Myrmikan Research

September 18, 2023

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

The Missing Piece

> When a wave breaks, it is the top that crashes first. Watch a great roller surging in upon a shelving shoal. It may seem to be about to break several times before it really does; several times its crest may gleam with white, and yet the wall of water will maintain its balance and sweep on undiminished. But at last the wall becomes precariously narrow. The shoal trips it. The crest, crumbling over more, topples down, and what was a serenely moving mass of water becomes a thundering welter of foam.
>
> When the American economic system broke, it was likewise the top that broke first: the crazily inflated structure of common-stock values which had been built up in the speculative madness of the Bull Market. Several times this structure had toppled—just as the crest of a roller curls over—in the successive stock-market breaks of June, 1928, of December, 1928, and of March, 1929; prices had cascaded down and thousands of speculators had been caught in the spate; yet each time the structure had recovered its balance and had lifted itself higher and yet higher. When, in the early autumn of 1929, another cascade of prices began, most observers supposed that, at the worst, these earlier episodes would once more be repeated. There would be a brief storm of selling, prices would drop thirty or forty or fifty points, a few thousand insecurely margined traders would lose everything, but the wave of values and of stock-market credit would catch its balance again and move forward. That the whole wave would go crashing down seemed almost inconceivable.

Frederick Lewis Allen wrote these lines in 1935 about the onset of the Great Depression, but they could apply to any one of the countless credit bubbles before and since.

The current credit mania began in 1960 when Keynes's disciples wrested control of money and credit under Kennedy. "Men's minds had to be conditioned to accept new thinking, new symbols, and new broader concepts of the public interest," wrote Walter Heller, the chairman of Kennedy's Council of Economic Advisors. The new thinking included the fallacious Philip's Curve policy that fallaciously that assumed price stability and full employment were incompatible.[1]

1 A 1958 study by A.W.H. Phillips had showed that in England from 1861 to 1957, the higher inflation had run, the lower the unemployment rate would go, a relationship that became known as the "Phillips curve." The period studied was one during which the world was or aspired to be on a gold standard, and so inflation manifested mostly in the context of credit inflations. It should be quite obvious that during a credit mania, prices should rise and unemployment should fall, whereas prices should collapse and unemployment soar when the inevitable bust arrives. But the Keynesians mistook the Phillips curve as a policy lever—as if there were a permanent, stable relationship between unemployment and increases in prices, irrespective of whether those increases were driven by credit inflation or monetary debasement.

President Johnson's war and stimulus spending sent consumer prices higher; the Fed kept rates low to fund government expenditures, sending asset markets higher as well. Gold as a percentage of the Fed's balance sheet plunged from 41% in 1957 to 12% by 1969. The wave crested in 1969, banks ran into trouble, and the Fed responded, and again in 1973, and again and again, as discussed in Myrmikan's previous letter.

Even Volcker's storied hike in rates is less impressive than casual history records. Exactly like today, his initial interest rate increases did little to slow the economy or inflation. Volcker complained to the FOMC in late 1980:

> I was out in Chicago yesterday [and asked a banker]: "What do you fellows think you're doing? You're expanding your assets like crazy in the middle of interest rates rising; you're eroding your capital positions; you're getting more extended on liquidity; and you have every lending officer out there on the road." His answer: "I sure do. If we get into trouble, the government will protect us."

