Myrmikan Research

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Lord of the Flies

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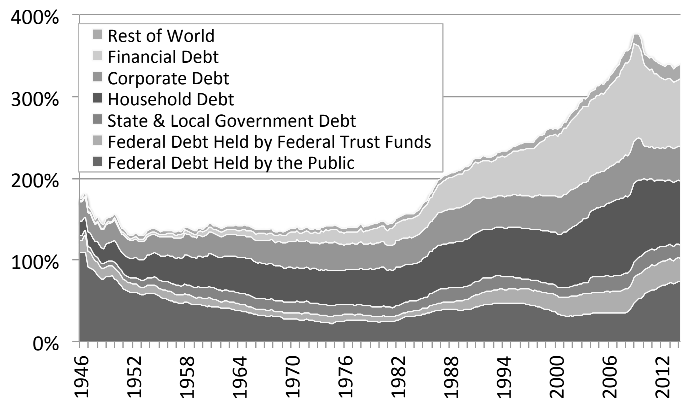
Apparently, if you put a bee and a fly in a jar, point the bottom at a light source, and leave the top open, the bee will never escape. It sees the light and is smart enough to know where it wants to go. It will die trying to get there. The fly, on the other hand, is far stupider. It will bounce around inside the jar, with no clear purpose, and eventually, randomly, escape.

Debt Levels Near Historic Highs in Terms of GDP



Gold investors feel like the bees of the financial markets. The thesis is obvious: the world in general and the U.S. in particular have the highest debt levels ever recorded in human history. The chart at right, calculated from the Federal Reserve Statistical Release,[1] scary as it is, doesn't capture modern forms of debt. According to the International Monetary Fund, the shadow banking system, has reached $15 - $25 trillion in the U.S.[2], adding another 88% and 146% of GDP to the chart above. The wide range of possible size – what's $10 trillion dollars among friends? – implies how opaque there market is. The size of the global shadow banking system tops $70 trillion.[3] Page ii of the IMF report helpfully defines trillion as "a thousand billion," for those who needed a reminder of just how absurd that number is. None of these figures capture unfunded liabilities of Congress, which reach into the hundreds of trillions, or derivative positions, which clock in at over $1 quadrillion.[4]

The whole financial system rests on promises to deliver dollars, either at certain times and in certain, growing amounts for debt contracts or in ever growing quantities with regards to equity securities. But only $4 trillion of base money exists – how are even a fraction of these promises ever to be fulfilled? They cannot be, ergo, they will not be. Unless, of course, the Fed prints tens of trillions of the things, in which case delivery will be accomplished, but their purchasing power will collapse. Gold wins either way.

Nevertheless, it is the flies that have prospered. Buying first Apple, then S&P calls, then Linked In and Tesla, now Alibaba, all while leveraging their houses to plow more into the market. Margin debt stands at record highs; consumer credit growth is dominated by negative equity auto loans and student debt.

1 http://www.federalreserve.gov/datadownload/Choose.aspx?rel=Z.1
2 http://www.imf.org/external/pubs/ft/gfsr/2014/02/pdf/text.pdf
3 http://www.bloomberg.com/news/2014-10-01/imf-urges-more-oversight-of-60-trillion-shadow-banking-system.html
4 See http://www.myrmikan.com/pub/Myrmikan_Research_2013_11_16.pdf on why notional derivative exposure does not innocuously cancel itself out.

Money managers facilitate this recklessness. At a recent Bloomberg hedge fund conference, a certain firm argued: a) bad things happen to good people, b) should defaulting on a mortgage [or multiple] in 2008 forever disqualify a borrower from the credit markets? c) banks fear to tread in the subprime swamp because of regulatory overreach, d) but that's where the returns are, e) these are good people, so f) it's up to private equity to fill the gap.

Private equity is now lending these deadbeats capital to buy again houses and cars their productive powers do not support. These hedge fund wizards are not so naive as to hang on to this debt – they flip it into the wholesale markets reanimated by Fed largess to pension funds mandated to achieve returns that only debt of this kind currently generates.

These hedge funds are the spiders who consume the flies that escape the jar. The borrowers' assets are digested when asset prices fall and the flies find themselves defaulting on their loans and selling the collateral into a void. More accurately, the hedge fund managers are the spiders. The inventory of semi-processed toxic debt may well also kill the fund (and the investors), but the managers will have already extracted their take. The Fed, Lord of the flies, orchestrates the macabre dance: asset prices rise and fall, with chaotic delay, according to the speed at which their printing press runs.

