

# Myrmikan Research

January 18, 2022

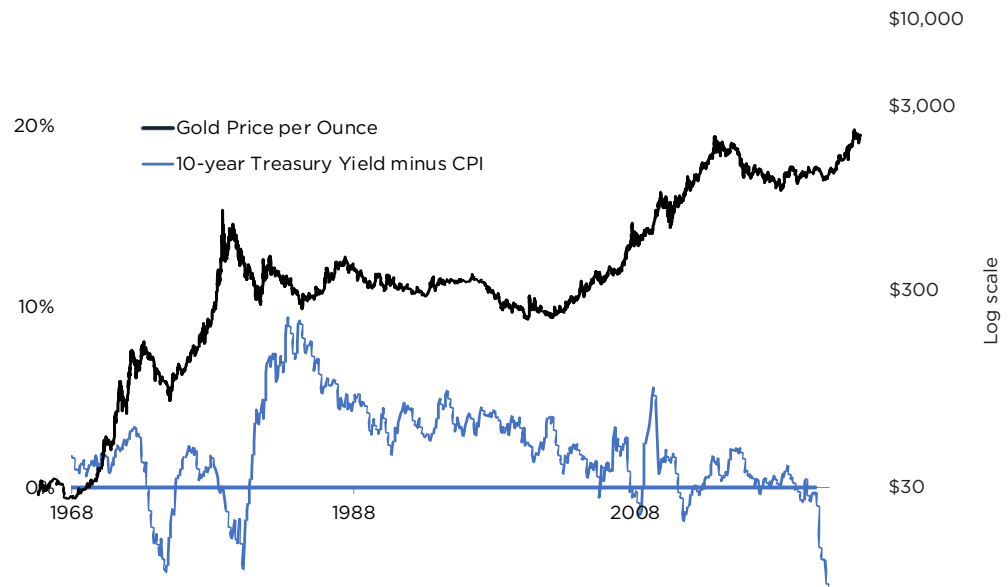
Daniel Oliver  
Myrmikan Capital, LLC  
doliver@myrmikan.com  
(646) 797-3134

## The Bubble is Bursting and Gold is Strong

A year ago inflation was running at 1.4%; Fed economists were whining that inflation was too far below their 2% target. By June inflation had jumped to 5.3%—the Fed deployed the “transitory” defense. In November, Powell retired the word, saying: “Transitory is a word that people have had different understandings of.” The latest inflation report printed a 7.1% increase in prices. That rate for only ten years would cut the dollar’s purchasing power in half.

Politics dictates that the Fed pivot to support the dollar, and that means the end of QE, balance sheet runoff (letting the Fed’s securities mature and not replacing them), asset sales *in extremis*, and hiking rates. The 10-year Treasury bond yield has jumped from 1.35% in early December to 1.8% currently, the highest yield since before COVID lockdowns.

The highest *nominal* yield, that is. With inflation running at 7.1%, the *real* yield is -5.3%, a new 50-year record, lower than the two spike lows of 1974 and 1980, both of which corresponded with epic gold bull markets. The fact that gold hasn’t gone parabolic, yet, prompts a deeper look into what drives gold prices.

