THE MONEYCHANGER

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A MONEYCHANGER INTERVIEW

DANIEL OLIVER: SIGNS THE CREDIT BUBBLE IS BURSTING

Daniel Oliver Jr. is President of the Committee for Monetary Research & Education, a non-profit educational organization founded in 1970 to promote greater public understanding of the nature of monetary institutions and of the central role that a healthy monetary system plays in the well-being, indeed, in the very survival of a free society.

In 2009, he founded Myrmikan Capital, an investment firm specializing in micro-capitalized gold mining companies. Previously, he worked for Bearing Capital, LLC, a private equity firm in Buenos Aires focused on Latin American commodities investments.

Mr. Oliver graduated from Columbia Law School with honors in 2001, where he was President of the Federalist Society. After practicing corporate law at Simpson Thatcher & Bartlett and co-founding two venture companies, he attended INSEAD and obtained an MBA in 2005.

His first job was at the International Herald Tribune in Paris, which filled him with a love of writing. He currently publishes commentary on monetary principles in various media outlets, on financial television and radio programs, and speaks at monetary and investment conferences. He is finishing a book on the nature and history of credit bubbles, which stretch back to ancient Greece and beyond.

Visit http://myrmikan.com/port/ to sign up for his free monthly commentary, elegantly written and filled with historical understanding and original insights.

Dan is a National Review Institute Fellow and is an alumnus of the Swiss American Foundation's Young Leadership Conference. He lives in New York City with his wife and two daughters, and kindly made time for this interview on 24 October 2018. He is just finishing a book, Golden Tears: A History of Credit Bubbles which should be published next spring. It is an elegantly written picture of 5,000 years of credit bubble. I have read a draft and can recommend it without reserve or hesitation.

It would help your understanding of this interview to read again

the July 2016 Moneychanger article, "Nor a Lender Be," and our January 2017 interview with Mr. Oliver – F. Sanders

Moneychanger I've got a big question burning a hole in my head. How will we know the bubble is popping?

Oliver Great question. History shows that bubbles form when the banking system creates credit instead of allocating savings. When it creates credit, a banking system drives interest rates too low, which encourages malinvestment. Since interest rates define the value of future cash flow, when rates are driven too low we get a false picture. Low rates make future cash flows look more valuable than they really are.

How does this play out, practically? Everyone runs out and starts building big capital assets like buildings and ships and airplanes. When they do that based not on consumer demand but simply because the bank system has sent these artificial interest rates signals on money, it creates overcapacity and that drives down rent (income from assets). That drives down price. Once that happens the profit margins of those projects shrink, and they can't then pay the capital cost.

What are signs of a popping bubble? What's happening to the pricing power of (especially) capital projects *very far from consumers* like buildings, power generators, locomotives, or airplanes? Also look at the health of the banking system. When I look out my window, it looks like Shanghai. There are cranes everywhere. Why? Because since 2008 rates have been almost zero and any

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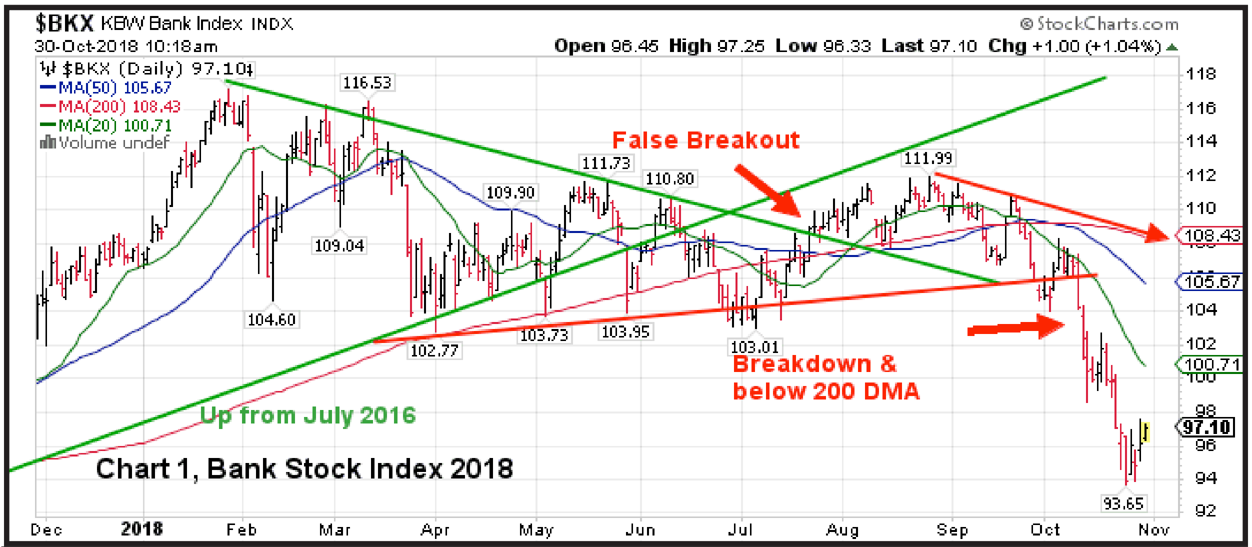

project becomes profitable at a zero percent interest rate.

It takes a long time to build a building. All around, though, they are going up everywhere. At the same time, I'm reading articles every week saying that real estate is falling. Well, you don't just stop building your building because of a blip in rent.

All this overcapacity comes on line at the very moment that rents are already falling. Of course, the overcapacity then makes them fall further. Then the question is, how on earth do these projects pay their debt back or get a return for capital investment to their investors?

One thing I've been watching is the share prices of the very globally connected banks. [See charts 1, 2, and 3.] Those, of course, did very badly in 2008 as you would expect when a bubble pops. They are doing very badly now which tells you that returns on their investments are very poor.

To answer your question, from my perspective, the bubble is popping right now.

Interest rates are going up. That makes these investments not work. It makes overcapacity lower the rent then the banks get stressed and the whole thing comes tumbling down.

I can't predict exactly when the Lehman moment will happen. That might still be a ways off. But I think we've passed the top of this credit bubble already and now we're on the way down. My question is - How far do we go down?

Moneychanger You picked two things that interest me. I've been watching the price of real estate. Local bubbles seem to be popping around the country. Also, the bank stock index (BKX) has tanked since September.

Oliver That's right. You're starting to see write offs now, not wholesale but little banks here and there saying, "This mall that should have a return of 100 cents on the dollar is actually giving 20 cents on the dollar." Things like that.

It's not the money center banks yet. It usually starts in the fringes, whether subprime housing last cycle or emerging markets this cycle. Problems often begin in emerging markets. You'd expect to see the most thinly capitalized people, the biggest speculators,

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get stressed first and that's exactly what you see now.

Overbuilding always concentrates, like in Las Vegas or New York City. When you look at the pockets of frenetic activity, they're looking very stressed. The bank stocks aren't doing well because the market is figuring out that in a high interest rate environment the investments banks make don't make sense.

Bernanke arranged all this. He's the man who took rates to zero, and he recently quoted Paul Samuelson who said, "At a zero percent interest rate it makes sense to flatten the Rocky Mountains to save on gas driving back and forth across Colorado." This is an absurd example but he's right. When you have a zero percent interest rate, you have infinity amount of time to make back your capital. I mean if the cost was actually free and you have forever to make your cash flow, it does make sense to flatten the Rocky Mountains.

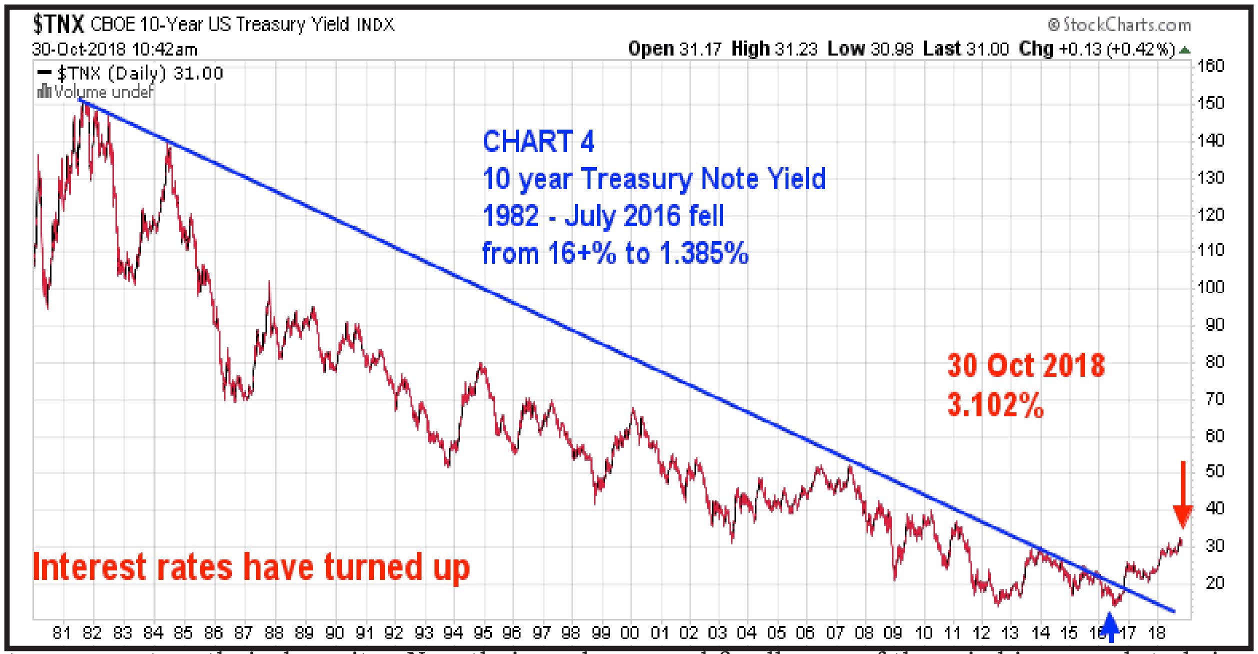
It's extraordinary. When ultra low rates exist for several years, you see huge amounts of craziness not unlike that anecdote. There exist now plenty of real-life examples that cannot survive a high interest rate environment. The end cannot be far off.