What is a poor investor to do, who realizes the bankruptcy of the system, but fly directly to the safety of gold, albeit with a nagging feeling that no progress is being made. Even though the direction seems right, food and water are running low, bumps on the head are getting larger, and the succor of gold seems to come no closer. Current gold investors are not the first to die in the jar.

Much of the important literature on gold is decades if not centuries old. Ludwig von Mises, Murray Rothbard and others warned more than fifty years ago that the growth of debt in the U.S. was unsustainable and heralded a great economic crash. Since gold is the antithesis of debt, being unique in that it is the only financial asset that is not someone else's liability, it would be the only investment sure to survive the collapse.

Fifty years is a long time to be wrong and brings to mind David Hume's commentary on public debt written in 1742:

> These [creditors of the public] make a figure at present on their income; but in case of a public bankruptcy, would, in an instant, become the lowest, as well as the most wretched of the people. . . One would incline to assign to this event a very near period, such as half a century, had not our fathers' prophecies of this kind been already found fallacious, by the duration of our public credit so much beyond all reasonable expectation.

Britain's debt at the time he wrote this was £48.8 million. By 1771 the debt had reached £128 million. Ignoring his own analysis, Hume wrote in a letter:

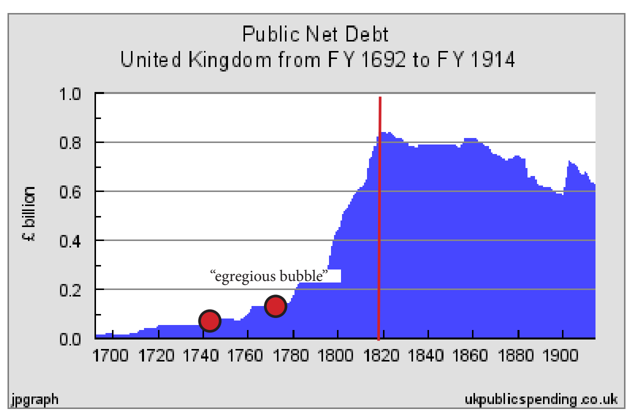
> But all these inconveniences are slight, in comparison of our public debts, which bring on inevitable ruin, and with a certainty which is even beyond geometrical, because it is arithmetical. I hope you have more sense then to trust a shilling to that egregious bubble. . . . I can foresee nothing but certain and speedy ruin either to the nation or to the public creditors.

Like Austrian economists a couple hundred years later, Hume's insights into the insidious nature of debt were profound:

> *First*, It is certain, that national debts cause a mighty confluence of people and riches to the capital . . .
>
> *Secondly*, Public stocks, being a kind of paper-credit, have all the disadvantages attending that species of money. They banish gold and silver from the most considerable commerce of the state, reduce them to common circulation, and by that means render all provisions and labour dearer than otherwise they would be.
>
> *Thirdly*, The taxes, which are levied to pay the interests of these debts, are apt either to heighten the price of labour, or be an oppression on the poorer sort.
>
> *Fourthly*, As foreigners possess a great share of our national funds, they render the public, in a manner, tributary to them, and may in time occasion the transport of our people and our industry.
>
> *Fifthly*, The greater part of the public stock being always in the hands of idle people, who live on their revenue, our funds, in that view, give great encouragement to an useless and unactive life.
>
> . . . These taxes [current] being all mortgaged, what difficulty to find new ones! what vexation and ruin of the poor!
>
> Duties upon consumptions are more equal and easy than those upon possessions. What a loss to the public, that the former are all exhausted, and that we must have recourse to the more grievous method of levying taxes!

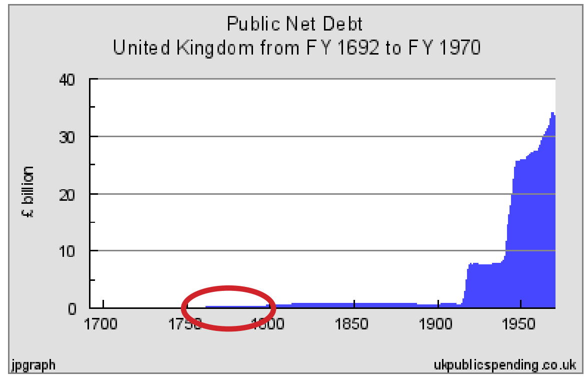
Hume died in 1776. England's debt grew another 6.5 times, peaking at £844 million in 1819 at the end of the Napoleonic Wars. England never defaulted.