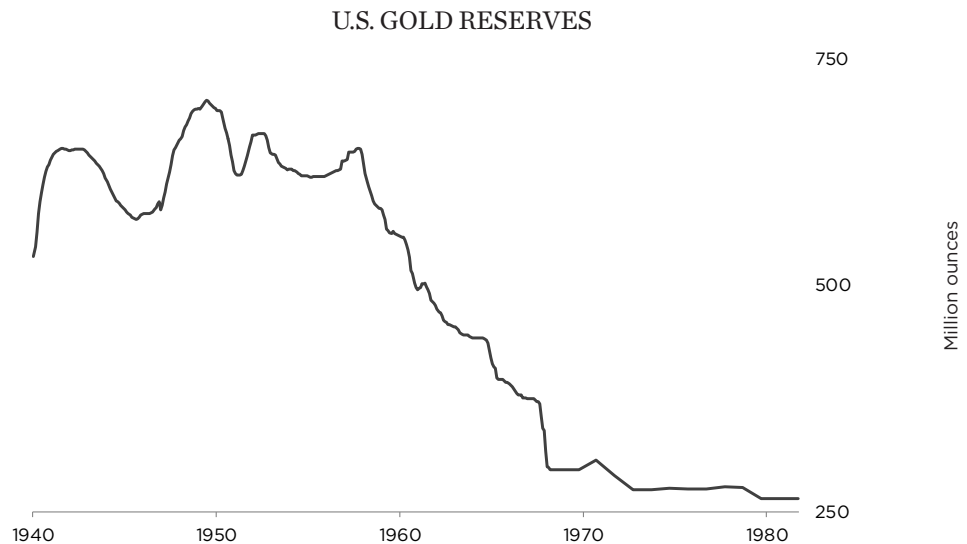


**NOTE:** This material is for discussion purposes only. This is not an offer to buy or sell or subscribe or invest in securities. The information contained herein has been prepared for informational purposes using sources considered reliable and accurate, however, it is subject to change and we cannot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

The 1970s was a period of monetary transition. The U.S. dollar had become the global reserve currency after World War II because the American government held over a quarter of the known gold in the world. The institutions created in the aftermath of the war institutionalized that position. Bretton Woods made non-U.S. currencies convertible into dollars at pre-defined pegs, and dollars remained redeemable into gold (a privilege granted to governments only) at \$35 per ounce. European governments importing materials to rebuild infrastructure set their pegs too high to overvalue their currencies in order to create more purchasing power. Undervaluing the U.S. dollar led to a scarcity, of course, not to mention enormous European trade deficits and exploding inflation: from 1948 to 1961 the money supply increased 4.3 times in Italy, 4.7 times in Germany, and 5.1 times in France.

Mounting inflation prompted reform in Germany and especially in France. Under the leadership of Charles de Gaulle (and Jacques Rueff), the franc was abandoned for a new franc backed by hard-money policies that quickly returned France to preeminence in Europe.

The U.S., meanwhile, under Kennedy, Johnson, and Nixon, decided to relieve the scarcity of dollars through enormous deficit spending. Scarcity became a glut. Europeans increasingly redeemed their dollars into gold. Kennedy demanded they stop: “The United States will not devalue its dollar. And the fact of the matter is the United States can balance its balance of payments any day it wants if it wishes to withdraw its support of our defense expenditures overseas and our foreign aid.” Economics always defeats politics in the end, and Kennedy’s threats had no effect.



*Note bene* for those who think the U.S. government manipulates gold prices directly: observe the years from 1961 to 1968 on the chart above when the U.S.-led Gold Pool operated to suppress the price of gold at the thirty-five dollar per ounce peg. It worked but at tremendous cost and was not sustainable. The scramble for gold that ensued after the British devalued the pound in 1967 overwhelmed

the Gold Pool. In March 1968, Gold Pool participants surrendered control of the private market but agreed that they would buy and sell gold only among their respective central banks and at the peg, creating an uneasy truce.

The U.S. government kept spending, and by 1971 the game was up. The Europeans knew if they demanded gold it would create a run on the dollar. But as with any prisoner's dilemma, they also knew whoever acted first would win. France and England defected and demanded redemptions. Faced with crippling demands for gold, Nixon announced he would "suspend, temporarily, the convertibility of the dollar into gold or other reserve assets."

Nixon's team scrambled to create a new anchor for the dollar, prompting Henry Kissinger to develop what would become known as the petrodollar system ("petrowar system" would be a better moniker). After the oil embargo inflationary spike, Kissinger offered Middle Eastern countries a deal: if they would demand dollars in payment for oil and recycle their dollar profits into Treasury bonds and U.S. bank deposits, the U.S. would sell them unlimited amounts of military hardware. The Arabs could not resist; arms sales exploded. Kuwait's annual military budget, for example, quintupled from less than \$200 million before 1974 to over \$1 billion in 1975 (\$1 billion was a lot of money in 1975).

