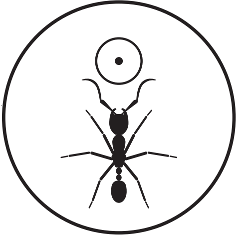

Myrmikan Research

February 14, 2018

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End Game

Myrmikan erroneously called the end of this credit cycle in the summer of 2015. China's stock market had cracked, and the world was following the classic model of how credit bubbles pop, repeating a pattern established in the nineteenth century. The fractional reserve money creation process would push yields in the London money center artificially low. Low rates would encourage domestic malinvestment and prompt capital to go abroad in search of higher returns in sketchy locations. Overcapacity always ends a boom, usually affecting the credit periphery first because the most thinly capitalized are the least able to bear the diminution in cash flow that overcapacity brings. As capital began to be wiped out abroad, there would grow a need for liquidity in the money center from those most affected, which would drive interest rates higher, and thus the contagion would spread to the center.

The 2008 panic was a variation of this story in that the periphery was not some place like Argentina or Poyais (a fictional country of which Scottish adventurer Gregor MacGregor purported to be king in order to raise credit in London) but the U.S. subprime housing market. Nevertheless, the mechanism was the same: despite the Federal Reserve's continual claims that it had "contained" the risks, losses in subprime housing credit crept inwards toward the center until the fractional reserve process suddenly reversed and nearly took down the global banking system.

In the summer of 2015, it appeared as though the market had finally realized that all of the Chinese malinvestment in ring-roads, scale copies of Manhattan and Paris, empty malls, maglev-trains to nowhere, and the infrastructure to build such had the same value as the sovereign debt of Poyais. China consumes roughly a third of most important industrial commodities (it imports roughly half and then re-exports around a sixth), so commodities fell swiftly, putting pressure on especially the European banks that had funded many commodity projects in Latin America. Since European banks are connected to U.S. banks through the hundreds of trillions of dollars of notional derivative exposure, the contagion swiftly spread to the U.S. market with the DJIA sinking more than thirteen percent in the space of a month.

The world received a sudden reprieve, however. Unlike the nineteenth century, when societal adherence to classical liberalism prevented politicians from resisting the market to any great extent, the sabotage of the gold standard has allowed the bureaucrats to push monetary intervention deep into reckless territory. In China's case, the ruling communists are aware that instability means regime-change, so they cannot allow the

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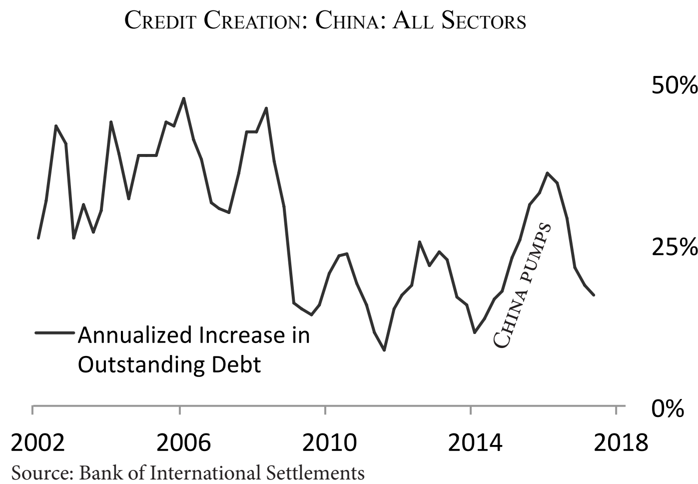
credit bubble to unwind. The only thing to do was to double-down on the model. As the chart below shows, the authorities permitted/encouraged credit creation to return to absurd pre-2008 levels.

CREDIT CREATION: CHINA: ALL SECTORS



Source: Bank of International Settlements

The Chinese stimulus bought another two-and-a-half years and counting: its market recovered, commodity demand recovered, and the banks were saved. But, as anyone with even a passing familiarity with Austrian economics knows, more credit cannot solve a credit crisis—all it can do is delay it while making the ultimate adjustment worse. And, with credit growth plummeting after the Communist Party Congress established Xi Jinping as the most powerful Chinese ruler since Mao, it was a good bet that a crisis worse than 2015 would soon erupt.

But then Donald Trump intervened to alter completely the likely path of the next credit implosion. First came the tax cut. Tax cuts are good because they defund the state, which, as H.L. Mencken observed: "still remains, as it was in the beginning, the common enemy of all well-disposed, industrious and decent men."

