

# Myrmikan Research

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

## Spiking the Punch Bowl

Federal Reserve chairman Jerome Powell announced in his Jackson Hole August 23 speech that the Fed is preparing to begin sustained interest rate decreases this month: “The upside risks to inflation have diminished. And the downside risks to employment have increased.... The time has come for policy to adjust.”

The Fed’s stance is remarkable because it violates the storybook version of central bank management that was presented in 1955 by Fed chairman William McChesney Martin:

It seems rather striking that one of the ideas now firmly embedded in our articles of material faith, the concept of governmental responsibility for moderating economic gyrations, is almost entirely a product of our own Twentieth Century.

This concept, which is steadily being brought into sharper focus, has evolved from general reaction to a succession of material crises heavy in human hardship. It grew from mass desperation and demand for protection from economic disasters beyond individual control.

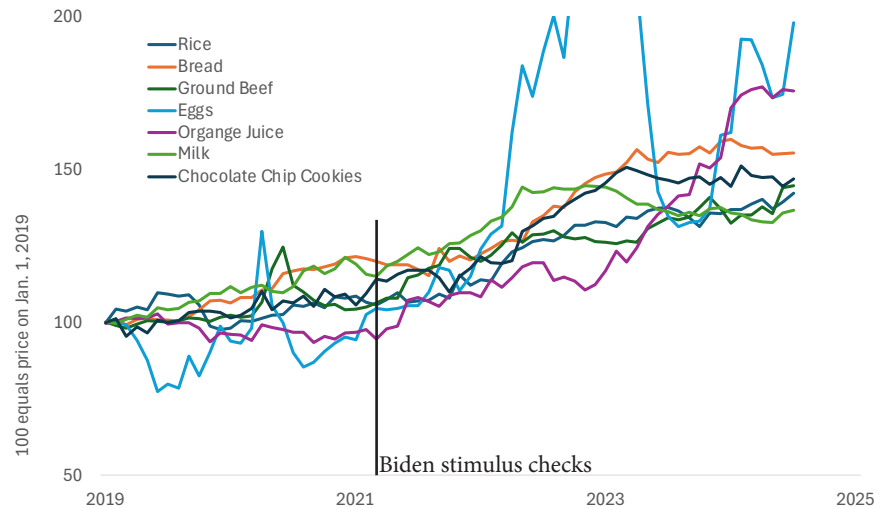
The Federal Reserve System, which I have the honor to represent, was our earliest institutional response to such a demand. It emerged out of the urgent need to prevent recurrences of such disasters as the money panic of 1907, and out of the thought that the Government had a definite responsibility to prevent financial crises and should utilize all its powers to do so.

While he did not say it, Martin was aware that Federal Reserve interventions are, at essence, money printing (or, to be precise, credit printing), which brings financial excesses. Therefore, once the crisis was over, Martin added that the Federal Reserve was “in the position of the chaperone who has ordered the punch bowl removed just when the party was really warming up.”

Powell is in the opposite camp: there is no crisis, and he spiking the punch bowl to try to keep the party going: The NASDAQ stands only 9% below its intra-day all-time high, up 152% since 2019. Nvidia, the poster child for this bubble, remains 1,600% higher than pre-COVID, retaining a \$2.6 trillion market cap. Official CPI was up 2.9% in the past twelve months. The Case-Shiller U.S. National Home Price Index hit a new record in June (its most recent reading), up 5.4% annually, up 53% since COVID. Electricity prices are rising at 5.3% per year; homeowners insurance premiums are increasing at 7.1% annually. And the Fed wants to ease?

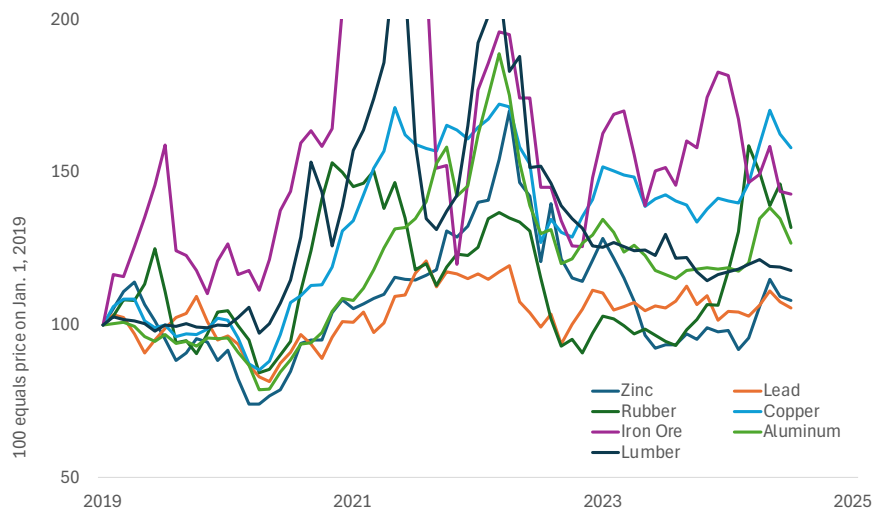
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Major food staples stand at or near record highs, having surged in the four years under the Biden presidency: note that prices did not start to inflect sharply higher until March 2021, when the Biden stimulus checks arrived.



