

Myrmikan Research

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The Fed Begins to Ease

The gold complex is impatient. For six long years the price of gold has failed to break above \$1,370/oz. Every attempt to cross that line has been beaten back mercilessly. The stakes are enormous. At \$1,300/oz, most gold mining companies make decent cash: enough to pay down debt gradually and provide for nice salaries. But—especially after the trauma of the past seven years—that price does not entice them to speculate in new projects. And if the gold companies are not going to lead, third-party capital will seek other sectors.



When gold finally breaks out above \$1,370/oz, it will likely explode higher, for it will signal the end of the current trading range and the resumption of the uptrend that began in 2000.

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The effect on the mining sector will be enormous. If \$1,300/oz provides a decent living, \$1,600/oz at the current cost structure is decadent. Senior mining companies suddenly will have more cash than they can deploy in their current projects. The majors on average have seen their reserve lives fall from eleven to eight years during the trough and will have to acquire projects from intermediates: it is the only way to rebuild reserves rapidly. Intermediates, in turn, will have no choice but to snap up the juniors, many of which are marooned with no access to capital and trading at 2015 lows. The first movers will be able to exploit the bargains, but competition for the paucity of decent projects will quickly cause share prices of good juniors to spike.

These trends will be exacerbated by the return of external capital to the sector. At \$1,600/oz gold, cash flow generation will be such that the mining industry won't need external capital, and that is always precisely when it plunges into a sector. And gold isn't going to stop at \$1,600/oz. Once it gets going, it will easily surpass the previous record of \$1,900/oz.

The previous parabolic move in gold—from 2000 to 2011—occurred in the context of a credit bubble. Gold may have been rising in dollar terms, but it was falling in terms of industrial commodities. Gold rose 3.2 times from 1999 to mid-2008, for example, but oil jumped 11.6 times. Advancing gold prices were met with mining costs rising even faster, compressing margins. The mining shares delivered underperformance instead of the leverage they are supposed to—how terrible to accept all of that enormous project risk and still underperform the metal itself.

The next parabolic move in gold, by contrast, will be in the context of global currencies collapsing. Prices of industrial commodities—which determine the major input costs of gold mining—may rise in nominal terms, but they will fall in real terms. The gold mining shares will finally deliver the storied operational leveraged they exhibited in the 1930s and the 1970s.

That this outcome will occur is not in doubt, nor is such a statement hubristic. Thousands of years of history confirm common sense that excessive deficit spending by government must result in accelerating debasement and economic collapse. It is true that debasement at first gives a jolt to industry, increasing demand for industrial commodities as capitalists construct hard assets for protection (as from 2000 to today); but overcapacity soon devalues these false havens as well.

Instead of repeating the somewhat tedious technical explanation found in previous letters as to why this occurs, let us instead review one particular episode to learn from its example: the French assignat as recorded by Andrew Dickson White in 1896.

The plenty of currency had at first stimulated production and created a great activity in manufactures, but soon the markets were glutted and the demand was diminished.... Heavy duties were put upon foreign goods; everything that tariffs and custom-houses could do was done....

With the plethora of paper currency in 1791 appeared the first evidences of that cancerous disease which always follows large issues of irredeemable currency.... [A]t the great metropolitan centers grew a luxurious, speculative, stock-gambling body, which, like a malignant

tumor, absorbed into itself the strength of the nation and sent out its cancerous fibres to the remotest hamlets. At these city centers abundant wealth seemed to be piled up.... In the schemes and speculations put forth by stock-jobbers and stimulated by the printing of more currency, multitudes of small fortunes were absorbed and lost while a few swollen fortunes were rapidly aggregated in the larger cities....

This great debtor class, relying on the multitude who could be approached by superficial arguments, soon gained control ... [and] a superstition gained ground among the people at large that, if only enough paper money were issued and were more cunningly handled the poor would be made rich....

In speeches, newspapers and pamphlets about this time, we begin to find it declared that, after all, a depreciated currency is a blessing; that gold and silver form an unsatisfactory standard for measuring values....