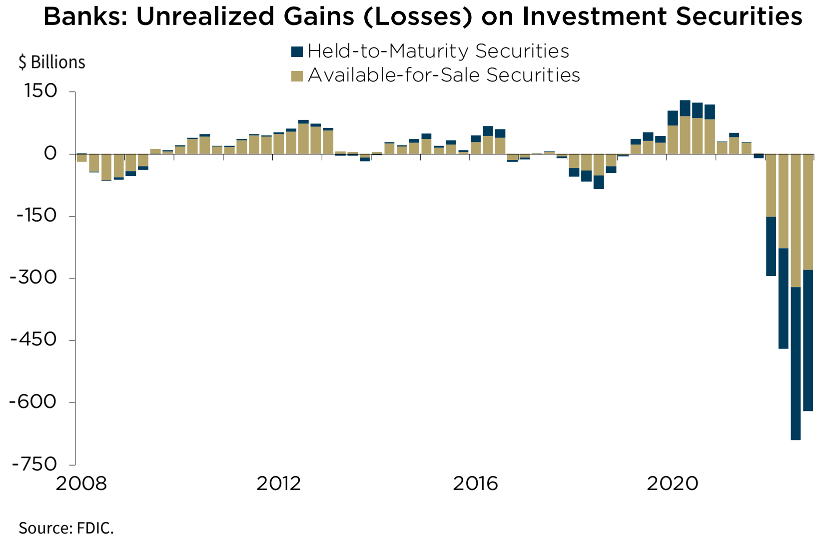
The bankers were correct. High interest rates eventually choked commodity prices, which threatened the value of bank collateral, especially at Continental Illinois National Bank, the country's largest originator of commercial and industrial loans. Volcker told the FOMC: "Continental is probably manageable with difficulty; $40 billion institutions are difficult to manage. Having two or three $40 billion institutions is a horse of a different color. If we have two or three, I don't think we're going to stop at two or three." And so the Fed forced rates lower to protect the banks.

Consumer disinflation continued despite monetary expansion and falling rates for a variety of reasons, including: total public debt as percentage of GDP was 34%, enabling the U.S. Treasury to offer sustainable, positive real yields on its debt; massive overcapacity in mining and energy production constructed during the 1960s and 1970s put a cap on commodity prices (pressure that continued through the 1990s when the Soviet Union collapsed, throwing Soviet overcapacity onto the market); the lack of pricing power for commodity producers met overcapacity down the chains of production, especially in automobile manufacturing and in durable goods (pressure that continued when China joined world trade markets); and technological innovation drove prices in some sectors down relentlessly.

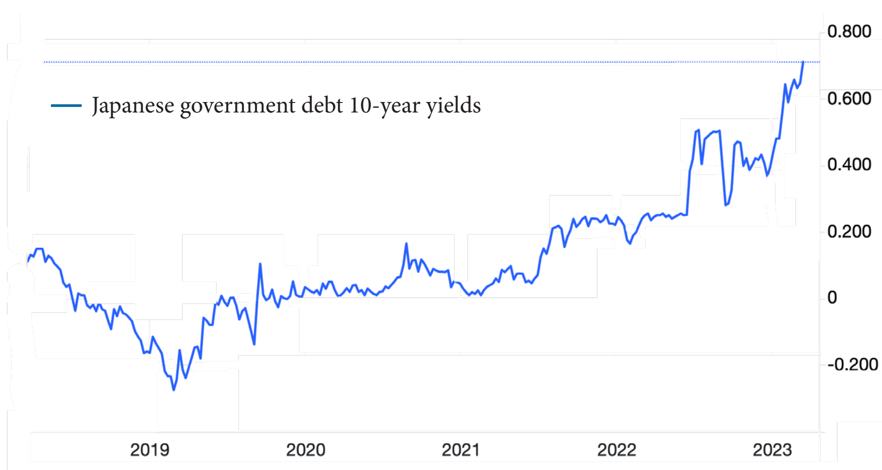
Under Greenspan, the Fed's effort to keep the credit wave from cresting, to restore its balance, to keep it sweeping on undiminished expanded from bank balance sheets to stock market prices: "I'm always worried about the stock market," Greenspan admitted on the television with David Brinkley. "Every day, every hour?" "Yeah."

With Greenspan's aid, the credit wave swept over the shoals of 1987, the 1990s, the internet bust, and then the housing bust with Bernanke's help. The wave was cresting again and about to tumble in 2019 when Powell intervened to reverse QT and then bail out the multi-trillion dollar repo market, propelling the credit wave to new heights.

We are reaching the point, however, where the shoals become shallower and the wave narrower. The crypto bubble broke a year ago. The regional banks broke with SVB: the Fed's Bank Term Funding Program emergency support continues to grow, while losses on the investment securities soar. The last bar on the chart below is Q4 2022. Since that time, 10-year rates have moved from 3.87% to 4.28%, making those losses larger still.



Subprime auto dealers are failing.[1] Credit card debt has reached a new high, over $1 trillion (up from $800 billion in 2018),[2] while the average rate has increased to 24% (compared to 16% in 2018);[3] the credit card delinquency rate at smaller banks has pierced 7.5%, the highest since this data series began in 1992.[4] Abroad, yields on the 10-year Japanese government debt are rising in an uncontrolled manner.



