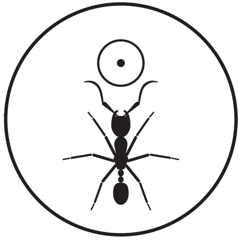

Myrmikan Research

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On the Other Hand

Our classics teacher at Groton reminded us daily that every μεν has its δε. The first of these ancient Greek words means "on one hand" and the latter "on the other hand." Especially in later, philosophical texts, quite a number of words could pass between those two words, but there could never be one without the other. The instruction was both a linguistic law and life lesson, one that the Greeks knew well.

Herodotus tells of Croesus—whose name remains an epithet for riches—demanding of the wise Solon to tell him who was the most fortunate man that Solon has seen. Solon disappoints and names only those already dead: "In a long span of time it is possible to see many things that you do not want to, and to suffer them, too.… I cannot answer your question before I learn that you ended your life well … for the god promises fortune to many people and then utterly ruins them." Croesus proceeded to lose his son in a freak accident, to suffer the suicide of his wife, and to be defeated in battle by Cyrus the Persian. Herodotus records that as Cyrus lit the pyre upon which the captive Croesus was bound, he heard Croesus call out Solon's name. Upon being informed of the context, Cyrus ordered the flames quenched, realizing that he now stood where Croesus once had and eager not to tempt the gods.

On one hand Croesus was rich and powerful; on the other hand he ended life a servant and with no family. Herodotus's story may contain some embellishments, but the story survives because its lesson so accurately portrays common experience.

We can apply this same design to empires. On one hand, the fall of the Soviet Union made the United States the undisputed colossus, the greatest empire that has ever existed, powerful through love not fear, with other peoples envious of the riches capitalism produces and unfearful of political dominance. On the other hand, at that very moment, instead of using the opportunity to bind the world to an order based on definable, Pareto efficient trade rules, Clinton bombed Serbia to distract attention from personal domestic scandals, shattering the prospect of a rules-based order and any hope of uniting East and West. That bombing remains a Russian *casus belli* today as American imperial power rapidly fades. Then Bush invaded the Middle East, the graveyard of empires, bankrupting the country.

Political movements also fit within the Greek framework. On one hand, following the 2000 election, conservatives proclaimed that politics were over. Republicans controlled the White House, the Congress, and the Supreme Court. The leftward aberration of the American experiment fostered by Franklin Roosevelt could at last be corrected. Government could be returned to its proper size, constrained to nineteenth century functioning that lifted a world from poverty. On the other hand, Bush's "compassionate conservatism," or soft-leftism, that helped Republicans win that

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election, increased government intervention in the market, especially in the housing market, and led to complete financial collapse that resulted in Obama and the gallop toward statism, which slowed only temporarily under Trump.

The dichotomy between μεν and δε is perhaps most pronounced in the financial markets because there are no final victories in markets: you are only as good as your last trade, goes the old Wall Street adage. On one hand, valuation by revenue multiple (as opposed to by profit) or by mouse click volume was proven correct as the last short covered into the tech rally of 2000, as was the proposition that stocks had reached a permanently high plateau in 1929. On the other hand, at the very moment of their triumph, it turned out that both conclusions were wholly dependent on Federal Reserve liquidity.

Or consider the bond market in 1980. On one hand, gold bulls were calling for imminent hyperinflation as high and rising inflation crushed bonds and the value of the U.S. dollar. Imagine the sentiment of bond bulls. On the other hand, at that very moment the high yields had granted Treasuries a real, positive yield, possible because debt levels were such that the country could afford the interest payments. The dollar stabilized and gold entered a two-decade bear market.

Two years ago saw the opposite extreme in bonds. On one hand, in 2021 there 4,500 distinct bond securities worth $18 trillion that had a negative yield—not a negative real yield, a negative nominal yield. Investors paid more for a bond than the total principle and interest payments owed over the bond's life. Inflation was dead, and there was so much money, and so few safe places to put it. The banks would not even accept large deposits, as there were not enough places to put the money to work, and additional deposits meant increased reserve requirements and less earnings in relation to bank equity.

