



Myrmikan Research

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Pop goes the Bubble

Recent days have seen volatility in the broader markets and gold stocks not seen since the 2008 financial crisis. The standard deviation in daily returns for the GDXJ ETF since inception is 2.8%; whereas, for the past 18 trading days it has been 5.3%, while the GDXJ itself has fallen by 32% in just the past 13 trading days.

For months and years the most pressing question for gold investors has been whether gold and gold stocks would get hit when the credit bubble pops and then run, as they did in 2008, or whether the Fed would print so much money to prevent the next crash that gold would run without dipping. Notwithstanding February's results, the answer is still not clear.

On the one hand, why should things be any different: Our credit bubble is defined by banks creating and issuing credit in dollar terms. When those debts are all called in at once, there is a massive short squeeze on dollars. The monetary base is currently \$3.4 trillion, and there are around \$90 trillion in dollars owed globally. When the debts become due, everyone dumps whatever assets they can to raise currency to ward off default and foreclosure, which includes gold and gold stocks.

On the other hand, unlike from 2001 to 2008, when gold's nominal price participated in the bubble (quadrupling from roughly \$250/oz to \$1,000/oz), gold remains \$300/oz below its peak price in 2013. Gold's nominal run last time attracted momentum investors. When those investors got margin calls and redemptions, they were forced to sell positions at any price, irrespective of value: many junior gold mining companies were down 90% or more, some reaching the minimum allowable bid on the TSX of half a penny.

In this latest bubble, by contrast, managed money has been mostly short gold, and there is almost no generalist capital in the gold mining sector, certainly not in the junior portion of it.

There are other contrasts. In 2008, the Federal Reserve learned of teetering financing institutions from the *Wall Street Journal*, at the same time as investors, and was completely reactive. Now, the Fed keeps moles inside the big banks to stay ahead of the information curve, making a deflationary debt collapse less likely. After all, the Fed's core mandate since the 1930s has been to avoid falling prices that would

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lead to a depression, and the Fed no longer has gold standard shackles to constrain its ability to print money.

In addition to Fed moles, structural changes in the debt markets have made it easier for the Fed to be proactive. In the previous cycle, banks issued debt directly and then took their debt products and securitized them—when the music stopped, they were stuck with an inventory of toxic loans. Today, non-bank lenders originate a growing percentage of debt with credit they borrow from money center banks, somewhat insulating the banks from first losses. The Fed can observe funding conditions directly through the repo market and so become instantly aware of credit problems before institutions have a chance to fail.

Funding problems broke to the surface dramatically last September, and the Fed leapt to the rescue through “temporary” liquidity programs aimed directly at the repo market. With the Fed resisting all market forces that attacked the bubble, it seemed nominal prices were safe no matter how much overcapacity the market was enticed to construct due to the artificially low rates, which is the Keynesian/monetarist dream. Gold investors were left wondering when inflation would finally rise to cause a decline in asset values in real terms (i.e., stable asset prices and a rising gold price, the 1970s stagflation).

Then the Wuhan coronavirus hit. China quarantined millions of people, and more than half of its 1.4 billion population became subject to travel restrictions. This was especially problematic because much of the population had traveled away from work for the Chinese New Year holidays and could not return to their factories. Manufacturing ground to a halt.

Economists who look at the economy in aggregate figures would not be concerned, large as the Chinese manufacturing sector may be. But aggregates in economics are always misleading. A car engine, for example, has over two thousand moving parts. If only one is missing, first the engine assembly line stops and shortly thereafter the whole automobile line stops as well. This same dynamic applies for every product, especially complex, expensive products like iphones. Lose access to one component, no matter how cheap its price, and production stops. Just-in-time inventory systems make production chains brittle.

If 2001 to 2008 was a housing bubble, 2010 to 2020 has been largely a corporate debt bubble. Corporations take on debt to buy back their shares to boost earnings per share to juice share price and the value of management stock options. A recent study found that between 2011 and 2016 “total buybacks and dividends were \$3.7 trillion, which is 91% of net income over the period, and 46% of companies deployed more than 100% of net income into buybacks and dividends.” Another recent study showed that “a firm is 47% more likely to repurchase [its shares] in months where the CEO also sells equity due to vesting [of his options].”

Levering up a company’s capital structure makes it brittle: a small interruption in cash flows can make a company unable to support its debt and thereby eviscerate equity value. Frozen supply chains and collapsing sales (and cash flow) is why the stock market has fallen so far so fast in the wake of the Wuhan virus and likely has a lot further to go.