Then came the spending increases. Most of the government's budget is subject to automatic increases, and, as if that were not enough, last week's budget deal increased spending by an additional $300 billion over the next two years, a discretionary increase that yields only to Obama's stimulus in size. Republicans seem to have forgotten, or never learned, Milton Friedman's dictum that the burden of government is not how much it taxes but how much it spends: they are always willing increase government spending as long as it is done on their watch.

Increasing expenditures sharply while decreasing revenue will result in increasing deficits. A big increase. It is true that lower taxes will boost the entrepreneurial spirit and productivity, but the trajectory of the deficit after the Reagan tax cuts demonstrates that additional tax revenue is never enough to satisfy Congress. And, whereas Reagan cut taxes in the context of a public debt-to-GDP ratio of 31%, that figure is currently 104%.

Mike Mulvaney, Trump's own budget director, admitted in an interview this week, first, that he would not have voted for the budget had he still been a congressman and, second, that the deficit in 2019 will now be around $1.2 trillion, or around 6% of GDP, a level usually associated only with war and economic crises. Last June, the Congressional

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Budget Office projected that the 2019 deficit would be $689 billion. In the space of only seven months, the projected 2019 deficit has exploded by 74%, and that is with the economy growing at a nominal rate of 4.1%! Whatever happened to saving in the boom to spend in the bust? Imagine what it will look like if a recession hits, increasing social payments as tax revenue decreases.

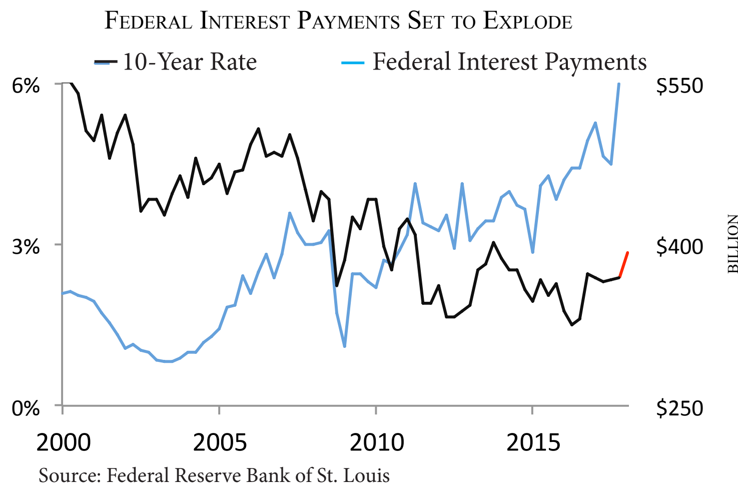
The budget deal, in fact, has made that outcome much more likely. The Treasury Department recently published their planned auction schedule to place the enormous quantities of bonds needed to raise the funds. The huge increase in supply is occurring at the same moment that the Federal Reserve is selling its bonds into the market. The anticipation of simple supply and demand dynamics has already slaughtered the bond market: the yield on the 10-year Treasury bond has spiked from 2.32% in early December to 2.85% yesterday (it was 1.37% back in July of 2016).

That increase may not sound like a lot, but they teach in business school that the U.S. Treasury yield represents the risk-free rate, and all other cash flows are priced at a spread to that rate. If we consider, for example, a 50-year cash flow growing at 5% per year (equity cash flows are theoretically infinite, though in reality busts make them quite finite), increasing the discount rate from 2.32% to 2.85% reduces the net present value by 14% (an increase from 1.37% to 2.85% reduces it by 36%).

Mr. Mulvaney, in fact, frankly admitted: "Certainly there is a risk that interest rates will spike. . . . I think what triggered [the thousand point drop in the market] was not the fact that we were overheating the economy but that we were borrowing too much money. The Treasury had reached out to some of the primary [Treasury bond] dealers last week to anticipate the additional debt."

A quotation from the president of the Federal Reserve Bank of Philadelphia Patrick Harker last week completes the thought: "If you start to believe that the long end of the curve is going to start to go up, it makes sense that equities would have an adjustment."

The increase in rates does more than just lower equity valuations—it calls forth an additional supply of Treasury bonds, as the chart below reveals.