The petrowar system shifted dollars from current demand into bank reserves, which did temporarily suppress consumer inflation at the expense of increased credit inflation. But that scheme by itself would not have worked to maintain the dollar standard globally: non oil-producing countries, Europeans, for example, could easily transfer currencies into dollars the moment before paying for oil—the petrowar system itself gave no reason for them maintain dollar deposits or reserves.

The new global anchor for the dollar that maintained its global reserve status post-Bretton Woods came about despite government policy, not because of it, in the creation of the Eurodollar system. Eurodollars were invented in the late 1950s by the Russians, who wished to hold U.S. dollars but not in U.S. banks, so they deposited their dollars in British and French banks. These banks operated beyond the reach of American regulators and lent out these dollars to foreign borrowers.

Until the mid-1980s, American banks were subject to Regulation Q, which prohibited interest on demand deposits and limited the interest they could offer on saving deposits (reinforcing the existing banking cartel). But all cartels cheat. The banks discovered that they could open offshore subsidiaries that were regulated locally. Whenever interest rates neared the limits set by Regulation Q, American banks would recommend to their large clients that they move their deposits to that bank's London branch in order to capture the higher rates offshore, and then the New York branch would borrow the money back again. Best of all, there were no reserve requirements applied to Eurodollar deposits.

The Eurodollar market exploded in size from \$192 billion in 1973 to \$1.3 trillion in 1980 and \$4.5 trillion by the late 1980s, returning London to its former glory as a financial center. When the U.S. Comptroller of the Currency enlisted the aid of

the Bank of England to clamp down on this regulatory arbitrage, an official told him: “It doesn’t matter to me, whether Citibank is evading American regulations in London. I wouldn’t particularly want to know.”

Recall that the fractional reserve banking system creates dollars out of thin air, and this is no less true for Eurodollar banks. In other words, a European bank armed with \$1 billion in dollar deposits could lend out \$10 billion if reserve requirements were 10%. Except the Fed has no authority in Europe, so there are no reserve requirements! And that means that a bank is not limited to issuing a mere \$10 billion against \$1 billion in deposits; in fact, it does not actually need to have any dollar deposits at all.

If the Bretton Woods system got the whole world (including the communists) using dollars for transactions on an equity basis (because of U.S. gold holdings), the Eurodollar system got the whole world using dollars because of debt. And this is what anchors the dollar today: not gold but the need to repay debt plus compounding interest.

According to the Federal Reserve, the face value of dollar denominated debt within the U.S. is \$86 trillion. The exact size of the Eurodollar market is unknown (given the lack of regulation) but is estimated to be around \$12 trillion, around two-thirds the size of the U.S. banking system.

All of this debt, both foreign and domestic, represents claims on Federal Reserve liabilities, a unit of which is called a dollar. Even after the 2020 QE, which increased the quantity of Fed liabilities from \$3.7 trillion in 2019 to \$8.8 trillion currently, there is still eleven times more debt than there are base dollars. If the global economy were to experience a sudden stop—as it did briefly in March of 2020—there would be eleven debt claims for each dollar of currency. This is why the Fed had no choice but to release the floodgates in 2020, in 2008, and any other time that the debt pyramid threatens to unwind.