MONEYCHANGER One thing that makes the bank stocks' plunge potentially more lethal is that they're falling in the teeth of rising interest rates. Theoretically shouldn't higher interest rates mean wider margins for banks and greater profits? [See chart 4.]

OLIVER Not really. Victor Sperandeo wrote an article about this a couple months ago where he pointed out that if you're a bank and you buy a treasury bond and you put it in your hold-to-maturity account, you no longer are required to mark its value to market. This has tremendous implications.

A couple years short term interest rates were zero. Banks were paying zero percent for deposits, and 30-year Treasury bonds were paying 3 or 3-½%. A bank could take deposit money, which cost it zero, buy a 30-year bond, and make a 2-1/2% spread for free!. And, when interest rates go up, driving the bond's market value down, you don't need to mark that bond's value down on your books! Your assets still show the value of that 30-year bond the same as the day you bought it.

Of course, if a bank buys a bond at three and a half percent and 30 year interest rates rise to five percent, they've suffered a tremendous loss but they don't have to report that, either. So today a bank can say, "Our assets are fine," even though, behind the scenes their cash flow is shrinking. All of a sudden they have to pay one, one and a half,



two percent on their deposits. Now their cash margin on that trade is cut in half. And if short term rates then go to three and a half percent, they are now making nothing on that trade and must realize their cash flow is about to go negative. Rising rates are lethal to banks because of the games banks play.

No. An interest rates increase is not good for banks. It is very, very bad, and that's what the market is telling us. I think it was Paul Singer, a hedge fund guy from Argentina, who said he has 200 investment advisors and analysts that work for him. They tried to decipher the balance sheets for the banks and they couldn't do it. So if he can't do it, no one else can do it. In fact, *the banks can't even do it.* That's why they hire these big consulting firms to try and figure out what is going on inside their own bank. Banks don't even know what's happening.

Banks are very compartmentalized. The top people have all of these different departments below them that compete with each other to make money. The guys in the tippy top really don't know a whole lot of what's happening. Below them is where all these scandals happen. The guys at the top say, "Oh, we had no idea." They didn't have an idea because they don't know, they don't care -there is a culture of just make money and just don't get caught.

MONEYCHANGER I realize that it's impossible to foretell what the bubble-bursting catalyst will be. You can't see everything in the market so you don't know who is in the worst condition. But do you have any idea what that catalyst will look like?

OLIVER I'm writing a book on the history of credit bubbles that goes back 5,000 years. What usually happens is that as rates start rising the weaker players start rolling over, and finally one of them is big enough to bring down the big players.

Go back to 2007. In May a European fund blew up. It was a small fund of just a few million dollars. No one cared. Then a month later two other hedge funds went down. They were maybe a few billion dollars - still not big enough to bring the system down. Still they were symptoms of a big problem. Then a European bank went down and the central bank couldn't bail it out.

While these little things around the edges were faltering, stocks kept going up. They made new highs that autumn, then started leaking lower. Next you got a bigger collapse of an entire firm. Lehman Brothers (someone big enough to bring down the entire system) didn't go down until a year later. That's why I've been looking around for those little failures that are not big enough to bring the system down but are symptomatic of stress under the surface.

And there are some. Look at Argentina, at Turkey, at the bank situation in China. I was very intrigued by the failure of the hedge fund GAM, Global Asset Management last summer. They were a big firm of about $150 billion. Apparently the manager of this fund was not following proper due diligence procedure and they simply stopped redemptions; they gated the fund. Nobody could get their money out. It turned out the manager wasn't just not following policy. He was investing in emerging market debt that got crushed and blew up the fund. So they gated it because they got 10% redemptions and couldn't liquidate the holdings. There was a run on the fund. I see no news on what's happened since then. But, again, it started off as internal problem.

There have been little failures like GAM here and there, not really enough for me to

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think that we're on the cusp of a major failure but a big bust can happen without them. That's what happened in 1929.

In 1929 there really weren't that many failures leading up to the collapse. The market just was so overbalanced, so high, that it simply crashed. It hit a peak in early September 1929, and, within six weeks, it was 40% lower. Two years later a lot more failures piled up. So, there is no rule that you have to have little failures first. It's certainly possible you could see the stock market crash first, then see other systems blow up in the last big, huge credit cycle. I look for little failures that are symptomatic of stress under the surface that you really can't see as a retail person looking at wholesale money markets because they can be good signs of what's to come. [See chart 5.]

One reason stocks are so high now is because companies have been borrowing money to buy back their shares. Company executives like this because they get paid stock options and these purchases help the stock options, but it's not real. The company is just adding to its debt load. Now, rates are rising. That means they have to refinance that debt and, all of a sudden, it's more expensive. This has made these companies' financial structures much more brittle.

Also, if you see any setbacks in your business, equity can get really crushed. IBM is a great example. They've been buying shares with borrowed money. They sell their software to companies on credit, so they don't even get cash for their product. When the music stops, IBM won't simply sell less software to companies, they won't even get paid for something they've already sold, so they won't have any money to refinance their debt. Companies like IBM have the potential to go down 90% (That's not a prediction.).

When you make your capital structure more brittle, the business doesn't *have to* go down 90%. The stock will go down a big portion of that. But your equity is highly, highly levered. On the upside this is great, especially for the upper executives. But the down side is very, very lethal. Low interest rates made it logical for all of these companies to play this game in their own self-interest. This game, though, also made the market extremely dangerous and is another reason I expect it to go very, very much lower.

MONEYCHANGER I remember well a speech Bernanke made in November 2002 long before he was appointed head of the Federal Reserve. It earned him the nickname Helicopter Ben because, if he didn't say in fact, he certainly implied that in a financial panic he would drop $100 bills out of helicopters.

OLIVER He said he had a technology called a printing press.

MONEYCHANGER Right -- that famous statement. Anyone who read tha had some idea of what Bernanke would do, but the performance in fact astounded me. He doubled the size of the Federal Reserve's balance sheet in three months. He created that much money and then lowered interest rates to zero and God only knows whatever else he did. He loaned $16 trillion to foreign banks and everywhere else to keep the whole world afloat. If they do that in the green tree, what will they do in the dry?

My imagination falters to think of what they will do to save the banks this time. This is also part of the historical record, that the people who engineer bubbles are usually powerful enough to get the government to rescue them. What in the world will it look like this time?

OLIVER I think that's the right question. Bernanke didn't really drop money from helicopters. Remember the Austrian model of a credit bubble is that banks made bad loans to very capital intense industries, then they run out of money because banks fail. And then the Keynesians say, "Look, demand has faltered." No. Demand hasn't faltered. You have built over capacity.

Then the Keynesians say, "We need to recapitalize the banks." So Bernanke didn't give money to consumers to buy stuff. He gave money to banks to lend it to create more capital and this capital actually has the adverse effect of lowering prices of things that capital produces.

That's how he created a new bubble. Because of Bernanke's low interest rates, the banks doubled down on the model and, of course, debt levels are much higher now than then. So it wasn't the printing press. He created credit reserves at the central bank.

Now the imbalances are much, much greater than they were. And the Fed was not designed to do this. It wasn't designed to support the government. But that's what's happening. It has become a mechanism to finance the state. That is its stated mission at this point.

When markets crash and stocks collapse, government tax revenues dry up. What does the government do? She borrows money so she can keep spending. The Fed's job is to run in and make sure that the treasury bond market is working. That finances the state.

