Myrmikan Research

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Taper Scare

Myrmikan's last letter raised the possibility that markets are following the previous economic cycle, only at an accelerated pace: banks finance a bubble; the market crashes; the Fed prints huge amounts of money; gold rips higher; it turns out that most of the money printed is in the form of banking reserves; banks begin to lend, stoking credit inflation but not consumer inflation; credit sensitive segments of the economy surge; unemployment falls; the Fed declares victory, stops printing; gold crashes.

Events over the past couple of weeks have supported this view of events. Last week, Fed governor Christopher Waller said he expected the July and August unemployment numbers to be strong, and, if so, the Fed should consider tapering QE early. The Friday employment report showed an increase of 943,000 jobs, with the unemployment rate falling from 5.9% to 5.4%. More concerning for the Fed, the average hourly working wage surged by 4%, opening the specter of wage-push inflation (the theory that higher wages leads to enhanced buying power, which increases retail prices, which allows workers to demand higher wages).

None of this should be news. Anyone not engaged in self-lock down has seen prices rising and services curtailed throughout the economy due to lack of workers. According to the Bureau of Labor Statistics, there were 10 million jobs openings at the end of June versus 7 million in February of 2020, before the government-mandated lock downs—three million missing employees. The BLS also reports that there were 8.7 million unemployed at the end of July, so at least in aggregate everyone who wants a job ought to be able to find one, and they'll have to as soon as the COVID super-unemployment benefits expire.

With the employment situation normalizing and real estate prices at bubble highs, Senator Manchin (arguably the most powerful man in America) wrote a letter to Fed chairman Powell expressing what most Americans are thinking:

> With the recession over and our strong economic recovery well underway, I am increasingly alarmed that the Fed continues to inject record amounts of stimulus into our economy by continuing an emergency level of quantitative easing (QE) with asset purchases of $120 billion per month of Treasury securities and mortgage backed securities.… The record amount of stimulus in the economy has led to the most inflation momentum in 30 years, and our economy has not even fully reopened yet.

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It was, then, no surprise that the market smashed gold as soon as the Friday jobs report was released, with the yellow metal plunging $40 per ounce to $1,760, and then another $80 when the market opened Sunday night.

The situation, however, is not as rosy as the current aggregate numbers portray. First, total employment in the U.S. remains 570,000 less than it was before the COVID lock down, not adjusting for population growth. Fed chairman Powell has signaled that the Fed's mandate to ensure price stability is now subsidiary to encouraging maximum employment, which suggests the Fed has more printing to do.

This policy pivot was pragmatic in its origin. As Bastiat pointed out, politicians (and court economists) concern themselves with the seen and ignore the unseen. The job losses from the lock downs were seen; future inflation was unseen and, in fact, unexpected. Even now, when inflation has arrived, it is easily dismissed as transitory, caused by supply chain issues that will resolve themselves over time.

Even assuming the Fed were to realize that inflation is not transitory, Powell finds it impossible to retreat from his redefinition of the Fed's mandate. Powell's term expires in February, and the hard-left Fed governor Lael Brainard is vying for his position. Powell's only chance to remain in office is to burnish his progressive positions. Of note, Chris Waller, whose speech single-handedly smashed gold's attempted break out last Thursday, was the final Trump appointee to the Fed, confirmed in December of 2020. Whatever his opinions, he will become ever more in the minority.

It is also interesting to note that the increase in employment is a statistical construct: the number of jobs reported in July is actually 133,000 less than in June, but the Bureau of Labor Statistics adjusted the number higher for seasonality. The BLS has played games with adjustments in the past; and, even if honest, the assumptions behind the math may not be valid in a post-lock down economy.

A full 40% of the reported job gains were in the leisure and hospitality sector (mostly waiters and bartenders). Another quarter were in the education sector. One wonders what would happen to these jobs should Biden impose new lock downs in the Autumn, as is rumored. Even mask mandates, which have already been reimposed in many places, suppress revenue in the leisure sector, and proof-of-vaccination requirements will as well.