On the other hand, inflation was already breaking out. As chronicled in these pages, whereas 2008-style QE stuffed the banks full of reserves to support the asset bubble, the COVID transfer payments hit a limited supply of consumer goods and sent prices flying. After ignoring inflation because it was "transient," central banks spiked interest rates suddenly in an attempt to regain control of the value of their currencies.

But the Fed faces three large problems. The first is that it has the wrong tools. Since 1980, the inflationary effects of credit creation have dwarfed the effects of government deficit spending. The Fed could raise rates, curtail the activities of financial actors, and moderate inflation. Now, however, Biden's mad deficits of $2 trillion per year (which will grow now that U.S. must surge military support to both Ukraine and Israel) is pouring straight into the economy like so many COVID transfer payments.

As discussed in Myrmikan's previous letter, for now the deficits are being financed by money that the Fed printed in 2021 that had been sequestered in the Fed's reverse repo facility.[1] Last month we noted that the cash in that facility had fallen from $2.6 trillion to $1.6 trillion. It has now plunged to $1.2 trillion, $400 billion surging into the economy over just the past month. Stealth QE means that Washington as yet feels no pain from the exploding deficits. When the reverse repo is drained, however, rates will either have to rocket higher to attract money or the Fed will have to intervene (the third possibility, that Congress cuts spending in an election year, seems fanciful).

The second problem the Fed faces is the market's propensity to hold dollars. When rates (and inflation) are very low, economic actors face no penalty for holding large dollar balances (the reason why the market would pay a slight fee to store cash in the

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

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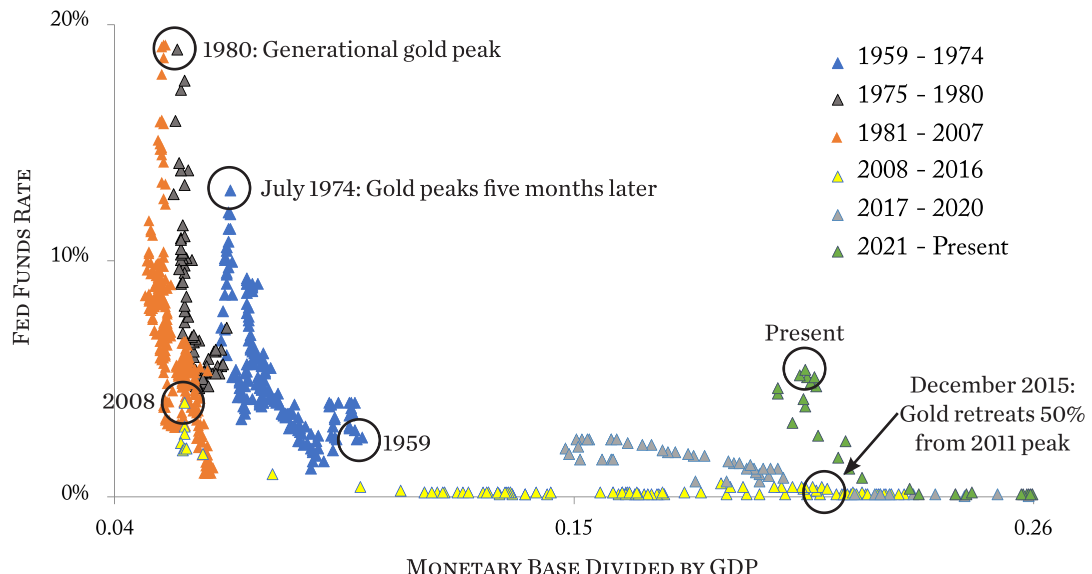
form of negative yielding bonds). However, the opportunity cost of holding cash rises with interest rates.

