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Inflation Tsunami Just Offshore

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Investors are understandably frustrated that gold and gold miners have not performed better in the face of ongoing money printing by the Fed. We think that is about to change. To review Myrmikan's thesis, recall first that the Fed does not really print money, it prints bank reserves. Banks use those reserves primarily to lend against assets that then rise in price. Increasing the price of a financial asset while holding its cash flows constant means (by definition) that discount rates have fallen. Falling discount rates encourage the construction especially of capital-intense projects such as office buildings (see, for example, Shanghai or mid-town Manhattan). Overcapacity eventually reduces cash flows (*lowering* consumer prices), malinvestments default, banks fail—unless the central bank bails them out, provides new reserves, allowing the whole cycle to begin again at a higher scale. Eventually, society's working capital gets trapped in illiquid malinvestments. The analogy writers used in the 1930s was Pharaoh's pyramids: wonderful economic stimulus while they were being built, but what did they produce? What was the return on invested capital?

Myrmikan's thesis coming out of the COVID panic was that the normal Austrian economic cycle described above had entered a different phase. The government decided early on that no one should be made to suffer to consequences of freezing the economy. Those who were prevented from working—both individuals and corporations—received transfer payments from the Treasury financed by issuing Treasury bonds to the Fed. In this way, the Fed began to sponsor consumer inflation directly. After all, if income and expenditures stay constant in the face of falling supply (due to lock-downs), then prices must rise, by definition.

The Fed's balance has more than doubled since the COVID panic began. M2 money supply has increased 34% and continues to rise at a blistering pace: the compounded annual increase in M2 in August was 16.4% (the Fed used to report M2 weekly—now it does so monthly with a considerable lag). What is curious is that the price level (as measured by CPI) has increased only 5.4% over the same time period.

This divergence between M2 money growth and inflation is nothing new: over the past several decades, there have been four major factors that have kept the rate of consumer price increases well below the growth rate of the money supply. First, technological innovation serves to lower costs and prices. Second, China introduced millions upon millions of new, disciplined workers into the global economy. Third, under-priced investment capital prompted firms to merge and reduce working capital by creating hyper-efficient supply chains. Fourth, the CPI was jiggered to under-report inflation by ignoring decreases in quality.

These disinflationary forces are no longer operative, some even in reverse. First, our malfunctioning financial system has redirected technological development to non-productive ends. Instead of elevating man's physical and mental powers for the purposes of innovation and increased productivity, technological development today focuses on three primary goals: entertainment, pursuit of efficiency, and financial speculation. Mass entertainment requires lowest-common denominator content, sapping the moral fiber of the country. Radical efficiency comes at the cost of flexibility and resilience and introduces horrors such as the Amazon warehouse and mass surveillance and fast food robot chefs: mass conformity, for which communist countries are rightly mocked, becomes ubiquitous. Financial speculation misallocates capital into various ponzi schemes where it is sooner or later destroyed.

Second, China has already plunged over the demographic cliff created by its one-child policy. According to Louis Gave during his recent appearance on Grant William's podcast, the latest Chinese census shows that the number of Chinese workers has already decreased by three million, a number that will accelerate higher as the population ages. Gave also points out that China has pledged to meet Paris climate-change goals not because it is so gullible as to believe the nonsense that spews out of the U.N. but because carbon imports through the South China Sea and from Russia (a natural and historic enemy) make it vulnerable: the green revolution in China is about national security.

As a result of these long-term policies, China is beginning to find itself starved of people and energy. Rolling blackouts have been imposed on factories, which were already straining in the attempt to fill orders from Americans armed with stimulus checks. The price of shipping a container from China to the U.S., which had surged from $1,500 to $24,000, has suddenly plunged because there is much less to ship. Imagine what is about to happen to the price of basic consumer goods as wholesalers attempt to reorder and find both that factory capacity is less and that input prices have soared.

And it is worse than that because, third, just-in-time inventory systems are not only designed to deliver product to the retailer moments before final sale but are also about getting manifold numbers of commodities and intermediate goods at various assembly and manufacturing locations at precisely the right moment. Stuttering production systems cause increasing disruption as missing components freeze whole supply chains.

The shortages so prevalent at the beginning of the COVID hysteria are returning to big-box retailers. They are also spreading to more durable goods. Consulting firm AlixPartners projects that chip shortages will cause automobile manufacturers to produce 7.7 million fewer cars this year than they had planned. Liquor producers cannot obtain glass bottles to ship their product. Gray-market Rolex watches are trading at triple official retail prices because so few are available at retail. Bloomberg reports that Apple is cutting production of the iPhone 13 by 10 million units also because of chip shortages. Trucking companies cannot find drivers even with rapidly rising wages. The list goes on.