The Fed jumped to rescue, of course, as it always does when there is a market crash. After the crash of 1987, Greenspan announced: “The Federal Reserve, consistent with

its responsibilities as the Nation's central bank, affirmed today its readiness to serve as a source of liquidity to support the economic and financial system." When the market cratered in 2008, Bernanke told investors: "The Federal Reserve is providing liquidity to facilitate the orderly functioning of financial markets." Powell two weeks ago announced: "The Federal Reserve is closely monitoring developments and their implications for the economic outlook. We will use our tools and act as appropriate to support the economy," and shortly thereafter surprised the market by cutting the fed funds rate by half a percent.

Bernanke explained the Fed's thinking in 2008: "It is not our job to target stock values or to protect stock investors, but I think that this [plunge] is a symptom of both sharply mounting concerns about the economy and increasing problems in credit markets." But when does the stock market ever go down when there are not sharply mounting concerns about the economy and increasing problems in credit markets? Greenspan at least was most honest: he told David Brinkley "I'm always worried about the stock market." "Every day, every hour?" "Yeah."

The problem is that money printing is not going to work this time. The normal transmission route from Fed printing to higher asset prices is that Fed liquidity provides banks with more reserves, upon which they create credit, to lend money to businesses, which construct new assets/collateral. Companies demand components and labor to build their new projects, driving raw materials and labor prices higher, a sugar-high of activity. Only later does overcapacity reduce cashflows, which brings about economic distress.

With the Wuhan virus freezing supply chains, however, businesses will not have the ability to increase net borrowing regardless of the interest rate. And let us not forget the travel sector: cruise ships (which cost more than a billion dollars each) and airplanes (which cost hundreds of millions each) and hotels are experiencing catastrophic decreases in revenue, shrinking the demand for new capacity to zero.

That leaves fiscal stimulus as the only alternative. Oliver Blanchard, former IMF chief economist, recommended: "It is all about fiscal policy now. We should not hesitate to spend even 5-10 per cent more of gross domestic product." Trump has advocated reducing or even suspending the payroll tax. Democrats have asked the IRS to postpone the April 15 tax filing deadline, which would provide corporate taxpayers with temporary working capital. Congressional Democrats and Republicans are busy negotiating a stimulus package.

The United State was already running a trillion dollar per year deficit before the Wuhan virus hit. Stimulus of whatever form will add directly to that number, not to mention enormous unemployment claims and the diminution in tax receipts that will result from a slowing economy. There is only one place the money can come from: the Fed.

Let us revisit the quotation that bestowed the monicker "Helicopter Ben" on former Fed Chairman Bernanke:

A broad-based tax cut, for example, accommodated by a program of open-market purchases to alleviate any tendency for interest rates to increase, would almost certainly be an effective stimulant to consumption and hence to prices. Even if households decided not to increase consumption but instead re-balanced their portfolios by

using their extra cash to acquire real and financial assets, the resulting increase in asset values would lower the cost of capital and improve the balance sheet positions of potential borrowers. A money-financed tax cut is essentially equivalent to Milton Friedman's famous "helicopter drop" of money.

Of course, in lieu of tax cuts or increases in transfers the government could increase spending on current goods and services or even acquire existing real or financial assets. If the Treasury issued debt to purchase private assets and the Fed then purchased an equal amount of Treasury debt with newly created money, the whole operation would be the economic equivalent of direct open-market operations in private assets.

In other words, this QE will be vastly different from the previous ones. It is not going to add reserves for banks to create more credit and reinvigorate the credit cycle (which was negative for gold); it is new money to pay for current expenditures, it is sheer debasement, it is the helicopter, and gold should fly when it takes off.

Currently, gold shares are trading in sympathy with broader markets. On March 9, for example, gold rose \$4/oz and oil prices fell 25%. This is fantastic for the economics of gold mining: rising revenues and falling costs. But with the S&P 500 down 7.6%, the HUI Gold Bugs Index fell by 8.0%. The following day, gold fell \$30/oz and oil rose 10.4%, which hurt gold mining margins. But the S&P 500 climbed 4.9%, and the HUI managed to rise 0.4%.

Gold stocks may continue trading in line with the broader markets on a short-term basis, but they will diverge higher: liquidity determines prices in bubble markets; discounted cash flows determine value in a depression. As credit continues to unwind, gold's value in terms of oil and other mining input costs will continue to rise, and gold mining margins and cash flow will rise as well.

This is the precise thesis that brought Myrmikan into the gold space back in 2009: oil had collapsed by 80% from the peak, gold had declined 30% in nominal terms, meaning gold mining margins in gold terms were increasing. The HUI proceeded to rally 325% from the trough—many juniors rose ten fold.

This time around will be better. The printing—and it will be printing this time, not QE—will cause gold to rise both in real and nominal terms. There is no better environment for gold miners.



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