Source: Federal Reserve Bank of St. Louis

Interest *payments* on the debt have been increasing sharply even as the interest *rate* has been plummeting because of all of spending under Bush and Obama. Note that

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the last data point on the interest payment line is the fourth quarter of 2017, whereas the last data point on the 10-year rate line in red includes the current value for the first quarter of 2018: the payment spike has begun even before rates begin their serious increase.

Mounting interest payments will force Congress to borrow even more money to pay for them, which will add to the supply of Treasuries, which will send their prices lower and rates and interest payments higher again in a positive feedback loop.

Many budget commentators worry about the trajectory of deficits over the next decade, but they miss the bigger picture. A progressive tax system requires that incomes keep rising in order to keep revenues rising to pay for rising spending. If increasing interest rates send the market sharply lower, capital gains and income will follow. The system is not going to implode in a decade, but as soon as the market stops rising. After all, Ben Bernanke spent years lecturing the country about how his policy of artificially lowering rates would create a wealth effect:

> [L]ower corporate bond rates will encourage investment. And higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion.[1]

Why should not higher rates, then, reverse all of these effects?

Falling tax revenue will exacerbate the debt problem and become part of the vicious loop: 1) higher rates, 2) additional supply of Treasuries, 3) higher rates, 4) falling asset prices, 5) lower tax revenue, 6) additional supply of Treasuries, and repeat. Missing from this progression is the fate of pension funds and the effect of the "automatic stabilizers" such unemployment benefits and welfare, which will add to the virulence.

The cost of this folly will land particularly on those holding dollars and most especially on those holding assets that promise to pay dollars in the future, the largest of which is the Federal Reserve. As rates go higher, the value of the Federal Reserve's holdings will be crushed.

In 1969, at the beginning of the previous inflation-induced default on American obligations, 23% of the Federal Reserve's Treasury bond holdings had a time to maturity of less than 90 days and 1.2% had a maturity date greater than 10 years. The Treasury bond portfolio itself comprised 68% of the Federal Reserve's assets, the balance being "cash items in process of collection," foreign currency, and gold. That was a resilient balance sheet.

Currently, 6% of the Federal Reserve's Treasury bond holdings have a time to maturity of less than 90 days and 26% have a maturity date greater than 10 years. The Treasury bond portfolio itself comprises 55% of the Federal Reserve's assets, and another 40% is comprised of mortgage-backed securities. That is not a resilient balance sheet—it is highly sensitive to interest rates.

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1 https://www.federalreserve.gov/newsevents/other/o_bernanke20101105a.htm

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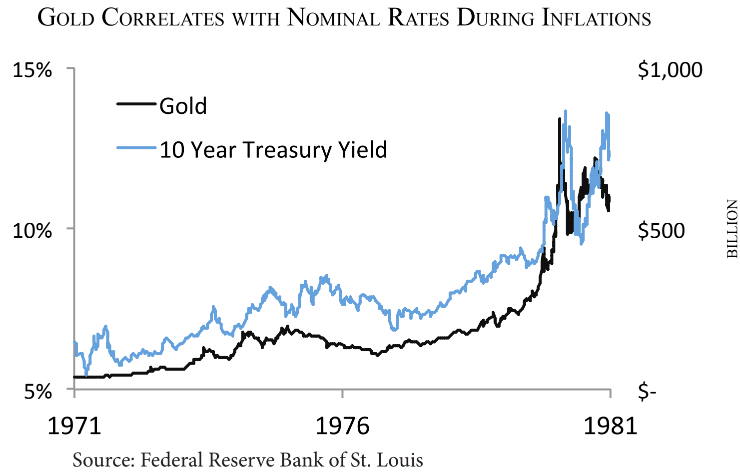
Myrmikan has argued for eight years that it is rising rates that will destroy the value of the Federal Reserve assets and, therefore, the value of its liabilities, a unit of which is known as a "dollar." Gold, having the most stable value of any substance in nature, must rise as the dollar falls. Therefore, gold naturally correlates with interest rates, as the following chart of the inflationary 1970s illustrates.

