Myrmikan Research

September 14, 2022

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Net Worth Craters

Gold stocks had another frustrating month, erasing early gains to end down sharply. Having dropped nearly to the bottom seen earlier in the summer, gold stocks are rallying hard in September and are heading higher again despite yesterday's stock market rout. We continue to think that gold and gold miners are finding (or have found) a bottom to complete the 50% correction that began in August of 2020.

In recent months, the Fed has hiked interest rates at unprecedented speed. Fed officials (and politicians) have long acknowledged that monetary policy effects take time to percolate through an economy as enormous as America's. When Nixon wanted his Fed chairman Arthur Burns to lower rates for his reelection, for example, he ordered him: "I think we've really got to think of goosing it. Shall we say late summer and fall this year in order to affect next year? As you know, there's a hell of a lag." The Fed has, therefore, always moved cautiously when raising rates, worried it will go too far too fast and cause a recession. It acts suddenly only to abate widespread panic.

The results of the Fed's sharp interest rate hikes already taken will, therefore, affect the economy for many months into the future regardless of its future actions. And the Fed is still hiking, with expectations of at least another 75 basis point increase this month.

We may not know the future, but we can make some pretty good guesses as to the outcome of Fed policy. Myrmikan's June letter examined previous periods of tightening cycles, from 1920 to 1969 to 2000 and 2006, and showed they have similar outcomes: sharp recessions, financial distress in levered parts of the economy, collapsing commodity prices and then equity prices. And no wonder. Let us recall, again, Greenspan's rationale for dropping the fed funds rate to 1% 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." Rising rates will produce the opposite effect and, as Greenspan noted, not only in the housing sector but on consumption throughout the economy.

The economy was looking weak even before the Fed started tightening in March. Our letter last November observed that the long-end of the yield curve had already inverted, that consumer sentiment was probing record lows, and asked: "Wouldn't it be ironic if all of those containers stuck on cargo ships anchored outside of Los Angeles arrived a few months from now right as consumers run out of money and go on a buyers' strike." And now we see supply chains choked with inventory.

This week, Electrolux, the world's second-largest appliance manufacturer, warned: "market demand for core appliances in Europe and the US so far in the third quarter is estimated to have decreased at a significantly accelerated pace compared with the second quarter." The company added: "High retailer inventory levels have amplified the impact of the slowdown in consumer demand."

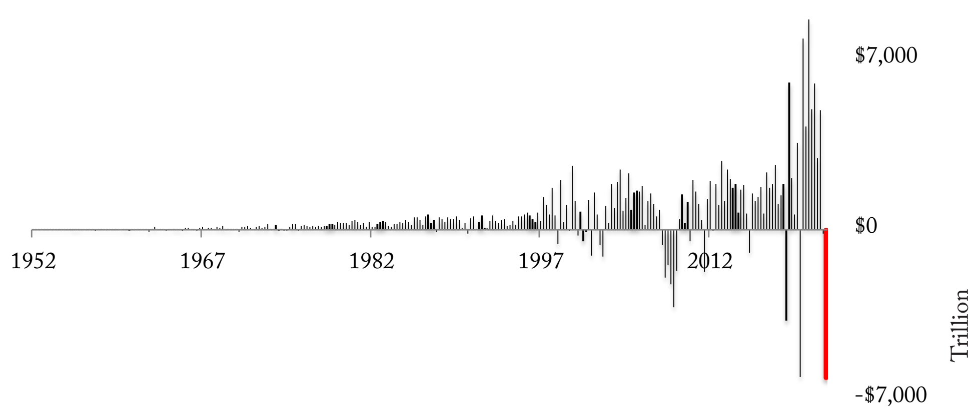
The used car market, another credit sensitive sector, is also showing signs of distress. Used car prices had risen 67% since 2020 and are now weakening, down 4% in August alone.[1] Industry observers note that "repo" companies are not leasing but purchasing vast fields to store all the cars that the banks are foreclosing on—they expect this to be a long-term trend. The number of "no sales" at wholesale auctions has soared as banks hang on to inventory to try to protect prices. The dam will break at some point—it always does.