This decline in the government paper was at first somewhat masked by fluctuations. For at various times the value of the currency rose.... But despite these fluctuations the downward tendency soon became more rapid than ever.... None felt any confidence in the future in any respect; few dared to make a business investment for any length of time and it was accounted a folly to curtail the pleasures of the moment.*

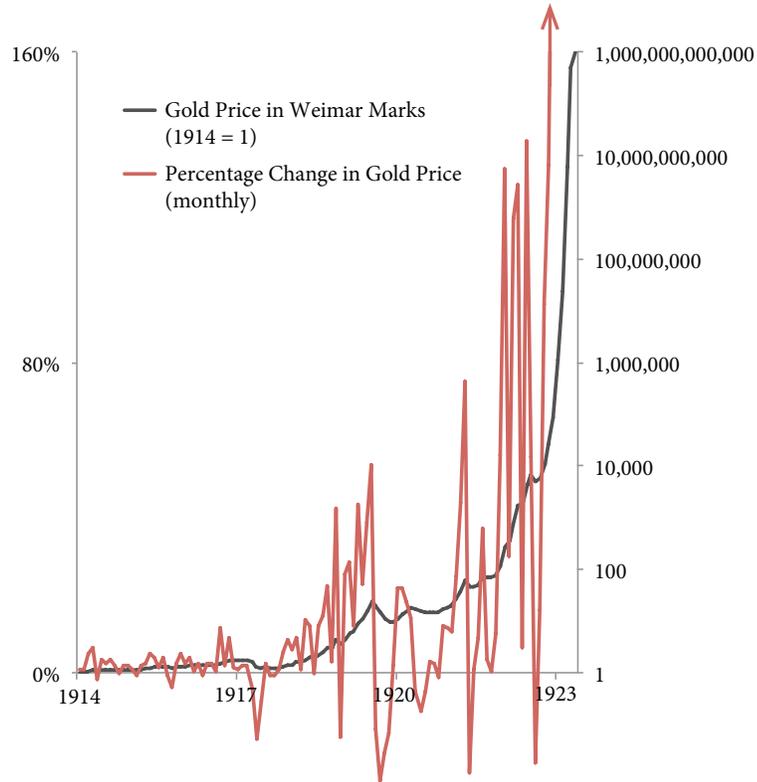
Here in history we see our present age. Stimulus leads to gluts, which leads to depression, which leads to more stimulus. Tariffs attempt to neutralize global overcapacity. A falling currency causes asset prices to soar. Fortunes become concentrated, leading to “QE for the people,” which has been renamed Modern Monetary Theory. In the second stage of currency debasement, the crashing currency inhibits industry instead of stimulating it. This is the stage for which the gold miners wait.

This pattern was already known at the time France was inflating. White wrote of one pamphleteer: “Anyone today reading his prophecies of the evils sure to follow such a currency would certainly ascribe to him a miraculous foresight, were it not so clear that his prophetic power was due simply to a knowledge of natural laws revealed by history.” But France printed anyway, and so is every nation today. It requires no miraculous foresight to see that the dollar’s value is going to collapse and, therefore, gold is heading very much higher.

But the simplicity and inevitability of the gold thesis masks a snare. As White mentions in his text, the value of the assignat sometimes *rose* on its way to zero, which is another way of saying that the price of gold did not go straight up. The reason is that the faster prices rise, the more speculators will borrow in nominal terms to bet on higher prices. Any pause in the advance of prices—even if they rise at a pace slower than the nominal interest rate—and a reaction sets in. Speculators sell to meet margin calls, which tips over the next speculator, and so on: there is a giant short squeeze on cash. Because borrowing levels increase as a currency devaluation gathers pace, the reactions become more pronounced, and the currency become more volatile. This means that for domestic speculators, who think and borrow in currency terms, it appears as if gold becomes more volatile as it rises.

* White, Andrew Dickson. [1896] 1933. *Fiat money inflation in France: how it came, what it brought, and how it ended*. New York: D. Appleton-Century Co.

The chart below shows this phenomenon in terms of gold priced in Weimar marks.* Looking at just the price line, betting on gold seems the most obvious trade there could be. How many speculators could resist leveraging up their bets (even at enormous nominal interest rates) only to be wiped out in the unexpected reactions? Hubris in the gold trade is exhibited not by assuredly predicting the ultimate outcome but by being financially and mentally unprepared for the volatility.



Myrmikan has long been agnostic as to whether gold's initial move in the coming financial panic will be up or down. Examining the chart on the front page, imagine how many investors will be thrown out of the trade if gold breaks down through the rising trendline in place since 2000. It could happen: repeating the 2008 experience would mean a sharp correction followed by a good tripling once the Fed starts to print wholesale. A different market structure created by a six-year correction, however, suggests we have already seen the reaction and can launch higher directly when the financial system cracks.

And we may not have to wait long. According to a recent CNBC survey, 63% of economists forecast a rate hike in 2020 if not before. They are looking at lagging indicators such as unemployment (NB: the government recorded that unemployment in August 1929 was 0.4%†). The fed funds futures market, on the other hand, implies an 80% chance that the Fed will cut rates. The economists and the market cannot both be correct, and there is one particular market signal that indicates that—not surprisingly—it is the market that will proven right. But to understand the signal requires some background discussion.