In the textbook, a sharp move higher in yields should strengthen a currency, at least until the market starts worrying about solvency. The yen has dropped from 128 per dollar in January straight down to 148 (having begun 2021 at 103 when yields were much lower). Gold in yen terms is surging to new all-time highs.

The most important bubble, socially, is the stock market. Examining the chart below, how could Allen's words be more appropriate.

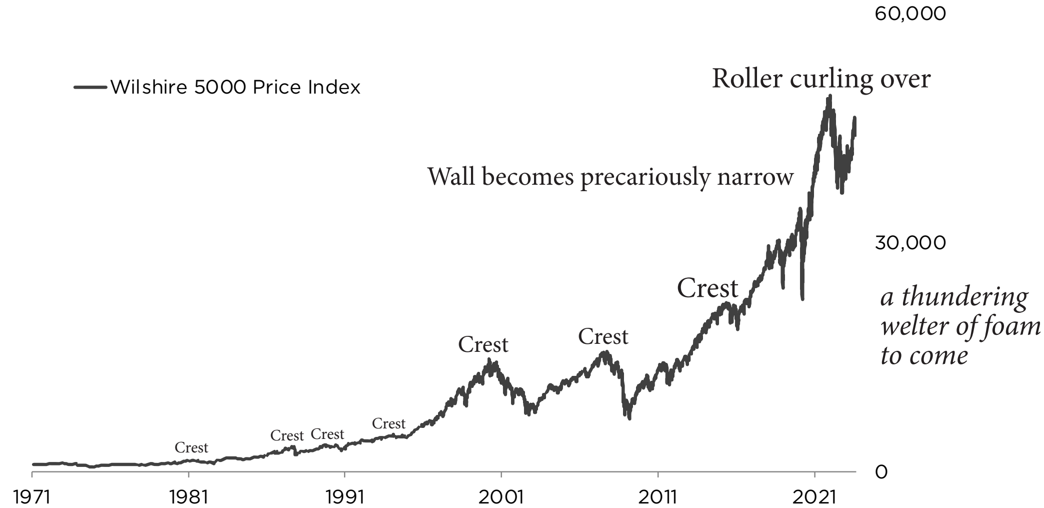
---

1 https://www.zerohedge.com/markets/another-one-fails-subprime-auto-dealership-faces-collapse

2 https://www.newyorkfed.org/medialibrary/Interactives/householdcredit/data/pdf/HHDC_2023Q2.pdf?sc_lang=en

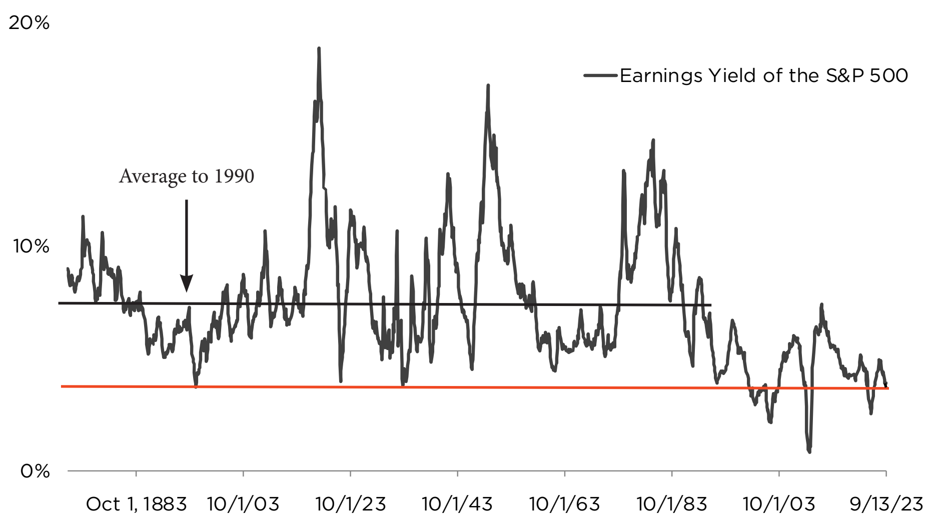
3 https://www.investopedia.com/average-credit-card-interest-rate-5076674

4 https://fred.stlouisfed.org/series/DRCCLOBS



Stock valuations have just two components: earnings and earnings multiple. From September 1929 to June of 1932, the dividend yield on the stock market jumped from 2.92% to 10.3%.[1] This by itself, assuming that dividends were unchanged, sent the market down 72%.[2] But dividends were not unchanged. Revenues fall faster than expenses in a depression, forcing dividends to be slashed, by 65% in this case. Combining a 72% decline because of multiple contraction with a 65% decline because of earnings results in a stock market return of negative 90%. No wonder the generation that lived through that event never touched stocks again.