The housing sector is the largest locus of family wealth, and the median sales price for housing hit a new record high in Q2.[2] But if home prices went up, market dynamics are horrible: In the first month of Q3, sales were 26.3% fewer than in July of last year and inventory surged 30.4%.[3] This inventory is soon to be supplemented by a record number of housing units under construction: 1.68 million, well above the 1.42 million units under construction at the peak in 2006.[4] Rising inventories and plunging sales are starting to pressure prices: bubble markets such as Austin, Phoenix, and Orange County saw prices fall 5.2%, 5.6%, and 8.4% respectively, from May to July. August numbers have not yet been reported, but with mortgage rates back above 6% and mortgage applications down 20% since the end of June, prices can only have declined further.

Some economists are now noting the "Zillow Effect" whereby homeowners can get valuations on their homes in real time. Whereas for the past two years Zillow.com provided everyone comfort that they were making thousands or tens of thousands of dollars each month just by sitting in their living rooms, the Zillow real-time valuation is now having the opposite effect on consumer confidence.

Myrmikan's June letter explained that to contain demand the Fed needed to decrease both the money supply (the ability to spend) and asset values (the propensity to spend). Last week's release of the Z.1 financial data shows the dramatic impact the Fed has had on the latter metric, the steepest quarterly decline on record.

CHANGES IN NET WORTH: HOUSEHOLDS AND NONPROFIT ORGANIZATIONS



1 https://publish.manheim.com/en/services/consulting/used-vehicle-value-index.html

2 https://www.federalreserve.gov/releases/z1/dataviz/z1/changes_in_net_worth/table/ and U.S. Census Bureau and U.S. Department of Housing and Urban Development, Median Sales Price of Houses Sold for the United States [MSPUS].

3 https://www.prnewswire.com/news-releases/remax-national-housing-report-for-july-2022-301607277.html

4 U.S. Census Bureau and U.S. Department of Housing and Urban Development, New Privately-Owned Housing Units Under Construction: Total Units [UNDCONTSA].

Notably, the $6.1 trillion collapse in household net worth recorded in Q2 was net of a $1.4 trillion *gain* in real estate values. The third quarter will show another large negative print as housing prices roll over. This metric should continue to drop sharply as the lagged effect of the Fed's previous rate hikes bite . . . and the Fed is still raising rates.

Perhaps this is why the dollar has begun to change direction. The market knows that the Fed has already suppressed demand enough so as to kill inflation even with geopolitical stress on supply chains, implying a pretty grim future. Despite yesterday's hot CPI print (heavily influenced by increases in rents, which metric lags housing prices by several months), the five-year breakeven rate (the market's forecast for CPI five years from now) has fallen back to 2.56%, not far above the Fed's 2% target. Today and yesterday also saw the 2-year yield increase and the 30-year yield decrease, further inverting the curve.

Recall from Myrmikan's May letter that "Fed economists (and politicians) don't care so much about the price level—they care mostly about year-over-year changes in the price level." Those living on fixed income will never see their purchasing power return. But future CPI levels falling back toward 2% will spook Fed economists, who spent the last two decades writing papers warning that inflation was too low and designing policies to boost CPI. This institutional bias caused the Fed to ignore inflation through November of last year (the month that Powell abandoned the "inflation is transitory" defense). Now Fed board members are hell-bent on slaying inflation Volcker-style and are recklessly jacking up rates without pausing to gauge the long and medium term effects. How embarrassing it will be when ballooning debt levels threaten widespread defaults and economic collapse, and they are forced to print again. And when they print again it will need to be sudden and dramatic to overcome the lagged effects of previous policy.

The market will sniff out this shift before Fed economists are fully aware of what is happening. The Fed will then face a choice: print in accordance with market demands or witness cascading failures throughout the financial system. It isn't really a choice.

When they do print again—and it is only a matter of time—they will face another problem. If asset price declines are depressing the propensity to spend and, therefore, pressuring corporate balance sheets, the ability to spend as represented by household liquidity has barely moved, down 3.3% in 2022, compared to a 64% increase since 2018.[1] Quantitative Tightening (the inverse of QE) is scheduled to begin in earnest only this month. The velocity of economic collapse means that the Fed will not get very far into QT before having to print again and adding even more ability to spend. Given that every investing person has become aware that market direction is determined by Fed policy, the recovery in asset prices should be extremely sharp.

Myrmikan's November letter explained that "Central banks print like this not because they are insane but because the path to hyperinflation is paved with deflationary scares." The path to hyperinflation is also characterized by sharply-rising volatility. The economic data suggests we are about witness both. Gold will seem to be volatile, as its nominal price whips around. But it is, in fact, the anchor of stability; its nominal price volatility reveals the decaying spiral of fiat currency.

1 https://fred.stlouisfed.org/graph/?g=THOw