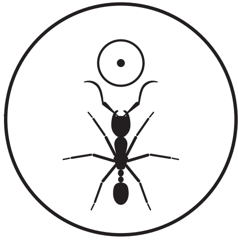


Myrmikan Research

September 14, 2021

Daniel Oliver
Myrmikan Capital, LLC
doliver@myrmikan.com
(646) 797-3134

Real Rates Go More Negative

Gold equities fell sharply in August, with the HUI gold miners index falling 7.3%, a reminder that the junior mining sector can be extraordinarily volatile: since inception in 1996, the HUI's standard deviation for its monthly return is 11.5% (as opposed to 3.8% for the S&P 500 during that period). While investors prefer lower volatility, in the case of gold equities, they serve the function of being insurance against the failure of global central banks, and insurance by its nature has nonlinear payoffs.

Myrmikan maintains that the Fed has steered the economy and the financial system into a cul-de-sac. Myrmikan's July letter illustrated emerging risks to the economy: Consumer income is stagnating, with extraordinary unemployment benefits expiring, eviction moratoriums ending, and housing costs soaring. Slackening consumer demand has led to soft commodity prices, weak housing sales, declining airline sales, etc., the signals the Fed monitors to judge aggregate demand. Meanwhile, the costs of doing business soar as global supply chain problems grow worse not better.

Recent economic news suggests that these trends are beginning to erode the macro outlook. The most recent jobs report from the Labor Department showed that employment had risen by 235,000 as opposed to market expectations of 720,000. Goldman Sachs lowered their Q3 GDP growth forecast from 9% to 5.5%. The real number may be far worse: the Atlanta Fed's real-time GDPNow growth forecast for Q3 has plunged from 6.2% in mid-August to only 3.7% as of September 10.

Large companies are beginning to sound profit warnings. Paint conglomerate PPG last week announced that it expects sales volume in Q3 to fall by $275 million while raw material costs will increase by $70 million, pretty much the definition of stagflation on a micro-scale. The CFO of mega-conglomerate 3M similarly projected declining production due to microchip shortages (i.e., lower revenue) combined with sharply rising input costs: "Moving over to raw materials. Again, I think the inflation is unprecedented. We are seeing inflation in the same areas I talked about earlier: jobs, raw material, labor, and logistics.… I think inflation is way outstripping anything that we thought." With M2 money supply 34% higher than at the beginning of 2020, it seems strange anyone should be surprised by the inflation level.

Recent speeches by regional Fed governors promoting an early and abrupt end to QE most likely reflect business angst over accelerating inflation in input costs. The real power, however, resides in Washington and New York and reflects the academic, the political, and the banking interests. Their nightmare is the 1937 policy error, the episode in which the Fed tightened in middle of the Great Depression, snuffing

NOTE: This material is for discussion purposes only. This is not an offer to buy or sell or subscribe or invest in securities. The information contained herein has been prepared for informational purposes using sources considered reliable and accurate, however, it is subject to change and we cannot guarantee the accurateness of the information.

out the incipient recovery. The choice remains the same: keep printing and stoke accelerating inflation, or stop and watch the markets fall apart.

In terms of the immediate direction for gold, Myrmikan remains agnostic as to Fed action, just as in 2019. By the end of that year, it was growing clear that the corporate debt bubble was fraying. The question then was the same as it is now: would the Fed allow a crash to happen first and then respond, or would it print money preemptively to prevent the crash? Would gold investors get liquidated along with the market, or would the market send gold straight higher in anticipation of Fed action? The only difference is that the Fed was not printing money in 2019, whereas now it is printing $120 billion per month. How large would QE have to be now to prevent a crash? to recover from one? Where would gold trade? And if the Fed were to choose not to respond, first the markets would unravel, then the economy, then the government. Where would gold trade then?

More QE may not even work. Market prognosticators that focus solely on Fed policy overlook the bifurcated nature of our banking system. The Fed is the creator of fiat money and banking reserves, but the banks issue credit. This is why market weakness during the 2016 "lift-off" of rates was so short lived. The Fed reduced the creation of bank reserves, but the banks did not need any more reserves: by 2014 excess reserves in the banking system had reached $2.7 trillion. Irrespective of whether the Fed was adding more, the banks had plenty of fuel to lend against assets rising in price.