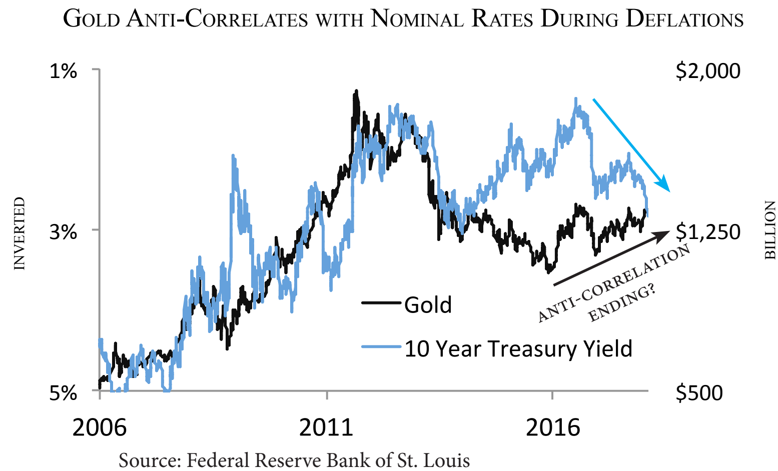
GOLD CORRELATES WITH NOMINAL RATES DURING INFLATIONS



Source: Federal Reserve Bank of St. Louis

The problem with the thesis is that for more than a decade, gold has been anti-correlated with rates (note that, unlike above, the left axis is inverted):

GOLD ANTI-CORRELATES WITH NOMINAL RATES DURING DEFLATIONS



Source: Federal Reserve Bank of St. Louis

Myrmikan's explanation for this anomaly has been that in a world in which there are around US$4 trillion of base money demanded by the interest needed to service the $90 trillion of U.S. dollar denominated debt, increases in rates intensifies the short-squeeze on the dollar by forcing borrowers to hold larger cash buffers against these interest payments. The two scenarios that can break a short-squeeze are either mass default—the debts are written off so the need to hold dollars diminishes—or enough supply coming into the market, which Trump is busy working on.

Already the rise in rates has resulted in a sharply lower trade-weighted dollar, which has lost over 5% since November when rates started to take off. That isn't supposed to

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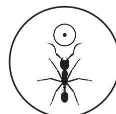
happen. Under conventional theory, higher rates attract the marginal bond investor—and, to buy the bonds, first they must buy the currency. Only by understanding that the dollar as a unit of liability of the Federal Reserve reflects the value of its assets does it makes sense that a sharp rise in rates should result in a sharp drop in the dollar.

Trump actually wants a lower dollar because he thinks it will grant the U.S. a trade advantage. His Treasury Secretary proclaimed at Davos: "Obviously a weaker dollar is good for us as it relates to trade and opportunities," as if the perennial policy of Argentina and Zimbabwe had brought them peace and prosperity. Of course the opposite is true: a weak dollar increases prices for consumers and diminishes the pay producers get for their work.

Usually it is the provinces that are the most reckless, the reason why most crises begin there. But Trump's policy—cutting revenue, increasing spending, while planning great infrastructure projects, while preparing for war—increases the chances that the next crisis will begin at the center. Trump's policy mix is an old one, pursued by the Romans under empire, Italy and Germany in the last century, not to mention Nixon and Bush. History is very clear on the outcome.

One of the largest dangers, in fact, is that the good parts of Trump's legacy will be tarnished for decades. The Tariff Act of 1857, for example, reduced protective duties to historically low levels in keeping with the nineteenth century's embrace of free trade. The raging railroad bubble burst within a year, and the tariff reduction got the blame. American's next president boasted: "My politics can be briefly stated. I am in favor of the internal improvement system, and a high protective tariff" as he took the country to war. When the bubble bursts, Trump's tax and regulatory cuts will get the blame, not the spending. Democrats will be catapulted into power, as they were in 1933, allied with Jeremy Corbyn (the UK's version of Bernie Sanders) across the pond, in an even more virulent rendition of the 1970s. Just imagine the pain to come, when rising interest rates and a plunging currency force dramatic spending cuts despite soaring taxes imposed by the socialists. This nightmare has a good chance of happening, which is why the well-disposed, industrious and decent need to protect themselves with gold now.

Once gold begins to correlate with rates again, as it did in the 1970s—and, as the previous chart shows, they may already be happening—it will signal the beginning of the end game for the dollar and for the markets and the beginning of gold's hyperbolic move. Positive feedback loops do not last long because they intensify at an exponentially increasing rate until the system blows apart. Gold moved from \$103 in August of 1976 to settle at \$843 in January of 1980—it rocketed eight times higher in the space of three-and-a-half years. This time around the bubble is bigger and the Federal Reserve's balance sheet is worse. The final move, once it starts, should be further and faster.



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