Shifting back to our own time, the earnings yield[3] of the S&P 500 is currently 3.9% (this is the inverse of the P/E ratio). This figure was matched as a spike low in 1894 and did not reach that low again until 1998. In other words, stock prices spent a century



1 https://fred.stlouisfed.org/series/M1346BUSM156NNBR

2 To explain: posit a company that pays out an annual dividend of $2.92. At a 2.92% yield, the stock must be priced at $100 because 2.92% of $100 is $2.92. If the dividend yield on the whole market jumps to 10.3% and we assume that the $2.92 payout remains the same, then the stock must be worth $28.35 because 10.3% of $28.35 is $2.92. The stock thus falls 71.6% even stipulating that cash flows are exactly the same.

3 Tax law changes have incentivized companies to engage in buybacks, acquisitions, or reinvestment instead of issuing dividends, making earning yield a better metric at the current time. However, this yield is to the company, not cash flow to investors, and is often adjusted. https://www.multpl.com/s-p-500-pe-ratio

with yields higher than the present time. Only during the past two decades of extreme monetary expansion has the yield gone consistently lower.

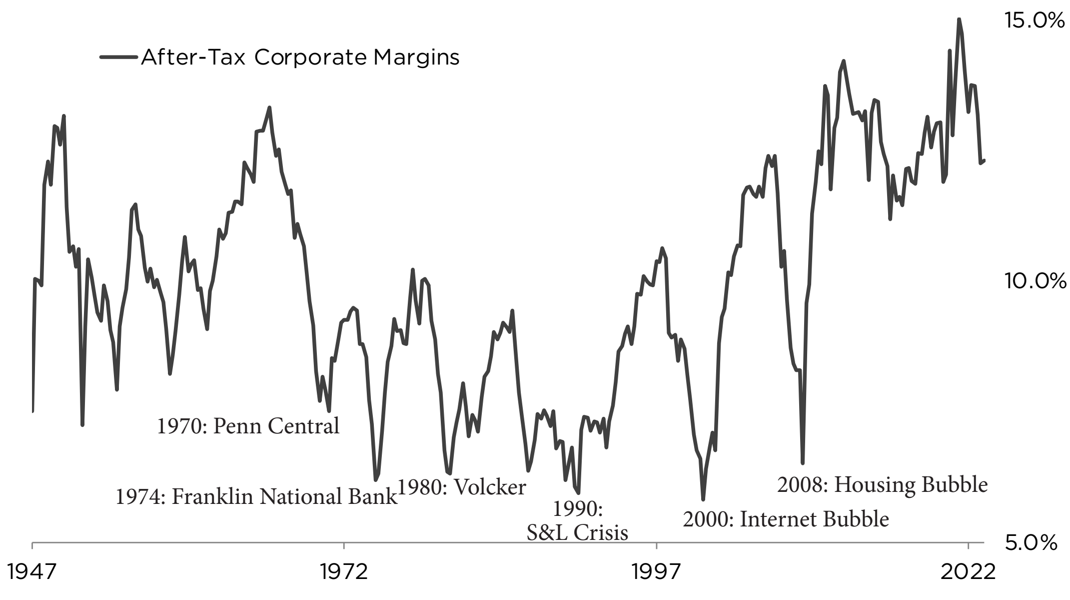
The Federal Reserve has, meanwhile, pledged to keep rates “higher for longer” to combat inflation. The yield on a 4-month U.S. Treasury bill is currently 5.5%. It is irrational to accept a yield that is 1.6% less by owning stocks, speculative by their nature—unless either the market expects that profits will grow substantially in nominal terms (either real growth or through massive inflation that somehow allows companies to maintain profit margins) or that the Fed will lower rates substantially in the near future.