Yes, when things are bad enough they will run out and support the banks to keep prices rising, as in that two percent inflation target they have. It's crazy but it's their target to support the market. To me it wasn't the fact that they doubled up the monetary base or tripled it.

In autumn of 2008 the Fed issued $6 trillion in guarantees. The guarantees weren't triggered but if you're a private company and the guy you lent money to is shaky, and the Fed says, "Hey, don't worry, if he doesn't pay you, we will" – well, okay. Now you're more patient. Also, don't forget Bernanke's Fed suspended mark-to-market accounting, which gave the banks more time to recover. Now because the imbalances are so much greater than they were then, to stabilize the system in the next crash we'll be talking numbers much, much bigger than last time.

I don't know exactly. No one knows because a lot of the bubble is the shadow bank system and no one can get a handle on how big it is. But it's going to be enormous. It's not going to be $6 trillion. It will be $12 trillion - numbers of that magnitude.

The next question is, do the guarantees work? Again, the Fed guarantees these crappy assets in the banks. What happens when the private bank says, "You know what? The bond is dead. We're calling in the guarantee. Here's this paper back, we want the money." Suddenly those bad assets --bad credit -- get converted into currency. That's when you start getting the big [*consumer price*] inflation that's been missing from the equation because they didn't print currency. They printed credit. But when you convert that credit into currency to keep the system afloat, which they will do in extreme situations, then comes the crushing inflation.

This scares me because I think it's inevitable. It's inevitable because the alternative is to allow a 1930s style depression where the banks all collapse and close.

Moneychanger Is hyperinflation really possible in the United States? It's the largest, strongest economy in the world. Does it make sense to talk about hyperinflation?

Oliver It's not that it could happen, it already has happened. Look at the American Revolution. The 1970s aren't comparable because the private and federal debt levels in the 1970s were not that high. Look at debt as a percent of GDP or in terms of gold. Today the debt levels have gone vastly, vastly, vastly higher.

Hyperinflation is certainly not inevitable. They could take a 1930s outcome, which I think is better, but hyperinflation is not an event, it's a process. When the treasury bond market complex collapses (which it will) and rates are going crazy and the federal government cannot fund itself and no one else can fund themselves, then the Federal Reserve will buy bonds wholesale everywhere to stabilize interest rates and prices.

When they start buying things above market price, they suddenly become the only buyer and they have to buy all. Then their balance sheet will increase to three times, 20 or 30 times, numbers like that, and that's when you get a huge inflationary chill. But what will they do next? What if they just stop? Maybe a one-time devaluation that would set the dollar lower by a big number, 70 – 80%. Then the country would move on with a lot less debt and everyone would be happier.

But they never stop and allow something like this to play out because stopping is very, very painful. Everyone says, "Hey, this is great. I'll take on more dollar debt and I'll gamble." Don't forget. You have an agency problem here, not just people with their own money. They're running banks, corporations. Say you're a CEO. You're not very rich but you say, "If I can get stock options a whole bunch of my debt goes away because I personally made a lot of money. And if it goes wrong it's not my money. It's someone else's. I'll just keep doing that until the market forces the Feds to end this game because of inflation."

It's hard to imagine in our world where more than half the country are direct recipients of government spending. When that stops, would everyone say, "Let's just go back to free market"? Hard to envision, but possible.

So maybe we see not wide margins hyperinflations but certainly 1970s plus type hyperinflation.

Moneychanger Weimar Germany's 1923 hyperinflation just ended in exhaustion. The *Rentenmark* that replaced the *Reichsmark* was not particularly strong, but it was accepted because something had to stop the hyperinflation.

More than 50% of the people in the United States take their income from government spending, more than 50%. Hyperinflation would throw those people out on the street – a huge social disruption.

Oliver It wouldn't take hyperinflation, just high inflation.

I think if Trump wins the next election, something bad will happen. I think the market will crash. Certainly, two years is a very long time for this market to survive, but does he blame the Fed and everyone believes him, and then he's elected?

Or does the pendulum swing from Trump to someone hard core left like Cory Booker or Elizabeth Warren? If the pendulum swings way to the left then things like hyperinflation become more realistic because the government would essentially be run for the people getting money from the government. And then the Fed would be mandated to support this type of spending.

Elizabeth Warren proposes that all corporate boards with more than a billion dollars of revenue have labor representatives, Medicare for all, and forgiving student loans. How would all this be financed? Through treasury bonds and who has the treasury bonds? The Federal Reserve. The path to hyperinflation, certainly a very high inflation, would go through a left-wing victory in 2020.

Moneychanger Right. Looking at what the Fed did already they'll do anything to keep the system going.

Oliver It's crazy but the system is pernicious and evil and should go away. But they're very powerful and their job is to maintain it as long as they possibly can and they will. Don't forget the people at the Fed come out of the biggest banks in the world. So the prospect of these guys getting religion and letting big banks go down is fantasy. It will never happen until there are riots in the streets.

Moneychanger Until that complete exhaustion.

Let me ask about gold. I've been in the gold business since 1980 and I've never been through a time as weary and disappointing as the last two years. In our January 2017 interview, you said that a low interest rate environment is very bad for gold because gold has no cash flow and hence it goes down. Did you expect it to go down this much?

Oliver It's counterintuitive but in a low interest rate environment, economically sensitive assets like buildings and ships become very valuable because cash flow is discounted at a low interest rate -- so valuable you want to build it. To build a building you acquire huge amounts of industrial commodities, which pushes up their prices. [See chart 6.]

Gold generates no income, no cash flow. It's not subject to those forces, so on a relative basis it falls against everything else in a credit boom. History clearly shows that gold does badly during credit booms, and then the opposite happens. When rates shoot higher and no one wants to build buildings the next 30 years because too many have been built, gold shines. All of the pieces that go into construction are now in massive overcapacity up and down the supply chain so the pricing collapses. Gold is relatively immune to this story.

It's not an expectation that gold would do so badly, it's a realization that as long as the bubble lives gold will not do well *relatively*. I now expect that because the bubble is fraying that we are near to a huge reset in the gold price.

Still, there are other issues. When the music really stops you get your Lehman moment and panic for dollars. [See chart 7.] Don't forget, there's $4 trillion dollars that exist on that Fed balance sheet, and there's $90 *trillion* of dollar denominated debt globally that needs dollars all day long to pay interest. When there aren't enough dollars to go around a big short squeeze occurs and the dollar becomes really, really valuable. People sell whatever assets they can for dollars to pay their debts. If they don't pay their debts they lose their collateral.

Is gold one of the things they'll sell? In

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2008 the answer was *yes* because hedge funds and momentum players had been riding the gold trade up from 2000. They were forced to sell gold to get collateral for their other assets. [See chart 8.] I don't see that today. Today if anything there's a short gold position and those shorts will have to buy gold, not sell it.

That's the western market. In the eastern market, especially in China, some debts are specifically backed by gold collateral, so when they default the lender takes the gold and sells it because he needs cash to pay off his creditors. You saw a big drawdown in the gold price last summer because the Chinese bank system is under pressure. In Turkey the price of gold was a full three dollars less than global market which told you that gold collateral was being liquidated there.

But that's temporary. I'm not at all certain which way gold will go immediately when the music actually stops. I think higher, but I am sure that when the dust settles gold will be very, very much higher than it is now.

What's the takeaway? Don't hold gold on leverage because if it drops for a month you'll be knocked out of the trade and miss the move to $10,000. But if you have it in an equity position (fully paid for and owned) then you could ride down that volatility and not worry about it.

Moneychanger Back in 2008 gold tanked before stocks, but not only did it recover faster than stocks, bottoming in November before stocks bottomed in March, for the next three years it also vastly outperformed stocks. Will gold behave the same way this time? Then gold was in a bull market phase, having peaked at $1,000 in March 2008. Today gold is in a completely different world. It has been in a bear phase since 2011 and these last two years have wrung out gold's price. A massive short overhangs the market. Commitments of Traders short positions are at 15 or 20 year highs. Although there obviously will be a run for dollars when the panic arrives, you just have to wonder if it will look exactly like it did in 2008. And it doesn't seem to me that it will.

Oliver I don't think it will, for the reasons you just stated. I think gold will go straight up. When we've seen big down days on the stock market we've seen gold have big uptakes and *vice versa*. The market is signaling us *that's* how it will happen.

I think gold stopped at $1,900 in 2011 because the Fed was able to restart a new and bigger credit bubble. When the next big crisis comes can they do it again? Can we get another cycle up out of this super cycle?

I'm not all sure about that. If that is the case, we do expect gold to run to $3,000 plus, after a big crunch when the Fed has to print money to supply lots of dollars to the world so they can pay their debts and not default. Then if they create a bubble I would expect another period of time when gold is very weak. That's the cycle we've been playing now for 40 years at least, for 4,000 years in some form.

But it's also possible that the Fed's efforts to re-start don't work. Maybe we're tapped out. Maybe there's just too much capital misallocated, so when the Fed guarantees all the assets, people actually take the guarantees. Then you can see gold prices up at $10,000 plus -- completely resetting the system.