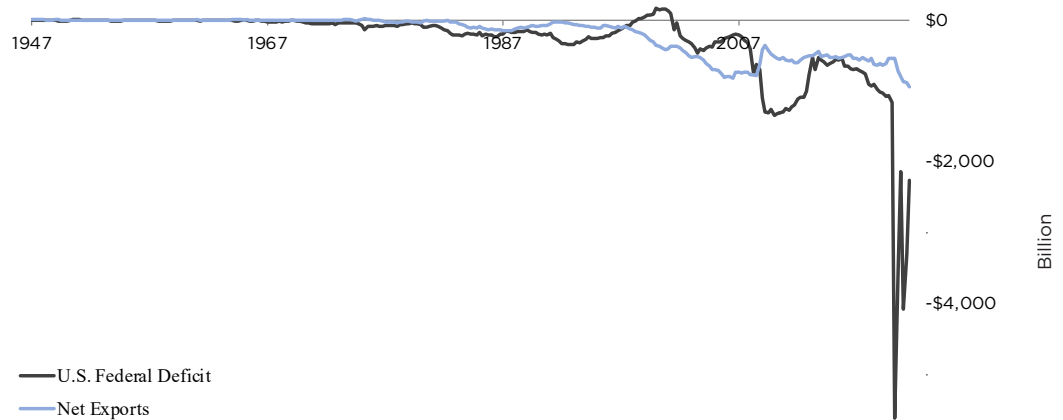
The Eurodollar system not only supports the dollar’s value internationally (by creating insatiable demand), it also imposes Fed policy on the global economy and determines the relative value of the dollar. When the Fed increases interest rates, U.S. banks follow, and Eurobanks must as well or they would experience a run on their reserves as claimants would play the rate arbitrage to redeposit in U.S. banks. In financial crises or when the Fed is raising rates, the dollar rises not because of safe haven demands or because a percent or two of extra yield compensates for the risk of investing in a completely insolvent government, but because Eurodollar borrowers need more dollars to service their debts.

The twin, mortal threats to the current dollar system, thus, is either a financial collapse in which borrowers (foreign and domestic) default *en masse*, losing their assets but also their need to bid on dollars, or the over-issuance of dollars during an economic downturn, satiating the demand for dollars without prompting the creation of new debt.

With that in mind, consider the black line on the chart below that shows the U.S. Federal deficit. This amount of money must be financed—either by the Fed’s

creating new money directly or by banks leveraging up Fed reserves—or else the U.S. government will default, ending the dollar system. This chart makes the Fed's threat to end QE hardly credible (for more than a brief period).

#### ANNUALIZED U.S. BUDGET AND TRADE DEFICITS (QUARTERLY)



The chart above also shows the trade deficit: the quantity of dollar surpluses, net, for exporting countries. One way to think about it is that over the past twelve months, of the \$2.3 trillion new dollars created to buy Treasury bonds to finance the deficit, \$1 trillion leaked offshore, and not as debt.<sup>1</sup> The non-U.S. earners of these dollars must spend them buying goods (pushing commodity prices higher), sell them for other currencies (pushing the dollar lower), or invest them into U.S. securities. For the last few decades, foreigners have had the propensity to do the last of these choices, keeping the dollar up, commodity prices down, and interest rates low. Will non-U.S. holders of dollars continue buying U.S. debt instruments with real yields of negative 5%?

The Fed probably imagines that when it raises interest rates from 0% to, say, 1%, or 2%, or even 3%, the dollar will strengthen, as it has for the past few decades under the Eurodollar system. But what if dollars are no longer scarce internationally and, therefore, the Eurodollar interest rate transmission mechanism is broken? Will a 3% nominal yield entice international buyers witnessing U.S. inflation running at 7%? Which buyers want direct exposure to the U.S. budget deficit at any yield? The Fed would need to impose a Volcker-style shock to make U.S. Treasuries economically attractive, but given the magnitude of federal debt that would quickly force a sovereign default.

<sup>1</sup> Dollars can also move offshore when Americans purchase non-U.S. assets and return onshore when they sell them. Americans currently hold around \$24 trillion of non-U.S. equity investments compared to foreigners holding \$30 trillion of U.S. equity investments. On the debt side, Americans are owed approximated \$11 trillion whereas Americans owe foreigners \$21 trillion.