More likely, stocks must fall, and fall significantly, just to increase yields to a competitive rate compared to Treasuries. A decline of 51% would push the earnings yield from the current level to 8%—the average yield from 1871 to 1990. Stock picking abilities cannot avoid this multiple adjustment. It is worth noting that near the end of the inflationary 1970s, earnings yields reached 15%, which would require a 74% decline from the present level—assuming, again, that earnings stay constant.

That is a bad assumption. Easing monetary conditions boost profit margins broadly throughout the corporate sector: companies are able to raise finance cheaply to make investments that lower costs; consumers are flush with gains from stocks and housing, increasing sales. Tightening credit conditions does the opposite.

The chart below shows that corporate margins collapsed during each of the major credit events since 1970 and then recovered with strong Federal Reserve intervention. From a broader perspective, the general trend was negative from 1965 to 1990, the beginning of the Greenspan Era: “I’m always worried about the stock market.” Since that point, margins have climbed relentlessly higher to a peak in Q2 2021.

Corporate margins have already been declining, from a peak of 15% to 12.3% in Q2 2023. They will fall sharply as high and rising interest rates integrate into the economy. The figures presented are for the whole economy, not just for companies in the S&P 500; those giants tend to have higher margins (Facebook (Meta) and Apple both have margins of 24%, as examples), which means they have further to adjust.



And, course, margins are only part of the earnings story; the other is revenue. With the popping of the credit card bubble, the housing bubble, and the stock market bubble, it is hard to see how corporate revenues could avoid a sharp decline as well, especially for companies like Apple.

Using only modestly negative assumptions for these three elements—the yield returning to 8%, profit margins falling by 20%, and static revenues—would produce a 61% plunge in the stock market. It is likely to be far worse, unless, of course, the central bank intervenes again and strongly.

Greenspan may be a malevolent figure in monetary history, but he was correct that the stock market is the key to the American system. For if anything like the above scenario were to transpire, it would topple the largest wave of all, the largest in history, the U.S. Treasury bond market.

In August, the Congressional Budget Office projected that the federal deficit in 2023 will double to $2 trillion compared to $1 trillion in 2022.[1] By comparison, the controversial, extraordinary deficit in 2009, following the housing crash, was $1.3 trillion. The CBO attributes the increase in 2023 to, among other factors, a $448 billion (19%) decline in individual income taxes (reflecting shortfalls in capital gains taxes), a $106 billion decrease in transfers from the Federal Reserve,[2] a 30% increase in interest payments, an 11% increase in Social Security spending, and an 18% increase in Medicare.

In June, the CBO projected a 2024 deficit of $1.5 trillion (and that it would only grow thereafter). But its projections assume continuity in economic affairs. Interest payments on the debt and tax revenues are already materially worse than projected. If the credit wave crashes, government expenditures will spike and tax revenues collapse.

But let us ignore that for a moment and assume, heroically, that the CBO's projections will prove accurate. The U.S. Treasury is going to need to issue $3.1 trillion in new bonds over the next two years, adding to the existing stock of $32.3 trillion. It will also have to replace another roughly $3 trillion of maturing Treasuries. And the market has to absorb sales by the Fed, China, and potentially Japan, if the yen situation worsens. The question is not who will buy these $6 trillion in bonds; the question is at what price, at what yield.

For the moment, yields are well behaved. Myrmikan's previous letter discussed how money parked at the Fed, whether by the U.S. Treasury or by financial dealers in the reverse repo account, is thereby removed from the banking system and cannot add to inflation. We pointed out, further, that the reverse repo facility peaked at $2.6 trillion, or more than half of COVID QE.