As recently as the 1930s the market staged a run on the central bank by presenting paper dollars to be redeemed in gold. You can't go with dollars to the Federal Reserve to get gold today, but you can go to the coin store and buy gold with dollars. I can't redeem them but I can convert them into gold.

In 1980 gold peaked over $800. At $600 an ounce the 8,300 tons of gold on the Fed's balance sheet completely backed their liability, the dollar. We were on a *de facto* economic gold standard. It represented a run on the Fed. I see the exact same thing happening when the Fed finally loses control of interest rates and people convert dollars to gold – gold will rise to a price that balances the Fed's balance sheet. That is a very, very big number. I almost don't want to say it because

it sounds so crazy. When the super cycle ends you're going to see gold over $10,000 for sure.

Moneychanger You have called this the greatest debt bubble the world has ever seen. If so, then it's the end of the super cycle.

Oliver That's right. And again, these things don't crash. They're not just economic, they're political, too. The debt in France brought on the French Revolution. Think of the Russian Revolution. When the Depression hit we got Franklin Roosevelt who was basically a fascist. The National Recovery Act (NRA) was based on Fascism, but the Supreme Court shut it down. The idea was a government-regimented economy, but we escaped.

It's never just an economic event, it's also political. When half your country draws its income from government spending and that all goes away in real terms there will be major political ramifications.

That's what really scares me. Do we go down the hard Fascism road where government, the guys in charge of banks, and the government just don't let the system collapse but send tanks out to keep people in line? Or do they let it go down so we can start writing off the debt again and return to a free market? I'd like to think it's the latter, but I don't know.

This country was pretty homogenous last time this happened, a Protestant Christian nation for the most part. That's no longer true. We have multiculturalism, people with different ideas. I don't know that we have the cohesiveness to survive the political problems that this collapse, the greatest in history, will create.

Moneychanger People accept Fascism because they have no other hope. It's certainly foreseeable that when this debt bubble crashes a lot of people will be left with no hope. Anything is preferable to chaos and starvation.

Oliver In 1935, the Supreme Court said the NRA was unconstitutional after Roosevelt's court packing tactics. Over the last 70 years they've essentially eviscerated the constitution. It's very scary.

Moneychanger It is, but there's also the hope buried in there somewhere that we'll get rid of the Federal Reserve.

Oliver That is a hope, too. Absolutely. The American country which has been forgotten is still very solid unlike the elites who run everything. The country is very divided, more and more so all the time between the hard left and people who adhere to traditional American virtues and values.

When the government starts doing crazy things what happens? What does the Texas National Guard do? I don't know. I would hope that the system is robust enough that states build up power and get the people to say we will not go down this road these elites want to take.

Moneychanger I think there is a solid core of Americans that sees and knows something is wrong but there's no direction for them to go. That's the reason why Trump -- good, bad, or indifferent – has been so popular. He offered an alternative to the elites.

Oliver. The last ad he ran he was in some manufacturing plant or hanger with the workers and he had a montage of Janet Yellen and Lloyd Blankfein and the whole crowd. I thought, This is the conflict. This is why he's going to win. And he did.

Moneychanger I deeply appreciate the time you have given me.

[End of Interview]

STEPS OF A DEBT BOOM/BUST CYCLE

1. Banks expand credit.
2. *Boom*. New abundance of money lowers interest rates and misdirects capital into building capacity not needed
3. *Bubble*. Success begets excess. Excess debt begets overcapacity, overproduction, and bubble.
4. Overcapacity kills cash flow so that the debt can't be serviced
5. *Bust*. Panic rush for cash drives down prices of assets in overcapacity.
6. *Default*. Debtors default, a default made inevitable by Step 1.
7. *Prices plummet a long time* to liquidate overcapacity.

INTEREST RATES, BOND PRICES, & THE CREDIT CYCLE

The inverse relation between bond or asset prices and the discount or interest rate isn't self-evident to the uninitiated. Why do bond prices move opposite to interest rates?

WHAT'S THE DISCOUNT?

Think of it this way. What is a bond worth *today* that has a 5% interest rate and pays $100 in one year? (Interest rate is also called "discount rate," *i.e.*, the rate by which today's price is 'discounted' from the future price.) It's worth $100 today, *less the future interest payment*. So the value today ("net present value") of that bond is $100 - $5 = $95.

What happens when you *raise* the discount rate? What about a bond with a 10% discount rate that pays $100 in one year? Today it is worth $100 - $10 = $90.

So it's a see-saw. The higher the interest rate, the lower the bond price. When interest rates rise, bond prices fall. When interest rates fall, bond prices rise. It's simply a mathematical relationship.

CAPITAL ASSETS

A "capital asset" is any asset that can produce a future stream of revenue ("cash flow"). For instance, a plant building washing machines is a "capital asset." Its value is determined by *discounting* that future stream of revenue to the net present value. Think of bonds, too, as "capital assets," because they produce a future stream of revenue; or stocks, paying future dividends.

Suppose the profit from a washing machine factory were $100 a year, and suppose the interest rate is 10%. The net present value of the factory is $90.

What happens if the interest rate falls to 5%? The net present value of the capital asset rises to $95. It doesn't matter whether the interest rate is forced down by the abundance of bank credit, or because consumers are saving more so they can consume more in the future: the *signal* to factory builders is the same, namely, "Build more factories!"

CREDIT BOOM - OVERCAPACITY – OVERPRODUCTION - BUST

But if interest fell *only* because banks issued more credit, then consumers don't really *want* to consume more in the future and factory builders received a *false* signal that consumers want more machines. When the future arrives, unsold washing machines back up on display floors, and capital asset owners discover that *overcapacity* in washing machine factories has caused *overproduction*. They lower their prices, a little at first, and then fear sends them tumbling and cascading. Even lowering prices won't clear all the excess washing machines off the market, so producers go bankrupt. *Enough producers must go bankrupt to eliminate all the overcapacity.*

STOCKS & BONDS

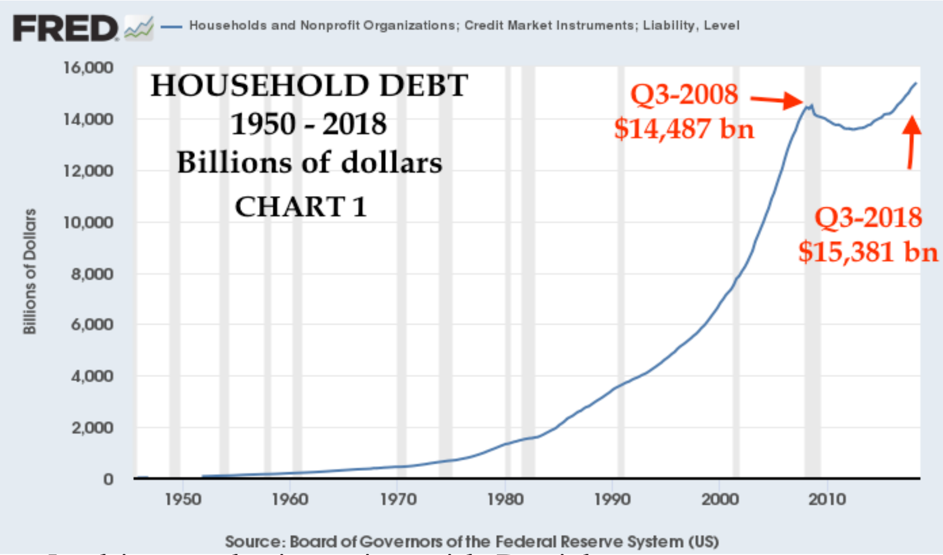
Now think of all stocks and bonds as "capital assets." Everything is priced according to its *net present value*, discounted by the economy's base interest rate (plus a premium for risk, riskier assets paying a higher interest rate.) If interest rates fall, markets will *re-price* all capital assets *higher* because mathematically their net present value rises. Increasing bank credit lowers interest rates, which in turn raises asset prices. This is one reason the stock market rises when interest rates are lowered. The opposite is also true, that rising interest rates will lower asset prices.