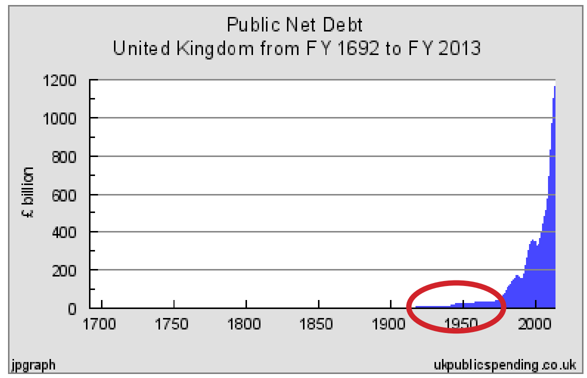
Hume's analysis failed because he did not appreciate how quickly the economy was expanding along with the debt. No doubt much of the funds raised were wasted, like all government expenditure, but much of the money went to the navy, which enforced Pax Britannica, allowing trade to flourish, causing London to become the global center of capital. The largest increase occurred during the Industrial Revolution, and there were few government social programs to burden the productive with supporting the idle. Extraordinarily, in 1819, after the Napoleonic Wars, the borrowing stopped in real and nominal terms, an identical measure since England never devalued. The next century saw Great Britain evolve into an economic colossus even while it slowly paid down its debts, belying the modern claim that ever expanding debts are necessary for growth.



The subsequent century was less kind to England. The scale necessary to chart the nominal borrowings to fight the world wars makes the previous borrowings that worried

Hume vanishingly small. These new debts could never be repaid in real terms, and England was forced to devalue in 1931 and again in 1949.





The next chart shows what happened after England embarked on its socialist revolution financed by national debt. Even the borrowings of two world wars disappear in significance, forcing a devaluation in 1967 and then a continual devaluation since 1971.

Hume was not wrong in theory – his observations were an accurate description of 18th century France, from whence they were drawn, and 20th century England. What he missed was that it matters less how large debts are than what they fund. If an enormous debt funds an enormous capital investment, then there are returns with which to pay the debt. If the debt funds consumption, then all the evils Hume described, especially the grasping for ever more taxation, must come to pass.

Ludwig von Mises was more precise on this point:

> If the government uses the sums borrowed for investment in those lines in which they best serve the wants of the consumers, and if it succeeds in these entrepreneurial activities in free and equal competition with all private entrepreneurs, it is in the same position as any other businessman; it can pay interest because it has made surpluses. But if the government invests funds unsuccessfully and no surplus results, or if it spends the money for current expenditure, the capital borrowed shrinks or disappears entirely, and no source is opened from which interest and principal could be paid. Then taxing the people is the only method available for complying with the articles of the credit contract. In asking taxes for such payments the government makes the citizens answerable for money squandered in the past. The taxes paid are not compensated by any present service rendered by the government's apparatus. The government pays interest on capital which has been consumed and no longer exists.

Since the death of classical liberalism in the throes of World War I, government debt has served two primary purposes: armaments and transfer payments. Neither produces any value with which to pay interest on the enormous sums borrowed. Taxes rise to the apex of the Laffer curve and then beyond, and that is when the economic implosion begins: higher taxes produces less revenue needed to serve ever greater interest payments.

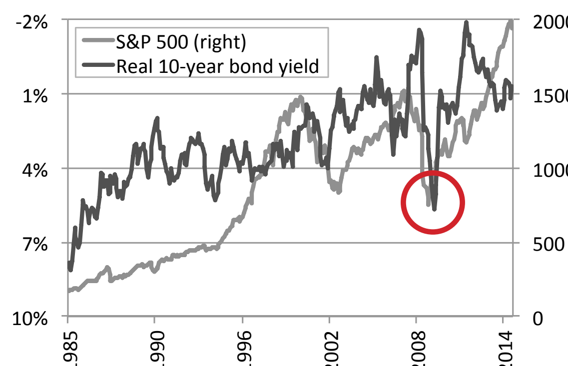
The United States shares a similar economic history to Great Britain's. Government debt increased sharply in percentage terms during the Civil War and then again during World War I. But, the debt contracts were respected both in nominal and real terms. Like Great Britain after the Napoleonic Wars, the U.S. slowly retired its debts after 1918. After World War II, the scale of the debts made them too great to repay. By the late 1960s America's trading partners began to demand repayment in gold, and there was no alternative but default. Nixon completely abandoned the gold standard and, free to float, gold shot up in price devaluing the debt in real terms.