We are in a similar situation today: the banks have more than enough reserves to lend into the economy. The problem is that given the economic mess induced by the COVID hysteria, there are few borrowers capable of borrowing more. Bank lending to commercial and industrial loans, for example, has declined from $2.8 trillion in May 2020 to $2.5 trillion today. Bank lending against real estate is flat (mortgages up, revolving home credit lines down). Meanwhile, bank lending to the U.S. treasury and agency securities has soared from $3.4 trillion to $4.3 trillion (which funds transfer payments directly to favored constituents). Financial institutions also have parked $1.1 trillion in the Fed's reverse repo facility, which pays 0.05% interest per year, suggesting they cannot find risk-adjusted returns above that rate.

The Fed is finding itself right back where it was in 1935 when then Fed chairman Marriner Eccles told Congress: "One cannot push a string. We are in the depths of a depression and … beyond creating an easy money situation through reduction of discount rates and through the creation of excess reserves, there is very little, if anything that the reserve organization can do toward bringing about recovery."

How quaint. The crisis last year saw the Fed purchase mortgage-backed securities, purchase and guarantee corporate debt, and become a direct counterparty to both lenders and borrowers in the repo market. In April of last year, after the interventions had been implemented, Janet Yellen (between her jobs of being Fed chairman and Treasury Secretary and while making millions giving speeches to banks) told CNBC that the Fed should have the power to buy equities. Yellen has been consistent on this point, having defended the proposal in 2016, saying: "It could be useful to be able to intervene directly in assets where the prices have a more direct link to spending decisions"—i.e., stocks.

That the Fed will buy equities may currently seem inconceivable, but so were the interventions deployed in the previous two crises before those episodes. If the banks will not lend, and the $98 trillion USD debt pyramid starts to implode through

NOTE: This material is for discussion purposes only. This is not an offer to buy or sell or subscribe or invest in securities. The information contained herein has been prepared for informational purposes using sources considered reliable and accurate, however, it is subject to change and we cannot guarantee the accurateness of the information.

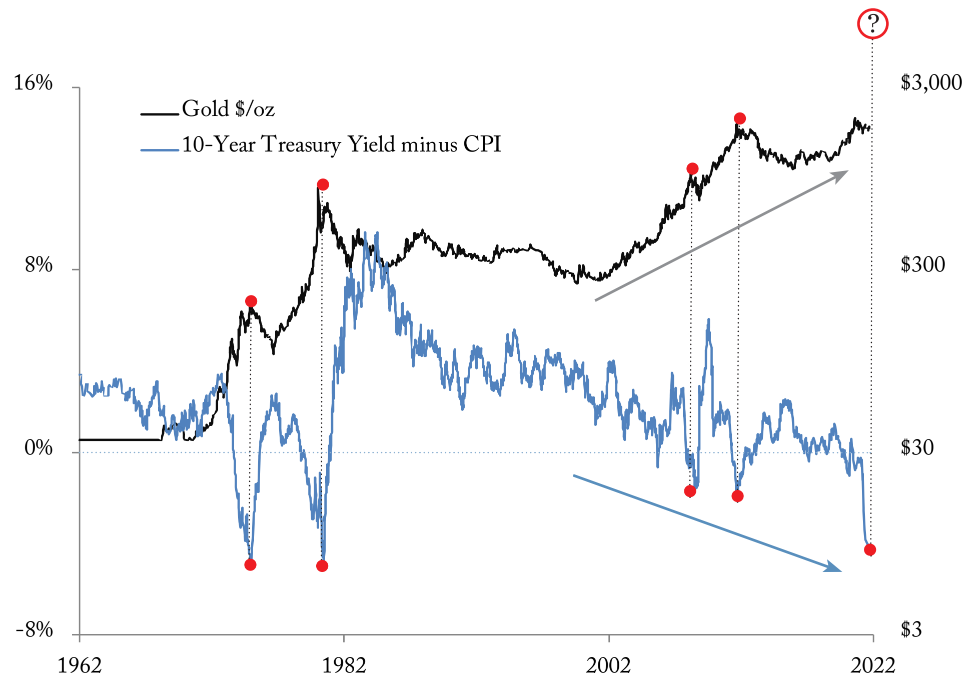
cascading defaults, the Fed will have little choice other than to funnel cash directly to individuals to maintain aggregate consumer spending (how ironic, though, that Janet Yellen—who was appointed as a Fed governor originally by Clinton to represent the interests of the working class—advocates a policy to send the newly printed cash to asset holders, those who need it least).