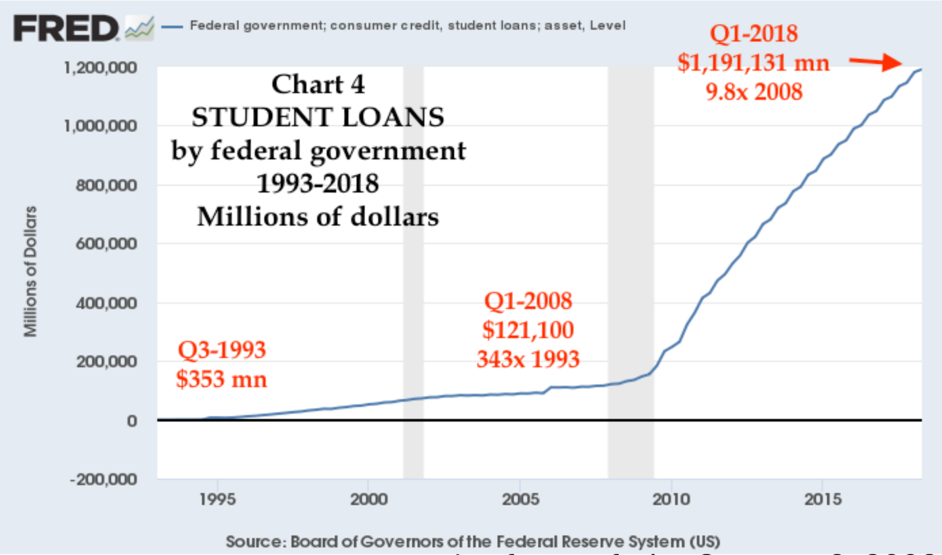
Why? Because interest rates and prices are, mathematically, a see-saw. When rates rise, prices fall, and when rates fall, prices rise.

But of course, merely increasing bank credit can never increase asset prices *permanently*. Otherwise every Tom, Dick, and Harriet would be rich and sipping fine champagne on the Riviera. Rather, a credit boom makes stocks more and more overpriced until finally some realizer says, "Sell! I want my money."

Thus are unleashed the dogs of panic. – F. Sanders

HOW BIG IS THE DEBT?





In this months interview with Daniel Oliver we talk about the debt bubble – biggest in world history – bursting. To give you a feel for just how big and vulnerable that debt bubble is, I've put together some charts for household debt, business debt, and government debt. Judge for yourself whether they're overblown.

CHART 1, HOUSEHOLD DEBT

First obvious on this chart is the parabolic rise from about 1980, not coincidentally about the time the Federal Reserve began chronically suppressing interest rates. Household debt peaked in Quarter 3 2008 at $14,487 billion. After a shallow retrenchment, it has since rise in Quarter 3 2018 to $15,381 billion -- bigger than it was at the 2008 Great Financial Panic.

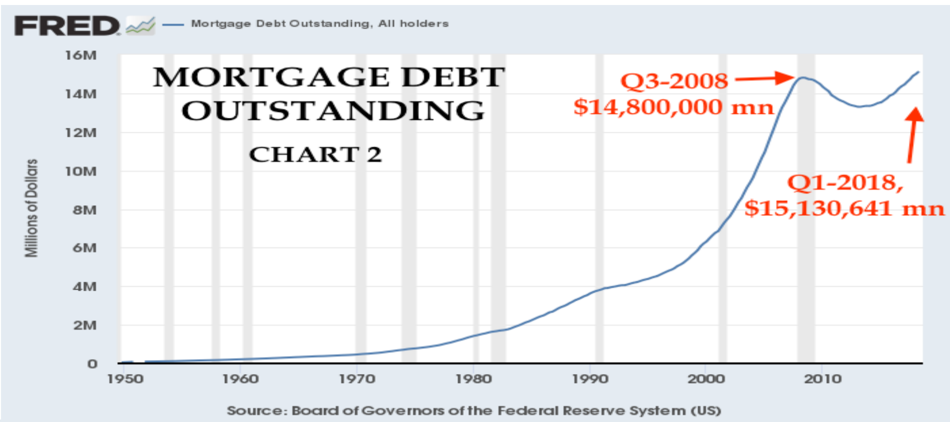
CHART 2, MORTGAGE DEBT OUTSTANDING

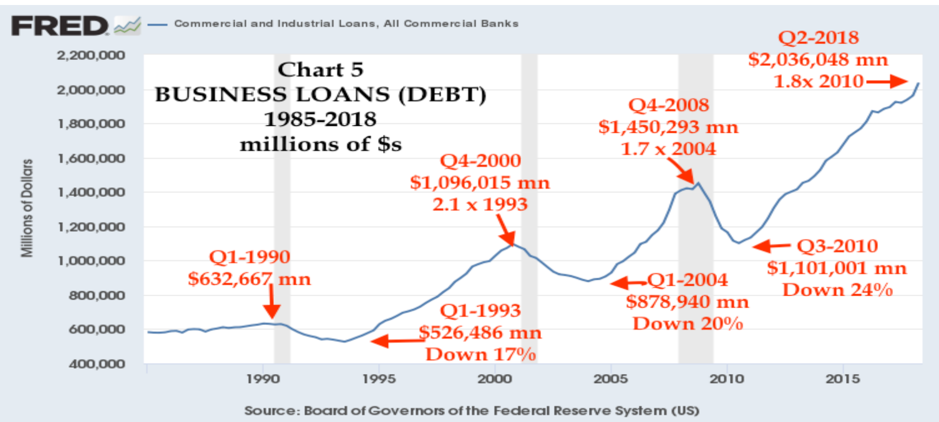
The popping real estate bubble was the catalyst for the 2008 financial panic . At the peak in Quarter 3 2008, Mortgage Debt stood a $14,800,000 million. Yes, yes, it sank shallowly after the panic, but as of Quarter 1 2018 is *higher* than 2008 at $15,130,641 million.

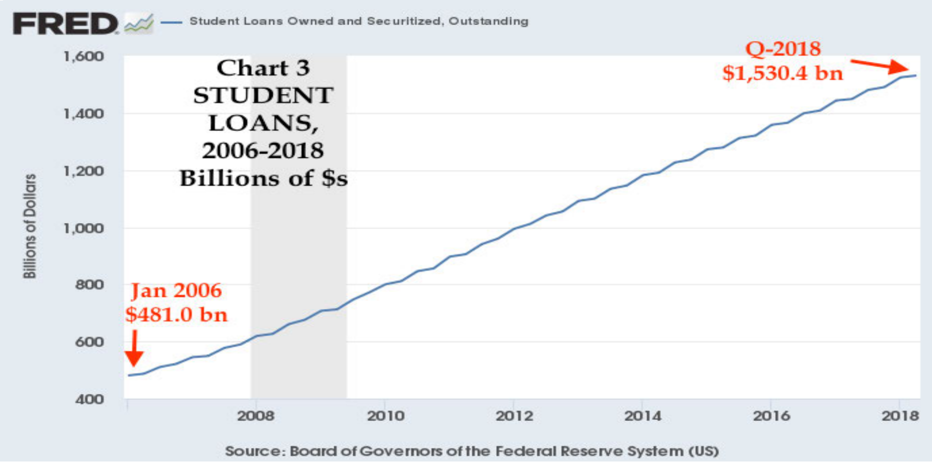
If gigantic mortgage debt was a bubble in 2008, what is it today?

