Myrmikan Update

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Waiting on a Snowflake

As related by Herodotus, when Deioces became king of the Medes, the first thing he did was seclude himself:

> He allowed no one to have direct access to the person of the king, but made all communication pass through the hands of messengers, and forbade the king to be seen by his subjects. . . . This ceremonial, of which he was the first inventor, Deioces established for his own security, fearing that his compeers, who were brought up together with him, and were of as good family as he, and no whit inferior to him in manly qualities, if they saw him frequently would be pained at the sight, and would therefore be likely to conspire against him; whereas if they did not see him, they would think him quite a different sort of being from themselves.

Deioces' contrivance is sound policy for any leader. Familiarity may not always breed contempt, but it often creates skepticism as to why one man should have power over his fellows.

Bernanke should have read his Herodotus before increasing transparency at the Fed, which has correlated with its loss of legitimacy. It wasn't until 2009 that *Lords of Finance* exhibited to the public the foibles and ineptitude of the central bankers of the 1920s, who created the imbalances that plunged the world into the Great Depression. Ubiquitous media augmented by Freedom of Information Acts have allowed a contemporary puncturing of the myth that our financial and political leaders are different sorts of beings from ourselves.

Most recently, the publication of emails among Barclays's CEO Bob Diamond, Bank of England's Paul Tucker, and Jeremy Haywood, private secretary to Prime Minister Gordon Brown, have revealed these people to be so ordinary, perhaps a greater sin than the topic of discussion: manipulations to LIBOR.

As a reminder, LIBOR is the average rate London banks are charged for borrowing funds from other banks. Presumably, LIBOR is set by market conditions, which is the reason that $800 trillion – yes, trillion (according to the Wall Street Journal) – of floating rate debt and derivative contracts are pegged to LIBOR. But, earlier in the month, the myth of a free market collapsed when internal Barclays's emails among traders were released:

> I really need a very very low 3m fixing on Monday. . . . We have about 80 yards [billion] fixing for the desk and each 0.1 [one basis point] lower in the fix is a huge help for us. So 4.90 or lower would be fantastic.

and

> For you…anything. I am going to go 78 and 92.5. It is difficult to go lower than that in threes, looking at where cash is trading. In fact, if you did not want a low one I would have gone 93 at least.

and

> if you know how to keep a secret I'll bring you in on it . . . we're going to push the cash downwards on the imm day . . . if you breathe a word of this I'm not telling you anything else . . . I know my treasury's firepower… which will push the cash downwards . . . please keep it to yourself otherwise it won't work.

And many more.

Aside from other speculators in the market, every person paying a floating rate mortgage, student loan, car payment, etc. is affected by manipulations to LIBOR. Every beneficiary of a pension fund holding floating rate debt is conversely affected.

The glimpse inside the financial palaces reveals that rank corruption not efficient allocation of capital enables the extraordinary wealth extracted by bankers. The politicians who are charged with preserving the structure of the market are caught instead directing the corruption.

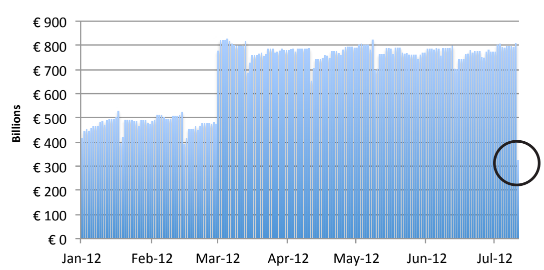
The Federal Reserve publicly manipulates the Treasury market. The big banks have now admitted to manipulating the private debt markets with full knowledge of the authorities. It is not a stretch to assume that the equity and commodities markets are rigged as well. In fact, a July 20 report by the Labor Department revealed that certain high frequency traders gained access to economic data reports before public release, enabling them to front-run markets.

Who would keep their wealth in these casino markets, knowing that the larger players are allowed to rig the game? But, the alternatives are difficult. Cash is just another market, and hard assets concentrate risk and require active management.

Perhaps it is the correct belief that market forces will eventually overpower the authorities that convinces many to ignore the shenanigans. But, in this case, investors should understand in which direction the manipulations run. For the most part, the banks were conspiring to lower rates, not raise them.

Long ago, there was a view that banks liked high interest rates. The idea was that the bank represented those with capital, and the more the capitalists could charge for use of their capital, the richer they became. Those days have passed. Today, banks are themselves the largest debtors. They borrow short and lend long, and it is that spread they hope to widen. And, as long as short rates stay low, real money buyers must chase yield elsewhere, pushing other asset prices higher.