Milton Friedman and Keynes agreed that cash balance preference has a causal effect on nominal prices. The theory goes like this: Imagine that everyone holds enough cash for six weeks of expenditures. Now imagine everyone decides all at once to keep only three weeks of cash on hand. Each person would go spend half his money on stocks, property, food, goods, services, etc. But the money is not destroyed—every purchase has the effect of transferring the cash to someone else. The transferee of the cash must now spend not only half his original cash position but all of the newly received money as well. As everyone buys things in an attempt to lower his cash balance, the price level must rise. Ultimately, once the price level has doubled, then the same amount of cash that each person started with will become sufficient for only three weeks of expenditures. Friedman concluded: "Let individuals on the average decide to hold half as much cash, and the ultimate result will be a doubling of the price level."

Friedman and Keynes used this theory to justify state management of money: the people are irrational, given to fits of madness, and so wise bureaucrats must enforce order through central banks. We reject the thesis that cash balance preference is an independent variable: in our view, rising rates serve to impair the central bank's assets, which leaves the currency with less value, which is why the market demand for the currency falls and prices rise. This thesis suggests that while the underlying cause of inflation is central bank mismanagement, the effects do not manifest fully until rates begin to increase. The data supports this view.

The x-axis on chart below measures the monetary based divided by nominal GDP—that is the quantity of cash balances in terms of the turnover in the economy, in other words: cash balance preference. The y-axis is the fed funds rate. The monetary base has declined in nominal terms only for limited, brief periods, which means that any movement left along the x-axis represents nominal GDP expanding in terms of the money supply, another way of saying that cash balance preference is decreasing.

The chart demonstrates that as interest rates increase, cash balance preference decreases, and vice versa. It should be no surprise, then, that we find peak prices for gold in the upper left hand quadrant of the chart and troughs in the lower right.



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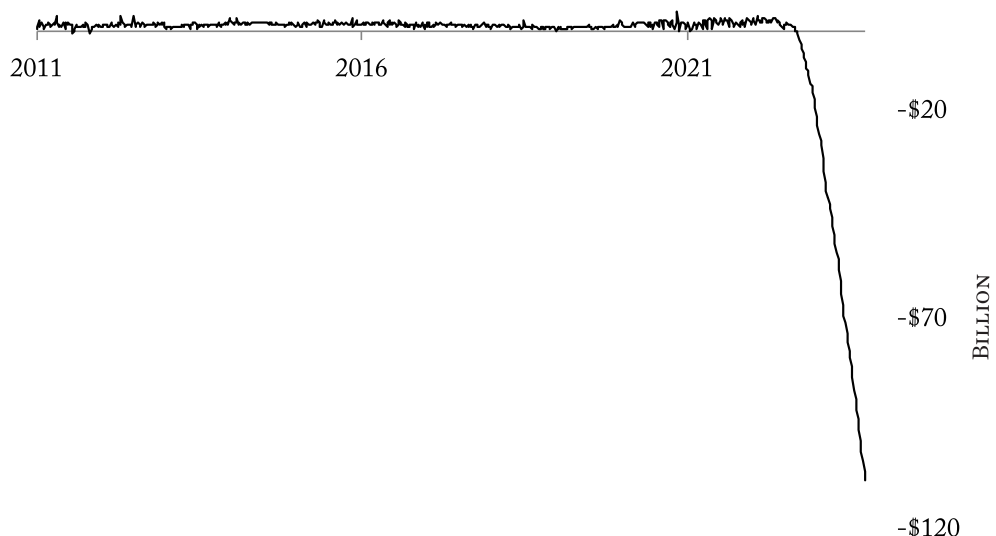
Consider that none of the datapoints before Bernanke's interventions exceeded 0.1 on the x-axis. Then hypothesize that economic forces must at some point push cash balance preference from its current reading of 0.2 back to that pre-Bernanke peak. Mathematically, there are only two ways to do it: cut the monetary base in half or double nominal GDP (or some combination). The former is impossible because the financial system and the government would implode. The latter could be achieved by a sudden doubling of prices. And there is no reason why cash balance preference should stop at the pre-Bernanke peak. It would require a 227% inflationary burst to get cash balances in terms of GDP back to the pre-2008 average.