* Bresciani-Turroni, Costantino. *The Economics of Inflation: a Study of Currency Depreciation in Post-War Germany 1914-1923. With a Foreword by Lionel Robbins.* Translated by Millicent E. Sayers, Allen & Unwin, 1968.

† National Bureau of Economic Research, Unemployment Rate for United States [M0892AUSM156SNBR], retrieved from FRED, Federal Reserve Bank of St. Louis

Banks are required to keep a certain proportion of their assets as reserves at the Federal Reserve. Pre-2008 crisis, banks held as little reserves as possible since reserves earned no interest. Banks with excess reserves would lend them out to other banks who needed more reserves to support lending growth. The market interest rate on excess reserves is called the fed funds rate, which by definition is the lowest rate available in the banking system.

In order to lower interest rates, the Fed would buy Treasury bonds from banks and pay for them by increasing the reserve account balances of the sellers. This increase in the supply of reserves decreased the rate needed to borrow them (i.e., the fed funds rate), lowering the cost of capital for the whole banking system. Conversely, when the Fed sold Treasuries, reserve balances would fall, and the fed funds rate would increase.

There was a second mechanism to ensure interest rates stayed where the Fed wanted them: the discount rate. Banks in trouble could borrow from the Fed itself at the discount rate, which was set considerably higher than the fed funds rate. Thus, in a crisis, even if the Fed's open market operations were insufficient to control the market, the discount rate put an upper limit on the fed funds rate.

During the 2008 financial crisis, the Fed flooded the system with reserves so that banks would not have to sell their impaired assets to meet reserve requirements. The quantity of reserves held at the Fed that exceeded statutory requirements jumped from less than \$2 billion in 2007 to \$2.7 trillion by 2014. With such an enormous quantity of excess reserves, all available to be lent, the fed funds rate was stuck near 0%. The Fed then faced a quandary of how to raise interest rates to constrain out-of-control asset markets.

The solution was to start paying interest on excess reserves (IOER). The theory was that increases in the IOER would also increase the fed funds rate. The fed funds rate should not be less than the IOER because no bank would prefer to lend to another bank when it can get the same or higher return from the Fed. The fed funds rate should also not be more than the IOER because to the extent that it is, banks can earn a spread by withdrawing reserves from the Fed and lending into the inter-bank market until the supply of funds pushes the fed funds rate back down to the IOER.

During the first ten years of the program, the fed funds rate persisted well below the IOER. The Fed's proffered explanation is that a bank that tries to earn a spread by borrowing from the fed funds market to deposit funds at the Fed (and earn the IOER) faces higher deposit insurance costs and increased capital requirements.* As a corollary, the fed funds rate should *never* rise above the IOER. First, there is the spread; second, capturing the spread lowers insurance costs and capital requirements; so, really, the fed funds rates should always be well below the IOER. And yet, the fed funds rate has been above the IOER since March 22.

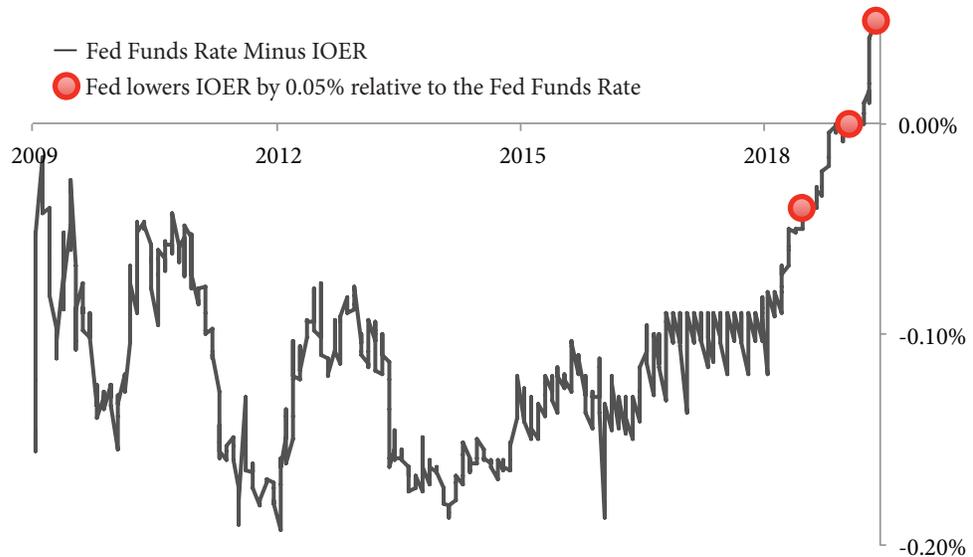
Various bank analysts have offered various explanations for this phenomenon, but only one makes sense. Excess reserves are not distributed evenly throughout the banking system. One bank may have enormously excessive reserves while another may have only the statutory minimum. A bank facing funding stress must turn to the fed funds market to borrow reserves. Total excess reserves still stand at \$1.4 trillion, and all of this is available to be lent into the fed funds market. The extent to which healthy

