Myrmikan Update

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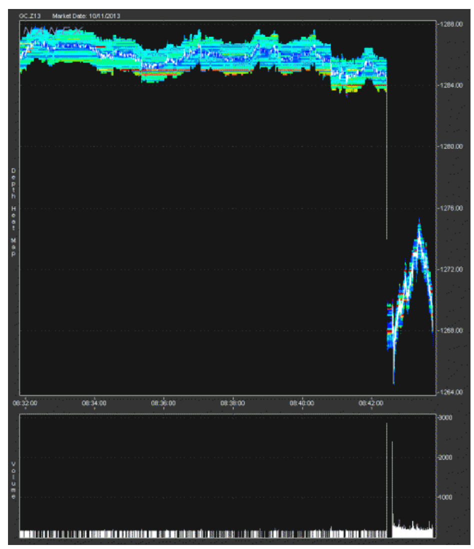
Flexible Targets

President Obama has nominated Janet Yellen to replace Ben Bernanke as head of the Federal Reserve. In a fitting epitaph to his reign, Fed Chairman Ben Bernanke admitted during his final Congressional testimony: “I’m not a qualified financial adviser.” Shortly after, to prove the point, he said: “nobody really understands gold prices.”

When looking up the price of a security in any financial market, the standard three prices presented are the best bid, the best ask, and the most recently traded price. Those who subscribe to full market data are able to see not just the best bids and asks, but all of the bids and asks, and the quantity of those latent orders, at all prices. Traditionally, buyers and sellers attempt to get the best possible price. A seller trading a large position must gauge market depth – that is, the amount of bid interest at lower prices – and space his sell order across a period of time so as not to have his order drive the price lower.

On September 12, a party sold so much gold so quickly that it filled all of the “bid stack.” In order words, all orders to buy, even those far away from the market price, were suddenly filled. With no live bids, the market closed for 20 seconds – an eternity in the world of high frequency trading – to allow the computers to re-establish bids. Rational sellers do not behave this way. It’s a good bet that, contra Bernanke, the person placing this order understood that 2000 contracts sold in less than a second would send gold prices lower.



In fact, the manipulating seller returned on October 11, selling 2 million ounces in one trade, taking out all the bids and breaking the market for 10 seconds. The chart at right demonstrates the violence of the move. As John Brimelow reports, the open interest figures show that these are not margin calls or liquidation selling, and no other markets were moving violently: it is obvious manipulation of prices, though by whom is a matter of speculation.

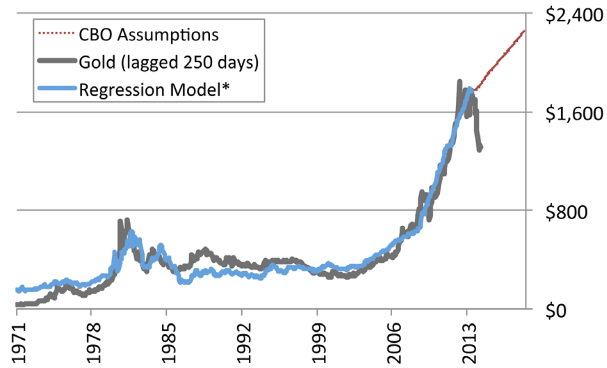
Some think it is the Fed, acting through intermediaries, warning investors to stay away from gold, especially in the context of a possible default on Treasury bills and the appointment of über-dove Janet Yellen. Others point to a recent report showing that Goldman Sachs bought 3.7 million shares of GLD in the second quarter, becoming its seventh largest holder, even while the Goldman sell report was blamed by some for the April gold smash: a big buyer sometimes slams a price lower to see if stop loss selling enables the accumulation of a larger position at a lower price, a practice known as “shaking the tree.”

Whether the manipulation is for private gain or public policy reasons, market manipulations can never last long, the reactions are usually violent, and the fundamental reasons for owning gold continue to strengthen.