This inquiry leads to the third major problem facing the Fed. Leaving interest rates higher for longer to try to drain the money supply is crushing the financial system. Treasury bonds are the primary collateral of the banking system. This is not by accident; it is how the system was designed during the Civil War to create artificial demand for government debt to allow unrestrained government spending first for war then for domestic purposes. Mark-to-market losses on bonds are only theoretical as long as the bank can hold them: they still produce income. The problem come when a bank becomes illiquid either because its cost of capital rises above the income from its bonds or because it makes losses elsewhere, on its commercial real estate loans, for example. If it has to sell its bonds to meet capital losses or withdrawals, the theoretical losses turn into very real ones.

The Fed has introduced the Bank Term Funding Program under which banks can borrow 100% of the face value of bonds regardless of their market price. But the banks have to pay interest on the monies borrowed, and it makes the Fed a partially unsecured creditor.

The Fed's facility is more than ironic since its own position is much worse than the banks'. The Fed must remit all of its excess profits to the Treasury. Since the Fed pays out prevailing rates on its deposit facilities (the reverse repo and bank reserves held at the Fed), and since the Fed's income is from the fixed-rate bonds it purchased when rates were much lower, the Fed is suffering operational losses. The Fed tracks its losses as a negative remittance to the Treasury. We first printed the following chart in September 2019, when the cash losses equaled $4 billion. Behold:



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The Fed claims that it can bear capital and operational losses with impunity because there can never be a run on the Fed. It is true that the Fed is different. If a depositor at a commercial bank demands a withdrawal, the bank must come up with physical or electronic cash by selling assets. There is no way for a holder of a Fed liability to demand that the Fed liquidate capital to redeem.

However, returning to the cash balance preference, those who hold dollars and are wary of the central bank's solvency can redeem them into goods or services or assets, sending prices shooting higher.

The standard procedure for central banks to defend their currency is to sell assets and buy back their currency. This week, for example, the Bank of Israel sold $30 billion of assets to repurchase shekels to support its value by shrinking supply. Traders worry that the Bank of Japan may sell U.S. Treasury bonds to buy back yen if the yen sinks below 150 to the dollar. Which assets would the Fed sell if it were ever called upon to support the dollar? At what price?

A wit on Twitter wrote: "Let's imagine a stock that's 50-60% owned by one actor, who over the years has accumulated their stake at any price, & in unlimited quantities. Then, for whatever reason, that actor not only stops buying, but starts selling. And on top of that, the company (stock) starts issuing more shares: what do you think the stock would do? That's bonds, in a nutshell."

On one hand, gold investors are past their limit in frustration. Everything needed for the investment thesis has occurred or is occurring: massive federal deficits, inflation, labor strikes, giant holes growing in the banking system, a central bank that is insolvent and illiquid, a lost war in Ukraine and now a second war in the Middle East, the fraying of the petrodollar system, and, most importantly, a rout in Treasury bonds, the asset that underlies the banking system and the Fed.

On the other hand, all of these developments are recent, at least in their intensity. Consider that the recently-ended bond bull market lasted forty-one years. And the previous bond bear market lasted 33 years, from 1947 to 1980. Plus, any number of accidents could begin a chain reaction to accelerate disorder: a third war front in Asia; a yen collapse that forces the Bank of Japan to dump Treasuries; terror and sabotage in the U.S. from Hamas sleeper cells smuggled over the Southern border Biden left open in a grab for future constituents; Russian or Chinese hacking of critical infrastructure, including the internet; supply chain disruptions overseas that send the prices of certain commodities and imported goods sharply higher; cascading regional bank failures as the commercial real estate market implodes; a market crash that requires additional stimulus while drying up tax revenues, causing the deficit to explode higher even from current levels.

Empires are not felled by a single failure or even a series. They collapse when faced with multiple systemic disruptions, especially if their reserves have been expended on previous emergencies. The U.S. spent its capital reserves on bailing out the banks in 2008, its economic reserves on the COVID hysteria, and its military reserves in Ukraine. Its enemies know that the American empire is vulnerable.

Benjamin Anderson wrote of the 1929 crash: "[T]here is no point to assigning any particular cause for the break's coming at the particular time it did. It was overdue, and long overdue." The collapse of the financial system that has been in place since 1980 is long overdue. Gold investors are the bond bulls of 1980.

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