have the answer.

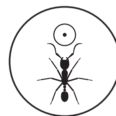
Afterward: Representative Democracy

It was Franklin Roosevelt who finally killed the American experiment, substituting the republican design with the administrative state. Obama has merely continued and strengthened the stranglehold of the bureaucrats on the body politic. Every now and again, however, a faint ember burns to provide hope that all is not lost, as exampled by following clip:

https://www.youtube.com/watch?v=BulC2aVG0zo

Lest one become too optimistic, however, for every Jason Chaffetz there is a Hank Johnson:

https://www.youtube.com/watch?v=v7XXVLKWd3Q



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