And what are those fundamental reasons? Though the current Fed Chairman professes to have no idea, in fact they are quite clear. As expounded in these pages incessantly, the dollar, which was originally defined as a certain weight of silver, is now *defined* as a liability of the Federal Reserve. It is axiomatic that if the assets on a balance sheet lose value, the liabilities must lose value as well. And what are the assets of the Federal Reserve? Primarily treasury bonds and mortgage backed securities. Treasury bonds lose value when the Congress issues more of them, and both lose value when interest rates rise.

Note the method of reasoning above. Unlike the pseudoscience of Keynesian economics, written in calculus to confuse, Austrian economics uses reason to move from axioms to conclusions. However, it is useful to look at the data to see whether the conclusions reflect reality.

Running a regression analysis of federal debt squared and the 10-year Treasury yield squared against gold returns an R^2 of 0.94. Statisticians and Keynesians would correctly point out that because the residuals of such a regression autocorrelate, the model cannot be used as proof of the relationship. But, the purpose of showing the model is not to prove causality – that was accomplished through sheer reasoning per above – but rather to show how closely reality correlates with the reasoning.



*Gold price (lagged 250 days) = 64.83 + 6.04 * gross federal debt squared + 2.4 * 10-year Treasury yield squared: $R^2 = 0.94$
Source: Federal Reserve Bank of St. Louis

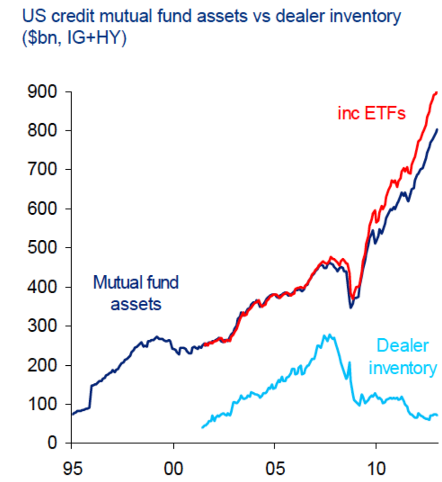
Of note is the April crash in gold, driven by liquidity flows rather than by fundamentals. Although, to be precise, lagging gold by 250 days maximizes R^2, meaning the model has not yet failed to predict April's crash. However, to get the model to plunge on target in December would require a sudden drop in federal debt or a severe plunge in interest rates achievable only by a short squeeze in dollars of historic proportions. Given Fed liquidity programs, it is probable that only an implosion of the quadrillion dollar derivative market could trigger such a shortage. And, perhaps the most immediate cause of a toppling of the derivatives tower would be a default of the Treasury bond market, the foundation of modern financial structures.

A short squeeze may drive the value of a financial product far beyond its true value, but it is a limited event. Generally, short squeezes affect financial instruments that are heading lower: it is because the trade is so obvious that it gets overcrowded. When the squeeze ends, the path lower renews with added vigor. And so it will be with Treasury bonds.

Wall Street is not unaware of the danger. When asked recently: "How worried are you that at some point the bond markets move against the United States?" JP Morgan CEO Jamie Dimon responded:

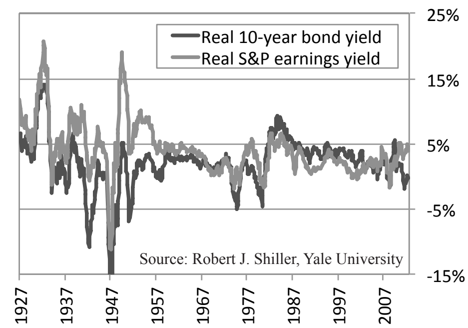
> It's virtually assured, the question is when and how. It will happen. It is a matter of time. The United States can't borrow indefinitely. Over hundreds of years there have been bankruptcy after bankruptcy of country after country that thought they could get away with it because they had the reserve currency and the military power in the world. We are going to have fiscal discipline. It's either imposed upon us or we do the right thing and do it to ourselves the right way.