The question of new draconian restrictions on individual behavior is, in fact, a major problem for the government disease narrative. Looking at past epidemics, it is clear that respiratory diseases come in waves. The Russian pandemic of late 1889, for example, came in three waves, appearing again in the spring of 1891 and then again in 1892. The Spanish Flu also came in three waves: first in the spring of 1918, then again that autumn, then again in the late winter of 1919. Cities, towns, and countries tried many of the same policies imposed over the past two eighteen months with little avail. Scientists estimate that one third of the human population became infected, and over 50 million people died.

Interestingly, neither the Russian Flu nor the Spanish Flu ever went away. The former (actually a coronavirus that affected taste and smell) lived on as a common cold that still circulates, and the latter became incorporated (and may even be the main cause of) the seasonal flu (evidence suggests that previous flus were more periodic

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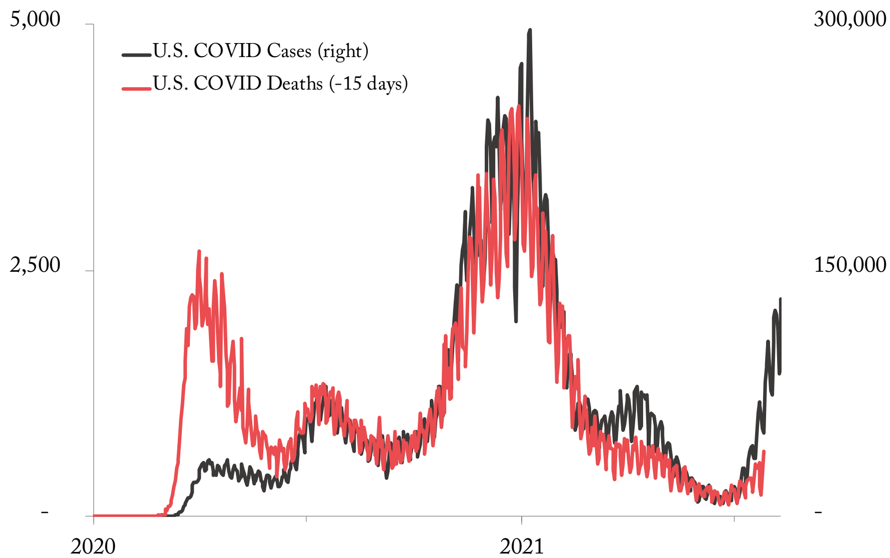
than seasonal). Both viruses mutated to become more infectious and less deadly, a good Darwinian move (though both still kill those with weakened immune systems).

Armed with a little history, it should be no surprise that lock downs did little to contain the virus from Wuhan, nor that the disease is making a third trip around the globe. Nor should be it any wonder that its lethality seems to be declining each time it comes around. As the chart below demonstrates: mortality in the second wave was disproportionately lower than in the first, and this third wave is lower still.

CDC COVID DATA



Source: Center for Disease Control

It may well be, as the government claims, that the population is getting less sick because so many have had the vaccines. But this certainly was not true for the second wave. And declining virulence is the normal evolutionary course for all viruses. It is also interesting that a recent study of COVID-Delta patients concluded: “We find no difference in viral loads when comparing unvaccinated individuals to those who have vaccine ‘breakthrough’ infections.”

If the dynamics of Delta observed in India and the U.K, hold, the U.S. should see a surge of cases into September and then collapse, regardless of government policy. And therein lies the quandary for the government. If locking down the economy made sense in the first two waves, then should not the policy response be the same? And if so, is there any chance the Fed will taper in the autumn, as is now widely expected?

If the government chooses not to redeploy its draconian responses and death rates continue to be low despite the fact that (according to the Mayo Clinic) only 50.4% of the U.S. population is fully vaccinated, then what happens to the propensity of non-vaccinated individuals to get vaccinated? Countries and states all around the globe are rolling out vaccine passports to engage in economic activity, such as travel and dining, even shopping at retail stores. What happens to the strength of these sectors (and Fed policy) if a large part of the population is banned from normal commerce?