Treasury rates are creeping higher, and the Fed has allowed the reverse repo rate to persist at a slightly lower rate. Institutions have, therefore, withdrawn cash from the reverse repo presumably to purchase Treasuries (as an alternate risk-free asset). From May to now, the Treasury has raised $1.5 trillion from the public, half of which came

1 "As reported in the Monthly Budget Review: July 2023, CBO updated its projection of the deficit for all of fiscal year 2023 to $1.7 trillion. Without the outlay savings recorded in August 2023 to reflect the Supreme Court's ruling, that shortfall would be about $2.0 trillion. The deficit for fiscal year 2022 was $1.4 trillion. Removing the cost recorded in September 2022 for student loan debt cancellation, that amount would be $1.0 trillion. Excluding the effects of the changing plans for student loans, the deficit is on track to double from $1.0 trillion in 2022 to $2.0 trillion in 2023, CBO estimates." https://www.cbo.gov/publication/59474/html

2 The Fed is required to remit most of its profits to the Treasury, but it is now making extensive losses.

from the reverse repo.[1] Over the past month, the incremental issuances of Treasuries has matched the withdrawals from the reverse repo.[2]

This Federal Reserve policy is not only funding Biden's mad deficit spending in preparation for the 2024 election but is incredibly inflationary. It is delayed QE. The money may have been printed in 2021, but it is only now escaping the basement of the central bank, and in the most inflationary way. The Treasury issues a bond, takes the funds from the reverse repo, transfers it to favored constituents, who spend it. This has led economists such as Paul Krugman to bleat: "The economic data have been just surreally good. Even optimists are just stunned."

The newly issued Treasury bonds, meanwhile, represent value that does not exist, that has been destroyed. Ninety-three percent of the federal budget is for entitlement transfers, the military, and interest. Much of remaining 7% is similarly wasted. Nevertheless, the financial institutions that withdrew the funds from the reverse repo now have Treasury bonds that act as collateral that the banking system uses to create credit. The system is surreally bad.

However, like the strategic petroleum reserve, which Biden drained for political purposes, the reverse repo, the delayed QE, will soon be depleted. What will happen to interest rates then?

In slowdowns and crashes heretofore, asset and goods prices have plunged together, allowing the Fed cover to print, reduce interest rates, and allow the credit wave to maintain its balance and sweep on even greater than before. The wave may be too steep this time. The degree of QE needed to lower rates will be stunning; not that they will not try, but they will quail at the magnitude necessary.

And there may not be deflation to give the Fed cover to print. Macro conditions are exactly opposite to the disinflation of the 1990s: total public debt as a percentage of GDP is 120%, preventing the U.S. Treasury from offering a sustainable, positive real yield on its debt; underinvestment in mining and energy production caused in part by the Marxist global warming scam has reduced supply in certain key commodities (sanctions on Russia has reduced supply further); rising input prices meet a hollowed-out industrial base (China's shrinking population will lower productivity and raise import prices as well); and technological innovation is directed ever more towards entertainment instead of productivity.

When the next crisis begins, insecurely margined traders will lose everything, but the consensus will be that the wave of values and of stock-market credit will catch its balance again and move forward. That the whole wave could go crashing down seems almost inconceivable.

This backdrop makes gold investors understandably frustrated. The final end of the Keynesian experiment approaches, yet gold is uninspiring and the miners are a disaster. Consider, however, that while the gold miners liked the initial printing to save the system in 2009, it did not like QEs II and III. The previous plunge began in late 2011, right as the Fed was scheming to expand its balance sheet by another 60%. Gold miners fell and fell, then investment funds closed, and the miners fell more. When the stocks finally turned it was explosive.

1 https://fiscaldata.treasury.gov/datasets/debt-to-the-penny/debt-to-the-penny
2 https://fred.stlouisfed.org/series/RRPONTSYD

The delayed QE is causing similar conditions: absurdly high valuations in tech (see Nvidia) and absurdly low in gold mining. The deficits, the QEs, the cresting bubbles in crypto and such, they are not what drives the gold price to the next level—the missing piece is the lagging consequences of these developments, the financing crisis to come and the central bank's inevitable reaction. We're nearly there.

The analogy for gold investors is not a wave cresting into a shoal, but a harbor from which the water suddenly retreats, leaving the boats lying on the wet sand crooked; perhaps some tourists wander out to see the pretty shells. The animals and birds know better and are flying for the hills. The local premium for gold in China is $100/oz. They know what is about to happen. When the water comes back in, nothing can stop it.

Departing from the Beaver Creek Precious Metals Summit last week, we pondered that a number of the companies we met with—with economic and growing gold resources, with development plans and permitting progressing, often managed by or employing one or multiple PhDs—are valued by the market less than fancy flats in New York City. We suspect that the market will rectify that imbalance, probably in dramatic fashion and soon.