This is a stunning admission by the chief of a primary dealer of Treasury bonds. And the other Treasury dealers agree with the assessment. The Treasury Borrowing Advisory Committee is comprised of some of the largest financial institutions, including JP Morgan, Citibank, PIMCO, Bank of New York, etc, who deal in Treasury bonds. Their 2013 Q3 report to the U.S. Treasury included the graph at right with a caption in the best tradition of British understatement: “Liquidity likely to prove a problem on the way out.”



Source: ICI, NY Fed, Bloomberg, Haver Analytics.

Notice the dealers, per Dimon, have already positioned for the inevitable. Holding the bag will be retail investors, pension funds, the Chinese, and the Fed. And, to be clear, it’s not just bond holders who will face the pain.



As the lower chart shows, the earnings yield of the stock market closely correlates with the yield on the 10-year Treasury bond. Since Treasury yields are defined in modern finance as the “risk-free rate,” risky stocks must better that yield (or offer growth prospects that they will better the threshold yield in the future). *Ceteris paribus*, if yield rises, price must fall. Therefore, when yields rise, stocks will be crushed along with bonds. In fact, since equities theocratically have no maturity date, the value calculation is simple: if yields double, price falls by half.

This is the context in which Janet Yellen’s ascension to the Fed chairmanship must be viewed. Janet Yellen is credited with spreading the doctrine of “flexible inflation targeting”:

> In terms of the targets, or, more generally, the objectives of policy, I see continuity in the abiding importance of a framework of flexible inflation targeting. By one authoritative account, about 27 countries now operate full-fledged inflation-targeting regimes. The United States is not on this list, but the Federal Reserve has embraced most of the key features of flexible inflation targeting: . . . the FOMC will take a “balanced approach” in seeking to mitigate deviations of inflation from 2 percent and employment from estimates of its maximum sustainable level.

In more colloquial terms: “To me, a wise and humane policy is occasionally to let inflation rise even when inflation is running above target.” But, only the context of low yields, through financial repression, to keep those with savings from fleeing the markets. This will require ever expanding doses of QE.

“Flexible inflation targeting,” the Keynesian trade-off between inflation and unemployment, used to be called the Philips Curve, and it was the theory that Arthur Burns blindly followed in the 1970s that drove the dollar nearly to destruction. Only the pain of Paul Volcker’s 21% interest rates saved the financial and economic systems. With debt levels where they stand, there can be no modern Paul Volcker: interest rates far lower than 21% would blow up the overlevered financial system and crash the economy. Inflation, the rise of nominal prices because of a fall of the dollar, is now official policy. And, eventually, as investors flee a bond market offering only wealth confiscation, the Fed will be faced with the choice of allowing yields to rise, or buying the entire market.

Yet investors take no notice. Paul Singer, CEO of Elliott Management Corporation, revealed in a recent interview: "The investors in our fund probably have under their control several trillion dollars. I talk to my investors on a periodic basis: I've yet to find one institutional investor that has any significant positioning for inflation."

Professional investors assume that they will notice the first signs of inflation and be able to front-run the market. Therefore, according to Singer: "The first whiffs of inflation may cause a self-reinforcing set of market events, which might include a sharp fall in bond prices and in stock prices, and rapid increases in commodities."

Notice the Singer innately understands that higher interest rates are not negative for gold: it is precisely a collapsing bond market that will cause a rapid fall of the dollar and rise in nominal prices of goods: "Global institutions are under-owned in gold [and imagine] some combination of people changing their mind about bonds and wanting to front-run the Fed."