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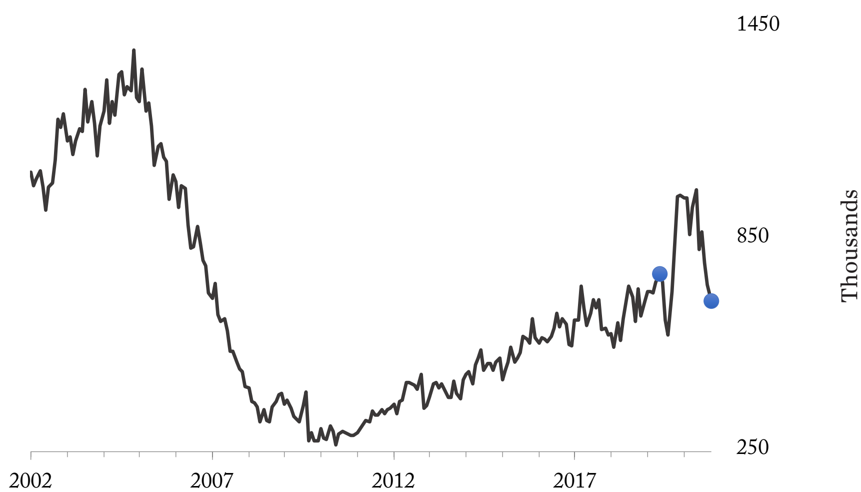
Delta's effect is already being felt in the transportation industry: on Monday Airlines Reporting Corp. reported that industry ticket sales in the week ending August 8 are down 51.4% compared to 2019. Just three weeks ago, ticket sales were down 46.1%.

Beyond total employment numbers and destructive lock down policies, real estate conditions are another reason why the Fed may not taper so quickly. Housing is the main reservoir of asset wealth for most Americans. It was for this reason that after the internet bubble burst, Greenspan lowered rates to increase housing prices. As he stated in 2003: "Low rates have also encouraged households to take on larger mortgages when refinancing their homes. Drawing on home equity in this manner is a significant source of funding for consumption and home modernization."

The corollary of this view is that falling home prices sap confidence and lower spending in a vicious circle. Investors should be aware, therefore, that even with the Fed continuing to buy $40 billion of mortgages per month, the number of new one family houses sold in June was *lower* than before COVID hit.

NEW ONE FAMILY HOUSES SOLD: UNITED STATES



Source: Federal Reserve Bank of St. Louis

Also interesting is that the price of lumber has plunged by 68% since mid-May, sending it back to levels seen in October 2019. Housing prices may still persist at bubble highs, but sales volume leads price (see the graph above at 2006 and 2007), and lumber is signaling that the housing sector is suddenly weak.

Other commodities also look sick. Oil prices are down 8% in the past month, copper prices are down 10% since May, iron ore prices are down 25% in the past month. Judging from past FOMC transcripts, plunging commodity prices will provide the Fed comfort that inflation is transitory and will give them concern that macro-economic demand is waning: not a great time to start tightening financial conditions by tapering.

These economic weaknesses are happening despite continued money printing. In fact, while certain members of the Fed may be talking about early taper, a chart of

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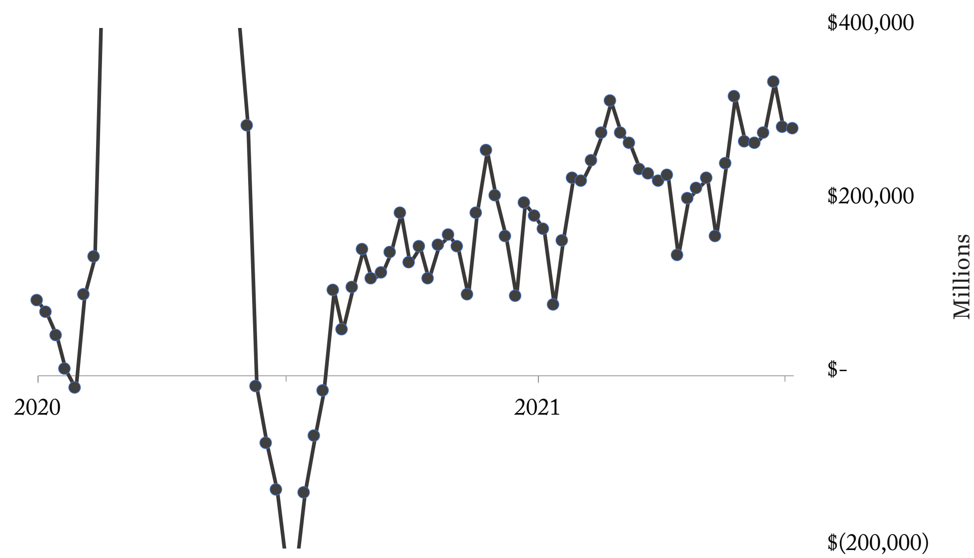
the change in the size of the Federal Reserve's balance sheet shows that the pace of printing is actually increasing.