* See Stephen Williamson, "Monetary Policy Normalization in the United States," Federal Reserve Bank of St. Louis Review, Second Quarter 2015: 102.

banks restrain from earning the spread (and thereby fail to push the fed funds rate well below the IOER) measures the credit risk premium that the market is demanding. In other words, a fed funds rate above the IOER signals distress in the banking system.

The canary for past banking crises was sharp increases in borrowing at the penalty rate from the Fed itself (indicating that the market was refusing to accept credit risk at a rate less than the penalty rate). The failure of Penn Central in 1970, Franklin National in 1974, Continental Illinois in 1984, the Savings & Loan crisis in 1988 all saw a surge of borrowing at the Fed's discount window. Then all was quiet until 2008, when borrowing from the Fed surged to \$35 billion from \$70 million a year earlier.

Under the current system, the canary is a fed funds rate that even approaches the IOER. The chart below shows that the spread between the fed funds rate and the IOER began narrowing dramatically beginning in 2018. Three times since mid-2018 the FOMC has responded by lowering the IOER relative to the fed funds rate. For example, in its last meeting, the FOMC voted to keep the target range for the federal funds rate unchanged at 2.25% to 2.5%. But in order to keep the rate in that range, the Fed was forced to lower the IOER from 2.4% to 2.35%. This action is designed to entice banks with excess reserves to lend more aggressively to those in distress in order to keep the fed funds rate from rising above the upper limit. In other words, before the last meeting, if the fed funds rate were to have reached the upper limit of 2.5%, banks with excess reserves could have earned a 0.10% spread (not including the insurance cost and capital requirement benefits), drawing capital into that market. Now they can earn a 0.15% spread, which makes it less likely the fed funds rate will get to 2.5%.



The first two reductions to the IOER occurred in the context of the Fed's increasing the fed funds rate. Increasing rates raises the cost of capital for banks, putting stress on the most thinly capitalized, which is why the fed funds rate to IOER spread began to narrow. This latest reduction of the IOER was designed specifically to lower the fed funds rate, which is the basic cost of capital for the banking system. In other words:

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forget about 2020, *the Fed is already easing financial conditions*. Admittedly, the easing is very small, and the way in which the Fed is doing it is so subtle that very few have noticed. But ease the Fed did, which marks the beginning of the next easing cycle. The economists are already wrong.

Lowering interest rates, *ceteris paribus*, gives the economy and asset markets an artificial boost. This is why the Fed does it. But the context in which the action occurs is never bullish. The last time the Fed began an easing cycle was September 2007. It lowered rates because, as Bernanke said in the FOMC discussion: “There is a general view [within the FOMC] that downside risks to output have increased with some very bad scenarios at least conceivable.” The S&P 500 peaked the next month and then began a 55% plunge. The previous easing cycle began in January 2001. The NASDAQ was already down by half and would fall in half again (the S&P 500 would fall another 40%).

Let us use White’s words to describe what will happen as deteriorating financial conditions force the Fed to act more powerfully:

The old remedy immediately and naturally recurred to the minds of men. Throughout the country began a cry for another issue of paper; thoughtful men then began to recall what their fathers had told them about the seductive path of paper-money issues in John Law’s time.... [T]he opponents of paper had prophesied that, once on the downward path of inflation, the nation could not be restrained and that more issues would follow....

The pressure for new issues became stronger and stronger ... and, a few months later, on June 19, 1791, with few speeches, in a silence very ominous, a new issue was made of six hundred millions more;—less than nine months after the former great issue, with its solemn pledges to keep down the amount in circulation ... specie [gold and silver] disappeared more and more....

In the last few credit cycles, debasement stimulated the economy. It is possible that the next round of debasement will as well. But at some point—and perhaps beginning right now—the Fed will print and get hyper-stagflation instead. When that happens, precious metals investments will be the only sector left standing.



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