Meanwhile, as any student of Austrian economics knows, a bubble requires continually falling rates, not merely low rates, to prevent collapse. This is why, when Janet Yellen predicted in 2017 that reducing the size of the Fed's balance sheet would be "like watching paint dry," she was sure to be incorrect. Just two years later the repo market blew up and the Fed was printing again.

Putting these two ideas together, what happens when rising rates destroy the U.S. economy (reducing tax revenues and increasing federal expenditures) but fail to strengthen the U.S. dollar, nominal commodity prices stay high (or go higher given scarcity of capital to increase capacity), and inflation continues apace or even accelerates? Will the Fed tighten financial conditions faster to contain inflation or will it abandon the program and restart the printing presses again?

The latter policy would be a continuation of the credit cycle as it has manifested over the past several decades. Already U.S. manufacturing production is declining, capacity utilization is stuck at 76% (down from 80% in 2018), retail sales fell 1.9% in December, China is loosening, and the Fed has not even started to tighten yet. After a major financial dislocation, the Fed would roll out their tools, every one of which is money printing in various guises. Rates would fall, and gold would leap to a higher trading range, as it did after 2008 and 2020, and, now, so would inflation.

But it is the former policy option that makes owning gold a necessity in this environment. When the Fed jacked up rates in 1979, the FOMC thought that inflation would head down immediately: it spiked instead. John J. Balles, president of the Federal Reserve Bank of San Francisco, for example, during the FOMC meeting of November 20, 1979, complained: "The only bad result I see from our October 6 actions [to limit severely the growth of the money supply] is the very sharp rise in long-term interest rates.... I can't get an answer from anybody else, including my own Staff [why that has occurred]. To the extent that those rates are influenced by expectations of inflation I'm still wondering why—I'm totally nonplussed—they went up instead of coming down."

Scott E. Pardee, manager for foreign operations of the FOMC, supplied the answer in the November, 1979 meeting: "As long as inflation remains very high there are still the real interest rate arguments. Most Europeans believe that interest rates have to be positive in real terms in order for monetary policy to have an effect; and many people in the exchange market believe that."

The day before the October 6 announcement, the 10-year Treasury yield had been 9.6%. Two weeks later it was 11%. But inflation was 12.1%. Real rates were still negative. Either rates had to go much higher (the 10-year yield would peak at 13.7% in early 1980), or the dollar had to fall to level that made economic sense to purchase it. As Myrmikan has written in past letters at length, when gold crossed \$650 per ounce in 1980, the gold on the Fed's balance sheet completely backed its liabilities—there was no remaining credit risk in the dollar at that price.

Myrmikan has always held that the end game for the dollar—what propels gold into the multi-thousands of dollars per ounce—is sharply rising rates that destroy the value of the Fed's assets and make further federal deficit spending impossible. Without a political reason to buy the dollar, it will seek out its economic value.

Myrmikan's January, 2020 letter discussed what nominal prices gold must reach to back the Fed's liabilities at various percentages, and why at some point gold will reach these levels. Back then, a gold price of \$5,000/oz was necessary to give the Fed one-third backing, the level (on average) that the market demanded the Bank of England maintain from 1720 to 1900. Gold at \$8,500/oz would have been required to back the Fed by 54%, the average level maintained by the Fed from 1914 to 1933. The dollar panic of 1980 sent gold to 133% of the Fed's liabilities, and in 2020 that would have required gold be at \$20,000/oz.

Currently, with the expansion of the Fed's balance sheet, those gold prices have increased to \$11,090/oz for one-third backing, \$18,150/oz for 54% backing, and a potential panic high (not equilibrium price) of \$44,700/oz. The Fed's balance sheet is sure to grow larger, increasing those figures further. It is difficult even for gold investors to imagine these prices. Yet they are what history and math suggest are coming. And, as the chart on page 1 shows, the first stop of \$10,000/oz is actually not that far away: investors are going to have to get used to logarithmic scales.



**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.