EIGHT WEEK CHANGE IN ASSETS HELD BY THE FEDERAL RESERVE



Looking at the graph above, it is no wonder that stocks are surging to record highs. But there have been warning signs here too, and not just in the airline industry. Clorox, for example, recently reported that its gross margins have plunged from 37.1% to 9.7% because of soaring manufacturing and logistics costs. Container rates from China have surged to $20,000 from $2,000 two years ago. Imagine what that does to the business models of Walmart and Amazon.

Companies have been forces to raise prices, and 12-month CPI inflation is running at 5.4%. This means that workers, who saw wages increase by 4% over the past month, are seeing their real wages shrink, reducing their buying power.

Customer demand should fall further in the autumn as extra-unemployment benefits and the unconstitutional eviction moratorium expire. Up to twelve million households are behind on their rent and (presumably) will face a wave of evictions. They will finding lodging somewhere else, but rents have already risen considerably higher, which will stress consumption. According to the *Wall Street Journal*: "Invitation Homes Inc., the largest single-family landlord in the U.S., raised rents by 8% in the second quarter, including 14% on leases signed by new tenants. Invitation reported occupancy of more than 98%, an extremely tight market."

Then, on top of surging input costs and falling demand, companies may face funding shortages. The Fed has established a reverse repo facility in which financial institutions can deposit cash risk free. On June 16, the Fed increased its reverse repo interest rate from 0% to 0.05% and has thereby attracted $1 trillion dollars (and growing around $50 billion per week steadily).

The implications are profound. As every Econ 101 textbook explains, cash in the banking system is available to be pyramided: when $100 of cash is deposited

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into a bank, that bank lends out $90, which then shows up as a new deposit at that or a different bank. The banking system then lends out another $81, etc., until $900 of debt is created from a $100 deposit (assuming a 10% reserve requirement). The trillion dollars that is deposited at the Fed is being taken out of the banking system and, therefore, cannot be used to expand credit.

Perhaps more importantly, the fact that financial institutions have parked a trillion dollars (and rising) of cash at 0.05% implies that they cannot find risk-adjusted loan opportunities above that return, not exactly a vote of confidence in the economy.

Prior to the COVID hysteria, Myrmikan was of the opinion that the next major financial crisis would be caused by corporate debt levels (as opposed to consumer mortgages). The Fed's liquidity spigot certainly delayed the resolution of that bubble, but perhaps now with taper on the table, rising costs, falling margins, consumers stretched, and banks unwilling to lend, stocks are finally vulnerable.

After the housing bubble burst, Bernanke expanded Greenspan's policy of boosting housing prices to stimulate consumption to include stocks:

> Lower mortgage rates will make housing more affordable and allow more homeowners to refinance. Lower corporate bond rates will encourage investment. And higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion.

In short, given the economic headwinds already in place, any material drop in real estate prices or the stock market will end Fed taper chatter.

It would be a mistake to assume, however, that the gold mining thesis relies on a politburo of central bankers. As previous Myrmikan letters of have discussed, the end game for fiat currencies is when the central bank loses control either of interest rates or inflation. No doubt economically sensitive commodities will correct sharply—volatility is endemic to inflationary economics—but consumer inflation seems to have well established itself with no end in sight. This makes the real interest rate ever more negative. The Fed will have choose whether to raise rates to chase inflation, and risk market instability, or sit back and watch the dollar implode.

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