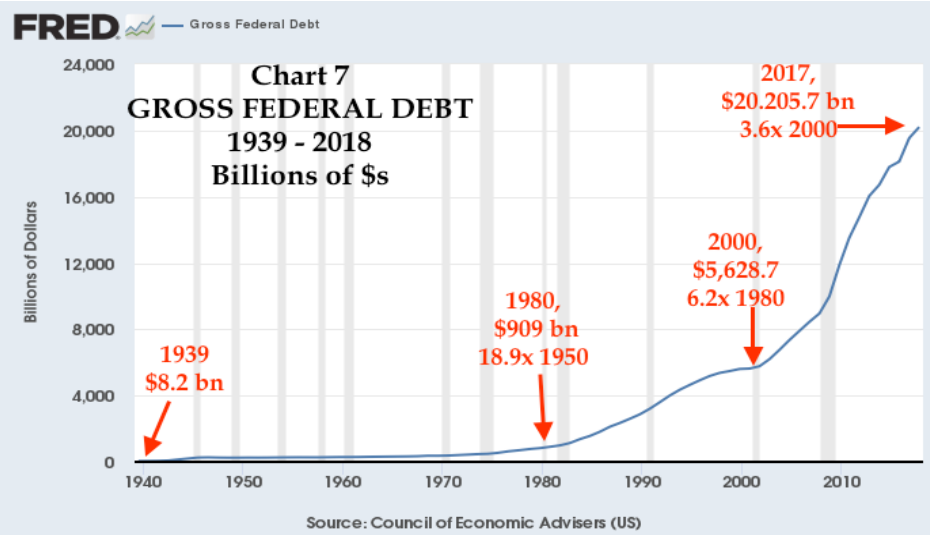
CHART 3 & CHART 4, STUDENT LOANS

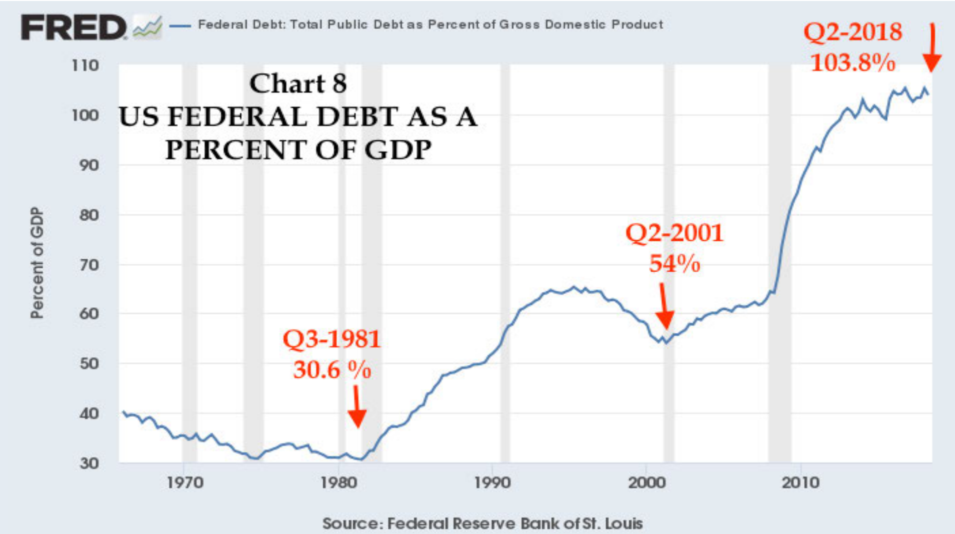
Chart 3 shows the growth of student loans from 2006 through 2018, from











$481 billion to $1,530.4 billion, a greater than three fold increase. Remember that since 2005 student debtors cannot take bankruptcy on student debt.

Chart 4, Student Loans by federal government 1993 – 2018 puts student loans into their proper metastatic perspective. From tiny beginnings in 1993 at $353 million they have ballooned 3,374 times to $1,191,131 million in Quarter 1 of 2018.

Picture that student loans are a form of chattel slavery where the borrower sells forward the rights to the fruit of his labor. Student debt is a nuclear explosion waiting to happen.

CHART 5, BUSINESS LOANS (DEBT) 1985-2018

The up and down waves of the business cycle appear plainly on this chart of business loans. If I were an Elliott Wave practitioner, and I am not, I would point out the completed five wave pattern that signals a top near. Notice that each peak climbs higher and higher. One suspects that business is tapped out and has no more room to add debt, but who knows?

CHART 6, NON-FINANCIAL BUSINESS DEBT AS A PERCENT OF GDP

Here's another take on business debt, measuring it as a percent of Gross domestic Product. This is the only chart that is not utterly hideous. It peaked in Quarter 3 of 2008 at 170.1%, declined, but in Quarter 1 2018 stood only at 150.9% -- still high, and that was six months ago. Would you be concerned if your debt amounted to 150% of your income?

CHART 7, GROSS FEDERAL DEBT 1939 -2018

It would be ungentlemanly of me to recur to 1939 when gross federal debt was a mere $8.2 billion. Therefore I will simply point out that in 2017 it reached $20,205.7 billion, 22.2 times the 1980 debt. This graph's swift, increasing-at-an-increasing rate rise is what we call parabolic, and usually signals a market about to top. Of course, the government an always just run a bigger deficit and borrow from the Fed, which creates money at will.

CHART 8, US FEDERAL DEBT AS A PERCENT OF GDP

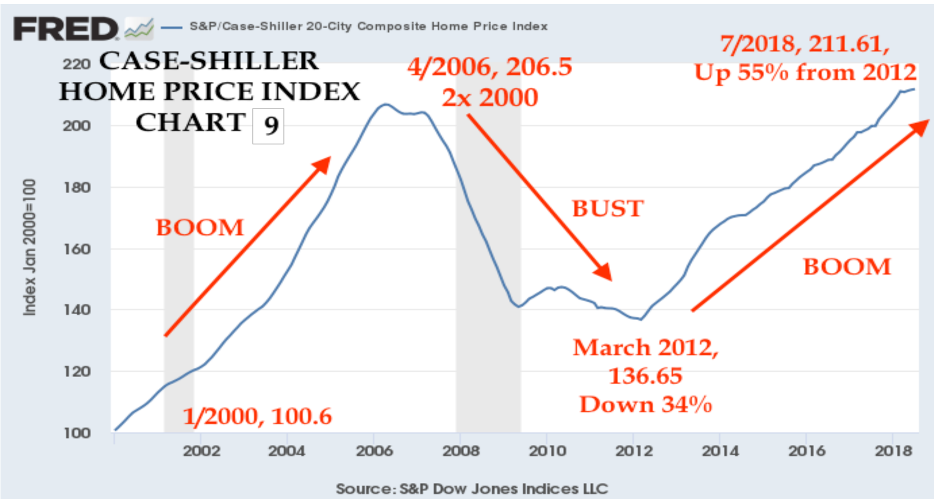
Think of GDP as your income. Would you be comfortable if your debt was 103.% of your income, up three times since 1981?

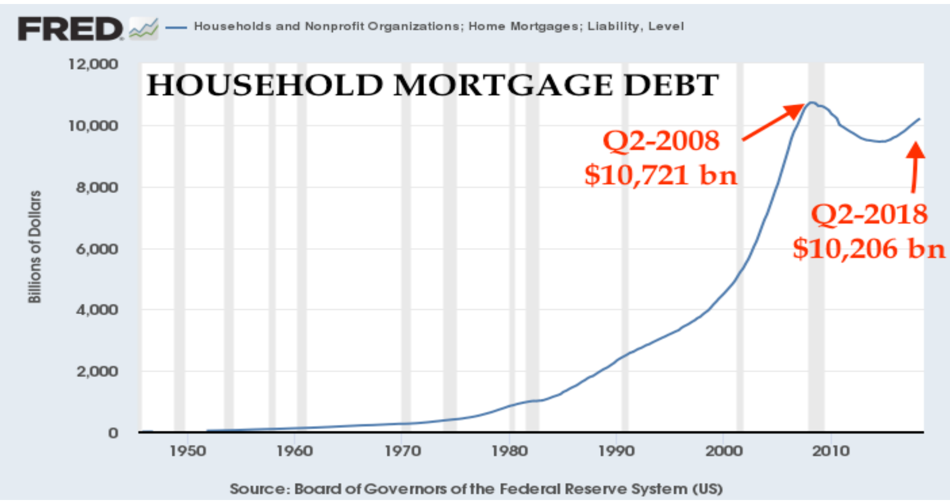
CHART 9, CASE-SHILLER HOME PRICE INDEX

This chart clearly shows the boom/bust cycle in residential housing. The price index doubled from 100.6 in 2000 to 206.5 as the residential housing bubble was peaking. It had plunged 34% by March 2012 when those zero interest rates really began to get traction to re-inflate the bubble. In July 2018, it stood at 211.61, *higher* than the 2006 peak.

I am so slow witted. I don't get why a 206.5 reading in 2006 was bad for the economy and resulted in a housing bust, but a higher reading in 2018 is not a dire warning to the housing industry and the economy.

-- F. Sanders





CURRENT MARKET PROJECTIONS
A CLOUD BIGGER THAN A MAN'S HAND

The last two months have seen stocks peak and plunge, but hold on there, Buddy! The technical and arbitrary definition of a market correction is a 10% fall from a peak. At close on 29 October all indices except the Dow Industrials and S&P500 has fallen more than that, and foreign markets much more. Here's a list: Dow Industrials-8.9%; S&P500 -9.7%; Dow Transports, -14.5%; Nasdaq -13.1%; Nasdaq 100 -12.2%; Russell 2000 -15.1%; Wilshire 5000 -11.2%. Overseas indices: Shanghai SSEC, -28.6%; European Stoxx 600 -11;7%; German Dax -16.4%; French CAC -11.5%; Dow Jones World -14.3%; Nikkei -12.3%.

It's arbitrary, but a 20% drop from a peak in several indices over two months ushers in a bear market. Stock indices have not fallen enough to call that, but all have sunk beneath their 200 day moving average, the dividing line between and a bull and a bear market.

Of course volatility has increased too, with wild swings back and forth, but the general trend grinds inexorably lower. Gold made an important low back in August but in spite of a $60 rise still hasn't really capitalized on it. US dollar appears to be rallying, for the time being, hurting gold.

DOW IN GOLD

Chart 1 shows the Dow Industrials priced in gold. Since November 2016 it has formed a rising wedge, which usually ends in a downside break. That thrust above the upper boundary beginning in August is a "throwover" often seen at peaks.

On October 3 the Dow in Gold peaked with the Dow, and has sunk like a ball peen hammer in a rain barrel ever since. Now it has reached the wedge's bottom boundary and the 200 day moving average. A convincing close below that confirms that the Dow in Gold has reversed trend downward. Right now it is 10.7% below its peak.

Implication of all this is to sell stocks and buy gold.

STOCKS

Chart 2 witnesses that the S&P500 has lost all its 2018 gains. The beginning year price is marked by the purple line.