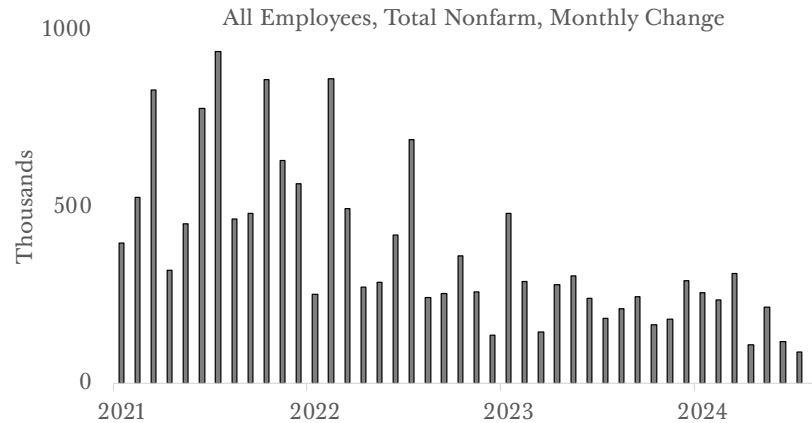
Note also that despite candidate Harris's charge that grocery stores are price gouging, the grocery store industry net profit margin in 2023 was 1.6%. She is correct that large companies have too much market power, but these price increases are clearly a response to money printing and inflation. And the Fed proposes to ease?

On the other hand, there seems little doubt that the economy is slowing as the COVID-stimuli wear off. Whereas the goods consumers buy are at or near record highs, industrial commodities (which are demanded mostly for capital investments) show a very different story. Prices spiked higher and faster than food commodities in response to Fed credit creation (as opposed to Biden/Harris/Yellen money printing). But they are now in downtrends as the interest-rate sensitive portions of the economy begin to stutter.



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Employment is looking shaky as well, as the chart below shows.



Keynesian and monetarist theory assume that the economy is an aggregate: money printing causes inflation, which causes all prices to go up equally; credit policies expand or inhibit the economy as a whole. In reality, the well-known Cantillon Effect means money *flows* into an economy, raising some prices (and incomes) first and others later; credit policies affect the capital-intensive portions of the economy much more than those portions closest to the consumer.

It should not surprise, then, that the data supports Powell’s claim that “the downside risks to employment have increased” because capital-intense businesses are suffering under the high rates. It does not necessarily follow and is not at all obvious, however, that “the upside risks to inflation have diminished.” Not only are many consumer prices at record highs and rising, the “Sticky Price Consumer Price Index,” which is “a subset of goods and services included in the CPI that change price relatively infrequently,” is still rising at a 4.2% annual rate.

In its previous FOMC statement, the Fed admitted that “the Committee is attentive to the risks to both sides of its dual mandate” of maintaining high levels of employment and constraining inflation. It seems the Fed has made a choice during this election season to support jobs and let inflation run.

Investors should be mindful, however, that the past supports the Austrian economic thesis that in order to maintain artificially high rates of capital growth, the central bank must print at an ever-increasing rate. In other words, an effective stimulus will require credit creation greater than 2008, greater even than COVID. And that will be hard to justify without a large accident in the capital markets.

Gold is unique in that it is the one capital asset that is priced like a good: to explain, capital is valuable because it earns income over time, making its price highly dependent upon discount rates. Industrial commodities are demanded principally to construct (and maintain) capital assets, making commodity prices highly levered to the value of capital assets (and, therefore, even more so to discount rates). Gold, by contrast, is valued as money, as value in the present. This is why gold underperforms during a credit bubble—when discount rates are falling and capital assets and commodities are surging—and outperforms in the bust. This is the reason why despite growing uneasiness in the capital markets, gold sits stubbornly just at all time highs, up 96%

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since 2019. Gold senses what is coming: further debasement by the next administration, whichever it is, and money printing by the Fed at a shocking pace.

The gold miners have yet to participate in gold's rise. Unlike gold, gold mines are capital assets, the values of which are dependent on future cash flows and capital inflows. Consider September 3, a day on which oil fell by 5.8% and the gold price was flat. That was a fantastic day for the economics of mining: revenues were constant, and one of the major costs fell precipitously. Of course it takes time for such changes to flow into cash flows, but the whole point of financial markets is to react to such changes immediately. Yet gold stocks got clobbered on September 3 from adverse financial market liquidity.

Just because gold stocks responded in the moment to general asset prices, however, does not mean that they are defective hedges against the coming financial chaos. We know from the 1930s and the 1970s that over all but the shortest of time frames gold mining shares do respond to the economics of mining: capital does and will find value.

It is already happening. On August 12, Gold Fields acquired Osisko Mining at a 55% premium to its 20-day VWAP, which implied a price of \$220/oz, the most expensive transaction since the 2021 froth when Kinross acquired Great Bear for \$275/oz (and the resource wasn't even defined until post-acquisition).

The difference between 2021 and now is that the gold price is trending higher not because of the sugar rush of Fed printing COVID money but because of major structural issues in the U.S. dollar. The Osisko acquisition put other companies on notice that they will have to pay up for premier assets. It also removes a large development project from the market. The juniors are challenged now because of the lack of capital flowing into the junior subsector. But they are far more operationally levered than the mega projects, and capital will find them at some point.

In the late 1990s, there was an analyst at Prudential Securities pounding the table on steel prices and steel mill stocks. His analysis was compelling even as steel prices slipped over 30% from 1998 to 2001, putting huge pressure on steel mill stocks. In 2001, the brokerage firm quietly let him go and dropped coverage of the steel universe. Steel prices promptly tripled. Nucor shares went up nine fold. U.S. Steel shares went up eighteen fold. Gold mining stocks are in a similar place as steel mill stocks were in 2001, except that the underlying commodity has already started to run. The miners will catch up.



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