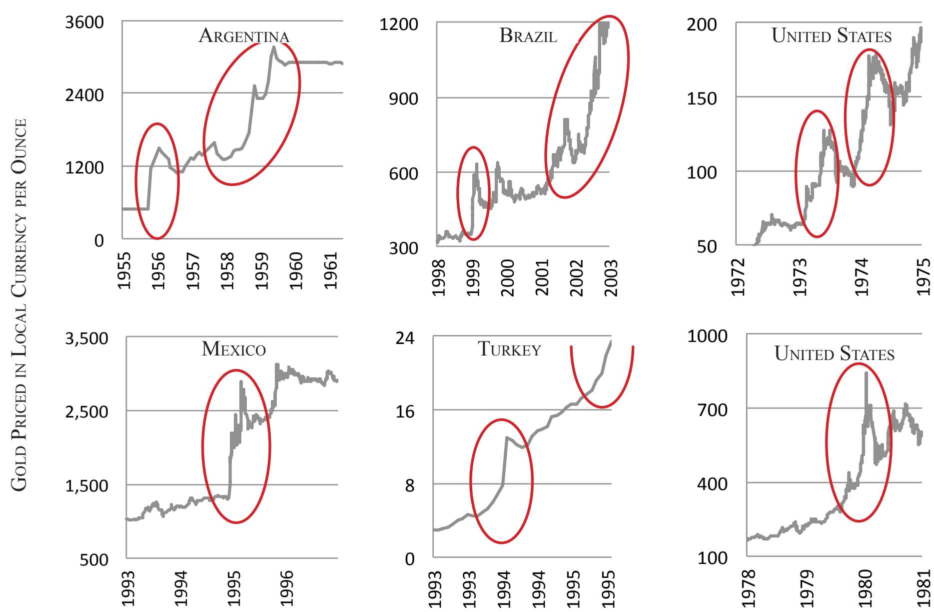
Most market participants see the momentum trade against gold and conclude that investors should wait until momentum changes. Ned Davis Research, for example, explained in an October 11 note: "Gold bulls continue to cling to the *illusion* that the core fundamental drivers matter today, when in *reality* the tape is telling us that they don't. . . . Our aim is not to crush the hopes of gold bulls. Today's point is only that gold continues to lose money flow, and until that trend changes, it is probably best to sit on the sidelines."

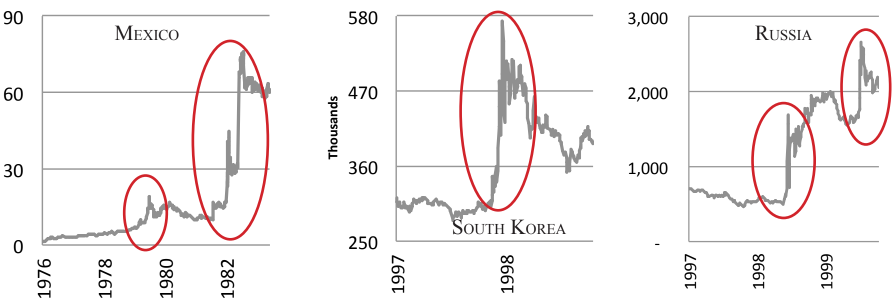
Singer has a riposte to this reasoning:

> As is the case in every serious market event, it's completely unpredictable and could arise with a moment's notice. Any money manager who thinks that he can assess when the tide is going to turn, when the conditions are ripe for a loss of confidence in paper money, I think is making a very large mistake.

Looking at how gold behaves during debt rejection reveals the danger of waiting until the trade becomes obvious. Shown below are just a few of the currency crises of the past fifty years: waiting for money flow to change was not a good strategy.

National debt failure causes currency crises: they are brutal, irreversible, and markets are not efficient at anticipating them.
The losses in gold over the last two years can be recovered in a week.





Sources: Federal Reserve Bank of St. Louis; Banco Central de la República Argentina; Bank of Russia, Banco de México

Yellen will print until the stock and bonds markets break, at which point there will be no time to get out. In the interim, it seems unlikely gold can persist at current levels, regardless of what money flows are doing. The signs of physical shortages in the market – backwardation, negative GOFO rates, record Indian premiums – that were so intense last summer at $1180 gold have returned this week with the smash down to $1250.

Bull markets are defined by higher highs and higher lows. On Tuesday, there were at least six instances of over 700 contracts ($90 million) being sold in less than a second, yet the market absorbed the selling without closing and without breaching $1250. Assuming that level to be the retest of the June low, the gold price seems set to renew its rise higher. Even assuming a regular market, the Fed's continued printing means the equilibrium gold price is substantially higher than it was two years ago, suggesting a sharp rise ahead. If the bond market breaks, gold could lurch higher suddenly, taking gold stocks along, but leaving the broader market behind.

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