The chart looks right pessimistic. First there is a double top, then the breakdown from the rising wedge, then the sheer plunge through the 200 DMA with a lifeless dead cat bounce, and now it's working on support from the 2018 lows. And all this plunging has been accompanied with rising volume.

What next? After the long drop, expect some sort of rebound rally that may carry to the 200 DMA or beyond before it fails. Historically October is a cruel month for stocks, but November may be crueler still.

A 20% fall would take the S&P500 to 2,340, and the Dow Industrials to 21,463. I cannot say yet we have seen THE ultimate top in stocks, but it looks like it. A little more confirmation will cinch it.

GOLD

Look at chart 3, Gold. It rose and pierced the neckline of that upside down head ands shoulders (red arrow) but so far as been stymied at $1,240 resistance. Now gold must rally to the 200 DMA, about $1,270. Its performance there will tell us whether this rally has staying power or not. In the short term, fighting US dollar strength, gold might dip, but once it escapes $1,240 it will find buyers and run. At some point investors refugeeing from stocks will discover gold.

In physical gold the supply of low premium coins like Austrian 100 coronas, Mexican 50 pesos, and US $5 commemoratives is drying up while premiums on other coins are creeping up. All this points to increased retail buying. As always, it's smartest to stick with the low premium coins so you get the most gold for your money.

SILVER

Silver (Chart 4) made a bottom back in September and has trended up ever since – *lazily.* Yesterday it fell through the 50 DMA but stopped at the rising trend line. Until silver conquers $15 it is just spinning tires in the mire. Commitments of Traders still are very favorable, but we've been waiting so long on silver we wonder if it will ever act. Be patient. At historic lows very few folks believe a rally is coming.

US 90% silver coins offer the lowest premium and lowest cost per ounce of all silver products right now.

GOLD/SILVER RATIO

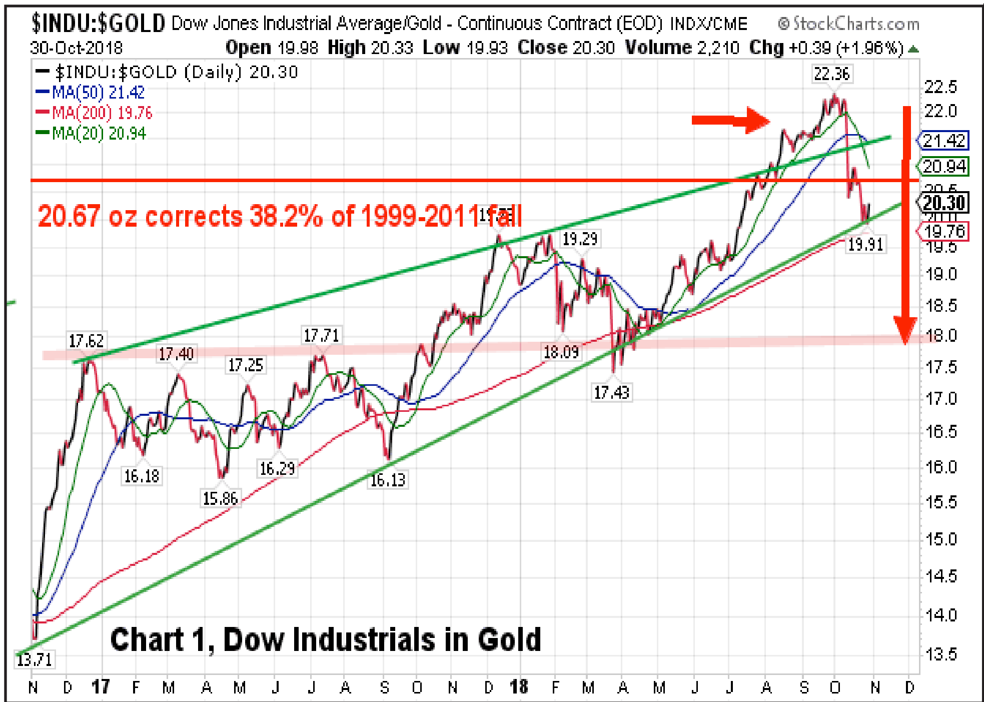
The gold/silver ratio (Chart 5) is the fly in the ointment. Yesterday it broke upward out of a rising wedge but today fell back. (*Hidden presupposition: the ratio falls during gold and silver rallies.*) Since yesterday it reached almost the same level as the September high, that may merely mark a double top in the ratio. Proof will come when the ratio sinks below 83.51 and keeps on sinking through the 50 DMA.

If you have any remaining gold to swap for silver, now's the time.

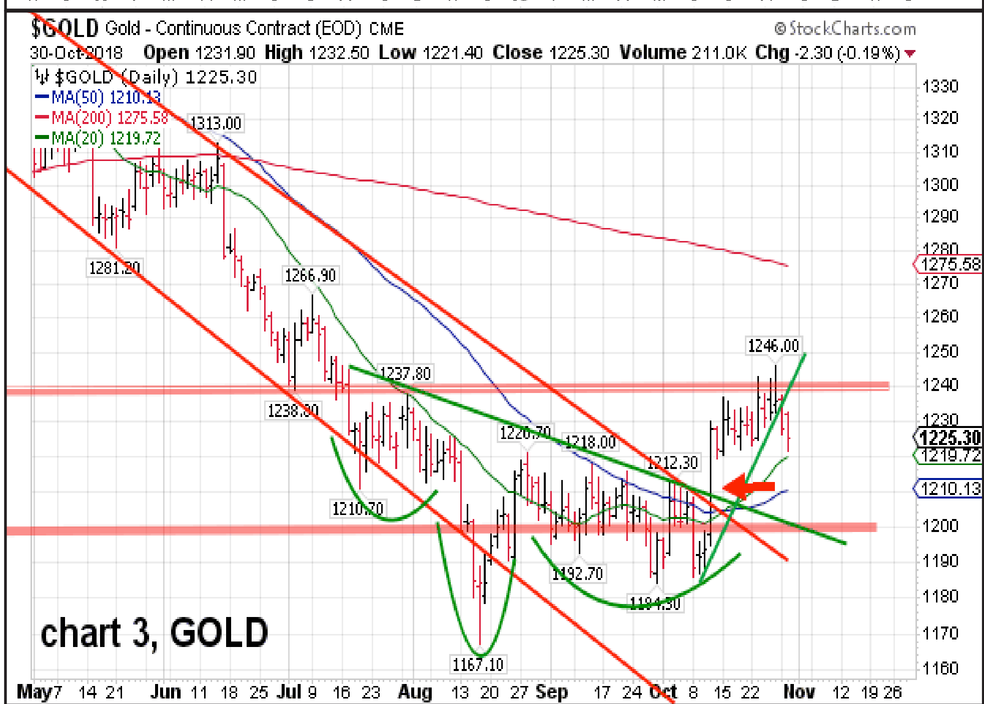
US DOLLAR INDEX

Chart 6 shows the last 11 months for the US dollar index. It appears the dollar index made an upside-down head and shoulders bottom with the head spreading across February, March, April, and May. However, the dollar index has labored poorly trying to finally establish itself above 95-96. Now it is making another try. Assuming that is indeed an upside down head and shoulders, the dollar index is targeting a move to 102 or even 103.

Obviously, the dollar rallying to 102 will slow down silver and gold. On the other hand, if the dollar fails again to break through 97, and follows through below 92.5, that dollar rally isn't coming. -- F. Sanders


$INDU:$GOLD Dow Jones Industrial Average/Gold - Continuous Contract (EOD) INDX/CME
©StockCharts.com
30-Oct-2018 Open 19.98 High 20.33 Low 19.93 Close 20.30 Volume 2,210 Chg +0.39 (+1.96%)
$INDU:$GOLD (Daily) 20.30
MA(50) 21.42
MA(200) 19.76
MA(20) 20.94
20.67 oz corrects 38.2% of 1999-2011 fall
Chart 1, Dow Industrials in Gold


$SPX S&P 500 Large Cap Index INDX
©StockCharts.com
30-Oct-2018 Open 2640.68 High 2685.43 Low 2635.34 Close 2682.63 Volume 3.3B Chg +41.38 (+1.57%)
$SPX (Daily) 2682.63
MA(50) 2849.00
MA(200) 2765.84
MA(20) 2775.30
chart 2, S&P500
Up from 2/2016


$GOLD Gold - Continuous Contract (EOD) CME
©StockCharts.com
30-Oct-2018 Open 1231.90 High 1232.50 Low 1221.40 Close 1225.30 Volume 211.0K Chg -2.30 (-0.19%)
$GOLD (Daily) 1225.30
MA(50) 1210.13
MA(200) 1275.58
MA(20) 1219.72
chart 3, GOLD