Shortages are, of course, impossible in an open market: higher prices resolve all shortages. But shortages do make sense in world with price controls or dominated by large companies convinced that inflation is transitory. Raising prices is an expensive, risky undertaking. Large, lumbering conglomerates would prefer to endure temporary shortages in place of the disruption and risk caused by increasing then decreasing prices.

But a phenomenon has appeared in the past few weeks that should end all debate about how transitory inflation will prove to be: the price of energy has surged. Austrian economics instructs us that artificially low rates will encourage malinvestment in capital intense projects *as a general proposition*, not as a universal directive. Indeed, the energy space had seen huge overinvestment until the oil price cracked in 2014. But capital decays swiftly if it is not maintained, especially in extractive industries, and the "green" climate-change craziness has resulted in historic underinvestment in the most productive sectors of the energy complex: oil, natural gas, coal, and nuclear. Natural gas prices in Europe have rocketed 6.6 times higher since before COVID, 10 times in the U.K. (natural gas is up 184% in the U.S.). Coal futures are up 267% (including 38% just in the past month). Oil prices have returned to 2018 highs and are on the cusp of breaking out (as natural gas consumers frantically attempt to convert back to oil).

It's not only energy. Despite cascading problems in the Chinese housing sector, copper is up 86% since February 2020, before COVID hit: this is no "baseline" effect. Zinc is up 76% (including 26% just in the past week). Wheat is up 38%. Soybeans are up 36%. Oats are up 120%. Cotton prices are up 72% (including 21% in the past month). Coffee futures are up 98% (including 32% since July). The charts of many commodities suggest they are preparing to break through 2008 speculative, spike highs.

The inflation-is-transitory view yet persists because each of these markets has a specific story as to why prices have surged. There was a fire in a major chip factory in Japan. There are enough containers once the shipping industry repositions them to the right places. The wind stopped blowing in the U.K., causing a short-term surge in natural gas demand. There is a drought. China closed a large zinc mine. Truck-driving schools were closed for eighteen months. All of these stories are true. They are seen. Unseen is the lack of price reductions elsewhere.

In an economy with a proper, free-market monetary system, the price level does not change. If oil suddenly becomes more expensive, consumers spending more on oil must spend less on other things. Relative prices fluctuate, but the overall price level is constant. This is how we know it is false to claim that the oil embargo caused the 1970s inflation. Yes, there was a war in the Middle East. Yes, because of the ensuing embargo, oil tripled over six months to $10.11 per barrel. But prices did not go down elsewhere in the economy. And on a monthly-closing basis oil has never again traded at so low a price. The embargo was the trigger, but monetary debasement by Kennedy, Johnson, and Nixon was the cause.

Inflationary economics also brings massive volatility. Oil shot from $11.16/bbl in 1976 to $39.50/bbl by 1980, then it reached a crash low of $11.57/bbl in 1986. But the average price for the next 14 years was $19.26/bbl, double where it had been in the 1970s, sevenfold higher than in the 1960s. Similarly, from 1992 to 2020, lumber traded in a range between $200 and $400 per board feet (except for brief periods). By May 2021, lumber was trading at $1,600, up over 300%. Then it crashed to $438 and is now trading at $758. The old price ceiling is the new price floor.

Similar to the 1970s, while many markets are soaring in price, there are no persistent and dramatic falling consumer prices (beyond in specialized markets and asset prices). Yes, each particular commodity has had a trigger event, and many of the spikes in price will reverse, as with lumber. No doubt the surge in natural gas prices in

Europe is due in part to short squeezes (commodity trading firms apparently go short European gas and long U.S. gas whenever the spread goes too wide assuming supplies will shift and have faced margin calls on their short positions). We're not in Weimar yet. And when downside volatility comes we will hear that inflation concerns were misguided. But the old price ceilings will be the new floors, and the prices trends will be higher, which has important implications for consumer prices.

All consumer products begin as commodities, which cascade through intermediate manufacturers to final assembly, then to the wholesaler, then retailer for final sale. The chains can be enormously complex. Natural gas does not just heat houses and generate electricity; it is a major input for fertilizer manufacturing, for example, and shortages have caused plants to shutter production. Rising fertilizer prices will increase the cost of growing crops, which will translate into higher input costs for food manufacturers. Fertilizer plants also produce carbon dioxide as a by-product. Carbon dioxide is used to put the bubbles in soft drinks and beer, to create dry ice to reduce transportation costs, and to stun pigs and chickens during slaughter, among other uses. In the U.K., soaring gas prices have already sent the cost of carbon dioxide up by five times. Carbon dioxide may represent only a small percentage of the overall cost of beer, for example, but other inputs have also soared: grain prices are up 32%, glass jar prices have surged 42%, and aluminum prices are up 76%.