DAILY ECB DEPOSIT FACILITY USAGE



For example, on July 11 the ECB lowered its deposit rate to zero. Not surprisingly, €484 billion were withdrawn the same day. Already, J.P. Morgan, Goldman Sachs, and BlackRock have closed their European money market funds to new investments as yields in France and Germany have gone negative.

Where is all the money going? The July 11 10-year Treasury auction resulted in a record low yield compared to where the secondary market had been trading, a record low nominal yield, and the second highest bid to cover ever with $75 billion tendered. Bernanke's thesis is that these record low yields should force money into riskier assets. As he said in his press conference of June 20:

> By acquiring securities in the market and bringing them on to the Fed's balance sheet, we induce investors to move in to substitute securities. For example, an investor who sells a Treasury security to the Fed may end up buying a corporate bond instead. . . . Or a bank, having sold its Treasury securities, may decide to make a loan instead.

And this is why politicians engage in complicity with the bankers to lower interest rates: first, because money flowing into sovereign debt enables them to spend more money and, second, because the promise of higher asset prices makes for happier voters. But none of this adds to wealth, merely the perception and distortion of wealth.

Moreover, Bernanke's thesis is not working: the transmission mechanism into higher general assets prices is broken. The banks are insolvent. They flee from one safe haven to another. As Herbert Hoover once lamented: "capital is acting like a loose cannon on the deck of a ship in the middle of a storm." The banks buy Treasuries not for the income, but because they can pledge them as collateral for more credit, which they require to remain liquid. They are pushed into taking sovereign duration risk because they are too weak to take business risk.

When the market does finally overpower the manipulations, sovereign debt markets will pop, interest rates will rise, the banks will tumble along with the markets they have rigged, and then the real witch-hunts will begin. It is this outcome, not more rounds of money printing, that will send gold up vertically in terms of the major currencies. The current inflation/deflation seesaw is merely the prelude to debt failure and currency revaluation.

Since the financial crisis broke, analysts have struggled to find analogs. The Keynesians have consistently warned against repeating the "mistake" of 1937 – that is, tightening too soon and the sending the economy back into depression. Myrmikan has instead argued that the world has been caught in the period between 1929 and 1931. The crash of 1929 wiped out the speculators who operated on margin, as in 2008. Everyone else experienced paper losses of paper gains they had not spent. It was not until 1931, when the bond markets cracked and interest rates shot higher, that the real depression began. It then took another two years to reach bottom, and the stock market did not reach its 1929 peak again until 1954.

The Federal Reserve has forestalled the inevitable bond collapse thus far through quantitative easing. The ECB has taken more indirect action. For example, last month the ECB scrapped the use of rating agencies and will now itself determine which bonds can be used as collateral for rediscounting. The goal of all these policy measures is to remove the pricing discovery mechanism of the market.

But, the bond market is huge and a trillion or two of dollars and euros will not satiate it for long. And, so, a 1931-style bond market failure comes back into focus. The mainstream is finally catching on. In June, establishment economist Paul Krugman wrote: "But now I'm hearing more and more about an even more fateful year. Suddenly normally calm economists are talking about 1931, the year everything fell apart." Among those to whom Krugman is referring are J Bradford DeLong and Barry J. Eichengreen, economists from Berkely, who recently wrote:

> In the same way that problems in a small country, Greece, could threaten the entire European System in 2012, problems in a small country, Austria, could constitute a lethal threat to the entire global financial system in 1931 in the absence of effective action to prevent them from spreading.

Niall Ferguson and Nouriel Roubini were more alarmist in their Financial Times article of June 8:

> [Germany] would do well to remember how a European banking crisis two years before 1933 contributed directly to the breakdown of democracy not just in their own country but right across the European continent. . . .
>
> A silent run on the banks of the eurozone periphery has been under way for two years now . . . But now the public is finally losing faith and the silent run may spread to smaller insured deposits. . . . This kind of process is potentially explosive. What today is a leisurely "bank jog" could easily become a sprint for the exits. In the event of a Greek exit, rational people would ask: who is next?

Indeed, the answer is: everyone. Just as the Creditanstalt failure of 1931 rippled through the banking systems of the world, any number of banks could act as the snowflake that starts the financial avalanche. When the banking system fails, the government debt markets will go concurrently, which will shortly thereafter be followed by currency devaluation.

In the meantime, the slog in the gold sector continues, only more violently. The first and last trading days in June were the two highest single day upward moves the sector has seen in this cycle, yet most gold stocks finished down. The heightened volatility augurs a violent move, though in which direction remains to be seen. Long term investors, however, should not be concerned. The Bernanke Put is the first line of defense, and if the central planners fail to act, currency destruction will closely follow. Gold goes up either way.

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