$SILVER Silver - Continuous Contract (EOD) CME
©StockCharts.com
30-Oct-2018 Open 14.47 High 14.53 Low 14.38 Close 14.46 Volume 71.4K Chg +0.02 (+0.14%)
$SILVER (Daily) 14.46
MA(50) 14.49
MA(200) 15.88
MA(20) 14.59
chart 4, SILVER


$GOLD:$SILVER Gold - Continuous Contract (EOD)/Silver - Continuous Contract (EOD) CME
©StockCharts.com
30-Oct-2018 Open 85.18 High 85.22 Low 84.46 Close 84.73 Volume 3 Chg -0.28 (-0.33%)
$GOLD:$SILVER (Daily) 84.73
MA(50) 83.51
MA(200) 80.44
MA(20) 83.59
chart 5, Gold/Silver Ratio


$USD US Dollar Index - Cash Settle (EOD) ICE
©StockCharts.com
29-Oct-2018 Open 96.22 High 96.47 Low 96.11 Close 96.35 Chg +0.22 (+0.23%)
$USD (Daily) 96.35 (29 Oct)
MA(50) 95.01
MA(200) 92.77
MA(20) 95.46
chart 6
US DOLLAR INDEX

LISTEN TO THE FAT LADY SING

	4-Jan-00	30-Oct-18	% chg frm 1/00	*All-Time High*	All-time High Date	% change From High	*LAST LOW DATE*	LAST LOW close	LAST HIGH close	LAST HI DATE
DJIA	10,997.93	**24,874.64**	126.18%	*26,616.71*	26-Jan-18	-6.55%	*24-Aug-15*	23,344.52	**26,828.39**	3-Oct-18
DUA	278.51	**742.58**	166.63%	*774.47*	14-Nov-17	-4.12%	*11-Dec-15*	*647.81*	774.47	14-Nov-17
DTA	2,862.17	**10,175.57**	255.52%	*11,373.88*	12-Jan-18	-10.54%	*20-Jan-16*	*10,159.60*	11,570.84	14-Sep-18
S&P500	1,471.21	**2,682.63**	82.34%	*2,872.87*	26-Jan-18	-6.62%	*20-Jan-16*	2,553.80	**2,925.51**	3-Oct-18
NasdaqComp	5,457.44	**7,161.65**	31.23%	*7,505.77*	26-Jan-18	-4.58%	*25-Aug-16*	*6805.96*	**8,109.69**	29-Aug-18
Nasdaq100	3,755.74	**6,810.12**	81.33%	*7,022.97*	26-Jan-18	-3.03%	*25-Aug-16*	*6322.6*	**7,645.45**	1-Oct-18
US$ Index	100.41	**96.79**	-3.61%	*121.02*	2-Jul-01	-20.02%	*24-Aug-16*	*88.16*	103.29	26-Jan-18
DiSoz	2,061.47	**1,727.05**	-16.22%	*2,566.04*	7-Jun-01	-32.70%	*14-Oct-15*	*884.68*	1,564.00	12-Dec-17
Dow/GoldOz	38.903	**20.346**	-47.70%	*925.42*	25-Aug-99	-97.80%	*25-Aug-16*	*13.74*	19.73	12-Dec-17
Gold	282.70	**1,222.60**	332.47%	*1,888.70*	22-Aug-11	-35.27%	*2-Dec-15*	*1,054.20*	1,888.70	22-Aug-11
Silver	5.340	**14.403**	169.72%	*48.584*	29-Apr-11	-70.35%	*14-Dec-15*	*13.666*	48.584	29-Apr-11
Gold/Silver	52.94	**84.885**	60.34%	*84.330*	17-Oct-08	0.66%	*10-Aug-15*	*65.017*	82.450	1-Mar-16
Platinum	413.70	**834.60**	101.74%	*2,167.80*	21-Feb-08	-61.50%	*21-Jan-16*	***771.90***	**846.30**	25-Jan-18
Palladium	441.90	**1,071.60**	142.50%	*1,112.35*	17-Jan-18	-3.66%	*12-Jan-16*	**837.20**	**1,122.80**	23-Oct-18

Bold face *items in "Latest Low" and "Latest High" are new from last month.*
"Latest" high or low means "last significant," not the very last in time.
"Dow/GoldOz" is the DJIA exprest in **gold** ounces. DiSoz is the DJIA valued in silver oz.

Last major low in Gold/Silver ratio occurred 30 April 2011 at 32.000.
Last major high in Gold/Silver ratio occurred 4 April 2018 at 82.45.

AftMkt	*Tuesday*		*30-Oct-18*		*DiG$*
Gold:	1,222.00	*DJIA*	24,874.64	431.72	$420.79
Silver:	14.450	*S&P*	2,682.63	41.38	
Ratio:	84.57		DJIA/GOLD:	*20.36*	oz.
Plat	834.60				
Palldm	1,071.60				
DJIA/Ag:	*1,721*				

	FINE METAL CONTENT	WHOLE-SALE BUY	WHOLE-SALE SELL	PREMIUM OVER CONTENT
AUSTRIA 100 cor.	0.9802	1,191.75	1,204.75	0.6%
20 corona	0.1958	238.05	241.05	0.8%
4 ducat	0.4438	539.60	546.10	0.7%
1 ducat	0.1106	134.50	137.40	1.6%
BRITAIN sov'rn	0.2354	289.80	302.80	5.3%
CANADA Mpl Leaf	1	1,225.50	1,235.50	1.1%
1/10 ML	0.1	129.55	133.20	9.0%
FRANCE 20 francs	0.1867	225.85	229.85	0.8%
SWITZ 20 francs	0.1867	225.85	229.85	0.8%
MEXICO 50 peso	1.2057	1,458.50	1,475.00	0.1%
20 peso	0.4823	582.90	592.35	0.5%
10 peso	0.2411	291.40	297.60	1.0%
5 peso	0.1206	145.75	151.65	2.9%
2.5 peso	0.0603	73.45	75.90	3.0%
2 peso	0.0482	59.55	61.30	4.1%
S.AFRICA K'rand	1	1,229.25	1,239.25	1.4%
1/2 Krugerrand	0.5	623.20	629.35	3.0%
1/4 Krugerrand	0.25	305.50	314.65	3.0%
1/10 Krugerrand	0.1	127.10	128.30	5.0%
Two Rand	0.2354	284.80	291.65	1.4%
USA $20 gold pieces, pre-1935:				
St. Gaudens MS62	0.9675	1,210.00	1,260.00	6.6%
Liberty MS62	0.9675	1,210.00	1,260.00	6.6%
St. Gaudens MS61	0.9675	1,205.00	1,255.00	6.2%
Liberty MS61	0.9675	1,205.00	1,255.00	6.2%
rawSt. G. MS60	0.9675	1,190.00	1,240.00	4.9%
rawLib. MS60	0.9675	1,190.00	1,240.00	4.9%
St.G XF	0.9675	1,185.00	1,235.00	4.5%
Liberty XF	0.9675	1,185.00	1,235.00	4.5%
USA Buffalo	1	1,248	1,258	2.9%
USA American Eagle, post-1985:				
Amer. Eagle	1	1,245.25	1,255.25	2.7%
1/2 Amer. Eagle	0.5	622.70	644.60	5.5%
1/4 Amer. Eagle	0.25	313.65	320.00	4.8%
1/10 Amer. Eagle	0.1	132.15	134.10	9.7%
GOLD BULLION	1	1,226.25	1,234.00	1.0%

	FINE METAL CONTENT	WHOLE-SALE BUY	WHOLE-SALE SELL	PREMIUM OVER CONTENT
PLATINUM Englhard	1	835	865	3.6%
Noble	1	850	880	5.4%
Koala	1	835	875	4.8%
Maple Leaf	1	860	892	6.8%
Amer. Eagle	1	895	945	13.2%
**				
SILVER, US COIN:				
90% coin,$1000bag	715	10,403	10,689	3.5%
40% 1/2s,$1000bag	295	4,027	4,201	-1.5%
Dollars,$1000 bag	765	26,500	28,500	157.8%
Silver Am.Eg.	1	16.30	16.53	14.4%
SILVER BARS & COINS, .999 FINE:				
Engelhard/plastic	100	1,460	1,480	2.4%
Miscellaneous	100	1,430	1,465	1.4%
Eng. or JM	10	143.00	148.00	2.4%
Misc. rounds	1	14.40	14.87	2.9%
Can. Maple Leaf	1	15.40	16.20	12.1%
**				

PLEASE READ THIS FIRST!

1. **All prices are wholesale. Add 3.5%-2.5%** commission plus shipping when applicable.
2. Not all the gold coins listed are always available, e.g., Austrians, fractional Krugerrands, Mexicans.
3. Fractional gold Maple Leaves are available & priced as American Eagle fractionals.
4. Small quantities subject to surcharge.
5. US$20s MS-61or better are PCGSorNGC (our choice) certified ("slabbed"); MS-60 & below are not slabbed.

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