If primary input costs are increasing 50% or 100% or more, if labor costs are soaring, if just-in-time inventory management is broken, if distribution networks are snarled, if shortages persist, large companies will sooner or later have no choice but to break and reset prices suddenly higher, much higher, just to cover their costs. Then they will raise prices further to anticipate future costs increases. CPI inflation will suddenly start rising faster than money supply growth, just as in the 1970s.

The concentrated nature of American markets means that when the reset comes it will be swift and will undermine the fourth reason why CPI inflation has so underperformed M2 growth over the past few decades. The BLS uses hedonistic adjustments and substitution (if filet mignon gets too expensive, it assumes consumers will substitute lesser cuts such as flank steak) to hide inflation. Every sentient consumer knows that quality had deteriorated even for products for which prices have remained the stable (though it is not easy to detect a Cheerio size or count shaved by 5%). That game ends if inflation suddenly pops 30%, perhaps higher—and everyone will know that such price increases are not transitory.

How will the Fed react? Perhaps mutedly as long as it continues to perceive inflation is transitory. Economists such as Kenneth Rogoff have argued that a sudden burst of high inflation would be a great way to reduce societal debt levels in real terms. Keynesians and monetarists view the economy as an aggregate: if the price level doubles then real debt burdens halve, so the thinking goes.

Economists are not businessmen. They do not understand that debasement does not affect all prices at once, that input costs for companies increase before consumers have the extra money to pay more for their products. Firms must choose between maintaining prices, thereby suffering decreasing profit margins, or increasing prices and suffering decreased revenue. Neither course helps service corporate debt.

Soaring consumer prices will also trigger calls for more transfer payments to favored constituents, making the deficit and inflationary spiral worse.

An inflationary debt reset would, however, be great news for gold miners. Commodity prices (which drive the input prices for gold mining) rise in terms of gold when credit rises, suppressing gold mining margins, and vice-versa. This is why gold mining is a bad business during the long periods of credit growth but then is pure bliss during credit crashes—and it does not matter if the credit crash is deflationary, such as in the 1930s, or inflationary, as in the 1970s.

Galloping inflation may, perhaps, spur the Fed to action: it says consistently that it would act forcefully if persistent inflation broke out. And indeed it could. But the sitting governors should reread Arthur Burn's apologia:

> Viewed in the abstract, the Federal Reserve System … [a]t any time within that period [of the 1970s], it could have restricted the money supply and created sufficient strains in financial and industrial markets to terminate inflation with little delay.… [But if] the Federal Reserve then sought to create a monetary environment that fell seriously short of accommodating the upward pressures on prices that were being released or reinforced by governmental action, severe difficulties could be quickly produced in the economy. Not only that, the Federal Reserve would be frustrating the will of the Congress, to which it was responsible.

If the Fed perceives price increases to be driven by supply chain problems, if it misinterprets each of the various triggers as the causes of price increases, then how would raising the cost of capital help alleviate the shortages? This idiotic idea was pushed by Biden himself in July as he promoted his highly inflationary multi-trillion dollar infrastructure bill: “Here's the deal. Moody's today went out, Wall Street firm, not some liberal think tank, said if we pass the other two [infrasctructure] things I'm trying to get done we will in fact reduce inflation, reduce inflation, reduce inflation. Because we're going to be provided good opportunities and jobs for people, who in fact are going to be reinvesting that money back into all the things we're talking about, driving down prices, not raising prices.”

Meanwhile, he cancels the Keystone Pipeline and appoints an eco-terrorist to run the Bureau of Land Management (Stone-Manning had to negotiate a plea-bargain with the FBI to avoid prosecution for conspiring to place spikes in trees to maim loggers). Mines and large infrastructure projects take years, even decades, to develop, finance, and construct. Major investment does not occur after policy shifts but after confidence that such liberalization will persist, and it can take a long time to convince the market. New capacity in mining or heavy industry is unlikely to suppress prices.

This winter many Europeans will have to decide if they want to eat or stay warm. America is several years behind Europe in the green madness and will not be as affected: the death toll will be lower but the price increases will nevertheless be shocking. The woke cultural, political, and economic coup has created deep fissures in American society that may burst apart as early as this winter. Major political unrest is unlikely to increase confidence in American institutions or currency or financial markets.

The missing element in this analysis is the price of gold. One would think that if an inflation tsunami were approaching that the gold market would provide some advanced warning. Recall, however, that finance (like nearly all other industries) has become massively centralized, and institutions don't like to buy gold. In addition, the prospect of Fed tightening has some convinced (especially institutions)that gold is vulnerable along with other asset markets.

If Myrmikan's thesis is correct, those factors will not matter. The surge of prices everywhere will either force yields higher or induce accelerating QE. The former would swiftly lead to a debt crisis and perhaps sovereign credit crisis. The latter destroys the currency. From 1971 to 1974 the gold price shot up five times. From 1978 to 1980 gold also rose five times. We are headed into similar times.