Whenever an investor begins to doubt the ability and propensity for the Fed to print money and in novel fashion, he should revisit Bernanke's famous 2002 speech "Deflation: Making Sure 'It' Doesn't Happen Here":

> The U.S. government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost. By increasing the number of U.S. dollars in circulation, or even by credibly threatening to do so, the U.S. government can also reduce the value of a dollar in terms of goods and services, which is equivalent to raising the prices in dollars of those goods and services. We conclude that, under a paper-money system, a determined government can always generate higher spending and hence positive inflation.

Direct cash transfers will complete the Fed's pivot from QE for the banks to QE for the people. As discussed in previous letters, it will mean instead of stimulating malinvestment and asset markets, the intervention will further increase consumer inflation. As CPI climbs, real rates will go ever more negative; and real yields have a strong influence on gold's nominal price, as the chart below demonstrates.

GOLD RISES SHARPLY IN NOMINAL TERMS WHEN REAL YIELDS GO NEGATIVE



The relationship presented in the chart above is so obvious that investors are understandably frustrated that gold is not already much, much higher. There seem

NOTE: This material is for discussion purposes only. This is not an offer to buy or sell or subscribe or invest in securities. The information contained herein has been prepared for informational purposes using sources considered reliable and accurate, however, it is subject to change and we cannot guarantee the accurateness of the information.

but two likely possibilities: gold is simply digesting its recent run from $1,500/oz only eighteen months ago and will soon launch higher, or gold is telegraphing a looming dollar liquidity crisis. It would not be the first time: from July 14 to August 28 in 2008, the S&P 500 rose 5% while gold was down 13% and the HUI gold and silver miner index was down 26%.

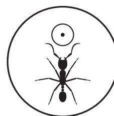
The third possibility is that Myrmikan's thesis is simply incorrect: the government can run rising deficits without limit, the stock market can accelerate higher forever, wealth concentration can continue with no societal or political effects, the U.S. empire can decline with no material consequences for Americans or our markets.

Gold and gold miners offer themselves as insurance that the propositions above turn out to be false. It may well be that a liquidity crisis (which might or might not hit gold as well) may be just the thing needed to evoke the policy response that would power the gold price into the multi-thousand dollars per ounce. It is also possible that gold will finally flush out the weak hands and power higher on the basis of negative real rates.

As in 2019, the long-term equity performance of well-run gold mining companies does not rely on Fed action or short-term market movements—their stock prices may decline sharply, but as long as they keep their capital structures intact, their stock prices recover with gold prices. Indeed, this is what happened on a broad scale from 2013 through 2016 and on a micro scale from January to April in 2020.

The end game is clear, even if the exact path is not. The authorities must keep asset prices aloft to encourage the propensity to spend and make possible debt payments and tax revenue. As corporate margins shrink and multiples compress—the toxic combination that sent the S&P500 down 89% from 1929 to 1932—the only way to sustain asset prices will be for the Fed to print money to make direct purchases. For the powers at the Fed, the cost of this policy—galloping consumer inflation—will be a small price to sustain the existing system.

There is no doubt that unlimited Fed power can hold markets aloft in nominal terms, and the dollar may not even weaken internationally as long as other central banks implement similar policies. But businesses and consumers will, at some point, arrange what the great economist Ludwig von Mises called "*die Flucht in die Sachwerte*, the flight into real values." The prices of goods and commodities will soar as everyone attempts to protect his purchasing power. This current bout of inflation is merely a preview of what happens when the market loses its trust in the currency.



MYRMIKAN CAPITAL LLC

The information transmitted is intended only for the person or entity to which it is addressed and may contain confidential and/or privileged material. Any review, retransmission, dissemination or other use of, or taking of any action in reliance upon, this information by persons or entities other than the intended recipient is prohibited. If you received this in error, please contact the sender and delete the material from your computer.

The material contained herein is for discussion purposes only and is not an offer to buy or sell securities. It has been prepared using sources considered reliable and accurate, however, it is subject to change and the accurateness of the material cannot be guaranteed.