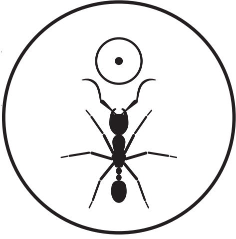

Myrmikan Research Note

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The Taper

Yesterday the Fed announced it would reduce its quantitative easing program from $85 billion to $75 billion per month. Gold fell $15 in the second before the release to $1220, rallied nearly $25 in the ensuing minutes, and now has faded below $1200.

The gold bear thesis is that central planning works. The Fed saved the system, the economy has recovered, and now it can phase out the printing. Interest rates have shot higher, which is good because it exhibits strong demand to borrow funds to exploit the economic expansion. An expanding economy lessens the insurance value of gold, higher rates increase the opportunity cost of holding gold, and therefore the targets for gold of $1000 or less come into view.

There is a different view based on the premise that central planning does not work. Free market, Austrian economics holds that an economy based on credit expansion must continually have lower interest rates to remain stable. Once interest rates hit zero, then accelerating money printing is required to continually lower rates deeper into negative territory. As exhibited in Myrmikan's most recent update, the Fed has indeed accelerated the printing for the past five years. Tapering, then, is a grave policy error, given the context, and will have inevitable, negative consequences.

First, removing a non-economic buyer of bonds in size cannot be bullish for bonds, especially while the Congress is scheming to increase deficit spending, which will add to the supply. Higher rates increase the velocity of money and erode the value of the assets on the Fed's balance sheet: both effects are dollar negative. It is the lack of velocity that has kept the $3 trillion the Fed has printed since 2008 from affecting the prices of goods – any increase would cause serious inflation, which is gold positive. With a broken balance sheet, the Fed will be powerless to intervene to support the dollar.

Second, since the debt crisis of 2008, the Fed has added copious amounts of additional debt to the economy. Raising rates increases the cash drain to support the debt pyramid, shrinking economic growth. This dynamic is especially severe in emerging markets where local business have taken advantage of dollar interest rates that are lower than rates for debt denominated in domestic currency. Rising rates in the senior economy always strains capital allocation to emerging economies, weakening local currencies, and exacerbating the financial strain of dollar debt payments for foreign borrowers, which stresses global banking systems.

Higher rates will thus inexorably undermine the economy and the markets that reflect it, especially since the markets are currently held aloft by record high margin debt, which becomes harder to maintain in a rising rate environment. An economic and market crash will force additional policy responses to lower interest rates still further, which can be accomplished now only by money printing at a new magnitude.

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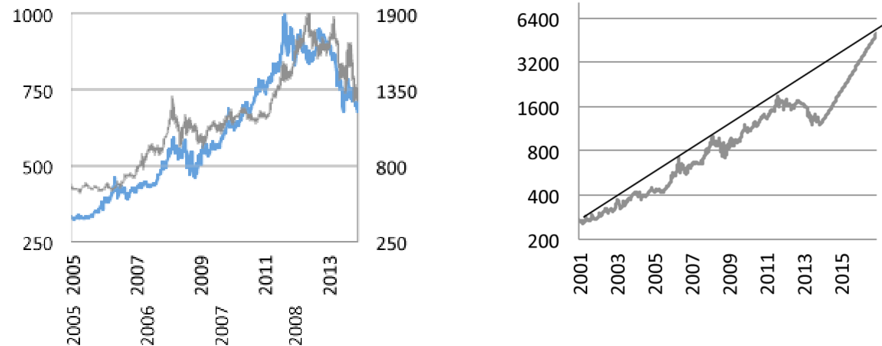
This next crash may come sooner than most expect. Consensus GDP growth for Q4 2013 is less than 2%; initial jobless claims reported this morning was the worst in nine months; existing home sales experienced its first annual decline in 29 months, while mortgage applications are down 60% from 2013 highs to levels not seen for 13 years: all this caused by rates going from 1.6% to 2.9%. What will happen when rates hit 3.5% and higher?

Official CPI inflation may be less than 2%, but anyone who shops knows it is far higher than that, suggesting that real rates cannot even approach positive territory without tanking the economy and the banking system.

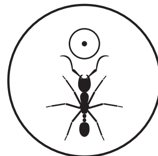
The conventional view of the panic of 2008 is that it was a perfect storm of random events. In fact, the cycle described above – rising interest rates causing inflation, but leading to debt collapse – has operated for decades, becoming more intense with each cycle. Since the global economy now has debt levels far greater than in 2007, the next crisis will be correspondingly worse and the policy response correspondingly greater.

Gold and gold investments are a hedge against the inevitable outcomes of Fed policy. Depressed gold investors should consider the two graphs below. The one at left shows gold prices from 2005 to 2009 overlaid upon prices from 2005 to today. The reader can determine which scale applies to which line while pondering whether to sell his insurance against the consequences of central planning.

The graph at right shows the logarithmic trendline for gold since 2001. Assuming it takes three years to next intersect the trendline, it will do so at over $5000 per ounce. Where will the miners be trading then?



The taper is the next step in this continuing economic crisis that hastens the arrival of the denouement: a cost-push, inflationary depression – the perfect storm for gold. As broader markets rise and gold investments fall, the relative insurance value of gold investments rises, recommending additional exposure.



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