The surge in inflation and interest rates created the horrible financial markets of the 1970s. Thus, in fact, the Austrian economists' warnings were not in vain, nor Hume's. There was no general calamity, though great discomfort, and many American families of ancient provenance were ruined. Bonds, the gentleman's investment vehicle of choice, were rendered worthless. Even equities fell 90% in terms of gold between 1968 and 1974, and another 50% by 1980.

The question investors must ask is: are current dynamics like Hume's England, a nation discovering the free market of classical liberalism in the context of the industrial revolution operating with decentralized common law to enforce private contracts and limits on government, ascending to global preeminence. Or, is the U.S. today more like Hume's France, a fading behemoth beset with a swarm of tax collectors sapping industry for unproductive purposes such as glorifying the state and supporting those who lead a useless and unactive life. Americans elected Mr. Obama as President twice. To ponder the question is to answer it. And those who think the recent Republican victory will shrink government waste and malincentives should consider that the last time Republicans controlled Congress and the presidency, they instituted the largest expansion of government since the Johnson Administration.

Unlike in Hume's day, there is no distinct class living large off of Treasury coupon payments, but the entire investor class nevertheless depends upon the health of public debt. All financial assets but gold are priced on their earnings yield, and this yield itself is priced in terms of a positive spread on the Treasury yield. When the Treasury rate falls, *certeris paribus*, all assets rise in price.

STOCKS AND BONDS ARE THE SAME TRADE



The chart at right shows the phenomenon described above as it has occurred over the past three decades. As the Treasury yield has fallen, stocks have roared higher. And not just stocks, but bonds, real estate, any investment with an implied yield is affected.

Interest rates artificially lowered by a central bank sends a false signal that more savings exists, ready to be deployed. An economic boom develops as businesses expand to utilize the extra savings, but, since the savings aren't real, at some point a bust must occur when the expanded businesses scramble for and then run out of real resources. The central bank must either allow the bust to liquidate the malinvestments or else lower rates again to preserve the illusion of the extra savings. The illusion becomes ever harder to maintain, given the mismatch between real resources demanded and supplied, so the distortions in the money market must become ever greater.

At present, instead of working toward greater distortions, a spooked Fed is pulling back on money printing. Last summer, it looked as though this might create an inflationary spiral reminiscent of the 1970s. In that period, as nominal rates rose, the Federal Reserve suffered huge losses on its balance sheet, sending the dollar sharply lower and, therefore, inflation sharply higher. Rising nominal rates resulted in falling real rates, which was great for the nominal prices of stocks and real price of gold. Last summer, a rising gold price, with a silver price rising even faster, and food prices skyrocketing in the context of the taper, all pointed toward this outcome.

Toward the end of the summer, nominal rates on Treasury bonds started falling, boosting the value of the dollar, sending gold and silver sharply lower. Unlike in the 1970s, there is one hundred trillion dollars of debt contracts (including the shadow banking system) that require interest payments. It may well be that this mountain of debt simply does not allow for the slow, inflationary write off of the 1970s: the moment the Fed stops printing, dollars become scarce, and weak credits teeter, and equities along with them.

There is a tipping point beyond which cascading defaults will take over. The force necessary to arrest the ensuing decline will be awesome, and the effect on gold should be spectacular.

And, perhaps this solves the riddle of the jar. A 1970s style inflationary blow off involves a rising, parabolic gold price that reinforces adherents over time and brings in newcomers to the trade. A deflationary collapse is discontinuous. One day gold closes at \$1200. The next it opens at \$3000. Only the hardiest of the bees get the sap.

To quote Hume:

> These seem to be the events, which are not very remote, and which reason foresees as clearly almost as she can do any thing that lies in the womb of time. And though the ancients maintained, that in order to reach the gift of prophecy, a certain divine fury or madness was requisite, one may safely affirm, that, in order to deliver such prophecies as these, no more is necessary, than merely to be in one's senses, free from the influence of popular madness and delusion.

Hume got his circumstance wrong. None is so wise as to be able to say with certainty what the future holds. But it is a good idea to be hedged in case Hume's analysis is right this time, as it has in every other period save at the height of classical liberalism.